

DSU Plans Require Careful Review to Avoid Adverse U.S. Tax Treatment

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by Marianne O'Bara

A Canadian company is planning to adopt a deferred share unit plan (DSU plan) for its directors. Only one or two of its directors are U.S. citizens or U.S. residents ("U.S. Directors"). With only one or two U.S. Directors, you wonder whether it is important to consider U.S. tax implications. The answer is a resounding yes because the typical form of Canadian DSU plan will not comply with U.S. tax laws governing deferred compensation. Participation by a U.S. Director will result in significant adverse tax consequences for the U.S. Director under Section 409A of the Internal Revenue Code. Specifically, for U.S. federal income tax purposes, 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/settlement of the DSUs is deferred until later termination of board service. In addition, a 20% penalty tax will be imposed.

A typical Canadian DSU Plan runs afoul of Section 409A in two ways. First, such plans frequently allow the director to "redeem" the units following termination of services by electing a redemption date either during the year of termination or during the following calendar year. This violates section 409A because it allows the director to choose, at or after termination of service, which tax year the payment/settlement will occur. Since Section 409A requires both documentary and operational compliance, the mere inclusion of the problematic language in the document constitutes a 409A violation and triggers adverse tax consequences for the U.S. Director. In other words, you can't simply postpone the U.S. tax review until later, figuring that you will fix it before the U.S. Director terminates board service.

The second common Section 409A problem arises because most Canadian DSU plans are designed to comply with the requirements of Income Tax Regulation 6801(d), which provides a specific prescribed exception to the salary deferral arrangement rules for Canadian income tax purposes. However, the payment timing requirements under Section 409A upon the U.S. Director's "Separation from Service" are in some circumstances inconsistent with the requirements of Income Tax Regulation 6801(d).

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Fortunately, through careful drafting and plan administration, a DSU plan can be designed and administered to avoid these problems. We work regularly with Canadian tax counsel to ensure compliance.

Tip: In thinking about whether any of a company's directors are U.S. taxpayers, remember that U.S. taxpayers are taxed on worldwide income, regardless of where they reside. U.S. taxpayers are: (i) U.S. citizens regardless of residency; (ii) non-resident aliens ("green card" holders); and (iii) non-citizens, 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 required).