

The Six Minute Program

Taxing Issues – “Tax-Friendly” in CCRA’s Ever- Changing World

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INTRODUCTION

A frequent issue which arises in respect of a wrongful dismissal practice, whether one is acting for the employee or for the employer, is how to address the tax implications on severance payments or settlements arising from or relating to a termination of employment.

From an employee counsel's perspective, the issue is generally how can you reduce or defer the employee's tax burden. From an employer counsel's perspective, it is what can an employer lawfully do, without exposing itself to the wrath of the Canada Customs and Revenue Agency ("CCRA"). Notwithstanding the employer's ability to require an employee to execute a tax indemnity in a Full and Final Release agreeing to indemnify the employer from any payments, penalties or costs which the employer may be required to remit in respect to any payments made to an employee, the employer's concern is a legitimate one, as it may not be able to reasonably rely upon the indemnity of a departing employee.

Whichever perspective is at issue, it is clear that the tax consequences will largely depend upon how the severance or settlement is paid or structured, and therefore the tax implications should be an important consideration for both parties.

I RETIRING ALLOWANCE

Generally, payments arising from or relating to a termination of an employment contract, verbal or written, whether pursuant to a settlement or an award of damages, will fall within the definition of "retiring allowance" as specified in the *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.) (the "Act"), and taxed at a lesser rate (the "Withholding Tax Rate"), than income from employment.

Specifically, section 248(1) of the Act provides that:

"retiring allowance" means an amount (other than a superannuation or pension benefit, an amount received as a consequence of the death of an employee or a benefit described in subparagraph 6(1)(a)(iv)) received

- (a) on or after retirement of a taxpayer from an office or employment in recognition of the taxpayer's long service, or
- (b) in respect of a loss of an office or employment of a taxpayer, whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal,

by the taxpayer or, after the taxpayer's death, by a dependent or relation of the taxpayer or by the legal representative of the taxpayer. (See also Interpretation Bulletin ("IT") – 337R4 Retiring Allowance, bearing in mind however that such bulletins do not have the force of law).

Section 56(1)(a)(ii) of the Act makes clear that a retiring allowance, "other than an amount received out of or under an employee benefit plan, a retiring compensation arrangement or a salary deferral arrangement", is to be included in computing the income of a taxpayer for a **taxation year** (emphasis added).

Pursuant to Regulation s.103(4) of the Act, when a retiring allowance is paid as a lump sum payment by an employer to an employee who is a Canadian resident, it is taxable at source at the Withholding Tax Rate, being a lesser rate than income from employment. This allows an employee to defer, but not avoid, income tax in the year he/she receives the retiring allowance.

The withholding tax requirements for all provinces, except Quebec, are as follows:

\$5,000.00 or less	10%
Over \$5,000.00 but equal to or less than \$15,000.00	20%
Over \$15,000.00	30%

In "recognition of the taxpayer's long service," as provided for in section 248(1)(a) has been interpreted to include a lump sum payment for unused sick leave credits paid out on retirement (*J. Camille Harel v. The Deputy Minister of Revenue of the Province of Quebec*) 77 DTC 5438.

Note that while an employee can receive a severance payment by way of ongoing continuing salary (for example, bi-weekly or weekly wages), the retirement or loss of office or employment shall not be deemed to have occurred until the continuing salary ceases. The tax treatment will therefore be different than if the severance payment is received as a lump sum or by instalments (See *Serafini v. Canada (M.N.R.)* [1989] T.C.J. No. 904). The salary continuation would be considered income from employment and taxable at the full rate.

The fact that an employee has ceased active work is not necessarily definitive of whether the employee has retired or suffered a "loss of an office or employment" in accordance with section 248(1)(b). Certain conduct may be seen by the Minister as inconsistent with the concept of "retirement", such as the employee's continued participation in the employer's pension plan, and thus the payment not qualify as a retiring allowance (*Serafini v. Canada (M.N.R.)*, supra).

While it seems that the CCRA considers payments made in lieu of earnings for a period of reasonable notice of termination (for example, a payment made in lieu of notice of termination made pursuant to Section 57 of the *Employment Standards Act, 2000*) to be income from employment and thereby distinguishable from a retiring allowance (IT – 365R2), it would appear to be arguable that such payments, if paid as a lump sum, do qualify as retiring allowances pursuant to section 248(1) (IT – 337R4).

