

Revised CRA policy will impose withholding tax on subcontractor reimbursements

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The Canada Revenue Agency (CRA) has announced significant revisions to its assessing policy that will affect payments made to non-Canadian contractors for reimbursed costs incurred for engaging Canadian subcontractors.

Fees paid to a non-Canadian service provider may include a reimbursement for costs incurred by a Canadian subcontractor. These reimbursed amounts were not previously subject to Canadian withholding tax. However, the revised CRA assessing policy may now lead to unintended tax liabilities and consequences to both the service recipient (i.e., the customer) and the non-Canadian service provider.

The new CRA policy will apply to payments made after Sept. 30, 2024.

Background to CRA policy

Pursuant to paragraph 153(1)(g) of the Income Tax Act (Canada) and Regulation 105, payments made directly by the customer to a non-Canadian service provider, if those payments include a fee for services that are performed in Canada, are subject to a withholding tax of 15 per cent. This Regulation 105 tax would be refunded to the non-Canadian service provider if the non-Canadian service provider could demonstrate they did not otherwise operate from a Canadian permanent establishment (in the event that a tax treaty were to be available) or that it did not otherwise carry on business in Canada (in the event that the service provider were not a tax resident of a country that has a tax treaty with Canada).

Conversely, no withholding taxes under Regulation 105 are required to be remitted for any service fee paid to a Canadian resident service provider.

In its [decision of Weyerhaeuser Company](#), the Tax Court of Canada provided guidance on whether Regulation 105 withholding tax is required in circumstances dealing with reimbursements and out-of-pocket disbursement incurred by the non-Canadian service provider.¹ The Tax Court made the following determinations:

- i. Regulation 105 applies only to those payments having the character of income earned in Canada by the non-Canadian recipient of the service fee.

- ii. Fees for work performed in Canada represent income earned in Canada.
- iii. Amounts paid to reimburse contractors for their disbursements are not income earned in Canada.
- iv. Amounts paid for time spent traveling to Canada are not income earned in Canada. Amounts paid for time spent traveling within Canada are income earned in Canada.
- v. Subject to any internal inconsistency, or contradictory evidence, the invoices are adequate to discharge the onus on the customer to establish the nature of the payments made by it to its non-Canadian contractors, and the extent to which fees paid were for work done in Canada.

This Weyerhaeuser **judicial decision was followed by the publication of the CRA's** assessing policy that clarified how the Regulation 105 withholding tax would apply to reimbursed expenses of a non-Canadian contractor.² The critical element of the CRA policy affected an invoice issued by the non-Canadian contractor, where such invoice separately itemized as a disbursement the fee paid to a Canadian subcontractor for services provided by the subcontractor in Canada. The CRA took the position that Regulation 105 does not apply to reimbursements paid by the Canadian customer to the non-Canadian service provider if those reimbursements related to services provided by a Canadian subcontractor. The rationale for this determination is that the reimbursements did not represent income earned by the non-Canadian contractor but were merely to compensate for an actual out-of-pocket disbursement.

The CRA's assessing policy provided significant administrative relief to both the Canadian customer and the non-Canadian contractor. If the non-Canadian contractor did not perform any work in Canada and merely arranged for Canadian subcontractors whose fees were recorded as a reimbursable expense, then the following results would arise:

- The Canadian customer did not need to concern itself with the administration of the Regulation 105 withholding tax; and
- The non-Canadian contractor would not incur the cash flow limitations inherent in the Regulation 105 withholding tax. In particular, the non-Canadian contractor would not incur a 15 per cent withholding tax on the total amount of its service fee and would not need to pursue a refund of that tax.

The CRA's revised assessing position

Under the CRA's revised assessing position,³ the CRA takes the position that all reimbursement amounts paid to the non-Canadian contractor on account of its Canadian subcontractor's fee are now subject to Regulation 105 withholding tax.

The CRA's new assessing position is effective for payments made after September 30, 2024.⁴

BLG's take

From our perspective, the revised CRA position does not appear to properly reflect the Weyerhaeuser decision.

Based on the Weyerhaeuser decision, a fee amount paid to a non-Canadian service provider must have the character of income earned in Canada for such fee to become **subject to the Regulation 105 withholding tax**. The CRA's revised position seems to imply that any fee reimbursement incurred by a Canadian subcontractor represents income earned in Canada by the non-Canadian contractor, which is not necessarily the case.

