

NO.: **IT-497R3**

DATE: February 12, 1996

SUBJECT: INCOME TAX ACT
Overseas Employment Tax Credit

REFERENCE: Section 122.3 (also sections 114 and 126 and section 3400 of the Regulations)

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This bulletin is being revised in order to reflect the decision of the Federal Court of Appeal in *Rooke v. The Queen*, 2002 DTC 7442, 2002 CarswellNat 2776, and *Timmins v. The Queen*, 99 DTC 5494, [1999] 2 C.T.C. 133, as well as legislative amendments to the Act since the date the bulletin was published.¹

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Application

This bulletin cancels and replaces Interpretation Bulletin IT-497R2, dated June 29, 1990. IT-497R, dated August 30, 1985, and the related Special Release, dated March 20, 1987, which applied to the 1984 to 1987 taxation years, are also cancelled.

¹ added June 11, 2003

Summary

This bulletin deals with the overseas employment tax credit (OETC). An individual who is resident in Canada may be entitled to claim this credit for qualifying income from overseas employment. The OETC provides a tax reduction for up to \$100,000 of income earned in a full year of employment outside Canada. To qualify for the OETC, the employment must be:

- (a) with a specified employer (generally, a resident of Canada);
- (b) in connection with a contract under which the specified employer carried on business outside Canada on a resource, construction, installation, agricultural or engineering project (or for the purpose of obtaining such a contract); and
- (c) performed outside Canada for a period of at least 6 consecutive months.

The bulletin explains various terms and conditions relating to the OETC. It also provides details of the calculation required to determine the OETC and gives an example of this calculation.

Discussion and Interpretation

General

¶ 1. The overseas employment tax credit (OETC) is available to individuals who are resident or deemed resident in Canada for any part of a taxation year. The current version of IT-221, *Determination of an Individual's Residence Status*, describes circumstances in which an individual is considered to continue to be resident in Canada after having physically departed from Canada. That bulletin also discusses deemed residents of Canada.

¶ 2. An individual described in ¶ 1 above who has earned qualifying income in a taxation year throughout a qualifying period while employed outside Canada by a specified employer with respect to a qualifying activity may, under section 122.3, deduct an OETC from the tax otherwise payable for the year. The terms “qualifying income,” “qualifying activity,” “qualifying period” and “specified employer,” as well as the OETC calculation, are explained below.

Qualifying Income

¶ 3. Qualifying income of an individual for OETC purposes is the employment income earned in a qualifying period while the individual was employed by a “specified employer” (other than for the performance of services under a prescribed international development assistance program of the Government of Canada as discussed in ¶s 16 to 18 below), provided all or substantially all of the individual's employment duties were performed outside Canada:

- (a) in connection with a contract under which the employer carried on business outside Canada with respect to a qualifying activity as discussed in ¶ 6 below, or
- (b) for the purpose of obtaining a contract for the specified employer to undertake a qualifying activity.

The fact that the employment is performed in connection with two or more separate contracts of the specified employer does not, in itself, affect eligibility to claim the OETC.

The “all or substantially all” test referred to above is considered to be met if 90% of the employment duties are performed outside Canada.

¶ 4. For the purpose of section 122.3, qualifying income earned by an individual employee during a qualifying period includes salary, wages and other remuneration, including gratuities, received from that employment for the qualifying period. It also includes all or a reasonable proportion of any taxable benefit or other amount required under section 6 to be included in income that can be considered to be received or enjoyed by the individual for that same period from, or as a consequence of, that same employment. Benefits under section 7 are similarly included. This type of income is reduced by all or a reasonable proportion of any applicable amount described in subsections 8(1) to (13) inclusive that can reasonably be considered to be deductible in calculating income during that same period from that same employment.

¶ 5. Individuals are not eligible for a deduction from tax under section 122.3 in respect of self-employed income.

Qualifying Activity

¶ 6. For OETC purposes, a qualifying activity includes:

- (a) the exploration for or the exploitation of petroleum, natural gas, minerals or similar resources;
- (b) a construction, installation, agricultural or engineering activity; or
- (c) any prescribed activity.

