A SEVERANCE PACKAGE: OPTIONS TO REDUCE TAXATION

CI GLOBAL ASSET MANAGEMENT

How can you help clients requiring advice on a severance package? Here are some details on different types of severance and their tax implications.

HOW IS THE SEVERANCE OR SETTLEMENT PAID, STRUCTURED OR CHARACTERIZED?

The Income Tax Act provides that compensation received as a result of termination or loss of employment may be characterized as employment income, a retiring allowance, non-taxable damages or a combination of the three. The ramifications for payroll withholding tax and income tax are dependent on how the severance is characterized.

(A) EMPLOYMENT INCOME

Employment income includes salary, wages and other remuneration. If the severance is treated as employment income, it will be subject to the taxpayer's normal withholding rate based on his or her tax bracket and is also subject to deductions such as Employment Insurance premiums and Canada Pension Plan contributions.

When a former employee is provided salary continuation payments, the courts have held that the payments are employment income. Similarly, when an employee continues participation in an employer's pension plan, the court has held that the severance cannot be a retiring allowance respecting a "loss of employment".

(B) RETIRING ALLOWANCE

Retiring allowances are payments arising from or related to the loss of employment or the termination of an employment contract, including those paid as part of a settlement or an award of damages. The Income Tax Act sets out that a retiring allowance may include payments received by an employee either:

A. On or after retirement in recognition of the taxpayer's long service; or

B. In respect of a loss of employment on account of or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal.

Retirement allowance payments in recognition of long service must be made on or after retirement and not before. However, there is no similar condition for "loss of employment". In fact, the Canada Revenue Agency (CRA) has specifically stated it is possible for an employee to receive a payment in respect of a loss of employment so long as:

- The payment is in respect of the loss of employment;
- There is evidence the loss of office is not speculative or contingent; and
- The severing of the employment relationship, including the severing of all benefits will occur on a specific date within a reasonable time frame

From time to time the courts have been asked whether a payment qualifies as a retiring allowance and have developed a two-pronged test:

1. But for the loss of employment, would the amount have been received?
2. Is the purpose of the payment to compensate a loss of employment?

If the answer to the first question is "no" and to the second question is "yes", generally the payment is a retiring allowance. In the end, whether a payment is a retiring allowance depends on the facts of any situation. For instance, the courts have held that continuation in a health or dental plan does not in and of itself mean the employee did not receive a retiring allowance. However, continuation in a pension plan of a former employer indicates a continuing employment relationship and a retiring allowance is not possible.

The determination of whether a payment is a retiring allowance is often difficult; each case depends on its unique circumstances. However, here is some guidance:

If a payment can be classified as a "retiring allowance", the minimum amount required to be withheld ("the withholding tax") by the former employer is lower than it is for employment income. The withholding tax rates are:

Amount of Lump sum	Tax Rate	Quebec[1]
Up to and including $5,000	10%	**5%**
Over $5,000 and up to and	20%	**10%**
Over $15,000	30%	**15%**

[1]As residents of Quebec file separate tax returns for federal and Quebec purposes, the rates shown are the federal portion. Additional rates apply for the Quebec portion.

In effect, the Income Tax Act allows a brief tax deferral by applying a flat rate which in most cases will be less than the actual tax rate on ordinary income; note though, this withholding is simply a prepaid estimate of taxes owing on the payment and, subject to the following planning opportunities, the final tax liability would be determined when the taxpayer files their tax return for the yea

1. Transfer of eligible retiring allowance to an RPP or RRSP

The Income Tax Act permits an employee to make a tax-free transfer of a portion of a retiring allowance to a registered pension plan (RPP) or registered retirement savings plan (RRSP) where the employee is the annuitant. In effect this allows the employee to defer payment of some or all of the income tax to a later time. Transfers to an RPP are not common because it may have an adverse effect on the employee's pension adjustment or past-service pension adjustment.

The amount that can be transferred is limited to:

- $2,000 for each year or part year of service before 1996; and
- $1,500 for each year or part year of service before 1989 in which an employer was making contributions to a registered pension plan or deferred profit-sharing plan which had not vested in the employee

A few things to bear in mind:

- The employee can include years of service with a previous employer, if that service is recognized in determining the employee's pension benefits (i.e. the employee was registered in the same pension plan with both employers);
- Salary continuation payments are income and therefore cannot be transferred into an RPP or RRSP for the purpose of deferral;
- The deferral is only available if the employee makes the contribution in the year he or she receives it or within 60 days after that year.

2. Direct transfer to an RPP or RRSP based on available room

An employee may also direct that a retiring allowance be paid to his or her RRSP or to a spousal RRSP subject to the employee's RRSP deduction limit.

A few things to consider:

- Any excess retiring allowance for which the employee does not have available room will be subject to withholding tax (amounts transferred directly to an RRSP from an employer are not subject to withholding taxes at source)
- The transfer must be made in the year the employee receives the payment or within 60 days thereafter

3. Retiring allowance payments in installments

It is possible to structure a payment in installments provided the terms of any agreement to do so clearly designate the payments as a retiring allowance. If an employer deducts EI premiums, benefits or other deductions, the payment cannot be designated as a retirement allowance.

A few things to consider:

- The installment payments are taxable in the year actually received;
- Installment payments sometimes include an interest calculation. That interest is taxable as income as it does not form part of the retiring allowance
- A portion or all of an installment payment may be transferred into an RPP or RRSP (subject to the about limits)

(C) NON-TAXABLE DAMAGES

The Supreme Court of Canada has held that the tax treatment of a damage award or settlement relating to the loss of employment is considered the same as the tax treatment of whatever the payment was intended to replace. This means if a payment is meant to replace employment income it is taxed as income; but if it was an award for damages for some other cause, it is treated as damages and therefore not taxable.

Damages arising from personal injuries including mental anguish sustained before or after the loss of employment that are separate and unrelated to the loss of employment are not subject to tax as they are not income or a retiring allowance. However, damages for harassment and mental distress may be considered employment income if they can be traced to the dismissal.

Determinations as to when a payment will be considered related to the loss of employment as opposed to some other cause of damage are complex. Compounding this complexity is the new doctrine of awarding "moral damages" when the manner of dismissal caused mental distress. Although clearly such damages can be awarded, it is unclear what the tax ramifications will be from such a payment.

CONCLUSION

The tax ramifications of a severance package are complex. However, depending on the classification of the award, limited tax planning is possible.

Visit us at ci.com/en/tax-retirement-and-estate-planning.
For more information, speak to your CI sales team.

CI GLOBAL ASSET MANAGEMENT

Published July 1, 2021

21-06-375116_E (06/21)