Where a disbursement recorded on an invoice reflects the actual charges incurred by the Canadian subcontractor and the non-Canadian contractor does not add any profit margin or mark-up to the disbursement, these disbursements should not then cause the non-Canadian contractor to become subject to Regulation 105 withholding tax. The reasoning is that an actual out-of-pocket expense incurred by the non-Canadian contractor should not have the character of income being earned in Canada by that non-Canadian. There should be no requirement to withhold Regulation 105 taxes where the non-resident service provider merely records and invoices the Canadian resident **subcontractor's fee as an actual out-of-pocket disbursement**. Nonetheless, the CRA disagrees, and any omission to collecting and remitting the Regulation 105 withholding tax may lead to a CRA audit challenge and likely imposition of non-remittance taxes and penalties.

What does this mean for the Canadian customer?

If you are a Canadian customer that has engaged a non-Canadian contractor, and the Canadian portion of the services were intended to be subcontracted to a Canadian service provider, the current tax alternatives could include the following:

1. **Withhold and remit 15 per cent on all payments** . The Regulation 105 withholding tax would now be imposed even if the services were performed in Canada by a Canadian subcontractor and subsequently invoiced as a reimbursable item or disbursement. For clarity, the Regulation 105 tax would apply to the entire amount of the fee payable to the non-Canadian contractor, even if some portion represented services performed outside Canada. This situation would impose two administrative burdens. First, the customer would need to apply for a withholding tax ID number from the CRA, if the customer does not already have such ID number. Second, the non-Canadian service provider needs to plan for cash flow issues on account of the withholding tax now being remitted to the CRA. The non-Canadian service provider would only be eligible to apply for a tax refund after the end of its fiscal year, and it may be an extended period of time before any tax refund is processed by the CRA.
2. **Restructure service contract as tripartite agreement** . Both the non-Canadian contractor and the Canadian subcontractor would each sign the customer's service contract as a principal, thereby resulting in tri-partite agreement. Under this revised agreement, each of the non-Canadian contractor and the Canadian subcontractor would be legally entitled to receive a service fee from the customer. The tripartite agreement would explicitly specify that the non-Canadian contractor would only provide its services from outside Canada, and as a result this portion of the fees should not attract the Regulation 105 withholding tax. Similarly, the tripartite agreement would specify that only the Canadian subcontractor would be providing the services that are to be performed from within Canada. Since the customer is considered to be dealing directly with the

Canadian sub-contractor, no Regulation 105 tax would apply on the fees paid to the Canadian sub-contractor.

3. **Request the non-Canadian contractor to pursue a tax waiver** . Currently, non-Canadian service providers who would not be subject to a Canadian income tax liability upon filing their tax returns may apply to the CRA for an advance waiver of the Regulation 105 withholding tax requirement. If the waiver is processed by the CRA, then no Canadian withholding tax would then be imposed. However, until the waiver certificate is issued by the CRA, the Canadian customer should continue to apply and remit the 15 per cent withholding tax on the service fees. The issue is that the non-Canadian contractors must commence the waiver process well in advance of any invoices being issued to the customer to ensure that the waiver will be processed by the CRA on a timely basis.
4. **Service contract itemizes a separate fee for work performed inside and outside Canada** . Under this alternative, the service contract would be executed only by the non-Canadian contractor and the customer. However, the service contract, and the resulting invoice to be issued, would explicitly specify (i) the portion of the service fee being charged for work performed outside Canada, and (ii) the portion of the fee charged for the for work performed in Canada. This alternative would minimize the scope of the Regulation 105 withholding tax to only the amount paid for the Canadian portion of the service fee. Although this alternative is not a complete solution to the withholding tax issue, it would mitigate the cash flow concerns to the non-Canadian contractor by requiring the 15 per cent withholding tax only on the portion of the fee amount allocable to the Canadian work.

For further information on Regulation 105 and its potential impact to your business, please contact the authors or any member of [BLG's Tax group](#).

Footnotes

¹ See *Weyerhaeuser Co. v. R.*, 2007 TCC 65, at para. 30.

² CRA Document#2008-0297161E5, "Regulation 105" (September 16, 2009).

³ CRA Document #2022-0943241E5, "Regulation 105" (April 29, 2024).

⁴ See CRA Document#2022-0943242E5, "Regulation 105" (May 28, 2024).

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