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Addressing expatriate tax issues

BY LYNNE MOLNAR

How Canadian companies deal with the tricky issue of income tax for expatriates

If there's anything universal in the world, it's taxes. Some countries have higher taxes, some lower. Some have simple tax schemes while others are extremely sophisticated. Therefore, it's not surprising that one of the most complex facets of an international assignment is tax treatment on income earned by employees, whether they're Canadians sent abroad or foreign workers brought in to Canada.

What are the potential tax implications of an assignment from Canada to, say, Singapore or vice-versa? What tax approach works best — does the employer handle all the details related to home and host tax or is everything left to the worker?

In its 2005 *Survey of Tax Policies for Canadian Expatriates*, ORC Worldwide, a New York-based compensation and HR management consulting firm, surveyed 45 Canadian organizations to get an understanding of how they handle tax issues for expatriates and foreign workers.

Tax equalization the most popular

Tax equalization continues to be the predominant methodology for survey respondents. Consistent with the balance-sheet approach to international pay, tax equalization holds that the worker neither gains nor loses with regards to tax liability as a result of an international assignment.

If the employee moves to a higher tax area, which is often the case, the company pays the difference. The worker is only responsible to the employer for a hypothetical home-country tax on income from all sources — the company pays all foreign taxes plus any actual taxes due at home.

If the employee transfers to a low-tax country, and there is a windfall that reduces tax liability for the individual, the organization pockets that difference.

Although other philosophies, notably tax protection and a "laissez-faire" approach, have their place in Canadian policies, only a minority of organizations surveyed use them. Laissez-faire relegates tax matters to the worker, leaving her to deal with higher or lower tax bills. On the other hand, tax protection protects the worker from a higher tax liability but lets her keep any windfall.

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But tax protection and laissez-faire have the potential to create perceptions of unfairness among workers in different regions. Employees working for the same company, earning the same salary, in different locations could wind up with vastly different incomes at the end of the day.

The mechanics of tax equalization

The study found that only 14 per cent of respondents used in-house experts to help them in tax matters. The rest looked to outside tax counsel for the data used in tax calculations and "what-if" scenarios.

That data is necessary for an integral part of tax equalization — calculating

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the hypothetical tax amount that represents an estimate of what employees would have paid on their income at home had they not transferred to a foreign location.

What goes into the calculation is different for each employer, not only with regards to the income and tax components, such as company-related income, other income, type of tax and social security, but also timing such as initial estimate versus year-end reconciliation.

Canadian employers often reconcile this estimated amount with a hypothetical home-country tax return at the end of the tax year to resolve any discrepancies that may result from understated or overstated tax, inclusion or exclusion of family income, private income and so on.

How Canadian companies equalize tax

General practices followed by Canadian employers with regards to equalizing tax include:

• **Company-related items:** Although most Canadian employers include common items such as bonus and incentive payments in calculations, when it comes to other components, particularly relocation-related items, the numbers start dropping in terms of company coverage of tax on these items. (See table below.)

• **Items not related to the company**: More than one-half (55.8 per cent) of respondents did not get involved with income not related to the company and outside investment income. Even more (79.1 per cent) take a hands-off approach to spousal income. Two-thirds exclude an individual's outside losses in calculations.

• **Federal and provincial tax**: For Canadian expatriates, the majority of organizations include federal and provincial tax in hypothetical tax calculations for which the employee is responsible. And employers frequently base the choice of province on the expatriate's residence rather than the location of corporate headquarters.

Residency status and tax liability

A major issue for Canadian expatriates is that their actual Canadian tax liabilities are based on resident or non-resident status.

Under Canadian tax regulations, a person who is a resident during a tax year is subject to Canadian tax on worldwide income from all sources. A non-resident is only subject to Canadian income tax from sources inside Canada.

The study found the majority of companies take a proactive stance and explain the implications of Canadian resident and non-resident status to expatriates before the assignment. But very few (12.2 per cent) require employees to break residency, leaving that decision with the worker.

Should the tax authorities raise a question with respect to a worker's status, 40 per cent will defend the employee's decision. Yet two-thirds do not, as a matter of practice, always obtain a ruling or opinion from the Canada Revenue Agency before implementing a non-resident decision.

Lynne Molnar is a senior consultant with ORC Worldwide's international compensation practice area in New York. She specializes in Canadian expatriate policies. She can be reached at lynne.molnar@orcww.com.

PAYING THE TAXES

Tax treatment of compensation elements

Pay component	% of employers that subject component to hypothetical tax
Bonus	90.7
Incentive compensation	83.7
Employer-issued stock options	65.1
Sales commissions	39.5
Relocation allowance	34.9
Company car	32.6
Foreign service/mobility premium	28.5
Housing allowance	26.1
Cost-of-living allowance	25.6
Hardship allowance	21
Education allowance	18.6
Home leave	15
Club membership	11.6

Source: ORC Worldwide's 2005 Survey of Tax Policies for Canadian Expatriates

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