



Employer's tax equalization policy for international employees continues past retirement

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Stikeman Elliott

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In a recent decision, the Ontario Superior Court of Justice (Court) held that deferred compensation amounts paid to a retired executive employee were properly characterized as employment income and subject to the employer's tax equalization policy (Hypo-tax Policy), even though the recipient was no longer an employee. (An appeal from the decision of the Court was dismissed by the Ontario Court of Appeal in April 2012.) Under the Hypo-tax Policy, the employer reduced the remuneration paid to eligible expatriate employees to reflect the taxes that would have been payable if the employee were a Canadian resident during the year. This case provides support to employers that maintain tax equalization policies for expatriate employees and continue to apply the policy to payments of deferred compensation made after the employment ceases.

In [Louis Ivandic v Scotiabank](#), the former employee (Mr. Ivandic) was a retired banker. He commenced employment with Scotiabank in Canada in 1983 and in 1989 he assumed the role of the bank's senior representative in Brazil. He became a non-resident of Canada in 1990. He then assumed senior roles with Scotiabank in different countries in Latin America eventually retiring from Scotiabank in 1990 in Peru. From the time of his departure from Canada, the bank subjected his salary to its Hypo-tax Policy, which was a mandatory term of the employment contract with Scotiabank's senior expatriate employees. Under the policy, an expatriate employee's remuneration is reduced in accordance with what would have been the taxes payable if the employee had remained a tax resident of Canada during the period in question. The bank then pays the employee's actual tax obligation in the country in which the employee is assigned in accordance with the tax laws of that country. The Hypo-tax Policy is intended to equalize the taxes payable by expatriate employees relative to the taxes that would have been payable if he/she remained a Canadian resident, and to make foreign assignments with the bank monetarily neutral in the countries where the bank operates. The Hypo-tax Policy effectively eliminates any income tax benefits or barriers that might come into play in an expatriate employee's decision to accept an international posting. The Hypo-tax was calculated annually by Ernst & Young.

In a 2006 letter setting out the terms of his assignment in Peru, Scotiabank advised Ivandic that the Hypo-tax Policy would be applied to his base salary, bonus and any stock-based compensation. Following his retirement in 2010, the bank continued to levy hypo-tax on all payments made to him (other than pension payments). Hypo-tax was therefore withheld from payments made after retirement under four deferred compensation programs in which he participated while a senior employee: stock appreciation rights (SARs), restricted share units (RSUs), performance share units (PSUs) and deferred share units (DSUs). From his retirement in May 2010 to July 2011, the bank withheld almost \$900,000 in hypo-tax.

Mr. Ivandic claimed the hypo-tax policy did not apply to payments made to him by the bank after retirement, and that it would be unfair to apply the hypo-tax regime to his deferred compensation payments after he had retired from the bank. He asserted that that his contract of employment did not provide for payments made after retirement to be subjected to the Hypo-tax Policy, and that it breached his privacy rights for the bank to be privy to his personal retirement income circumstances after he ceased to be an employee for the purposes of calculating the hypo-tax.

The Court held, on an application for summary judgment, that the post-retirement deferred compensation payments received by Ivandic had their source in his prior employment with Scotiabank, and under Canadian tax law the deferred compensation amounts are properly characterized as employment income, notwithstanding that he is now retired from the bank. Under the Income Tax Act (Canada), it is the source of the payment, not the status of the recipient, that determines the characterization of the payment for tax purposes, and employment income amounts paid after the employment has ended continue to maintain their character. The Court further found that that Ivandic was contractually bound to the Hypo-tax Policy on his salary and deferred compensation payments as a condition of his employment as an expatriate executive employee. As a result, the Court held that the payments under the four stock-based deferred compensation plans retain their character as employment income and as such are subject to hypo-tax under his contract of employment.

In obiter comments, the Court noted that the application of the bank's Hypo-tax Policy does not violate the employee's privacy rights as the tax returns are prepared by a professional accounting firm on a confidential basis and the accounting firm only informs the bank of the amounts it is required to pay as tax to the country of residence and the amount of hypo-tax required to be withheld.

Comments

This case shows the importance of clear documentation and communication to support the application of tax equalization policies to amounts paid after the employment relationship has ended. Where it can be demonstrated that the tax equalization policy is a condition of employment, the court will support the application of tax equalization policies to employment-sourced payments made after retirement or termination of employment. This case is also interesting in that the Court was not influenced in its analysis by the fact that the bank could (and in the case of Mr Ivandic did) receive a cash windfall on the application of the Hypo-tax Policy.

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