

DSU Plans May Run Afoul of U.S. Deferral Election Timing Rules Resulting in Adverse U.S. Tax Treatment

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A Canadian company adopting a deferred share unit plan (DSU plan) for its directors must consider U.S. tax implications for U.S. taxpayers. It is important to remember that U.S. citizens and U.S. residents for tax purposes (including green card holders) are taxed on worldwide income, regardless of where they reside. As such, participation by a U.S. director, including an expat or holder of dual citizenship, could result in significant adverse tax consequences under Section 409A of the Internal Revenue Code, as a typical Canadian DSU plan often runs afoul of Section 409A. In a prior article, [DSU Plans Require Careful Review to Avoid Adverse U.S. Tax Treatment](#), common payment timing violations of U.S. tax laws governing deferred compensation were discussed (as well as tips for properly identifying U.S. taxpayers). While payment timing is one common violation of Section 409A, it is also important to consider the timing of elections to defer compensation.

In order to avoid a violation of U.S. deferral election timing rules, a Canadian company should consider both the general deferral election timing rules under Section 409A, as well as the exceptions permitting more lenient timing. Generally, deferral elections must be made by the end of the taxable year before the year in which the services giving rise to the compensation that will be deferred are performed. For instance, for any amounts earned in 2023, the election to defer should be made no later than December 31, 2022. Once a deferral election is made, payment may not be accelerated, unless a specific exception applies, and payment may not be further deferred, unless strict second deferral election rules are obeyed.

While compliance with the general deferral election timing rule is always the simplest and least risky approach, there are exceptions to this general rule that provide greater leniency in some situations. One of the most common exceptions is for initial eligibility. Section 409A provides that a deferral election may be made within 30 days following the date that a service provider (e.g., a director) is first eligible to participate in the plan, provided that the election may only apply to compensation earned following the date of the election (and provided the service provider does not participate in another deferred

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compensation plan required to be aggregated with such plan under Code Section 409A). There are additional exceptions to the general deferral election timing rules for payments conditioned on continued service for a period of at least 12 months as well as for performance-based compensation. However, compliance with these exceptions can be rather tricky, and the consequences for failing to comply are severe, so these exceptions should be discussed with legal counsel proficient in U.S. tax law.

Where a U.S. director fails to make a timely deferral election within the meaning of Section 409A, the value of the DSUs as of December 31st of the year in which the DSUs vest (i.e. the year in which the DSUs are awarded for the majority of DSU plans) will be included in the U.S. director's income for that year, regardless of whether actual payment of the DSUs is deferred. In addition, a 20% penalty tax will be imposed on the U.S. director.

Advanced planning is crucial to ensure compliance with the above-mentioned deferral election timing rules in order to avoid the adverse tax consequences described above. A Canadian company with U.S. directors should have any such DSU plan reviewed by counsel proficient in U.S. tax law prior to implementation. However, even where review prior to implementation is not possible, a review after implementation would still be advantageous, as early correction may avoid or minimize certain adverse tax consequences. We work regularly with Canadian tax counsel to ensure compliance and/or to correct violations.