How To Keep The CRA Away From Your Severance Payment

If you’ve been lucky enough to exit your job with a couple of extra bucks in your pocket from severance or other payments, the Canada Revenue Agency (CRA) stands ready to kick you when you’re down by taxing that extra cash when you need it most. Fortunately there are a few strategies you can use to fend off the taxman’s assault on your dwindling bank account.

Under the tax rules, any money you get from an employer (or ex-employer) as a so-called “retiring allowance” (that’s tax talk for severance or other types of payments made on leaving a job) will be taxable as income to you. However, the CRA does offer a tax break if the funds received as a retiring 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 more about this 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 that source deduction.

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 – that is, the deduction is limited to the amount on which tax is paid.

So in order to get a full deduction in this case, it may be a good idea to “pass up” transferring some payments into an RRSP or pension plan for that year because 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 before 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 before 1989, the maximum deferral available for 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 – that is, to $2,000 – for years when 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.