

# The TaxLetter®

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Your Guide to Tax-Saving Strategies

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## TAXPLANNING

*Ease your tax burden and know where you stand*

# Severance and the taxman

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A recession may impact some people more than others. For many of us, our stock portfolios have fallen to such depths that climbing back up seems like hiking up Mt. Everest.

For others, that long climb is only part of the problem — the recession may also have hit closer to home with the loss of a job or a forced retirement.

Employers are feeling the pinch and handing out pink slips in order to keep afloat. Some unlucky ones faced with the loss of a job hope to exit with some extra pennies in their pocket thanks to a retiring allowance.

However, those pennies seem to lose their value when you realize that the taxman will be waiting around the corner to

get his last piece of the pie.

Under the Income Tax Act (the “Act”), any amount you receive from an employer (or ex-employer) as a retirement allowance will be taxable as income to you.

However, the CRA offers a tax break if the funds received as a retirement allowance are transferred to an RRSP or Registered Pension Plan (RPP).

### **RRSP or RPP Transfer**

In either case, contributions from a qualifying retiring allowance will enable you to make additional contributions to the plan, over and above the standard annual limits for certain years (the additional contributions cannot be made to a spousal RRSP, however).

But if a direct transfer is not made by your employer to your RRSP or RPP, the employer paying the retiring allowance must report the amount paid on Form T4A Supplementary and sadly,

must deduct tax at source.

So it may be beneficial to ask your employer to make the payment directly to your deferred plan to avoid source deductions.

If your retiring allowance was received as a result of duking it out with your past employer, legal fees are deductible — to the extent that the retiring allowance itself is not sheltered by transfers to a deferred income plan (in short, the deduction is limited to the amount on which tax is actually due).

So, in order to get a full deduction, it may be a good idea to “pass up” transferring some payments into an RRSP or RPP for that year.

Even if these payments are “rolled in” to these plans, you will eventually have to pay tax on them when they are received from the plan (although they will earn tax-sheltered income in the meantime).

NOTE – if the legal fees are reimbursed to you, they will be included in your income.

### **Before 1995**

For those years you worked with your employer prior to 1995, any amounts you receive on termination as a retiring allowance will allow you to increase your normal RRSP or RPP contribution limit and therefore enhance your tax deferral.

For years of service prior to 1989, the maximum deferral

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available for a retiring allowance through a contribution to an RRSP or RPP is limited to this formula: \$3,500 times the number of years during which you were employed.

NOTE – For years of service between 1989 and 1995, the tax-deferred ceiling is limited to \$2,000 in all instances.

However, for years where your employers made contributions to a pension fund or plan, or to one of their deferred profit-sharing plans, and those funds have vested with you at the time you receive the retiring allowance, the annual deferral is decreased by \$1,500 – to \$2,000.

In order to be eligible for the offsetting deduction, the contribution to the RRSP or RPP must be made within 60 days after the end of the year in which you include the retiring allowance as income.

### What is a retiring allowance?

Essentially, a “retiring allowance” is defined under the Act as: an amount received on or after “retirement” of a taxpayer from an office or employment in recognition of the taxpayer’s long service, or an amount received in respect of a loss of office or employment, including an amount received on account of or in lieu of damages.

(This specifically excludes superannuation and pension benefits, amounts received as a consequence of the death of an employee and benefits received from counselling services paid for by an employer.)

There is no requirement that a retirement allowance must be paid in cash.

For example, in a tax ruling, the CRA held that the fair mar-

ket value of a car transferred to an employee as part of a severance package was considered part of the retiring allowance, and taxed as such.

So if you’ve received a parting gift, think about whether this nice gesture on the part of your employer will land you with an extra tax liability.

However, CanRev says that retirement (or loss of a job) does not include a transfer from one office or position to another with the same employer. Nor does it include termination of employment (other than mandatory retirement) with an employer followed shortly by employment with an affiliate of the former employer, or termination as a result of death.

In the past, the term “retiring allowance” has often been synonymous with job severance payments.

However, CanRev pronouncements and some court cases in the area have complicated the situation. In fact, when all of the CRA technical rulings are put together, the result can be pretty confusing.

### Round Table Roulette

In a 1993 Round Table CanRev expressed the view that “termination pay” under the Ontario Employment Standards Act does not qualify as a retiring allowance.

This is because the legislation imposes a minimum number of weeks of notice prior to termination, dependent on the years of employment. During the notice period, the employee is entitled to receive regular wages.

So the CRA’s position is that if the employee is terminated without written notice, the

employee is entitled to termination pay equal to regular wages payable over the same number of weeks for which notice was required. What does this mean? Essentially, the termination pay is treated as a continuation of regular salary payments, in spite of the termination.

Yet, a different interpretation was given to “severance pay,” under which an Ontario employee may be entitled to payments by virtue of large employers discontinuing businesses, where 50 or more employees have been laid off within a six-month period. This does qualify as a retiring allowance.

### General Damages

The CRA’s administrative position is that an amount paid on account of damages for emotional distress under a court order may be a retiring allowance if the payment arises from a loss of office or employment. If you’re hoping that the word “may” opens the door for you to take the position that such damages are not retiring allowance, but tax-free payments, think again.

The CRA has stated that damages received as compensation for mental distress as a result of the loss of employment “would be taxed as a retiring allowance” — unless the damages relate to human rights violations.

### Pre-judgment/Post-judgment

CanRev has stated that pre-judgment interest on either a retiring allowance or a tax-free award is considered tax-free. Yet in another ruling they expressed the view that interest paid on an award for wrongful dismissal for the period after the date of settlement is taxable

as interest.

On top of that, it is not part of a retiring allowance and therefore cannot be rolled into an RRSP.

So, pre-judgment interest appears to get the best possible treatment — it can be completely tax-free (if related to a retiring allowance or a damage payment which is not income from employment). Post-judgment interest gets the worst treatment — it's fully taxable and can't even be rolled into an RRSP.

### Yet More Rulings

Besides CRA pronounce-

ments, there have been a few interesting court cases in the grey area in which not all damage payments received by a terminated employee fall within the definition of retiring allowance.

A case in point is *Bedard versus M.N.R.*, where it was held that compensation paid to an employee for defamation did not constitute a retiring allowance.

Some practitioners have also argued that exemplary damages and damages for mental distress awarded in a wrongful dismissal action are, arguably at least, non-taxable — in spite of a case that ruled to the contrary.

Other CRA rulings have dealt with typical scenarios. For instance, compensation for termination due to a work-related injury was held to be a retiring allowance under the particular situation.

Or, where an employee receives a payment as a result of a lay-off under the terms of a labour agreement, it will usually qualify as a retiring allowance. Or unused sick leave credits paid on termination qualify as a retiring allowance, but accumulated vacation pay does not.

The debate goes on. □