

Case Closed? Not So fast:

Labour & Employment Group

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The taxation of awards & settlement amounts in wrongful dismissal actions

When an employee receives compensation at the end of an employment relationship, either under a settlement agreement or as a result of a court or tribunal award, don't assume it's time to archive the file. Since the tax man always comes a knockin', parties should also consider the tax consequences when negotiating the terms of a settlement agreement or complying with a settlement or award.

An award or settlement may be taxed up to three different ways, depending on how the amount is characterized:

1. Continuation of Employment

Any amount paid pursuant to the terms of the employment contract will be taxed as income from employment. Such amounts include salary, accrued vacation pay and any amount paid for wages in lieu of notice of termination. Therefore, employers should continue to withhold and remit the same amount as when the employee regularly reported to work.

2. Retiring Allowance

Normally, amounts paid as damages for wrongful dismissal, such as severance payments or bad faith damages, are fully taxable as income to the employee in the taxation year in which they are received and the employer is required to withhold and remit according to the guidelines discussed below. However, by characterizing an amount as a Retiring Allowance, former employees, with service prior to 1996, can defer the tax if eligible amounts are directly placed into an RPP or RRSP by the employer and the employer need not withhold or remit on the deferred amounts.

"Retiring allowance" is defined to mean an amount received "on or after the retirement of an employee in recognition of long service or in

respect of a loss of an office or employment." (CRA Interpretation Bulletin IT-337R4) Whether the amount is paid in a single lump sum or in installments does not affect its characterization as a retiring allowance. Also, a retiring allowance includes payments for unused sick-leave credits on termination but does not include payments for accumulated vacation leave not taken prior to retirement.

The Courts have identified two questions to determine whether an amount should be characterized as a retiring allowance:

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

An amount received will be considered a retiring allowance if the answer to the first question is "no" and the answer to the second question is "yes".

Whether an individual has retired is a question of fact. The fact that an employer does not require an employee to report to work is not, by itself, determinative of whether the individual has retired. The CRA will look for indications of a continuing employment relationship. For example, the continued accrual of pension benefits indicates a continuing employment relationship; as does the employer's inclusion of the amount when computing Employment Insurance premiums and benefits. However continued participation in a health plan is not necessarily indicative, given that some plans specifically extend coverage to former employees.

A retiring allowance is deductible to the employer as a business expense, so long as it is a reasonable amount. In determining reasonableness, regard will be given to the length of the employee's service, the remuneration received during those years of service, and the value of pension and other retirement benefits to which the employee is entitled.

A long-term employee who has received a retiring allowance can defer some or all of the income tax on the amount by making a payment to a registered pension plan (RPP) or a registered retirement savings plan (RRSP) under s. 60(j.1) of the *Income Tax Act*. Employees with pre-1996 calendar year employment can roll a retiring allowance into an RRSP tax-free. The amounts that can be sheltered in an RRSP are as follows:

- up to \$2,000 per year of pre-1996 calendar year of employment, plus
- an additional \$1,500 per year of pre-1989 year of employment for which no deferred profit-sharing plan or employer pension contributions has vested.

Tax will not be paid on these funds until they are withdrawn from the RRSP (or converted into an annuity or RRIF), which must be done by the end of the year that the employee reaches age 71. The transfer of a retiring allowance to an RRSP does not affect the employee's annual RRSP contribution limits.

Where the employee opts to take advantage of the deferral, the employer pays this amount directly into the RRSP, thus eliminating source withholding.

Note that the employer can also directly transfer a portion of a retiring allowance accumulated after 1996 to an employee's RPP or RRSP, if the employee provides a written statement indicating that the amount is within his or her deduction limit. The employer does not need a letter of authority from the CRA.

Where any portion of a retiring allowance is not rolled into an RRSP, the employer is required to withhold and remit to the CRA according to the following guidelines:

- 10% for payments up to \$5,000
- 20% (of the total paid) for payments over \$5,000 but not over \$15,000
- 30% (of the total paid) for payments over \$15,000

These amounts apply to all provinces except Quebec. Also, where the retiring allowance is paid to a former em-

ployee who is not a resident of Canada, the retiring allowance is subject to a 25% non-resident withholding tax.

