Severance Payments and Retiring Allowances

Employees leave their jobs for a number of reasons on both a voluntary and involuntary basis. An employee may have voluntarily retired prior to their expected retirement date, or may have been encouraged to retire early through the offer of certain other payments from their employer. Additionally, they may have been terminated by their employer due to the elimination of their position.

Whatever the reason, terminated employees are eligible to receive various types of payments from their employer. These payments vary according to the reason for the employee's termination. This article will briefly describe severance payments and how these payments can be sheltered from tax by way of a retiring allowance.

Severance Payments

At present, two jurisdictions require payment of severance pay; the province of Ontario and federally regulated employers. Generally, the amount is related to the employee's period of service with the employer. Employers often structure their severance payments to avoid wrongful dismissal suits from involuntarily terminated employees. Another reason is to provide an incentive for taking early retirement or reward an employee for long service upon regular retirement. Generally, the longer you have been with the company, the higher the severance.

Severance payments can be made in either a lump sum or as a series of payments depending upon the degree to which the employer is willing to be flexible. The decision depends on a couple of factors; flexibility and tax deferral. A series of payments is like receiving a salary and may provide access to other company benefits including pension benefits. However, a lump sum payment may be preferable to pay off debt or if there are concerns about the company's ability to meet the on-going payments.

Regardless of how they arise, severance payments are eligible for treatment as a retiring allowance payment for tax purposes. These payments may be eligible in part or in whole for transfer to an registered retirement savings plan (RRSP) in the amounts allowed under tax legislation.

Retiring Allowances

According to the Income Tax Act, retiring allowances are considered to be payments made in the event of loss of office or employment at or after termination of employment. Like ordinary employment income, if a retiring allowance is received as cash it is subject to withholding tax at time of payment. This tax may be deferred if the funds are transferred to an RRSP. You have up to 60 days after the end of the taxation year in which the payment was received to re-contribute the eligible portion to an RRSP.

CCRA views a retiring allowance as a special RRSP contribution, so it has no impact on a person's regular RRSP deduction limit (over and above normal contributions).

The maximum amount a person can roll into an RRSP as a retiring allowance is $2,000 per calendar year (full or partial years) of service prior to 1996, plus $1,500 per calendar year (full or partial year) of service prior to 1989 (providing no 'vested' pension plan contributions were made in the year and no credit was received for any company contributions to a pension plan).

For example: An employee who began working in March 1985, joined the company's pension plan in January of 1987 (all pension benefits have fully vested), was terminated in April 2001 and given a severance package which includes a $50,000 amount that qualifies for a retiring allowance. The maximum amount this individual can roll into an RRSP as a retiring allowance is determined as follows:

Number of calendar years employed prior to 1996: 11 x $2,000 = **$22,000**

Prior to 1989, the number of calendar years employed when not a member of a vested pension plan or DPSP: 2 x $1,500 = **$ 3,000**

Total: $25,000

In our example, only $25,000 can be rolled into an RRSP as a retiring allowance. The remaining $25,000 would have to be taken into income, just like salary or wages, and taxed accordingly.

The eligible portion of a retiring allowance can only be transferred to a personal RRSP and cannot be transferred to a spouses/spousal RRSP.

Alternative Minimum Tax (AMT)

In the past, individuals receiving large retiring allowances had to be careful not to trigger the alternative minimum tax. The 1998 federal budget eliminated the need to include retiring allowances when calculating AMT and this change is retroactive to 1994.

Conclusion

The loss of a job is difficult under any circumstances and the first item you may need to deal with is how to handle any immediate payments offered. A retiring allowance payment can present you with an opportunity to significantly increase the value of your RRSP.

Note: The above article is for information purposes only and should not be construed as offering tax advice. Individuals should consult with their personal tax advisors before taking any action based upon the information in this article.