

## taxation of employment law damages

### tax considerations - overview

Payments received by a former employee in the settlement of an employment law case may be characterized in many different ways for Canadian income tax purposes. Such payments may be characterized as, among other things, one or more of a “retiring allowance”, employment income, interest income, expense reimbursement or general damages. The characterization of the payments will determine the Canadian income tax implications to the former employee and the withholding and reporting obligations of the employer.

#### a. retiring allowances

While a “retiring allowance” is generally taxable income to the recipient and subject to source deductions, there may be an opportunity for recipients to, in whole or in part, avoid such deductions and defer the recognition of such income. A retiring allowance generally includes an amount received in respect of a loss of an office or employment. The classification is therefore readily available in most settlement situations. The Canada Revenue Agency has also expressed the view that an amount paid by an employer for a former employee to relinquish a potential right to reinstatement likely constitutes a retiring allowance.

If payments to a former employee are characterized as a retiring allowance, part of the payment may be “rolled over” by the employee into a Registered Retirement Savings Plan (RRSP) or a Registered Pension Plan (RPP), thereby deferring taxes. The amount that may be rolled over is \$2,000 for every year of employment prior to 1996 plus an additional \$1,500 per year of employment before 1989 (for purposes of the \$1,500 calculation, excluded are years in respect of which employer contributions to a pension plan or deferred profit sharing plan had vested in the employee at the time the retiring allowance is paid). The potential contribution room for pre-1996 service is in addition to the ordinarily available contribution room which is tied to earned income and prior contributions.

Employers are not required to deduct income tax on the amount of a retiring allowance transferred directly to the recipient's RPP. Employers are also not required to deduct income

tax on the amount of a retiring allowance transferred directly to the recipient's RRSP if the employer has reasonable grounds to believe the transfer is within the limits outlined above or that the recipient otherwise has unused contribution room. In all other cases, employers must deduct and remit taxes at source. However, no Canada Pension Plan or Employment Insurance premiums are required to be withheld from a retiring allowance. It is not uncommon for employers to require individuals to confirm in writing that they have sufficient contribution room available which corresponds to any agreed settlement payments.

Where a retiring allowance is paid directly to a Canadian resident as a lump sum, the combined federal/provincial income tax withholding rate is as follows:

places of establishment	aggregate lump sum payment made to employee in year		
	≤ \$5,000	>\$5,000 and ≤\$15,000	>\$15,000
<i>any province other than Quebec (or no establishment)</i>	10%	20%	30%
<i>Quebec</i>	21%	30%	35%

## b. employment income

Any settlement payment that is considered employment income is earned income for RRSP purposes and is subject to regular source deductions. Examples of amounts paid in the settlement of a wrongful dismissal that may be considered employment income and not retiring allowances include amounts paid in respect of salary, wages, accrued vacation pay, and payments in lieu of earnings for the period of a reasonable notice of termination by virtue of the explicit or implied terms of the employment.

## c. general damages and other non-taxable receipts

Some payments in an employment law matter may be characterized as “general damages” and may be non-taxable. These payments could include payments for intentional infliction of mental suffering, harassment and defamation not arising out of the termination of employment. The onus in these situations is on the taxpayer to demonstrate that the damages are unconnected to the loss of employment. As a practical matter, many employers will usually wish to avoid the suggestion of liability for the claims associated with these characterizations.

Damages awarded by human rights tribunals are also generally not subject to taxation. Settlements of human rights claims are also generally tax-free, as long as the amount of the payment is reasonable in the particular circumstances.

Amounts paid in respect of re-employment or retirement counselling are also not generally taxable to the former employee.

Employers who incorrectly characterize any of the foregoing payments as non-taxable may face penalties for failing to withhold at source.

#### d. interest

The Canada Revenue Agency's current position is that a receipt on account of pre-judgment or pre-settlement interest is generally taxable as interest income if it is in the nature of interest. However, this position does not apply to pre-judgment or pre-settlement interest related to awards for personal injury or death, wrongful dismissal, and retroactive worker's compensation payments. A receipt on account of post-judgment or post-settlement interest is also taxable as interest income. Interest income, while not subject to withholding tax, generally must be reported by the payer on a T5 form. In terms of valuation and allocation of amounts to interest, any pre-judgment interest included in the calculation of a settlement should be consistent with the rate or formula mandated by relevant provincial legislation.

#### e. reimbursement of legal fees

Up to seven year's worth of legal expenses incurred by a former employee in collecting or establishing a right to a retiring allowance may be deducted from the retirement allowance receipt. Amounts received by a former employee as a reimbursement of legal expenses paid to collect or establish a right to a retiring allowance are required to be included in income.

Former employees are allowed a deduction for legal expenses paid in collecting, or in establishing a right to, salary or wages owed by an employer. Amounts received by a former employee as a reimbursement of such expenses are required to be included in income.

Administratively, the Canada Revenue Agency has indicated that no withholdings are generally required on a reimbursement of the legal expenses discussed above, but that the amount is required to be reported by the employer on a T4A slip and information return (in the case of reimbursement of legal expenses related to a retiring allowance) and a T4 slip and information return (in the case of reimbursement of legal expenses related to employment income).

by George Waggott and Ryan Morris

For more information on this topic, please contact:

taxation	Ryan Morris	416.865.7180	<a href="mailto:ryan.morris@mcmillan.ca">ryan.morris@mcmillan.ca</a>
employment and labour law	George Waggott	416.307.4221	<a href="mailto:george.waggott@mcmillan.ca">george.waggott@mcmillan.ca</a>

For more information on our Employment and Labour Relations Group, please contact:

Toronto	George Waggott	416. 307.4221	<a href="mailto:george.waggott@mcmillan.ca">george.waggott@mcmillan.ca</a>
Vancouver	N. David McInnes	604. 691.7441	<a href="mailto:david.mcinnnes@mcmillan.ca">david.mcinnnes@mcmillan.ca</a>
Montréal	Charles Chevette	514.987.5003	<a href="mailto:charles.chevette@mcmillan.ca">charles.chevette@mcmillan.ca</a>
Ottawa	Martin J. Thompson	613.232.7171 Ext. 127	<a href="mailto:martin.thompson@mcmillan.ca">martin.thompson@mcmillan.ca</a>
Calgary	Mark A. Klassen	403.531.4727	<a href="mailto:mark.klassen@mcmillan.ca">mark.klassen@mcmillan.ca</a>

#### [a cautionary note](#)

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

© McMillan LLP 2012