A qualifying activity refers to a qualifying activity of the specified employer and not that of the employee.

¶ 7. As long as all or substantially all of the duties performed by the employee are in connection with a contract under which the specified employer carries on a business with respect to a qualifying activity, the employee would qualify for the OETC provided that the other conditions referred to in subsection 122.3(1) are met. For example, if all of these conditions are met, the following employees of a specified employer carrying on a qualifying activity would qualify for the OETC:

- (a) instructors or administrative staff providing supporting services to fellow employees;
- (b) staff who train the personnel of the foreign customer; and
- (c) computer hardware and software specialists fulfilling terms of their employer's qualifying activity contract.

Sub-Contractors

¶ 8. Ordinarily, the specified employer will itself directly carry on the qualified activities described in ¶ 6 (a) to (c) above, that entitle employees to claim the OETC. However, assuming all of the other requirements of subsection 122.3(1) are met, the OETC is also available to employees of a specified employer that carries on business outside Canada in other than a qualifying activity. Often referred to as a sub-contractor, such a specified employer would be one who has a contract or subcontract to provide its services through its employees to another person in respect of a qualifying activity carried on by that person outside Canada, or in respect of such a qualifying activity which that person has subcontracted to a third party. For example, assume that a specified employer (A Ltd.) has contracted to carry on business outside Canada by providing data processing services to a non-resident company (B Ltd.) whose only business is the exploration for natural gas. Assuming the other requirements of subsection 122.3(1) are met, the employees of A Ltd. providing the data processing services would qualify for the OETC, since their employment is in connection with a contract under which the specified employer carried on business outside Canada with respect to qualifying activities.

Qualifying Period

¶ 9. A qualifying period, for OETC purposes, means a period of more than six consecutive months that commenced in the year or a previous year. The qualifying period must include part of the taxation year for which the OETC claim is made. In this context, a month means either an entire month named on a calendar or a period starting from a given day in one month to the day before the corresponding day of the next month. For example, if the starting date for the six consecutive months was December 14, 1992, the minimum qualifying period of more than six consecutive months, would run from December 14, 1992 into June 14, 1993.

¶ 10. A qualifying period may be composed of consecutive periods of time spent by an individual in one or more locations anywhere outside Canada, including the land and territorial waters of a foreign country, in international waters or Antarctica.

¶ 11. An individual's entitlement to the OETC will not be denied simply because the person was not a resident or deemed resident of Canada throughout the qualifying period. Similarly, an individual's entitlement will not necessarily be denied because the individual was not actually outside Canada or at the work location(s) for the entire qualifying period. Periods of vacation or consultation with the employer will not be considered to interrupt the qualifying period, provided they are reasonable. This will depend on the facts of each case, including the relevant industrial practice, the nature of the work performed and the remoteness from any established community. During a period of absence from the work location, an employee may perform duties of employment in Canada and still remain eligible for the

OETC, provided that substantially all of the employment duties, as referred to in ¶ 3 above, are performed throughout the qualifying period outside Canada.

¶ 12. However, if an individual, such as a drill rig worker, is employed on an "on demand" basis for various periods in the year and is paid only for those periods, with no commitment for indeterminate employment or for a minimum number of days of employment in the year, that individual would usually be considered to commence and cease employment at the beginning and end of each such period. Accordingly, such an employee would not qualify for the OETC unless one of the periods of employment that commenced in the year or a previous year, and ended in the particular year, exceeded six consecutive months.

Specified Employer

¶ 13. A specified employer, for OETC purposes, is described in subsection 122.3(2) as:

- (a) a person resident in Canada;
- (b) a partnership, provided that persons resident in Canada or corporations controlled by persons resident in Canada own more than 10% of the aggregate fair market value of all interests in the partnership; or
- (c) a corporation that is a foreign affiliate, defined in paragraph 95(1)(d), of a person resident in Canada.

