Personnel Tax Issues
TEI Toronto Chapter

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Agenda

1. Who is an employee?
2. Tax, pension and benefit issues relating to terminating employees
3. Cross-border employee transfers
4. GST input tax credits and pension plans

Who is an employee?

- Why does it matter?
- More than just tax…
    - CPP/EI
    - WSIB
    - Employer Health Tax (EHT)
    - *Employment Standards Act, 2000*
    - Common law entitlements

Who is an employee?

Legal Test

- control
- ownership of tools
- chance of profit/risk of loss
- integration into the business

Who is an employee?

Legal Test

Sagaz Industries Canada Inc. (SCC, 2001):

> "…there is no universal test to determine whether a person is an employee or an independent contractor…The central question is whether the person who has been engaged to perform the services is performing them as a person in business on his own account."

Who is an employee?

Sagaz Industries Canada Inc. (SCC, 2001):

- Factors considered:
  - level of control employer has over worker's activities;
  - whether the worker provides his or her own equipment;
  - whether the worker hires his or her own helpers;
  - the degree of financial risk taken by the worker;
  - the degree of responsibility for investment and management held by the worker;
  - the worker's opportunity for profit;

Who is an employee?

- The Ontario Ministry of Finance and the CRA generally follow the common-law principles
- They will also look at the intention of the parties upon entering into the relationship
  - a properly drafted contract will assist in demonstrating that intention

Who is an employee?

Control

CRA: Control is the ability, authority, or right of a payer to exercise control over a worker concerning the manner in which the work is done and what work will be done.

Who is an employee?

<u>Ownership of Tools</u>

CRA: When workers purchase or rent equipment or large tools that require a major investment and costly maintenance, it usually indicates that they are self-employed individuals, because they may incur losses when replacing or repairing their equipment.

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Who is an employee?

Chance of Profit/Risk of Loss

CRA: Usually, employees will not have any financial risk as their expenses will be reimbursed, and they will not have fixed ongoing costs. However, self-employed individuals can have financial risk and incur losses because they usually pay fixed monthly costs whether or not work is currently being performed.

Who is an employee?

Integration into the Business

CRA: Where the worker integrates the payer's activities to his own commercial activities, a business relationship probably exists... Where the worker integrates his activities to the commercial activities of the payer, an employer-employee relationship probably exists.

Who is an employee?

Identifying Criteria

1. In business "on own account"?
2. Ownership of tools/equipment?
3. Entrepreneurial activity?
4. Hired to achieve specific result?

Who is an employee?

Identifying Criteria

5. Set hours per week?
6. Freedom to reject work opportunities?
7. Variation in fees charged for services rendered?
    - Fee schedule versus stipend?
    - Project based compensation vs hourly/salaried compensation

Who is an employee?

Identifying Criteria

8. Integration:
   - An independent business or part of the employer's operation?
9. Degree of specialization, skill, expertise or creativity involved?
10. Control of manner and means of performing the work

Who is an employee?

Recent cases

Parties' intentions are important

- *Wolf v. Canada* (2002, FCA):

  … I say, with great respect, that the courts, in their propensity to create artificial legal categories, have sometimes overlooked the very factor which is the essence of a contractual relationship, i.e. the intention of the parties.

Who is an employee?

- *Wolf v. Canada* (cont’d):

  … When a contract is genuinely entered into as a contract for services and is performed as such, the common intention of the parties is clear and that should be the end of the search.

Who is an employee?

- Intention is not determinative if the contract doesn't accurately reflect the relationship
- *Royal Winnipeg Ballet v. Canada* (2006, FCA):

> …if it is established that the terms of the contract, considered in the appropriate factual context, do not reflect the legal relationship that the parties profess to have intended, then their stated intention will be disregarded.

Who is an employee?

Recent cases

- *Vida Wellness Corporation v. M.N.R.* (2006 TCC)
- *Bansal v. M.N.R. (*2010 TCC)
- *Neilson v. M.N.R.* (2010 TCC)
- *Choi v. M.N.R.* (2010 TCC)

Who is an employee?

Tips

- Written contract – document the relationship and ensure it the relationship is clear
- Treat contractors differently than employees
  - benefits
  - pay structure
- Change job titles – e.g. “manager” to “consultant”

Who is an employee?

Tips

- Request ruling from CRA
- Request indemnity from worker
- Obtain HST numbers from contractors

Who is an employee?

