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Phase-out of the OETC

An unwelcome surprise contained in the March 29, 2012 federal budget was the elimination of the Overseas Employment Tax Credit (OETC). The unexpected phase-out of the OETC may significantly increase the cost of international assignments, especially for companies in the construction and resource industries engaged to perform projects overseas.

By way of background, the OETC, which was enacted in 1980, can be claimed by an individual resident in Canada who works outside of Canada for at least six consecutive months for a specified employer in connection with a resource, construction, installation, agricultural or engineering contract, or for purposes of obtaining such contracts (“qualifying activities”). The stated objective of the OETC was to reduce the costs of employing Canadian resident employees on contracts abroad, thereby improving the competitiveness of Canadian resident companies or their foreign affiliates when seeking to staff such projects.

The OETC is equal to an individual's tax payable on 80% of his/her qualifying foreign employment income up to a maximum of $100,000. Thus, the maximum possible amount of income eligible for the credit would be $80,000. The budget proposes to phase out the OETC between 2013 and 2016: the percentage of qualifying income eligible for the credit will be reduced from 80% in 2012 to 60% in 2013, 40% in 2014 and 20% in 2015. The OETC will be completely eliminated in 2016.

Relief from the phase-out is available where an employer committed to a particular project in writing before March 29, 2012. According to the budget papers, this relief will extend to situations where an employer has submitted a written irrevocable tender before the budget date, but the tender is only accepted at a later date. In these cases, the phase-out between 2013 and 2015 will not apply. However, the OETC will be completely eliminated for 2016 and subsequent years. While the relief will be welcome, the elimination of the OETC may still have a significant impact on companies with foreign projects to which they had committed prior to March 29, 2012 and which are expected to continue beyond 2016.

In some cases, the phase-out of the OETC may not be as significant as it first appears because claiming the OETC reduces the employee's foreign source employment income for purposes of claiming a foreign tax credit (FTC). (It should be recalled that the Canada Revenue Agency had stated in a 2007 technical interpretation that an employee was not permitted to claim only part of an OETC in

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order to maximize the FTC.) OETCs have, however, produced significant tax savings where employees engage in qualifying activities in low (or no) tax jurisdictions and FTCs would be of less (or no) value in Canada.

The cost associated with the phase-out of the OETC and the determination of whether it is the employer or the employee who will ultimately bear the cost, depends on whether the employer operates a tax equalization or tax protection policy. With a tax equalization policy, the OETC benefit would accrue to the employer, so the loss of the OETC could represent a cost to the employer. With a tax protection policy, the employee generally receives the benefit of the OETC so the loss of the OETC will ostensibly represent a cost to the employee. However, it is anticipated that even companies with a tax protection policy will ultimately bear the cost of the loss of the OETC as they will likely be required to provide higher compensation in an effort to retain and attract the required talent.

In response to this unwelcome news, the first step for employers likely involves quantifying the exposure as a result of the loss of the OETC. This will entail considering the extent to which the tax savings brought about by the OETC can be replaced by claiming FTCs. In situations where the loss is large, such as in cases where an employee engages in qualifying activities in a foreign country with no income tax (common in certain countries with large oil reserves), it will be necessary to explore additional alternatives.

Since OETCs only apply to employees who remain resident of Canada, consideration may be given to whether it is possible for the employee to cease Canadian residency. This may involve significant restructuring of foreign assignments, but the tax benefits are potentially large. Since income that would be subject to the OETC is, by definition, not Canadian source income, such income would not be taxable to the employee in Canada where the employee is a non-resident. While the tax advantages of ceasing Canadian residency are potentially larger than the benefit provided by the OETC, not all foreign assignments lend themselves to the employee ceasing Canadian residency. There may also be tax costs associated with ceasing Canadian residency, and loss of Canadian residency can have an effect on an employee’s ability to participate in various benefit plans.

Quebec residents will be further impacted if Quebec adopts a similar measure, since the benefit granted by the province to employees on eligible projects is more generous than that of the federal government. In Quebec, the benefit attributable to a qualifying foreign project is claimed as a deduction in calculating taxable income rather than as a reduction of Quebec taxes payable. With no limitation on the deduction which may be claimed in connection with employment income earned on qualifying overseas projects, the Quebec tax savings may be much more significant than the more limited federal benefit of 80% of the federal tax otherwise payable on the first $100,000 of remuneration.

Employers engaged in activities that were eligible for the OETC should take early action and review existing contracts and potential opportunities in order to quantify the cost associated with the loss of the OETC and to consider ways to mitigate the impact of this significant tax change. An examination of employee assignments and possible modifications to compensation programs and assignment policies should be considered.

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