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Canadian tax alert

Quebec – phase-out of the overseas employment deduction

July 25, 2012

Summary

On July 6, 2012, the Quebec Minister of Finance released Information Bulletin 2012-5 "Harmonization with certain measures of the federal budget of March 29, 2012". It came as no surprise that the Minister announced that Quebec's tax legislation would be amended to conform to the federal budget measures relating to the elimination of the overseas employment tax credit (OETC).

The elimination of the federal OETC was discussed in our April 9, 2012 Alert, "**Phase-out of the OETC**", in which we reviewed the various implications for employers of this proposed budget measure.

Quebec's equivalent to the OETC is the overseas employment deduction (OED). The OED is similar to the OETC, but is a deduction that can be available to an individual resident in Quebec who works outside of Canada on a qualifying project for at least 30 consecutive days, as compared to more than six consecutive months for the OETC.

For an individual on assignment outside of Canada for a minimum of 12 consecutive periods of 30 days, the deduction available can be 100% of the eligible compensation.

The gradual elimination of the Quebec OED will be implemented by reducing the deduction otherwise available to the following percentage: 75% for taxation year 2013, 50% for taxation year 2014 and 25% for taxation year 2015. After 2015 no OED will be allowed.

One noted exception is that the current rules will continue to apply to taxation years prior to 2016 in respect of written commitments made before January 1, 2013. In other words, where an individual's duties outside of Canada are tied to a written commitment of a specified employer of the individual made before January 1, 2013, it is expected that the full deduction calculated under the current rules will be available. Note that this exception applies to written commitments made before January 1, 2013 whereas the federal exception only applies to written commitments made before March 29, 2012.

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As of taxation year 2016, the deduction will be eliminated in all cases. Accordingly, even contracts already in place will be affected if they extend past 2015.

Impact of the OED phase-out

The phase-out of the OED generally will have an impact similar to that of the OETC. However, residents of Quebec often will be impacted much more severely than residents of other provinces, since the benefit granted by the OED applies to an unlimited amount of eligible income, unlike the OETC that is capped at a maximum 80% of $100,000 of eligible income.

Employers with qualifying activities should consider the impact of these changes on both existing contracts (that may extend past 2015) and proposed contracts.

The cost associated with the loss of the OED/OETC may be substantial and should be taken into account by companies currently bidding on projects. For example, for a single individual resident of Quebec, the impact of the loss of such benefits is estimated as follows, before the application of any foreign tax credit.

Income level	Total estimated taxes (Quebec and federal) with OED/OETC	Total estimated taxes (Quebec and federal) without OED/OETC
$100,000	$5,600	$31,200
$300,000	$45,515	$126,810
$500,000	$92,820	$223,240

Next steps

Employers with Quebec resident employees should review the status of their contracts and proposed contracts to ensure that the maximum benefit is obtained from the OED phase-out provisions. Significant tax savings may result from entering into written commitments before January 1, 2013.

For contracts eligible for the phase-out rules, employers must review their current policies to evaluate the impact of these changes and determine whether it is the employer or employee who will bear the cost of the loss of the OED/OETC, and then consider whether changes to present corporate policies are desirable and/or necessary. Where an employer maintains a tax equalization policy, the loss of the OED/OETC will represent a cost to the employer. If an employer maintains a tax protection policy (or has no tax equalization or protection policy in place), the loss of the OED/OETC may represent a cost to the employee. However, even where the loss of the OED/OETC appears to represent a cost to the employee, the employer may ultimately bear the cost, as the employer will often be required to provide an increased compensation package to offset the employee’s loss in net income in order to attract and retain the best talent for foreign projects.

Employers may wish to find alternative ways to reduce the tax burden when employees are providing services in foreign countries with low income tax rates, since the benefit of claiming a foreign tax credit will be limited. For example, employers may wish to restructure foreign assignments such that employees are encouraged to cease Canadian residency for taxation purposes for the duration of the assignment, provided that the individuals’ factual situations support such a position and all of the tax consequences of ceasing Canadian residency have been carefully reviewed. While in the past, many employers' foreign assignment policies did not encourage employees to become non-residents of Canada while on assignment, the additional tax cost resulting from the elimination of the OED/OETC may cause many employers to revisit their foreign assignment policies.

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