In that regard, the Minister appears to have always taken the position that where a payment of damages arising from the loss of an office or employment included an amount in respect to the period of reasonable notice based upon length of service, the whole payment would be considered a retiring allowance.

Note that for a payment to be deductible to the employer as a retiring allowance, the CCRA requires it to be reasonable in the circumstances, having regard particularly to the "length of service involved, its relationship to the remuneration received for those years of service, and the value of pension and other retirement benefits to which the retiree is entitled in respect of that service" (IT – 337R4).

There are few additional effective means of reducing or deferring the tax consequences relating to retiring allowances. Those that do exist are subject to specific qualifying conditions.

(A) Transfer of Retiring Allowance to RSP or RRSP

Section 60(j.1) of the Act permits a taxpayer who has received a retiring allowance to defer payment of some or all of the income tax that would otherwise be payable on the amount received in computing the taxpayer's income for a taxation year by making a payment to a registered pension plan ("RPP") or to a registered retirement savings plan ("RRSP") **under which the taxpayer is the annuitant** (emphasis added).

The extent to which an employee may transfer a retiring allowance to a RPP or RRSP is limited by Section 60(j.1)(A)(B) to the total of the following:

- A. \$2,000.00 multiplied by the number of years, or partial years, before 1996 during which the employee or former employee in respect of whom the payment was made... was employed by the employer or person related to the employer, and
- B. \$1,500.00 multiplied by the number of years, or partial years, before 1989 in respect of which an employer, or a person related to the employer, was making contributions to a registered pension plan or deferred profit sharing plan which had not vested in the employee.

Note that for the purpose of the transfer calculation, the employee can include years of service with a previous employer, if service with that previous employer is recognized in determining the employee's pension benefits (eg. such as an employee who was registered in the same pension plan with both employers). As well, the Act does not stipulate that the employment must be continuous nor does it exclude part-time employment.

A TD2 form is no longer required for the employer to pay the retiring allowance into the RSP or RRSP without the withholding of tax.

The deferral is only applicable if the employee contributes the eligible amount of the retiring allowance to his/her RSP or RRSP in the year he/she receives it or within 60 days after the year in which the retiring allowance has been included in income.

The income tax is deferred until such time as the employee makes a withdrawal from his/her RSP or RRSP, at which time it is taxed at the applicable retiring allowance Withholding Tax Rate.

Amounts paid as continuing salary will not qualify as a retiring allowance pursuant to Section 248(1) of the Act and therefore cannot be transferred into an RSP or RRSP for the purpose of the deferral specified in Section 60(j.1).

(B) Instalment Retiring Allowance Payments

As stated above, a retiring allowance is included in calculating the taxpayer's income in the year it is received. However, there is still some limited room to structure a tax effective severance package within the concept of retiring allowance by staggering the payments over time.

The CCRA has stated that an employer can spread the payment of the total amount of the retiring allowance over an unrestricted period of years (IT – 337R4), and if the instalment option is chosen on or before the employment is terminated, the instalments are taxable in the year received.

However, if the employer treats the instalments as income from employment for the purpose of calculating employment insurance premiums and benefits, C.P.P. accruals or eligible pensionable service, retiring allowance treatment will not be permitted.

Note that some or all of each retiring allowance instalment may be transferred into an RPP or RRSP pursuant to section 60(j.1)

From an employer's perspective, there is a disadvantage for structuring a retiring allowance in this fashion in that pursuant to section 78(4) of the Act, the employer can only claim a deduction for that year for a retiring allowance paid within 180 days after the end of the taxation year.

(C) Constructive Receipt

Both employees and employers must be mindful of the concept of "construct receipt", whereby the CCRA will tax a taxpayer on retiring allowance amounts not actually received. This may occur in instances where a severance payment is, by agreement of the parties, subject to the employee's sole discretion as to the structuring of the manner of the payment.

