

# The TaxLetter®

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Your Guide to Tax-Saving Strategies

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## TAXMATTERS

*Helpful tips on how to keep more of your retirement allowance*

# Severance savvy

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During the recession some years back, the unemployment rate in Canada was hovering in the 8.5 per cent range.

Happily, that rate has since been steadily improving. That said, there will always be those who, for whatever reasons, are experiencing the stress of unemployment or termination of a job.

In the latter case, the hope is that you can at least exit with a couple of extra dollars in your pocket in the form of severance pay or a retiring allowance. That's assuming you can shelter those extra bucks from the CRA, who only seem to want to kick you when you're down by trying to scoop up some of that excess cash.

Under the Income Tax Act

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(the "Act"), money received from an employer (or ex-employer) as a retirement allowance will be taxable as income. However, the CRA does offer a tax-break if the retirement allowance is transferred to an RRSP or Registered Pension Plan (RPP).

With either option, contributing a qualifying retiring allowance will also allow you to make additional contributions to the plan, over and above the standard annual limits for certain years. The additional contributions cannot, however, be made to a spousal RRSP.

Sadly, 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 deduct tax at source.

It might be beneficial to instruct your employer to make the payment directly to your deferred plan to avoid source deductions.

On the other hand, if your

retiring allowance was received as a result of duking it out with your past employer, any legal fees incurred are deductible to the extent that the retiring allowance itself is not sheltered by transfers to a deferred income plan (note: the deduction is limited to the amount on which tax is paid).

In order to get a full deduction, therefore, it may be a good idea to "pass up" transferring some payments into an RRSP or pension plan for that year, even if the payments are "rolled in" to those plans. You will eventually have to pay tax on them when they are received from the plan – but they will earn tax-sheltered income in the meantime. And remember, if the legal fees are reimbursed to you, there is a corresponding inclusion in income.

### **Transfer to a registered pension plan or RRSP**

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

For years of service prior to 1989, the maximum deferral available in respect of a retiring allowance through a contribution to an RRSP or RPP is limited to \$3,500 multiplied by the number of years during which you were employed.

However, the annual deferral is decreased by \$1,500 (i.e., to \$2,000) for years where your

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

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.

The February 1995 Federal Budget eliminated the opportunity to enlarge RRSP and RPP contributions in respect of retiring allowances for years of service after 1995. However, the opportunity to make contributions in respect of retiring allowances for years of service before 1996 was not affected.

### What is a retiring allowance?

Essentially, a “retiring allowance” is defined under the Act as either of the following:

- ✦ An amount received from an employer on or after “retirement” in recognition of the employee’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.

The above 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, the CRA has stated that the fair market value of a car trans-

ferred to an employee as part of a severance package is considered part of the retiring allowance, and taxed as such.

So if you’ve received a parting gift, think about whether this nice gesture by your employer will end up burdening you with extra tax liability.

It should be noted that CanRev is of the opinion that retirement (or loss of a job) does not include a transfer from one office or position to another with the same employer.

It also doesn’t 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 technicals are put together, the result can be pretty confusing.

### Round Table Roulette

In a 1993 Round Table meeting with tax professionals, CanRev expressed the view that “termination pay” under the Ontario Employment Standards Act does not qualify as retiring allowances. 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. Because of this, 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 of employment. (Presumably, there would be similar problems in all provinces.)

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

### General Damages

The CRA takes the view that an amount paid on account of damages for emotional distress per 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 claim that such damages are not a retiring allowance, but may in fact be tax-free payments, think again.

The CRA stated in a ruling 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 to be tax-free.

But in yet another ruling, they indicated that interest paid on an award for wrongful dismissal for the period after the

date of settlement is taxable as interest – and on top of that, it does not form 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.

### **Caselaw**

Post-judgment interest, on the other hand, gets treated the worst – it's fully taxable and can't even be rolled into an RRSP.

Besides CRA pronouncements, there have been a few interesting court cases which have held that not all damage payments received by a terminated employee fall within the definition of retiring allowance.

Case in point: *Bedard v. M.N.R.*, where it was held that an amount paid to compensate an employee for defamation fell outside the retiring allowance definition.

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 – i.e., in spite of

another case.

### **Etc., Etc.**

A number of other CRA rulings have dealt with other typical scenarios, such as compensation for termination due to a work-related injury, which was held to be a retiring allowance under the particular situation; or where an employee received a payment as a result of a lay-off under the terms of a labour agreement (it will usually qualify as a retiring allowance); and unused sick leave credits paid on termination qualifying as a retiring allowance – but accumulated vacation pay does not. □