

Canadian Compensation Arrangements - When Do I Need U.S. Counsel?

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by Jenna Steiner

Imagine a Canadian company adopts a deferred share unit plan (DSU Plan) for its directors. At the time the plan is adopted, the company does not have the plan reviewed by U.S. counsel, because none of their directors reside in the U.S. It is not until several years later that the company learns that one of its directors, despite living in Canada, has dual citizenship with the U.S. Because the typical form of Canadian DSU Plan will not comply with U.S. tax laws governing deferred compensation, particularly U.S. Internal Revenue Code Section 409A (Section 409A), the company has quite a mess on its hands. You can read our prior articles on common payment timing issues with DSUs [here](#) and common election deferral issues with DSUs [here](#).

It is because of scenarios like the above that it is crucial to consider whether any of your employees or non-employee directors are U.S. taxpayers. Unlike most other countries, U.S. taxpayers are taxed on worldwide income, *regardless of where they reside*. U.S. taxpayers include: (i) U.S. citizens regardless of residency; (ii) legal permanent residents (“green card” holders); and (iii) non-citizen, non-green card holders who have a “substantial presence” in the United States under the U.S. income tax laws (but exceptions to this category apply – careful analysis of the facts and applicable tax treaties is required).

Section 409A is so broad that it covers most nonqualified deferred compensation arrangements, unless a specific exception applies, and it imposes specific timing, election and distribution requirements on covered arrangements. If a nonqualified deferred compensation arrangement fails to comply with the requirements of Section 409A, deferrals are includible in income at vesting (even if they are not paid out) and subject to a 20% additional tax. In some circumstances, an underpayment interest penalty will also apply.

Because of the broad definition of Section 409A, it is easy to overlook that employment agreements, change-in-control agreements, and severance agreements with U.S. taxpayers frequently contain provisions that subject them to Section 409A. Because the

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failure to comply with Section 409A can result in such onerous tax penalties, if a Canadian company has U.S. taxpayers participating in its equity plans or if the company is entering into any type of compensation arrangement with a U.S. taxpayer where such arrangement promises to pay compensation in a future taxable year, the company should consider having the terms of any such plan or arrangement reviewed by U.S. counsel.