

New Protocol to the Canada-US Tax Treaty: Trans-Border Pension Provisions and New Stock Option Apportionment Rules

Trans-Border Pension Provisions

The recently released Fifth Protocol (the "Protocol") to the *Canada-US Income Tax Convention* (the "Treaty") significantly expands the scope of the Treaty provisions dealing with pensions. The Protocol provides tax relief for individuals who have cross-border work assignments and who are covered by a qualified retirement plan outside their home country. Under the current provisions of the Treaty, relief is limited to an election to defer tax on income accrued in a plan in the other country until the plan makes a distribution. The election does not extend to contributions or accrued benefits under a retirement plan. The Protocol addresses these deficiencies with two new provisions that specifically apply to plan contributions and benefit accruals.

The Protocol provisions apply to plans which are designated as "qualifying retirement plans". Such plans are defined in one of the Diplomatic Notes that accompanied the release of the Protocol. For Canadian purposes, qualifying retirement plans include Registered Pension Plans under section 147.1 of the *Income Tax Act* (Canada) (the "Tax Act"), group Registered Retirement Savings Plans (RRSPs) under subsection 204.2(1.32) of the Tax Act, Deferred Profit Sharing Plans under section 147 and any RRSP or Registered Retirement Income Fund (RRIF) that is funded exclusively by rollover contributions from a listed plan. An individual RRSP, other than one funded with rollover contributions, will generally not qualify for Treaty benefits.

The new pension provisions will apply to individuals who are resident in one country while they work in the other country and contribute to a qualifying retirement plan in the country in which they work. For example, a Canadian resident who works in the United States may contribute to the US employer's pension plan. The individual's contributions to the plan will be deductible for Canadian income tax purposes. The amount of benefits credited under the US plan will not be included in the employee's income in the year they accrue. Such tax relief will be limited to the individual's available RRSP deduction room determined

under the Tax Act. The amount of any contributions to the US plan deducted by the individual will be taken into account in determining the individual's lifetime RRSP contribution limit.

A second provision of the Protocol will extend benefits to an individual who works in one country while continuing as a member of a qualifying retirement plan in the other country. This provision would apply to a US individual who takes up employment in Canada and continues to accrue pension benefits under his US employer's retirement plan. Subject to a set of detailed conditions, the contributions made to the US plan and benefits accruing under that plan would be deductible or excludible in computing the employee's income in Canada. The benefits of this relief are unavailable if an individual has performed services in the country of which he is not a resident for more than 60 of the 120 months preceding the individual's current taxation year.

To obtain relief under the provision, the individual must have been a member of the qualifying retirement plan immediately before taking up employment in the other country. A further condition to the availability of relief is that no contributions can be made to a qualifying retirement plan in the country of employment during the period of service. Note that for this purpose, if the employment is in Canada, an individual RRSP is considered to be a qualifying retirement plan.

The Protocol includes a number of additional technical improvements to the Pensions Article of the Treaty. For example, a Roth IRA is specifically added to the definition of a "pension" for purposes of the Treaty. The Protocol also makes clear that a member of a partnership that carries on a business will be considered to be in

an employer/employee relationship for purposes of applying the Protocol pension provisions.

The pension provisions will apply to taxation years that begin after the calendar year in which notifications of ratification are exchanged by the governments of Canada and the United States.

Stock Option Apportionment Rules

Canada and the United States have, for some time, expressed differing views on the taxation of stock option benefits received by an individual who is employed in both countries. This divergence can lead to double taxation. To eliminate the possibility of double taxation, Annex B to the Protocol provides a new apportionment rule that applies to situations where an employee is granted a stock option in one country and exercises the option in the other country while employed by the same (or a related) employer. Under the terms of the new rules, both Canada and the US will be entitled to tax the stock option benefit, but each country will be limited to taxing only that portion of the benefit that equates to the number of days that the employee's principal place of employment was in that country during the period between the date of grant and the date of realization of the subject options divided by the number of days in that period. There is, however, a discretionary power reserved to the competent authorities of Canada and the US to provide for an alternative allocation if the terms of the relevant options were such that their grant would be more appropriately treated as a transfer of ownership of securities (the examples given in the Annex reference situations where options were in the money or not subject to a substantial vesting period).

A Cautionary Note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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