Tips

- Make services project-based for contractors
- Ensure contractors are free to work for and do work for other organizations
- Understand the risks

Terminating an Employee

- Tax, pension and benefit issues
  - Salary continuation vs. lump sum/pension and benefit accrual
  - Payments for waiving right to reinstatement
  - Moving expenses, education expenses and other types of "damages"
  - Human rights damages/mental distress
  - Pension grow-in and terminations now

Salary Continuation vs. Lump Sum

- Lump sums are typically taxed as retiring allowances
  - employment relationship clearly over
  - eligibility for rollover to RRSP
  - can be paid by instalments, even over tax years
  - no pension accrual after end of ESA notice
  - group benefits may or may not continue

Salary Continuation vs. Lump Sum

- salary continuation
  - employee is paid from payroll
  - usual deductions
  - pension accrual may continue
  - group benefits may or may not continue
- might be combined with a mitigation clause (e.g. partial lump sum payment of remaining period if new job obtained)

Salary Continuation vs. Lump Sum

- Tips:
  - know what you're offering or CRA might decide for you!
  - clearly set out all termination entitlements in a letter, especially the nature of the payments and treatment of pension and group benefits
  - get a release

Waiving Right to Reinstatement

- Employer pays employee in exchange for employee waiving right to reinstatement
- Avoids EI repayment deduction from settlement because not "insurable earnings"
- Does NOT avoid tax!
  - CRA considers it to be a retiring allowance

Waiving Right to Reinstatement

- Tips:
  - ensure employee has a right to reinstatement
  - EI wants to see award/actual right vs. mere settlement of grievance
  - describe clearly and properly in the settlement documents in case CRA/EI reviews

Other Types of Damages

- Moving expenses, retraining, group benefit expenses, etc.
  - all considered to be a retiring allowance
- Re-employment counselling
  - not taxable
- Legal expenses
  - if incurred by employee to obtain settlement, no withholding

Other Types of Damages

- Human rights damages/mental distress
  - not taxable
  - were they plead?
  - is there any evidence?
  - assess reasonable of payment vs. magnitude of suffering

Other Types of Damages

- Tips:
  - document in settlement properly so that CRA and EI can determine what payment was for
  - have back up documentation ready in file in case of audit i.e. receipts, evidence of legal fees incurred, etc.

Pension Grow-In

- Currently:
  - DB Ontario members whose age and years of service or plan membership total 55 or more “grow into” subsidized early retirement benefits and bridge benefits
  - only on full or partial wind up
- Effective July 1, 2012:
  - **any** member who is involuntarily terminated (*i.e.* terminated other than for cause) **and** who has 55 points
  - no longer linked to a significant business event

Pension Grow-In

- Exceptions:
  - (Voluntary) resignation or retirement
  - Termination for wilful misconduct, disobedience or wilful neglect of duty that is not trivial and not condoned by the employer…[Where will this be adjudicated?]
  - Other prescribed exceptions…[wait and see]
  - JSPPs/MEPPs can elect out (OMERS already has)

Pension Grow-In

- Increases the commuted value of the pension
  - e.g. $125,000 vs. $200,000
- May increase employer cost of pension plan over the long term
- May increase total cost of termination package significantly
- Will affect terminations on and after July 1, 2012
- Can affect terminations **NOW** in Ontario

Pension Grow-In

Facts

- Ontario DB member terminated March 5, 2011
- Age 45 at termination date
- Length of employment: 22 years
- Unreduced early retirement “milestone” under the plan: age 60 with 80 points

Pension Grow-In

Severance Offer

- “Without Cause” termination
- Exit interview on March 1, 2011
- Salary continuation, benefits and pension accrual continue to March 1, 2012 at age 47
- This member will not be age 60 when her notice period ends

Pension Grow-In

- Pension implications without grow-in
  - doesn't meet age 60/80
  - age 47 with 71 points on March 1, 2012
  - reduced early retirement pension/lower commuted value
- With grow-in
  - unreduced pension at age 60/enhanced commuted value

Pension Grow-In

- Agree to characterize termination as resignation or retirement?
- Reduce severance offer in light of increased Pension? (beware of set off)
- Amend pension plan to eliminate subsidies (eliminates grow-in for all members)?

