[Tax & Payroll Treatment of Wages In Lieu of Notice]

Canadian companies often pay a hefty price to terminate employees without cause. That's because terminated employees are entitled to [termination payments under employment standards laws, including wages in lieu of notice]. The payroll and tax treatment rules for wages in lieu of notice vary depending on whether the payment is subject to federal or Québec law. Here's a briefing on what HR and payroll managers need to know to ensure accurate treatment and avoid costly mistakes.

Defining Our Termination Benefit Terms

First, we need to first clarify some key and frequently misunderstood termination payment terms.

Termination Payment: A generic term that doesn't come from a statute or regulation but is customarily used by the industry to describe wages in lieu of notice, retiring allowances and other money payments to a terminated employee.

Wages in Lieu of Notice: A payment of a single sum of money that employers must make under the employment standards laws when they terminate an employee without cause and notice.

Pay in Lieu of Notice: A less precise substitute term for "wages in lieu of notice" that you're better off not using. "Wages" is a more accurate designation because the money paid to the employee is in fact wages for each week of notice to which the employee is entitled.

Retiring Allowance: An amount a taxpayer receives for the loss of their employment of a taxpayer, whether or not received as, on account or in lieu of a payment, damages or other amounts the taxpayer wins against the employer in a lawsuit or civil proceeding.

Severance Pay (Official): Under the Ontario *Employment Standards Act* and *Canada Labour Code* governing federally regulated employment, severance pay is an official term that means payment of a sum required by law that an employer must make when it terminates an employee of stated seniority, respectively, 5 years or 12 consecutive months.

Severance Pay (Unofficial): An informal term used by people in the industry to describe a payment of money to a terminated employee. The industry term is broader than the legal definition because it covers not only the statutorily required payments in Ontario and federally, but voluntary payments that employers in any province agree to make to any employees they terminate. Some even lump wages in lieu of notice with severance pay. That's a mistake because severance pay is considered a retiring allowance subject to different tax and payroll treatment than wages in lieu of notice.

Separation Payments: A legal term from Sec. 36(9) of the federal *Employment Insurance Regulations* defined as "all earnings paid or payable by a claimant by reason of a layoff or separation from an employment." Separation payments, which under the regulatory definition would include both retiring allowances and wages in lieu of notice, are considered earnings that you must count when determining the number of weeks of EI a terminated employee is entitled to receive

The Employee's Right to Termination Notice

Having nailed down the terminology, you also need to have a grasp of the key laws governing payment of wages in lieu of notice. The first is the employee's right to termination notice. Unlike in the U.S. where employment is at will, employment in Canada can't be terminated without notice unless there's just cause for dismissal or other employment standards exceptions apply. Instead—or in lieu of—advance warning before termination takes effect, "notice" may take the form of wages for each week of notice the employee was entitled to receive. Thus, for example, an employee earning $1,000 per week who's entitled to 4 weeks' notice would get $4,000 in lieu of notice.

Calculating termination notice can be tricky and spur disputes that must be resolved in court, arbitration or an employment standards tribunal. The starting point is to look at the terms of the employee's employment contract or collective agreement. If there is no written agreement or the agreement doesn't specify how much notice is required upon termination, you must provide at least the minimum notice required under your province's employment standards law based on the employee's length of service.

In addition to "statutory notice," employees terminated without cause may be entitled to "reasonable notice" under common law, that is non-statutory law made by judges in ruling on actual employment disputes. Although it's not a precise measure, "reasonable notice" is generally more generous to employees than the employment standards minimum because it takes into account not only length of service but factors such as how faithfully the employee performed his duties, the reasonable expectations of the parties, the reason for termination, how the termination was handled and the employees' prospects of finding new employment.

Strategic Pointer: To avoid these extra costs, many employers insert clauses into the employment contract purporting to secure the employee's agreement to waive their rights to common law notice and accept only the minimum notice required by employment standards law in the event they're terminated without cause. Although this is legal, courts are generally reluctant to enforce termination notice limits and will seize upon any flaw or ambiguity in the language to invalidate the clause.

Employers might also have to make other payments under employment standards laws, such as accrued vacation and other benefits, as well as severance pay in 2 jurisdictions—Ontario and Federal. Also keep in mind that termination notice rules differ for group terminations and layoffs affecting a large number of employees.

Wages in Lieu of Notice vs. Retiring Allowances

There's one other significant kind of termination payment that may come into play when calculating wages in lieu of notice: retiring allowances. The [tax and payroll treatment of retiring allowances] generally differs from that of wages in lieu of notice. The challenge payroll managers face when making cash payments to terminated employees is to determine which part of the payment is for wages in lieu of notice and which part, if any, is for a retiring allowance. General principles to keep in mind:

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

Let's now delve into the payroll nuts and bolts of wages in lieu of notice using the following scenario.

Ginger Vitus earns $500 per week as a dental hygienist. The clinic she works for fires Ginger without cause at the end of week 6 of the 2026 tax year. Ginger doesn't belong to a union, and she has no written employment contract. She's not transferring any money into an RRSP. Assume that Ginger is entitled only to the minimum employment standards 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 Ginger gets no severance or other retiring allowances from the clinic.

If Federal Law Applied

Let's look at how payroll would deal with Ginger's situation if federal law applied.

Income Tax Deductions

The $1,000 that the clinic pays Ginger is wages in lieu of notice. The CRA has also made it clear that it considers wages in lieu of notice to be employment income (See, Employer's Guide T4001(E), and IT-365R2). Consequently, the $1,000 payment must be taxable along with Ginger's other earnings from her employment with the clinic during the 2025 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, the bonus method doesn't apply in this situation because Ginger hasn't hit the $5,000 earnings threshold. The reason she's below the threshold is that Ginger was fired before she had earned $5,000 for the tax year; and the clinic wouldn't annualize Ginger's earnings since she’s been fired, so 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 Ginger’s earnings for the year to date.

As long as you understand the rules, crunching the numbers is easy. Ginger worked 6 weeks at $500 per week. So, her base salary is $3,000. After adding in the $1,000 notice payment, Ginger’s 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 Deductions

The $1,000 of wages in lieu of notice would also be subject to deductions for CPP contributions at the 2025 statutory rate of 5.95%. So, the formula is paid earnings x contribution rate, up to the YTD maximum contribution:

$1,000 x .0595 = $59.50

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

EI Deductions

The clinic must also make deductions from the $1,000 for EI premiums at 1.64%, the premium rate for the 2025 tax year. The formula is earned income x employee premium rate, up to the YTD maximum:

$1,000 x .0164 = $16.40

If Québec Law Applied

In Québec, the rules governing the tax and payroll treatment of wages in lieu of notice are different.

Income Tax Deductions

Revenu Québec treats wages in lieu of notice as retiring allowances that are subject to source deductions (see RQ, Employer’s Guide). 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 provincial tax, which is 14% for single payments of $5,000 or less and 19% for single payments of $5,000 or more.

QPP Deductions

Because wages in lieu of notice are considered retiring allowances rather than 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 Ginger.

QPIP Deductions

Wages in lieu of notice are subject to QPIP. **Explanation:** 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 (0.494% for 2025), up to the YTD maximum:

$1,000 x .00494 = $4.94

CNESST Contributions

One final twist: The clinic must add the $1,000 payment in lieu of notice to Ginger's total remuneration for purposes of calculating the employer's contribution to the CNESST that employers must submit by the end of February in the next tax year.

Takeaway

While getting payroll right is always important, with termination 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 should help you avoid making any.