The employee can also deduct legal expenses incurred in bringing a wrongful dismissal action from the amount that would otherwise be taxed as a retiring allowance but this deduction is not available for amounts that transferred into an RRSP. Where legal fees can be deducted, the employer need not withhold or remit on that amount.

If an employee receives a retiring allowance as a large lump sum, there is a potential that she will be bumped into a higher tax bracket. In 2000, the *Income Tax Act* was amended so that retiring allowances can be averaged and the employee can pay tax on the lump sum as if it had been received over a number of years. The employee must submit information to the CRA to learn whether she qualifies.

3. General damages

Damages unrelated to wrongful dismissal are not taxable. These amounts must be for stand-alone causes unrelated to the loss of employment such as damages received as compensation for a human rights violation or damages for personal injury such as defamation, harassment, psychological damage or payment for a non-competition agreement.

Whether a payment will be considered non-taxable turns on the available evidence. In several cases, the courts have found that an amount cannot be treated as non-taxable where the settlement agreement does not explicitly state that the amount is intended as compensation for a ground unrelated to the termination of employment. The CRA has commented that "it must be clearly demonstrated that the damages relate to events or actions separate from the loss of employment."

Courts have usually found that a portion of the final settlement is non-taxable where a human rights complaint or civil action has been commenced. However, where a matter settles before a complaint or action has been filed, the taxpayer often lacks the evidence necessary to prove what portion, if any, was intended as compensation for the stand-alone issue.

In *Forest v. R.*, 2007 FCA 362, the Federal Court of Appeal confirmed that as long as some objective evidence was

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available, an award or settlement should be taxed according to its characterization. In this case, the Court found that the severance package was a retiring allowance, while an additional amount paid for psychological damage was non-taxable. In exchange for the settlement terms, the employee had agreed to discontinue his action in the Superior Court for psychological harassment. The Court relied on the Supreme Court of Canada's reasoning in *Schwartz v. Canada*, [1996] 1 S.C.R. 254: once it has been established that a payment has a dual purpose (such as compensation for an independent tort and damages related to the loss of employment), the bar for determining apportionment must not be set too high.

Unfortunately, courts continue to struggle with apportionment of settlements. In the recent case of *Grant v. R.*, 2008 TCC 163, the Tax Court of Canada refused to apportion the payment where the employee claimed that a large portion of the settlement represented a compromise to a civil claim for negligent misrepresentation. The employee had not initiated a civil action at the time that the settlement was reached. The court applied the two-part test discussed above and concluded that any damages relating to negligent misrepresentation were also related to the loss of employment. The court commented at para. 14:

What is important to note in addressing the “but for” test is not whether or not the damages arise from a breach of employment contract or from the tort of negligent misrepresentation, but whether, for purposes of the definition of retiring allowance, the damages are an amount received “in respect of a loss of employment”. So, even if I accept that there might be some possibility of a separate cause of action, it remains the case that failure to advance within the company comes about as a result of a loss of employment, and the damages are integrally connected to that employment. They are certainly “in respect of” the loss of employment.

This reasoning suggests that before damages can be apportioned courts must engage in the difficult task of dissecting a set of facts in order to extricate separate and unrelated grounds of liability. In many circumstances the facts of each cause of action may be so intertwined as to be conceptually inseparable. The Tax Court's reasoning in *Grant* appears to be at odds with the binding decision of the Federal Court of Appeal in *Forest*. However, the employee in *Grant* did not file an appeal.

Given the conflicting case law in this area, and the highly fact-sensitive nature of the inquiry, employers may prefer to characterize the entire amount as a retiring allowance when negotiating settlements, and make the corresponding source deductions, so as to avoid difficulties with the CRA later. In addition, employers should ensure that a release signed by a former employee in exchange for settlement funds specifically provides that the employee will indemnify the employer for any claims with respect to the failure to deduct or to sufficiently deduct taxes from the settlement funds.

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