Residency of Specified Employer

¶ 14. A specified employer that is a corporation is generally considered to be a resident of Canada if:

- (a) its central management and control are located in Canada; or
- (b) it falls within the criteria set out in subsection 250(4) which deem a corporation to be resident in Canada throughout a taxation year.

For further information on the residency of a corporation see the current version of IT-391, *Status of Corporations*.

The current version of IT-221, *Determination of an Individual's Residence Status*, explains the factors which apply in determining residency of individuals.

Specified Employer Carrying on Business Outside Canada

¶ 15. Whether or not a specified employer is carrying on business outside Canada is always a question of fact. In determining this, the major factors to be considered are:

- (a) the objects of the employer's business; and
- (b) the nature of the activities the employer is carrying on outside Canada.

Employment with the Government of Canada or a provincial or municipal government generally does not qualify for the purposes of section 122.3, because a body politic or government would not usually carry on business outside Canada under a contract.

Prescribed International Development Assistance Programs

¶ 16. For purposes of the OETC, employment for the performance of services under a prescribed international development assistance program of the Government of Canada is not qualified employment. Such programs are prescribed in section 3400 of the Regulations to be international development assistance programs of the Canadian International Development Agency (CIDA) that are financed with funds (other than loan assistance funds) which are provided under External Affairs Vote 30a, *Appropriation Act No. 3, 1977-78*, or another act providing for such financing. Section 3400 of the Regulations applies even if CIDA provides only partial funding for the project.

¶ 17. The exclusion of services performed under a prescribed international development assistance program does not apply if the qualifying period started before 1984, or started before 1987 in connection with a specified employer's contract entered into before August 16, 1983.

¶ 18. As indicated in ¶ 16 above, a CIDA program financed by loan assistance funds may constitute qualified employment. However, CIDA funding rules were changed in 1986 so that international development assistance programs are financed only by grants rather than loan assistance funds. As a result, after March 31, 1986, any employment under a CIDA-sponsored program will not qualify for the OETC unless the funding agreement was initially signed as a loan agreement before April 1, 1986.

Option to Claim Foreign Tax Credit under Subsection 126(1)

¶ 19. The tax credits provided under section 122.3, the OETC, and subsection 126(1), the foreign tax credit for non-business income, are optional. A taxpayer may claim one or the other, or both. However, to the extent that a portion of an employee's qualifying foreign employment income is used to calculate an OETC, it may not be used to determine a foreign tax credit (see the current version of IT-270, *Foreign Tax Credit*). An employee may choose to claim a foreign tax credit, for example, where the OETC would be rendered ineffective by virtue of the application of the alternative minimum tax under section 127.5.

Authorized Form and Reduced Withholding of Tax at Source

¶ 20. Form T626, *Overseas Employment Tax Credit*, should be completed and filed with a T1 return when claiming the OETC. The employer is also required to complete a portion of this form. An application may be made for reduced withholding of income tax at source if the taxpayer will be eligible for the OETC. To apply, a completed copy of form T626 should be submitted to the Chief of Source Deductions at the Revenue Canada tax services office serving the taxpayer, together with a letter

explaining the situation and supporting documentation, such as a copy of the contract for overseas employment. Where an employer has numerous employees on international assignment who clearly will qualify for the OETC, the Department will consider granting a blanket waiver to cover the reduction in withholdings at source.

OETC Calculation

¶ 21. Expressed as a formula, the amount that can be deducted under section 122.3 as an OETC is:

$$\frac{\text{The lesser of limitation A and B}}{\text{Adjusted income for the taxation year (see ¶ 22 below) where limitation:}} \times \frac{\text{Tax otherwise payable for the taxation year (see ¶ 23 below)}}{\text{365}} \times \$80,000$$

B = 80% of the individual's qualifying income (see ¶ 3 above) that is reasonably attributable to duties performed during the number of days referred to in A above;

Therefore, the OETC provides an annual tax reduction for a maximum of \$100,000 of overseas employment income earned in a full year of overseas employment. The \$80,000 base amount in "A" above represents a ceiling for a one-year period which is prorated if the employee is overseas for less than the full year. An analysis of the formula components and an example of the OETC calculation is found in ¶s 22 to 24 below.