In the case of *Crighton v. M.N.R.* (1991) 91 DTC 511, the employer made the employee a written severance offer of \$150,000.00 payable "in whatever form you choose which best suits your financial and tax requirements and is acceptable to the Corporation". The employee chose to have \$52,000.00 transferred into his RRSP as a retiring allowance and \$98,000.00 paid to an "employee benefit plan".

The CCRA argued that the employee should be taxed on the sum deposited in the employee benefit plan in the year of his termination as the payment was made at his sole discretion. The Court found however that the payment was not under the direction of the employee but rather was payable only upon the Corporation's acceptance of the employee's proposed manner of payment. Therefore, it was a contractual agreement and the employee was only required to declare those amounts that he actually received under the arrangement, which did not include the amount paid to the employee benefit plan.

(D) Qualifying Retroactive Lump Sum Payments

Note that the February 16, 1999 budget proposed changes to the taxation of retroactive lump sum payments received as, inter alia, retiring allowances.

These provisions were intended to counter the disadvantageous position of employees who received settlements or awards which constituted retiring allowances subsequent to the year of termination, when their income tax bracket is higher than it would have been in the year of termination.

To qualify, the lump sum must be:

1. received after 1994;
2. be at least \$3,000.00;
3. relate to the principal that is attributed to one or more years preceding the date of payment; and
4. constitute
 - (a) income from office or employment or income received because of termination of an office or employment, received under the terms of a Court judgment, arbitration award, or in settlement of a lawsuit...

An employee wishing to take advantage of such an adjustment must make a requisition in writing (section 2.43.02A, Tax Aspects of Litigation, ed. Bernie Aron, Thomson Carswell, 2003).

II RETIRING COMPENSATION ARRANGEMENTS

If a wrongful dismissal settlement involves the payment of funds by the employer to a third party for the benefit of the former employee, it may be treated as a retiring compensation arrangement ("RCA") pursuant to section 248(1) of the Act, which is given particular tax treatment, as described below.

Section 248(1) of the Act defines an RCA as:

"A plan or arrangement under which contributions (other than payments made to acquire an interest in a life insurance policy) are made by an employer or former employer of a taxpayer, or by a person with whom the employer or former employer does not deal at arm's length, to another person or partnership (in this definition and in Part XI.3 referred to as the "custodian") in connection with benefits that are to be or may be received or enjoyed by any person on, after or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the taxpayer or the loss of an office or employment of the taxpayer, ..."

Note that an RCA does not include, inter alia,

- a registered pension plan
- a disability or income maintenance insurance plan under a policy with an insurance corporation
- a deferred profit sharing plan
- an employees profit sharing plan
- a registered retiring savings plan
- an employee trust
- a group sickness or accident insurance plan

The employer is required to withhold from contributions to an RCA a special RCA Tax at a rate of 50% and remit it to the CCRA. Thus only 50% of the contributions are actually paid into the trust (s. 153(1)(p) and Reg. s.103(7)). Such contributions are deductible to the employer when made.

The trustee of an RCA must pay RCA Tax on certain income earned on the contributed funds which have not been paid out during the year, on a calendar year basis. In years where the trustee makes a distribution to the former employee beneficiary, RCA Tax is refunded to the plan at a rate of \$1.00 for every \$2.00 paid out (i.e. 50%).

Payments made by the trustee to the former employee from an RCA are subject to withholding tax in the year paid to the employee on the same basis as a regular retiring allowance, subject to the employee's ability to transfer such amount into an RPP or RRSP on a tax deferred basis.

Generally, the tax treatment of an RCA is designed to make it less attractive from a tax perspective to shelter funds in an employee benefit plan in which income could be earned on the gross amount of the payment.

Nonetheless, if an employee is not already in the highest tax bracket, an RCA can be used to ensure payment up front of the settlement by the employer, providing the employer with an immediate full deduction for the severance payment, while allowing income inclusions to the employee to be spread over several years and taxed, at least in part, at lower progressive rates. Also, such an arrangement provides an employee with greater security where the financial stability of an employer is in question. Further, an RCA can be used where the severance payments exceed the amount which can be transferred into an RRSP as a retiring allowance.

III DAMAGES FOR MENTAL ANGUISH

The compensation received by a taxpayer arising out of employment generally constitutes income from employment, a retiring allowance, non-taxable damages, or some combination thereof.

