

The U.S. TAXFAX

TOPIC: EMPLOYEES TEMPORARILY WORKING IN THE UNITED STATES

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This edition of the U.S.TAXFAX will address a number of issues that arise from having employees working in the United States. We will assume that the employees are nonresidents of the U.S. and that they are also not U.S. citizens.

Income Tax Considerations for Employees:

A Canadian employee performing services in the U.S. will have U.S. source employment income. The amount of U.S. employment income is generally calculated using a pro rata portion of the annual salary. The Canada-U.S. Income Tax Convention (Treaty) provides an exemption from U.S. income tax if:

1. The U.S. source wages are \$U.S.10,000.00 or less for the calendar year, or
2. the wages are paid by a Canadian resident employer with no U.S. permanent establishment or fixed base **and** the employee is not present in the U.S. for more than 183 days during the calendar year. It should be noted that days of presence include any part of any day that the employee spends in the U.S. regardless of whether this time was for employment purposes.

The Treaty also provides an exemption from U.S. income tax for those employees who are employed by a Canadian employer and the services are performed on a ship, aircraft, motor vehicle or train. This means that Canadian truck drivers who transport goods between the two

countries are exempt from U.S. income tax as long as they are employed by a Canadian resident employer.

Employees who are taxable in the U.S. under the above rules must file Form 1040NR, U.S. Nonresident Alien Income Tax Return, on or before April 15 following the year in which the income was earned. It should be noted that the due date for nonresident returns is ordinarily June 15. However, the due date becomes April 15 where a nonresident earns U.S. source wages. In our experience, oversight of this provision can result in costly late filing penalties. An automatic four month extension of time to file the return, but not pay the tax, is available if an extension request is filed on or before April 15. The taxes paid by the employees are eligible as a foreign tax credit on their Canadian income tax returns. As U.S. income tax rates are currently lower than the Canadian rates, the overall tax liability will generally not be increased as a result of filing in the United States.

Employees can also be subject to state taxation depending upon which state the services were performed in and the amount of income earned. Some states do not recognize the Treaty and may tax income that is exempt from federal taxation. Each case must be reviewed separately to determine the state filing requirements.

Payroll Tax Considerations for Employers:

Income Tax:

We have noticed over the years that many employers who have employees in the U.S. do not address U.S. payroll withholding

requirements. They do so at their peril as the IRS does not look favorably on this practice and will often assess substantial penalties and interest on top of any taxes that have been underwithheld. Generally speaking, employers must withhold income taxes on U.S. source wages earned by non resident alien employees, unless these wages are exempt from U.S. income tax under the Treaty (e.g. U.S. source wages less than \$U.S.10,000).

If employees are employed in a state with an individual income tax system, it is likely that the employer will be required to withhold state income taxes in addition to federal income taxes. The state will have its own registration and filing requirements, and rules relating to the depositing of taxes. It is also not safe to assume that the employer will be exempt from state withholding because it is exempt from federal withholding. This is the case because, as noted earlier, some states (such as California) do not recognize the Treaty.

Other Taxes:

In addition to federal and state income taxes, employers may be required to withhold U.S. social security and medicare taxes from their employees U.S. source wages. The amounts withheld vary depending on the level of wages. For example, the social security and medicare taxes required on \$65,400 of wages earned in 1997 is \$5,003 with a matching contribution of \$5,003 by the employer. Withholding for these taxes is not required if the employee is exempt from U.S. income tax under the Treaty.

The Social Security agreement between Canada and the U.S. provides for an exemption from U.S. social security taxes (including the medicare portion) for a Canadian resident temporarily working in the United States if:

1. The employer files for a Certificate of Coverage for the employee, and
2. The employee and employer continue to contribute to CPP in Canada on the same wages

As the employee and employer portion for CPP is considerably less than the same for U.S. social security, it is usually advisable to apply for Certificates of Coverage for all employees working in the U.S.. It should be noted that in some circumstances it may not be in the employee's best interest to file for a Certificate of Coverage. This can be the case when an employee intends to retire in the U.S. and wishes to qualify for U.S. Medicare.

Other potential payroll related taxes that the employer may be responsible for are the Federal Unemployment (FUTA) tax, the State Unemployment Tax and possibly workmen's compensation. It is very important that the employer review its responsibility for these taxes as employment related lawsuits in the U.S. can be very costly.

As the myriad of payroll requirements are constantly evolving and because the filing requirements are extremely time sensitive, we usually recommend that a U.S. payroll service be used to address the payroll requirements of employers with employees working in the U.S.. We also recommend that employers advise their employees of any U.S. filing requirements in writing prior to commencing employment in the United States.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained herein.