Adjusted income for the taxation year

¶ 22. For the purposes of the OETC calculation, as described in ¶ 21 above, the adjusted income for the taxation year for an individual who is resident in Canada throughout the year is the amount, if any, by which the individual's income for the year (including, before 1988, any forward averaged amount included in taxable income for the year) exceeds the total of:

- (a) the amounts deducted in the year under:
 - paragraph 111(1)(b) in respect of net capital losses; and
 - section 110.6 in respect of the capital gains deduction; and
- (b) the amounts deductible for the year under:
 - paragraph 110(1)(d.2) equal to 1/4 of the amount included in income under paragraph 35(1)(d) in respect of a prospector's or grubstaker's shares received after May 22, 1985, unless the amount

included in income is exempt from tax in Canada by reason of one of Canada's tax treaties;

- paragraph 110(1)(d.3) equal to 1/4 of the amount included in calculating income under subsection 147(10.4) with respect to employer shares received as part of a withdrawal after May 23, 1985, from a deferred profit sharing plan;
- paragraph 110(1)(f) with respect to certain amounts that are required to be included in income but are exempt from tax in Canada; and
- paragraph 110(1)(j) in respect of the amount of a benefit included in income as a result of an individual receiving a home relocation loan because of an employment relocation occurring in 1985 and subsequent taxation years.

For the 1993 and subsequent taxation years, the adjusted income of an individual who is resident in Canada during part of a taxation year will include not only the individual's income for the period in the year during which the individual was resident in Canada but also the individual's "taxable income earned in Canada" (subject to certain adjustments) as determined under section 115 for the period in the year during which the individual was not resident in Canada. This is reduced by the total of:

- the amounts listed in (a) above that were deducted in the year, and
- the amounts listed in (b) above that were deductible in respect of the period referred to in paragraph 114(a).

For 1992 and prior taxation years, the adjusted income of an individual who is resident in Canada during part of a taxation year is the amount, if any, by which the individual's income computed in accordance with paragraph 114(a) for the period or periods in the year throughout which the individual was resident in Canada, was employed in Canada or was carrying on business in Canada, exceeds the total of:

- the amounts listed in (a) above that were deducted in the year, and
- the amounts listed in (b) above that were deductible in respect of the period referred to in paragraph 114(a).

Tax Otherwise Payable for the Year

¶ 23. As defined in paragraph 122.3(2)(b), tax otherwise payable for the year is the amount that would be the tax payable under Part I of the Act for the year before

- (a) adding any amount for:
 - the amount of tax that is, under section 120, required to be added for income not earned in a province; or
 - forward-averaged income under subsection 120.1(2); or
- (b) deducting any amount for:
 - an OETC under subsection 122.3(1);
 - forward-averaged income under subsection 120.1(1);
 - minimum tax carryover under subsection 120.2(1);
 - a dividend tax credit under section 121;
 - a foreign tax credit under section 126;

- a logging tax deduction, a political contribution tax credit or an investment tax credit under section 127;
- a share-purchase tax credit under section 127.2;
- a scientific research and experimental development tax credit under section 127.3; or
- a labour-sponsored funds tax credit under section 127.4.

Example

¶ 24. Assume an individual resident in Canada during 1994:

- (a) is employed in the year for 73 days, commencing on October 20, 1994, outside Canada by a specified employer for the performance of any one or more of the duties described in ¶ 6(a) to (c) above;
- (b) continues to be so employed until April 30, 1995;
- (c) earns income of \$22,000 in 1994 that is reasonably attributable to the 73 days referred to in (a);
- (d) calculates adjusted income for 1994 to be \$64,000 under ¶ 22 above; and
- (e) calculates tax otherwise payable for 1994 to be \$14,000 under ¶ 23 above.

