

# New Federal Rules for Recovering Overpayments



The federal government's \$1 billion Phoenix payroll system has been a monumental disaster resulting in overpayments to government employees. In addition to the sheer incompetence involved, the Phoenix fiasco has focused attention on the inequity of current CRA rules which place the onus squarely on the shoulders of the victims, i.e., the employees, by requiring them to repay the *gross* overpayment amounts and then recover the excess between the gross and net overpayment later as a tax refund after refiling their income tax return for the year.

## How Current Repayment Rules Hurt Employees

To get a sense of just how harsh the current rules are on employees, consider the following example:

### Example

Phil, a federal government employee, takes 6 months of what's supposed to be unpaid parental leave. But as a result of glitches in the new payroll system, his pay isn't stopped. The gross payroll amount processed during these 6 months is \$75,000, of which Phil receives a net \$50,000 after pension contributions and other source deductions. But his employer insists that Phil repay the full \$75,000. Phil is expected to recover the difference by refiling his income tax return resulting in a refund of any income tax, CPP or EI previously paid on the \$75,000.

## The Disconnect in Repayment Rules

What seems to be missing from the current repayment rules is clear thinking on proper source deduction treatment of overpayments. Payments made because of a clerical, system or administrative error, which would include any of these Phoenix overpayments, are not "salary"; nor are they income taxable or subject to source deductions of any type, including income tax, CPP or EI.

If an employer makes a payment to employees by mistake, and this was treated as salary or wages at the time, the employer must amend any related T4s and reduce the Box 14, 24 and 26 amounts concerned. This treatment has been acknowledged by the CRA for some time. (see 2012 RC4120 guide, page 27, "Clerical or administrative errors," first para.; and, 2018 RC4120 guide, page 30, right-hand

column).

This treatment stems from section 6(3) of the federal *Income Tax Act* which provides that payments received by an employee from an employer are income from employment. However, this treatment doesn't apply to payments that meet all 3 of the following tests:

1. The payment is not consideration for agreeing to employment, i.e., a signing bonus;
2. The payment is not remuneration for services performed; and
3. The payment is not consideration for agreeing to a non-compete clause in a separation agreement.

### **Overpayments Due to Payroll Errors**

Overpayments made to employees due to clerical, administrative or system error are none of these 3 things and hence not income from employment. Practical question: What should be done when overpayments have been processed in payroll? The answer depends on when they're detected.

If such errors are caught during the tax year, i.e., before the last remittance to the CRA for that tax year, the employer can simply reverse or void the payroll transactions concerned and reduce its next CRA remittance as required. However, if errors are caught after this last remittance, T4s must be prepared (or amended) to show:

- The net income remaining after removing any overpayments; and
- The actual income tax, CPP and EI employee source deductions made and remitted during the year.

Where these bullets apply, if the employee were to refund to the employer only the net received, the employer would be out of pocket until the difference was refunded by the CRA. Until now, there's been no provision for the CRA to refund such remittances after they've been made.

### **Proposed New Rules**

The federal government recently released draft amendments to income tax, CPP and EI legislation to address this situation. The effect of these changes is to allow employers to recover from the CRA any income tax, CPP or EI source deduction remittances related to overpayments. Result: Employees will only have to repay the net amount of any overpayments received.

The way it would work is that employees would file T1 returns excluding the gross amount of any overpayments, even if they haven't received amended T4s from the employer. The employer could then recover any income tax, CPP or EI source deduction remittances related to the overpayments from the CRA via tax re-filings.

#### **Example**

As a result of a payroll glitch, federal employee Marge receives \$15,000 in pay after she retired. The employer amends her T4 to reduce the Box 14 employment income by the overpayment amount. The initial T4 slip issued shows \$65,000 in taxable income; after amendment, Box 14 shows \$50,000. Marge uses this \$50,000 figure when completing her T1 return.

Even though the draft changes haven't yet been officially incorporated into the

federal budget or a piece of legislation tabled in Parliament, Finance Canada is permitting employers to apply them immediately. The CRA will ultimately make regulations to implement the new rules.

### **Caveat: New Rules Don't Apply to Overpayments Caused by Employment Status Changes**

The new rules above don't apply to all situations the 2018 RC4120 guide describes as "overpayments," including overpayments deemed employment income at the time of payment to which the employee ultimately wasn't entitled due to unforeseen changes in his/her employment status. Examples:

- Maternity leave top-up amounts paid to an employee who doesn't return to work from maternity leave as required under the terms of her collective agreement;
- Vacation leave credits advanced to an employee who quits working for you before earning the credits; and
- A signing bonus paid to an employee who ends up not working for the time agreed to in his employment contract.

Unlike the overpayments due to payroll errors, the overpayments in the above examples are employment income under the employment contract at the time they were made. In other words, these "overpayments" are the result not of payroll errors but changes in employment status that occur after the payment is made. By contrast, "overpayments" due to payroll errors are *never* deemed wages or salary—either at the time of payment or after.

**Alan McEwen** is a Vancouver Island-based HRIS/Payroll consultant and freelance writer with over 25 years' experience in all aspects of payroll. He can be reached at [armcewen@shaw.ca](mailto:armcewen@shaw.ca) or (250) 228-5280. If you like these articles, please sign up to my email list to be notified of future postings.