Is an Early Retirement Incentive a “Retiring Allowance”? - Quiz



The "retiring allowances" senior employees often receive from their employer upon leaving the company are taxable under federal income tax law. However, the term "retiring allowance" can be misleading. The problem is that the CRA interprets "retiring allowances" as including any kind of severance paid by employers to compensate employees for loss of their employment. Thus, a severance payment may count as a retiring allowance even if the terminated employee doesn't actually intend to retire. Consider the following scenario.

Situation

Cy O'Nara has worked at XYZ Ltd. for 32 years. But all good things come to an end. XYZ is now under enormous financial pressure to downsize and Cy's position is one that the company would like to eliminate. So, XYZ offers Cy an early retirement package that includes, among other things, a $50,000 "severance" lump sum payment. Cy is to receive the money the week after he stops reporting to work. In addition, although he can't keep accruing benefits under the XYZ pension plan, Cy can stay in the XYZ health and dental plan for 2 more years. Cy accepts the deal.

Question

Is the $50,000 "severance" payment Cy receives from XYZ subject to income tax deductions as a retiring allowance?

1. Yes becauseit's paid by XYZ to Cy as a result of the cessation of Cy's employment.
2. Yes because Cy only gets the money after he stops reporting to work.
3. No because Cy's continued participation in the XYZ health plan indicates that he hasn't really retired.
4. No because Cy voluntarily chose to accept the package and thus wasn't compelled to retire.

Answer

1. **The $50,000 would be considered a retiring allowance because Cy received the**

money due to his loss of employment.

Explanation

Under Section 56(1)(a)(ii) of the *Income Tax Act*, retiring allowances are generally included in an employee's taxable income in the year they're received. Sec. 248(1)("retiring allowance")(b) defines "retiring allowances" as amounts received "in respect of" the taxpayer's loss of an office or employment. Courts use a two-prong test to determine if payments are "in respect" of employment losses:

- The taxpayer wouldn't have gotten the money but for the loss of employment; and
- The purpose of the payment was to compensate the employee for the loss.

The $50,000 payment from XYZ to Cy would satisfy both parts of this test. So, A is the right answer.

Why Wrong Answers Are Wrong

B is wrong because it's the right conclusion for the wrong reason. Explanation: A payment can also be considered a retiring allowance if it's made by the employer to the employee in recognition of long service (Sec. 248(1)("retiring allowance")(a)). To be considered a retiring allowance under the (a) clause, such payments must be made on or after retirement. But a retiring allowance in respect of a loss of employment under the (b) clause doesn't have to be made on or after retirement. In this case, the $50,000 payment to Cy is an "in respect of" retiring allowance. So, the fact that Cy got the money after he stopped reporting to work isn't relevant.

C is wrong because CRA Interpretation Bulletin IT-337R4 clarifies that an employee can still be considered retired even if he keeps participating in his former company's health plan for a "restricted period of time." So, the money paid to Cy can still be a retiring allowance even though Cy is still participating in the XYZ health plan.

D is wrong because early retirement incentive payments are generally considered to be retiring allowances under the (b) clause. According to IT-337R4, loss of office or employment "usually refers" to the elimination of a job or position "for economic reasons." In addition, IT-337R4 states that retiring allowances may include payments for loss of employment that an employee elects under an early retirement incentive plan. XYZ's elimination of Cy's position was motivated by economic reasons; and the $50,000 payment it made to Cy was an early retirement incentive.