To calculate the individual's overseas employment tax credit:

- (1) Determine the lesser of Limitation A and B:

$$A = \frac{(a)}{365} \times \$80,000 = \frac{73}{365} \times \$80,000 = \$16,000$$

$$B = 80\% \text{ of (c)} = \frac{80}{100} \times \$22,000 = \$17,600$$

- (2) The OETC is:

$$\frac{\$16,000}{\$16,000} \times \$14,000 = \$3,500$$

$$\underline{\$64,000}$$

In this example, because the individual's qualifying period exceeded six months at the time the 1994 tax return was required to be filed, the tax credit of \$3,500 may be deducted in calculating 1994 tax payable. However, when an individual commences the performance of employment duties outside Canada after October 31 in a particular year, the necessary qualifying period of more than six months would not be satisfied before the individual's return of income for that year is required to be filed (i.e., no later than April 30 of the immediately following year). As a result, a tax credit under section 122.3 for income earned outside Canada during the period of that year after October 31 cannot be claimed at the time such return is required to be filed unless it can be established that the individual will be performing the employment duties outside Canada for a period of more than six consecutive months. The individual can establish this fact by, for example, filing with the return a letter from the employer certifying that the individual will be performing the employment duties outside Canada for a period of more than six consecutive months.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

This bulletin cancels and replaces existing IT-497R2, which deals with the overseas employment tax credit (OETC) after 1987. The OETC reduces the tax otherwise payable by Canadian residents on qualifying income from employment outside Canada. We revised the bulletin to reflect amendments to subsection 122.3(1) enacted by S.C. 1994, c. 7, Schedule II (1991, c.49—formerly Bill C-18) and S.C. 1994, c.21 (formerly Bill C-27). We have made general revisions to improve the readability of the bulletin and to reflect recent departmental opinions on this subject.

The comments in this bulletin are not affected by any draft legislation released before September 28, 1995.

Legislative and Other Changes

¶ 2 reflects the Bill C-18 amendment to paragraph 122.3(1)(b) which clarifies that the OETC may be available in connection with employment on a project in international waters (see new ¶ 10).

New ¶ 6 describes what activities constitute a “qualifying activity.”

New ¶ 7 gives examples of employees who would qualify for the OETC.

New ¶ 8 reflects the Department’s position that employees of sub-contractors indirectly involved in qualifying activities may be entitled to claim the OETC.

New ¶ 9 replaces the comments at the beginning of former ¶ 5 on the meaning of “qualifying period” and provides an application of this term where the period includes a part of a month.

New ¶ 10 replaces the concluding comments in former ¶ 5 to reflect the Bill C-18 amendment to paragraph 122.3(1)(b). Previously, qualifying employment had to be “in a country or countries other than Canada.” It is now sufficient that the employment be “outside Canada.”

New ¶ 11 replaces former ¶ 8. ¶ 11 and new ¶ 12 set out more detailed interpretative positions concerning the effect of vacations and other absences from the worksite, as well as the treatment of individuals hired on an “on demand” basis.

New ¶ 14 sets out some general information on the residency of the specified employer.

New ¶ 15, former ¶ 11, includes the Department’s position regarding employment with various levels of Canadian government. The comments about commercial activities in former ¶ 11 were deleted. They were considered unnecessary because, as already stated in ¶ 15, “Whether or not a specified employer is carrying on business outside Canada is always a question of fact.”

New ¶s 16 to 18 add new interpretive details about the exclusion of services performed under a prescribed international development assistance program.

New ¶ 19 discusses the option to claim the Foreign Tax Credit.

New ¶ 20 replaces the comment on the authorized Form T626 in former ¶ 13. We have added new information about applying for reduced withholding of tax at source.

New ¶ 22 replaces former ¶ 12 and reflects Bill C-27 amendments to both subparagraph 122.3(1)(c)(ii) and subparagraph 122.3(1)(e)(ii) with respect to OETC calculations when an individual is resident in Canada for part of a year.

New ¶s 23 and 24 replace ¶ 7 with little change to the calculation and the example. The example recognizes the 1991 amendment to paragraph 122.3(1)(b) which provides that the OETC will be available where an individual is employed outside Canada, e.g., a project in international waters, rather than in a country other than Canada.