Incentives and Benefits

This regular feature is edited by Dov B. Begun of Osler, Hoskin & Harcourt LLP. It examines major trends and tax planning issues pertaining to executive incentive and benefit plans and arrangements.

DEFERRED SHARE UNIT PLANS

Canada-U.S. Cross-border Deferred Share Unit Plans – Trips and Traps

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Deferred share unit ("DSU") plans are a common compensation vehicle for Canadian corporations, including those with a global workforce. Simply stated, a DSU is a phantom unit having a value equal to the fair market value of a share of the granting corporation with the right to payment deferred until the holder's employment relationship with the corporation has been terminated.[1] Due to the ever-increasing ties between Canada and the United States, it may be important that a corporation's Canadian DSU plan operate effectively for employees in both Canada and the United States. The purpose of this article is to discuss one of the areas in which simultaneous compliance with both Canadian and U.S. tax rules may not be possible without active management by the corporation.

Background

DSU grants to employees who are residents of Canada or who render employment services in Canada are generally structured in reliance on paragraph 6801(*d*) of the *Income Tax Regulations*[2] so as to avoid being caught by the salary deferral arrangement rules. If structured properly, DSUs provide a deferral of tax until such time as the DSUs are redeemed and the employee receives payment. On the other hand, failure to comply with the requirements of Regulation 6801(*d*) may subject Canadian employees to an income inclusion upon the grant of the DSUs and on an accrual basis thereafter,[3] notwithstanding that no payment will have yet been received.

DSU grants to employees who are U.S. residents or U.S. citizens (referred to as "U.S. Taxpayers") typically need to be structured in compliance with the requirements of Section 409A of the United States Internal Revenue (the "Code"). Where a DSU plan that is subject to Section 409A of the Code is not compliant therewith, a U.S. Taxpayer may be subject to accelerated income inclusion on the value of the DSUs plus an additional "penalty" tax equal to 20% and interest charges.

Typically, where both sets of rules are at play, the DSU plan document will be drafted in accordance with Canadian tax rules, but will attach a special appendix dealing with U.S. tax rules, which conforms to the requirements of Section 409A of the Code. Where a particular DSU holder is subject to only Canadian tax rules or to only U.S. tax rules, no legal conflict should result, provided that the U.S. rules in the special appendix are stated to apply only to U.S. Taxpayers.

It is important, however, to appreciate that a particular DSU holder may, in some circumstances, be subject to both Regulation 6801(*d*) and Section 409A of the Code. This occurs most frequently where a DSU holder is a Canadian resident and/or provides employment services in Canada but is also a U.S. citizen. In such a situation, the DSU holder (referred to herein as a "Dual Taxpayer") will be subject to Canadian tax rules either by

[1] For a more general discussion of DSU plans and the requirements thereof, see, for example, Jessica Bullock, "Recent Administrative Positions of the Canada Revenue Agency Regarding Deferred Share Unit Arrangements" (February 2011) 22 *Taxation of Executive Compensation and Retirement* 1373.

[2] C.R.C., c. 945, ("Regulation 6801(*d*)").

[3] Pursuant to subsection 6(11) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

virtue of being resident in Canada (and thus being subject to Canadian tax on worldwide income) or by virtue of providing employment services in Canada (and thus being subject to Canadian tax on Canadian-source employment income[4]) and will also be subject to U.S. taxation by virtue of being a U.S. citizen (i.e., because the U.S. taxes on the basis of citizenship and not just residency). In such a circumstance, conflicts can arise between the requirements of the Canadian and U.S. tax rules. While many potential conflicts between the two sets of rules exist, the trickiest is dealing with the concepts of loss of employment and separation from service.

The Potential Conflict

One of the key requirements of Regulation 6801(*d*) is that payment in respect of the DSUs not be made until after the time of the employee's "death or retirement from, or loss of, the office or employment" (each, a "Payment Event") and that all such payments be received by the employee before the end of the calendar year following the year in which a Payment Event has occurred.

Section 409A of the Code, on the other hand, permits payments in connection with one or more of a number of permissible distribution events, which include: "separation from service," death, disability, change in control of the employer, unforeseeable emergency, or a fixed time or pursuant to a fixed schedule.

As the Canadian tax rules do not permit the payment of DSUs, absent a loss of employment, payments on account of disability, change in control, or unforeseeable emergency are not permitted.[5] It is typical, therefore, that a cross-border DSU plan limit the DSU payout events to "loss of employment" for Canadian employees and to "separation from service" for U.S. Taxpayers. It is the distinction between these two concepts that can be troublesome for Dual Taxpayers.