Pension Grow-In

- Release Language
- Disclosure Obligations
  - heightened if there is an option between lump sum and salary continuation severance package (*Allison v. Noranda*)
- Supplementary Plans
  - if grow-in rights flow through to “top up” plan, cost will be even greater

Cross-Border Transfers

- Canada - U.S. Treaty amended in 2007
- Changes effective January 1, 2009
- Remove barriers to the flow of personal services
- Address short-term assignments and commuters
- U.S. citizens participating in Canadian plans

Taxation of Pension Payments

- "Pension" includes RRSPs, RRIFs, IRAs
- Does not include income-averaging annuity contracts or social security benefits
- Now includes Roth IRAs (US)
- Affects treaty withholding tax rate and election to defer tax on income

Taxation of Benefit Accruals

- Before Protocol:
  - could elect to defer tax on investment income
  - but not contributions made or benefits accrued while outside home country

Taxation of Benefit Accruals

- Now, accrued benefits under tax-exempt plan of one country will not be taxed in the other country
- An election to defer taxation on income is not dependent on specific rules in the resident country
- Beware additional contributions made to Roth IRA while resident in Canada

Deduction of Pension Contributions

- Before Protocol:
  - an employee working in one country could not deduct contributions made to a plan in the other country

Deduction of Pension Contributions

- Short-term assignments:
  - Protocol now permits deduction of home country plan contributions during a short-term assignment
  - e.g. U.S. employee sent to Canada for 2 year project continues to participate in U.S. qualified plan

Deduction of Pension Contributions

- Short-term assignment is no more than 60 of the previous 120 months
- Services in host country must be for same employer
- Contributions and benefits must be attributable to services performed in the host country, and made and accrued during that period
- No double dipping (i.e. accruing benefits in host country while also accruing benefits in home country)

Deduction of Pension Contributions

- Commuters
  - employee who lives in one country but works in the other and participates in the other's plan
  - e.g. lives in Windsor but works in Detroit and participates in U.S. 401(k)
  - now employee can deduct contributions to 401(k) from Canadian tax
  - subject to tax limits of country of residence

Deduction of Pension Contributions

- U.S. Citizens resident and employed in Canada
  - contributions to a Canadian qualifying retirement plan will be deductible in computing U.S. taxes
  - limits ability to contribute to an IRA

Deduction of Pension Contributions

- Employers may also be able to deduct contributions made to plan

Planning Issues

- Considerations depend on:
  - length of transfer/nature of assignment
  - who is the employer
  - residence of employee
  - nature of retirement plan
  - citizenship
- Also, social security and health coverage

Included Plans

- RPPs, Group RRSPs, DPSPs, and RRSPs and RRIFs funded with a rollover from one of the foregoing

Included Plans

- qualified plans under 401(a) (including 401(k) plans)
- individual plans that are part of a simplified employee pension plan under 408(k)
- 408(p) simple retirement plan accounts
- 403(a) qualified annuity plans
- 403(b) plans
- 457(g) trusts providing benefits under 457(b)
- Thrift Savings Fund under 7701(j)
- IRAs funded with a rollover from the above

Excluded Plans

- New treatment only applies to a "qualifying retirement plan"
- IRAs, individual RRSPs, RCAs are excluded

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Tax Withholding for Commuters

- Withholding tax applies
  - waiver application
- Social security contributions
  - waiver application under Social Security Agreement

GST/HST on Pension Expenses

- New 33% rebate applies to pension expenses instead of Input Tax Credit
- Does not apply to RPPs funded through an insurance policy or contract
- All services, including internal employer expenses, are deemed to be supplied to the RPP
  - exceptions apply

New GST/HST Rules for Pension Plans

- Trusteed plans or plans administered by a pension corporation are now subject to increased GST/HST reporting and remittance duties
- Employers are deemed to make GST/HST-taxable “supplies” to the pension plan as a result of most of their normal course pension administrative activities
- Fully-insured plans (i.e. plans not funded by a trust) will not be affected (for now!)

GST/HST Rules for Pension Plans

- Employers must remit annually GST/HST on the value of:
  - All services procured by the employer for pension administrative purposes (e.g. asset management services from a third party manager)
  - All services provided by the employer's own employees for pension administrative purposes (e.g. the value of time internal HR employees spend on pension administration)

GST/HST Rules for Pension Plans

- Affected pension plans will be entitled to a 33% rebate of GST/HST paid (subject to certain conditions)
- Plans may elect to share with the employer who actually remits the tax

Proposed “Special Allocation Method”

- Proposed rules will require pension plans affected by the new “deeming” rules to adjust the HST payable on plan expenses for the year to reflect the proportion of their actuarial liabilities (for DB plans) or their assets (for DC plans) attributable to HST-provinces according to a formula
- The result will be either an increased HST obligation or an HST refund and offset against the new 33% GST/HST rebate
- Exemptions exist for small plans

GST/HST on Pension Expenses

- Rebate can be transferred to a participating employer
- Consider whether plan, trust and/or collective agreement language might impact that choice
- Fiduciary duties might also apply
    - expenses deemed supplied vs. paid by the fund