There has been some debate concerning whether damages for "mental anguish" (or humiliation, loss of self-respect, hurt feelings or the like), either as awarded by a Court or competent tribunal or as specified in a settlement agreement, is subject to income tax.

It would seem clear that **if such a payment arose as a result of a loss of employment**, it would be subject to tax as a retiring allowance (IT – 337R4).

Thus, in *John James Young v. M.N.R.* [1986] 86 D.T.C. 1567, dealing with the damages awarded to the taxpayer in a wrongful dismissal action, the Court held that damages for mental distress and exemplary damages were in respect of a loss of an office or employment, rather than damages in tort, and therefore that the Minister had properly taxed the awards as a retiring allowance.

It should be noted however that in that case, the parties proceeded on an Agreed Statement of Facts. The M.N.R. argued that the damages had been awarded as a result of the "method and manner of the loss of employment or the firing" by the employer. The Court stated that as the taxpayer had not presented any direct evidence or testimony to rebut the M.N.R.'s contention as to the origin of the awards, the M.N.R. did not act improperly in assessing them as a retiring allowance.

Where personal injury, such as harassment, discrimination or mental anguish has occurred before or after the loss of employment, **but is separate therefrom**, the compensation paid to an individual as a result can be viewed as unrelated to the loss of employment, and thus non-taxable.

That position has been confirmed by the Supreme Court of Canada in *Schwartz v. Canada* [1996] 96 DTC 6103. In that case, at issue was a payment of \$360,000.00, which the taxpayer received for "embarrassment, anxiety and inconvenience", after an accepted offer of employment was cancelled prior to the taxpayer commencing employment.

The Supreme Court of Canada stated that the amount was **not** a retiring allowance because it was not received in respect of a loss of employment, since the taxpayer had not commenced working for the employer.

The Court further confirmed that as there was no evidence to establish a specific allocation of the damages, they were not taxable as income under the employment contract and therefore, constituted non-taxable damages.

In the case of *Niles v. Canada (M.N.R.)* 91 DTC 806, a taxpayer had filed a Complaint with the Ontario Human Rights Commission alleging discrimination. The Complaint was later settled with the employee receiving a payment of \$5,000.00 from the employer.

The Court held that the Minister was correct in including the settlement in the taxpayer's hands as a retiring allowance as the Complaint had related to the taxpayer's loss of employment.

In *Jolivet v. Canada* [2000] T.C.J. No. 48 a taxpayer filed a grievance following the termination of her employment by an allegedly abusive employer. The union representative and the employer's lawyer decided to settle the case before it proceeded to a hearing. The agreed upon settlement amount was the sum of \$10,000.00. At the time of the termination, the employer had complied with statutory requirements for termination pay. The taxpayer signed a release as a condition of the settlement which provided that there was no admission of liability on the part of the employer. The Court concluded that, as a result of the release, there was no evidence that the settlement amount was received by the taxpayer as damages in compensation for a human rights violation and found the payment to be taxable as a retiring allowance.

Arguably, the *Niles* and the *Jolivet* cases are based on their particular facts as the CCRA has confirmed the position that general damages related to human rights violations can be considered unrelated to a loss of employment, even though the loss of employment is often a direct result of the human rights violation. Thus, when a loss of employment results from a human rights violation, whether a general damages award is made by a Human Rights tribunal or a Court or a payment is made pursuant to a settlement between the parties, a reasonable amount of such a payment can be excluded from income altogether. (IT – 337R4)

Thus in *Mendes-Roux v. Canada* [1997] T.C.J. No. 1287, the Tax Court of Canada was dealing with the tax treatment of a settlement for "special and general damages", together with interest and costs, made to an employee who had filed an Ontario Human Rights Complaint alleging discrimination upon being wrongfully terminated while on maternity leave. The Court held that such portion of the settlement which was attributable to loss of wages, overtime, earned vacation and earned sick leave were taxable as a retirement allowance, but that the portion attributable to damages for pain and suffering and costs were not a retiring allowance and not subject to taxation.

