Early Exit – What Qualifies As Retiring Allowance?

In September 2015, the Canadian unemployment rate edged up to 7.1 per cent from 7.0 per cent the previous month. Looking at the rates so far this year, this is an increase of 0.5 per cent since January. So it is fair to say there will always be someone who is feeling the pinch 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 a retiring allowance or severance pay. That's assuming you can shelter those extra bucks from the Canada Revenue Agency, which only seems to want to kick you when you're down by trying to scoop some of that excess cash from you.

Under the *Income Tax Act* ("the Act"), if you receive an amount from an employer (or ex-employer) as a retirement allowance, that amount will be taxable as income to you. However, Canada Revenue Agency does offer a tax-break if the funds received as a retirement allowance are transferred to a Registered Retirement Savings Plan (RRSP) or Registered Pension Plan (RPP) for certain years of employment. In both cases, contributions of qualifying retiring allowances will enable you to make additional contributions to the plan, over and above the standard annual limits for certain years—see below; however, the additional contributions cannot be made to a spousal RRSP.

If a direct transfer is not made by your employer to your RRSP or RPP, sadly, the employer paying the retiring allowance must report the amount paid on Form T4A Supplementary and must deduct tax at source. So 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; i.e., the deduction is limited to the amount on which tax is paid. So, in order to get a full deduction, it may be a good idea to "pass up" transferring some payments into an RRSP or pension plan for that year since 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, there is a corresponding inclusion in income.

Transfers to RRSPs or RPPs

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 thus 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 times 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. Note: 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.

Note: 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 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, Canada Revenue Agency has stated that the fair market 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 some extra tax liability.

However, Canada Revenue Agency 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, or 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, Canada Revenue Agency pronouncements and some court cases in the area have complicated the situation. In fact, when all of the Canada Revenue Agency technicals are put together, the result can be pretty confusing.

Round Table roulette

In a 1993 Round Table, Canada Revenue Agency 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. Because of this, Canada Revenue Agency'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 other provinces.)

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

Canada Revenue Agency's administrative position is 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 take the position that such damages are not retiring allowance, but may in fact be tax-free payments, think again. Canada Revenue Agency 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

The Canada Revenue Agency 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 expressed the view 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); and post-judgment interest gets the worst—it's fully taxable and can't even be rolled into an RRSP.

Case law

Besides Canada Revenue Agency pronouncements, there have been a couple of interesting court cases in the area which have held that not all damage payments received by a terminated employee fall within the definition of retiring allowance. A case in point is *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.

A number of other Canada Revenue Agency rulings have dealt with other typical scenarios: compensation for termination due to a work-related injury 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 qualify as a retiring allowance, but accumulated vacation pay does not.

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