Wages In Lieu of Notice Rules: Québec v. the Rest of Canada



When a company fires an employee, it usually pays a price. Literally. Unless the termination is for "just cause," the employee may be in line for termination payments. Perhaps the most common form of termination payment is 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 both federal and Québec source deductions.

This article will explain the tax and payroll treatment of wages in lieu of notice under both federal and Québec rules. And because there are so many mistakes in the terminology professionals use when talking about this subject, there's also a "Termination Notice Dictionary" that defines the various kinds of termination payment and explains the differences between wages in lieu of notice and "retiring allowances."

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. Like their U.S. counterparts, Canadian employers can fire any employee they want at any time. And if the termination is for "just cause," such as for egregious misconduct, gross incompetence, disloyalty, etc., the employer doesn't have to provide notice. But, unlike in the U.S. where the employer can fire with or without cause, in Canada if a termination is not for just cause the employer generally must provide the employee notice.

The term "notice" is a little misleading. Employers don't actually have to give employees advance warning before termination takes effect. Instead of—or "in lieu of" notice, they may pay the employee wages for each week of notice he was entitled to receive. Thus, for example, an employee earning $750 per week who's entitled to 6 weeks' notice would get $2,250 in lieu of notice.

Calculating 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? Determining appropriate notice can be tricky; and it's often a contentious issue that ultimately has to be resolved by a court, arbitrator or labour board.

To calculate notice, start by looking at the terms of the 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. Statutory notice is usually based on the employee's length of service.

Keep in mind that the ESA is just the minimum and that the employee may be entitled to additional notice and/or other termination payments. For example, the employment standards laws of two jurisdictions, Ontario and federal, require employers to pay not just wages in lieu of notice but also severance in some instances.

Moreover, employers might have to provide additional notice under common law, that is, non-statutory law made by judges in ruling on actual employment disputes. Under common law, employees are entitled to "reasonable notice." Although it's not a precise measure, "reasonable notice" is generally more generous to employees than the ESA 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 and how the termination was handled.

***Insider* Says:** This analysis applies to terminations of *individual* employees; notice rules differ for group terminations and layoffs.

Wages in Lieu of Notice vs. Retiring Allowances

There's another kind of termination payment we need to bring up before we get into the nuts and bolts analysis: retiring allowances. Dealing with retiring allowances is a big challenge. But for the purposes of this article, what you need to understand is that the 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, payroll managers 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 the ESA is considered wages in lieu of notice;
- Amounts paid above the ESA 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: **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 2013 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 ESA notice and that two weeks is the required minimum notice for an employee in Ginger's position under the ESA of the province. 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.

QUÉBEC Source Deductions Do *Not* Apply

Let's look at how payroll would deal with Ginger's situation for CRA deductions where the province of employment is not Québec.

Income Tax

First of all, we know that the $1,000 that the clinic pays Ginger is wages in lieu of notice. We also know that the CRA has made it clear that it considers wages in lieu of notice to be employment income (See, Employer's Guide T4001(E); and IT-365R2, section 15). Consequently, the $1,000 payment must be taxable along with Ginger's other earnings from her employment with the clinic during the 2013 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. The bonus method essentially means adding the amount of the bonus to an employee's annualized income.

For example, an employee who earns $1,000 a week has an annualized income of $52,000 a year. Paid a $5,000 bonus, tax on the bonus is the difference between the annual tax on $57,000 and $52,000. However, there's an exception that applies to Ginger: her annual income from her former employer will not exceed $5,000. In this situation, the $1,000 wages in lieu of notice payment is taxed as if it were a lump sum payment, at a flat 15%

Ginger worked 6 weeks at $500 per week. So her base salary is $3,000. After adding 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

The $1,000 of wages in lieu of notice would also be subject to deductions for CPP 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 Ginger 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 2013 tax year. The formula is earned income x employee premium rate, up to the YTD maximum:

$1,000 x .0188 = $18.80

QUÈBEC Source Deductions *Do* Apply

In Québec, the income tax rules governing the treatment of wages in lieu of notice are different. Also, there are two separate requirements to deduct income tax: federal income tax on behalf of the CRA and Québec income tax on behalf of the MRQ. EI premiums also apply.

Income Tax

Revenu Québec treats wages in lieu of notice, where the notice period is not worked, 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 Québec provincial tax, using the rate for single payments, which is 16% for single payments of $5,000 or less. Remember that the $1,000 wages in lieu of notice is also subject to federal income tax withholding, at 10%, the lump sum rate when the province of employment is Québec.

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 Ginger.

EI and QPIP

Wages in lieu of notice are, however, subject to EI and 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 both EI and QPIP deductions. The formula for calculating the QPIP deduction is employment income x the employee contribution rate (0.559% for 2013), up to the YTD maximum:

$1,000 x .00559 = $5.59

For EI purposes, there is a separate rate when Québec is the province of employment, 1.41%:

$1,000 x .0141 = $14.10

CNT 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 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

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.