As seen in the above mentioned cases, whether or not the payment for harassment or injury is related to the loss of employment will be a question of fact, and must be clearly demonstrable. In making the determination, the amount of severance which a taxpayer would reasonably be entitled to will be taken into account. (IT – 337R4).

The determination of "reasonableness" will also have regard to the maximum allowable under the applicable human rights legislation and the particular facts. Any excess would be taxed as a retiring allowance.

A review of the caselaw surrounding payments of mental anguish damages reveals that the Court rulings on whether these types of damages or settlement payments will be seen as retiring allowances are extremely unpredictable. In that respect, both parties are undertaking some risk if designating such a payment or award as being unconnected to the loss of employment and thereby non-taxable. In order to reduce the risk, as a prerequisite, the parties should clearly designate the origin of the award or payment; it should be based upon a written assertion of a human rights violation or a tortious injury independent from the loss of employment; and better still, arise by virtue of an active proceeding, be it a human rights complaint or a civil action, which sets out the proper and reasonable basis for such a claim.

IV PREJUDGMENT INTEREST

Prior to January 1, 2004, prejudgment interest payments made pursuant to a Court Order or settlement for wrongful dismissal were not considered to be taxable in the hands of the terminated employee.

However, as discussed in *Tech Interp* (external) 2004 – 0060321E5 – Pre-judgment Interest, issued on February 13, 2004, such payments made in accordance with Court Orders or settlements finalized on or after January 1, 2004 will be taxable as income pursuant to Section 12(1)(c) of the Act.

While Technical Interpretation letters have less authority than Interpretation Bulletins and are not binding upon the CCRA, the taxpayer, or a Court, they provide an indication as to how CCRA and its auditors will deal with the issue.

V EXPENSES

The CCRA has held that damages or settlements in lieu of expenses relating to the loss of an employment or office, including such things as relocation counselling and job search expenses, are part of a retiring allowance and therefore subject to the applicable retiring allowance Withholding Tax Rates.

However, where it is found that those expenses are unconnected to the loss of employment but rather relate to discrimination or harassment, they will be tax exempt.

In *Fournier v. Canada* [1999] T.C.J. No. 495, the taxpayer had claimed a settlement received from her employer after she had filed a Human Rights Complaint alleging sexual and physical harassment, to be exempt from taxation. The settlement represented reimbursement to the taxpayer for retraining and re-education costs as well as tuition, career training and counselling, child care and the purchase of employment related equipment to obtain re-employment.

The Court held that such payments were not received in respect of a loss of employment, but rather by reason of the harassment by the employer's employees, and were not taxable.

VI LEGAL FEES

Section 60(0.1) permits a taxpayer to deduct legal expenses paid to collect or establish a right to a pension benefit or retiring allowance.

The amount of the eligible legal fees that may be deducted under paragraph 60(0.1) is limited to:

- a. the amount of any retiring allowance or pension benefit related to those legal fees which is received and included in the taxpayer's income for the year or a previous year,

plus

- b. any reimbursement of legal expenses included in the taxpayer's income under paragraph 56(1)(l.1) for the year or a preceding year,

minus

- c. transfers to a RPP or RRSP deducted pursuant to Sections 60(j), (j.01), (j.1) or (j.2); this reduction is only required to be made to the extent that the amounts so transferred are amounts for which legal expenses eligible for deduction under paragraph 60(0.1) were incurred.

Any otherwise eligible legal fees which are not deductible because they exceed the above may be carried forward and may be deducted in any of up to seven subsequent years, to the extent that further related income arises and to the extent that the amounts in question were not previously deductible (IT – 99R5).

To the extent that the legal expenses of an employee are paid or reimbursed by the employer, and to the extent that the amount so paid does not exceed a reasonable amount, it will normally be deductible to the employer as a business expense (IT – 99R5).

Legal fees, if paid directly to legal counsel, are not subject to withholding and are not recorded on the T4A as a retiring allowance.

CONCLUSION

As discussed, whether amounts received by an employee upon termination will be subject to tax, and the level of taxation, will depend upon the characterization of the payment. In most instances, such payments shall be characterized as a retiring allowance and subject to tax at the Withholding Tax Rate. There are however, a few methods still available to defer the tax consequences which parties should consider prior to agreeing on the structure and manner of payment.