

## Retiring Allowances and Taxation: Practical Matters for Employers and Employees

By Stéphanie Séguin



We are living in times of great upheaval in the business world. Decreased profits, labour disputes and voluntary or forced retirements are more and more common, giving rise to a wave of business re-engineering affecting the labour force and bringing with it the all too familiar statistics on layoffs and job losses. In today's environment, the lump sum known as a "retiring allowance" which is often paid by employers in such circumstances has become commonplace.

### Definition of Retiring Allowance

Within the meaning of subsection 248(1) of the *Income Tax Act* (Canada) (the "Act") and section 1 of the *Taxation Act* (Québec) (the "Provincial Act"), a retiring allowance is an amount received by a taxpayer or, after the taxpayer's death, by a dependant or a relation of the taxpayer or by the legal representative of the taxpayer, under the following circumstances:

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

A retiring allowance could include payment of a sum for unused sick leave accrued at the time of the employee's resignation or retirement, or, in certain circumstances, an amount paid as damages.

Conversely, a retiring allowance does not include, among other things, a superannuation or pension benefit or an amount received as a consequence of the death of an employee. In addition, retirement

or loss of an office does not include situations in which an employee is transferred from one office or position to another with the same employer or those in which there is termination of employment with an employer followed by re-employment with the same employer or employment with an affiliate of the employer pursuant to an arrangement.<sup>1</sup> The following amounts are also not considered retiring allowances: salaries, accrued vacation pay and payments in lieu of notice of termination.

### The General Rule

Generally, pursuant to subparagraph 56(1)(a)(ii) of the Act and section 311 of the Provincial Act, a person who receives an amount as a retiring allowance must include it in computing his income as soon as the amount is received. An employer will generally be able to deduct the retiring allowance in computing its income if the outlay is reasonable and is made for the purpose of earning income.

An employer that pays a retiring allowance must declare the amount thereof on the T4A Supplementary form (at the federal level) and in Box O of Relevé 1 or Box G of Relevé 16 (at the provincial level).



<sup>1</sup> Interpretation Bulletin IT-337R3, "Retiring Allowances", January 30, 1998, paragraph 3.

## Withholding Tax

In general, when an employer pays a retiring allowance to an employee residing in Canada, the employer must withhold federal and provincial taxes on the entire amount paid as a retiring allowance.

The opposite table sets forth the withholding tax rates applicable to retiring allowances after the Quebec budget of March 29, 2001.

It should be noted that an employer is not required to withhold taxes on the portion of a retiring allowance which is transferred directly into a registered retirement savings plan ("RRSP") or a registered pension plan ("RPP").

Amount of retiring allowance	Federal withholding tax	Provincial withholding tax	Total withholding taxes
\$0 to \$5,000	5%	payments made after 30/06/01 and before 01/01/02 17%	22%
		payments made after 31/12/01 16%	21%
\$5,001 to \$15,000	10%	payments made after 30/06/01 and before 01/01/02 20.75%	30.75%
		payments made after 31/12/01 20%	30%
\$15,001 and over	15%	payments made after 30/06/01 and before 01/01/02 20.75%	35.75%
		payments made after 31/12/01 20%	35%

## Contributions

When an employer makes a payment of any kind whatsoever to an employee, certain employee and employer contributions payable under social security plans may apply.

The opposite table sets forth the cases in which neither the employer nor the employee will be required to make or pay any contribution with respect to a retiring allowance.

	CONTRIBUTIONS	OBLIGATION OF THE EMPLOYER AND THE EMPLOYEE TO CONTRIBUTE
FEDERAL	Employment Insurance	None
	Canada Pension Plan	None
PROVINCIAL	Quebec Pension Plan (QPP)	None
	Health Services Fund	None
	Financing of the Commission des normes du travail (CNT)	None
	Fonds national de formation de la main-d'oeuvre	None



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## RRSPs and Retiring Allowances

As mentioned hereinabove, an employee who receives a retiring allowance must include the amount thereof in computing his income for tax purposes. Nonetheless, paragraph 60 (j.1) of the Act and paragraph 339 (d.1) of the Provincial Act allow an employee who has received a retiring allowance to defer all or part of the taxes payable on the said amount by making a contribution to an RRSP or an RPP. However, no transfer may be made into a registered retirement income fund (RRIF) or, of particular significance, into the RRSP of the employee's spouse. In order for the transfer of the retiring allowance into the employee's RRSP or RPP to be effected validly, the employer must file an application therefor with the employee's financial institution.

