Payroll Treatment of Wages in Lieu of Notice

When a company fires an employee, it usually pays a price. Literally. More often than not, fired employees are in line for termination payments known as wages in lieu of notice. How do you treat wages in lieu of notice for payroll purposes? The answer depends on which province is the province of employment. More precisely, it depends on whether the payment is subject to federal or Québec law.

Here's a look at the tax and payroll treatment of wages in lieu of notice under both federal and Québec rules.

WHAT THE LAW REQUIRES

In the U.S., employment relationships are typically at-will. That means the employer can fire the employee at any time and for any reason, with or without notice. Canadian employers can also fire any employee they want at any time. But unless the employment is probationary, the termination is for "just cause," or another exception under employment standards laws applies, the employer must provide the employee notice of termination.

In lieu of notice, employers typically choose to provide fired employees wages for the weeks of notice to which they are entitled under the employment standards laws based on their years of continuous employment.

Calculating Termination Notice

The first thing you need to do when paying an employee wages in lieu of notice is figure out how many weeks of notice to provide. How?

Step 1: Look at Employee's Contract or Collective Agreement: Sometimes, termination notice is specified in the employee's written employment contract or collective agreement.

Step 2: Look to ESA Law: If the contract doesn't address termination notice or limits the employee to notice provided under employment standards laws, you need to do a little legal research to find out what your province/territory/federal law provides in way of termination notice. So called "statutory notice" is based on the employee's years of employments.

Example: In Ontario, employees fired after 6 to 7 years of continuous employment with the same employer are entitled to 6 weeks' notice. So, a 6-year employee earning $750 per week is entitled to 6 weeks' notice or $2,250 in lieu of notice.

Step 3: Account for Any Additional Notice: Wages in lieu of notice is just one form of termination payment. Under Ontario and federal, employers must also pay severance in some instances. (In addition, terminated employees are entitled to accrued vacation, statutory holiday pay, and other accrued earnings.)

Wages in Lieu of Notice vs. Retiring Allowances

There's one other kind of termination payment we need to bring up before we get into the nuts and bolts analysis: retiring allowances. Tax and payroll treatment of wages in lieu of notice generally differs from that of retiring allowances.

What this means, in turn, is that when cash payments are made to terminated employees, you must be able to determine which part of the payment is for wages in lieu of notice and which part, if any, is for a retiring allowance. Here are some general principles to keep in mind:

- Minimum notice required under employment standards laws is considered wages in lieu of notice;
- Amounts paid above this minimum (whether required by a contract or common law) are considered a retiring allowance; and
- Additional severance required under federal and Ontario ESA laws is considered a retiring allowance.

Example: An Ontario employee earns $1,000 per week. Under the ESA, he's entitled to 2 weeks' minimum notice and 2 weeks' severance. The employee is terminated without cause and given 10 weeks' notice. Of the $10,000 he receives from the employer, $2,000 would be wages in lieu of notice and the $8,000 balance would be a retiring allowance.

PAYROLL TREATMENT OF WAGES IN LIEU OF NOTICE : THE SCENARIO

Clara Septic earns $500 per week as a dental hygienist. The clinic she works for fires Clara without cause at the end of week 6 of the 2014 tax year. Clara doesn't belong to a union and she has no written employment contract. Assume that Clara is entitled only to the minimum ESA notice of 2 weeks. So the clinic pays her $1,000 wages in lieu of notice when it fires her. To keep things simple, we'll assume that Clara gets no severance or other retiring allowances from the clinic.

IF FEDERAL LAW APPLIED

*** Income Tax**

First of all, we know that the $1,000 that the clinic pays Clara is wages in lieu of notice. We also know that CRA has made it clear that it considers wages in lieu of notice to be employment income. Consequently, the $1,000 payment must be taxable along with Clara's other earnings from her employment with the clinic during the 2014 tax year.

Now we need to figure out how to deduct wages in lieu of notice for income tax purposes. Guide T4001(E) says that employers can use the bonus method to calculate deductions on wages in lieu of notice. However, in this situation, the bonus method would *not* apply because Clara hasn't hit the $5,000 earnings threshold. The reason she's below the threshold is that she was fired before she had earned $5,000 for the tax year; and the clinic wouldn't annualize her earnings because since she's been fired, she can't expect any further earnings from the position for the year. Consequently, the clinic must add the $1,000 payment of wages in lieu of notice to Clara's earnings for the year to date.

As long as you understand the rules, crunching the numbers is easy. Clara worked 6 weeks at $500 per week. So her base salary is $3,000. After adding in the $1,000 notice payment, her total earnings from the position for the year to date would be $4,000. Because $4,000 is below the $5,000 threshold, the clinic would deduct 15% from the $1,000 payment and list $150 in Box 22 and include the $1,000 in her regular salary in Box 14 of the T4.

* **CPP**

The $1,000 of wages in lieu of notice would also be subject to deductions for CPP employer contributions at the statutory rate of 4.95%. So the formula is paid earnings x contribution rate, up to the YTD maximum contribution: **$1,000 x .0495 = $49.50**

In this case, no basic exemption would apply regardless of how the clinic pays the wages in lieu of notice to Clara because these payments are not regular earnings attributable to the pay period in which they're paid.

* **EI**

The clinic must also make deductions from the $1,000 for EI premiums at 1.88%, the premium rate for the 2014 tax year. The formula is earned income x employee premium rate, up to the YTD maximum: **$1,000 x .0188 = $18.88**

IF QUÉBEC LAW APPLIED

In Québec the rules governing the treatment of wages in lieu of notice are different.

* **Income Tax**

Revenu Québec treats wages in lieu of notice as retiring allowances that are subject to source deductions (see RQ, Employer's Guide, Sec. 4.2.2.3). The clinic would list the full amount of the $1,000 payment in Box O of the RL-1 using Code RJ. The retiring allowance would be subject to the Québec lump sum tax rate of 15%, <u>plus</u> the provincial tax for single payments, which is 16% for single payments of $5,000 or less.

* **QPP**

Because wages in lieu of notice are considered retiring allowances rather than as employment income in Québec, they're not subject to QPP withholdings. So the clinic wouldn't have to deduct QPP contributions on the $1,000 payment it made to Clara.

* **QPIP**

Wages in lieu of notice are, however, subject to QPIP. <u>Explanation</u>: Wages in lieu of notice count as employment income under federal rules. And because QPIP is based on the federal definition, they're treated as employment income for purposes of QPIP deductions. The formula for calculating the QPIP deduction is employment income x the employee contribution rate (0.559% for 2014), up to the YTD maximum: **$1,000 x .0559 = $5.59**

* **CNT Contributions**

One final twist: The clinic must add the $1,000 payment in lieu of notice to

Clara’s total remuneration for purposes of calculating the 0.08% employer contribution to the *Commission des normes du travail* (CNT) that employers must submit by the end of February in the next tax year.

Conclusion

Getting payroll right is always important. But with notice payments, the stakes are even higher. Terminating an employee is often an emotional ordeal. It’s also a frequent source of litigation. So the last thing any employer wants when ending a relationship with an employee are payroll errors in the processing of notice payments. Following the analysis in this article should help you avoid making any.