To satisfy the Canadian requirement of a loss of employment, the Canada Revenue Agency (the "CRA") generally requires that the employment of the DSU holder with all affiliates of the grantor corporation be terminated prior to that holder being entitled to a payment in respect of the DSUs. In contrast, under Section 409A of the Code, a separation from service occurs when the employer and employee reasonably anticipate that the level of *bona fide* services the employee will perform (in any capacity) will permanently decrease to no more than 20% (or another percentage specified in writing by the parties prior to the separation that is greater than 20% and less than 50%) of his or her past service (determined based on average level of services performed over the prior 36-month period).[6]

Various scenarios can arise where, in respect of a Dual Taxpayer, the individual's "separation from service" arises on a different date than the "loss of employment." Two examples are as follows:

- Assume that a non-employee director who is a Dual Taxpayer resigns as a director on September 1, 2013, but remains, for the next two years, a casual employee of the grantor corporation working 1 day a month (determined to be less than 20% of his or her pre-resignation services). In such circumstances, the Dual Taxpayer's loss of employment would not occur until he or she ceased to be a casual employee on September 1, 2015, but his or her separation from service would occur on September 1, 2013. For Canadian tax purposes, the Dual Participant's DSUs could not be redeemed prior to September 1, 2015 but, for U.S. tax purposes, the DSUs

[4] Subsection 2(3) of the Act.

[5] It could be argued that, so long as the DSU plan does not contemplate the payout of DSUs in the event of a change of control and such change of control was not reasonably foreseeable at the time of the grant of the DSUs, the protection of Regulation 6801(*d*) should not be lost, such that the future payout should only be taxable at that time. This issue is discussed in Anu Nijhawan and Steven Sieker, "Topical Issues in Equity-Based Employee Compensation," *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Tax Conference (Toronto: Canadian Tax Foundation, 2009), 15:1-36.

[6] Further, where a U.S. Taxpayer is determined to be a "specified employee" (as determined pursuant to Section 409A of the Code), that DSU holder cannot receive a payment in respect of DSUs until six months following his or her separation from service. Specified employees will include, for example, officers with annual compensation over a certain prescribed amount. This delay can cause further issues with respect to the timing of DSU payments.

would need to be redeemed shortly after September 1, 2013.

- Assume that a non-employee director who is a Dual Taxpayer resigns as director of the grantor corporation on September 1, 2013, but, as of that date, the surrounding facts and circumstances indicate that the Dual Taxpayer will continue to provide consulting services, on a near full-time basis, to the corporation for a further two-year period. In this scenario, the individual's loss of employment would occur on September 1, 2013 but his or her separation from service would not occur until September 1, 2015. For Canadian tax purposes, the Dual Taxpayer's DSUs would need to be redeemed by December 31, 2014 but, for U.S. tax purposes, the DSUs could not be redeemed until September 1, 2015.

The foregoing examples show situations where technical compliance with both Regulation 6801(*d*) and Section 409A of the Code is not possible. While the CRA has not publicly commented on such a situation, it has issued one published ruling in which the DSU plan defined "termination date" as meaning the date of "separation from service,"[7] but it is not clear from that ruling whether the separation from service definition also applied to Dual Taxpayers. As such, it remains an open question whether the CRA will provide administrative relief in this sort of situation.

Conclusion

Assuming that no administrative relief will be made available by the CRA, there are various potential ways to deal with the foregoing conflicts. Where it is not commercially acceptable to exclude U.S. Taxpayers from participation,[8] a somewhat common approach is for the sponsoring corporation and the Dual Taxpayer to commit, formally or informally, to managing a future termination so that there is both a loss of employment under Canadian tax rules and a contemporaneous separation from service under U.S. tax rules. For example, on a future termination of employment, care will need to be taken to ensure that no Dual Taxpayer enters into, or can reasonably be expected to enter into, a consulting or part-time employment agreement with the grantor corporation at the time of the termination. Whether this management issue is incorporated into the DSU plan or is simply recorded in the grantor corporation's human resources files is a matter of debate.

[7] CRA *Document* 2009-0329411R3 (2009).

[8] While the approach of allowing Dual Taxpayers to elect not to participate in the DSU plan is seemingly straightforward, it may require the sponsor corporation to develop an alternative compensation regime for such individuals. Such an approach also does not deal with situations where a Canadian employee becomes subject to Section 409A of the Code after having been granted DSUs.