The portion of the retiring allowance which may be transferred into an RRSP or RPP is generally equal to the following:

THE LESSER OF (i) and (ii):

- (i) the amount of the retiring allowance;
  - (ii)  $2,000 \times$  the number of years before 1996 during which the employee was employed by the employer
- +
- $1,500 \times$  the number of years before 1989 during which the employee was employed by the employer and in respect of which employer contributions under either a pension plan or a deferred profit sharing plan of the employer had vested in the retiree at the time of the payment.

## Case Study

The following example clearly illustrates which portion of the retiring allowance is eligible to be transferred into an employee's RRSP.

Sylvain received a retiring allowance of \$10,000 after losing his job. He had worked for his employer from December 18, 1994 until January 22, 2001 and none of his employer's contributions had vested to his credit under an employee pension plan or profit sharing plan.

**AMOUNT WHICH MAY BE TRANSFERRED**  
the lesser of (i) and (ii):

(i) amount of the retiring allowance	\$10,000
(ii) $2,000 \times 2$ years of service before 1996 (1994 and 1995)	<b>\$4,000</b>
+	
$1,500 \times 0$ years of service before 1989	\$0

Thus, Sylvain would be able to transfer \$4,000 to his RRSP. The excess of the retiring allowance, namely \$6,000 ( $\$10,000 - \$4,000$ ), would be subject to a federal withholding tax of 10% and a provincial withholding tax of 20.75%. This amount would then be added to Sylvain's other income and would be subject to personal income tax when he prepares his income tax returns.

Assuming that Sylvain had worked for his employer from 1997 to 2001, no amount would be transferable in theory to his RRSP, because Sylvain would not have worked for his employer before 1996. However, the Act, the Provincial Act and the tax authorities would nevertheless allow Sylvain's employer to directly transfer the retiring allowance to Sylvain's RRSP, up to the maximum RRSP amount deductible from his income for that taxation year. Thus, if he had \$11,000 of unused RRSP deductions, the entire retiring allowance received, namely, \$10,000, could be transferred into his RRSP. To effect such a transfer, it would no longer be necessary for Sylvain to complete form TD2 or to send a letter to the tax authorities. However, it would be wise for Sylvain's employer to require him to provide a copy of the notice of assessment in which the maximum amount eligible under his RRSP is shown.

If Sylvain only had \$6,000 of unused RRSP deductions, only \$6,000 could be transferred to his RRSP. The remaining \$4,000 ( $\$10,000 - \$6,000$ ) would be subject to a 5% federal withholding tax and a 16% provincial withholding tax. It would then be added to Sylvain's other income and would be subject to personal income tax when he prepares his income tax returns.

## Damages

A retiring allowance may include an amount received as damages. Damages received, including damages for lost wages or employee benefits, are treated as taxable income for the employee. If a human rights tribunal awards an amount for moral damages (humiliation, hurt feelings, mental anguish, loss of self-esteem, etc.), this amount need not normally be included in the employee's income. Moreover, if the parties arrive at an amicable settlement with respect to a loss of employment involving a violation of human rights, a reasonable amount attributed to compensate for moral damages may be excluded from taxable income. It should be noted that the "reasonableness" of the amount allocated for moral damages depends on several factors, including the evidence presented as well as the maximum amount that can be awarded under applicable human rights legislation.

In conclusion, an employer should always clearly specify the nature of the payment in order to ensure that the tax withholdings and contributions are effected correctly.

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