Severance Packages – *better than a gold watch!*

As a "sign of the times", severance packages and early retirement options have once again come to the forefront for many taxpayers. Many companies are now offering, or will be offering in the near future, packages designed to reduce their workforce and by extension, their costs.

As I have mentioned many times before, income tax implications often come down to structuring. In the event you find yourself in this situation, here is a primer on what to expect and how to structure to your best overall tax advantage.

Retiring Allowances

The ITA defines a retiring allowance as an amount that is received in recognition of long service, or in respect of the loss of employment. This means that you do not necessarily need to actually retire and in fact a retiring allowance could be paid to an employee who is actually quite young.

Retiring allowances are further defined as not being an amount that is a superannuation or pension benefit or not an amount received upon death of an employee.

The ITA requires that the amount of a retiring allowance must be included in income in the year in which it is received. This can result in a rather large amount of income being included on your tax return in one year and requiring you to send ~46% *(depending on your Province)* to Canada Revenue Agency.

A portion of any retirement allowance may be classified as an "Eligible Retiring Allowance", which will qualify a portion of the payment to be eligible to rollover to your RRSP. This is based on calendar years, or part years, of service with the company. The eligible portion is $2,000 for each year of service prior to 1996 plus $1,500 for each year prior to 1989.

An employee receiving a retiring allowance this year, who began working for the company in 1970, would be able to transfer up to $84,000 directly to an RRSP. This is commonly referred to as a section 60(j) rollover. Many companies also offer payment for unused sick leave. These amounts are also classified as a retiring allowance, assuming that they are paid out.

Accrued Vacation Pay

Vacation Pay earned but not yet received may be part of the payment you receive. These amounts are classed as employment income and are not subject to the retiring allowances rules.

Continuing Health Care

If your severance includes continuing health care or insurance coverage, the premiums are taxed annually as income. A separate T4A slip will be forwarded to you for these amounts.

Other Payments

In addition to the items outlined, you may also receive payments in lieu of notice or salary. The ITA considers these amounts as employment income and they will be included on your T4 slip.

One item of note; the tax rules consider employer paid counseling as a non-taxable benefit, so this is one item you won't have to pay taxes on.

So is there a way around this tax bite? Let's go back to our example above where the employee began working in 1970 for the company. Let's further assume that our employee receives a salary of $96,000 per year and the employment is terminated June 30th.

Because our employee was very dedicated, the company has decided to pay him a severance allowance of $10,000 for each year he worked for them. This is in addition to the 50% of salary pension he will receive.

Add it all up, without the bells and whistles, and there is a total of $342,000 hitting the tax return this year resulting in the highest marginal tax rate. This big cheque has quickly become a lot closer to half a cheque.

Research your Options

In order to minimize the tax affects, here are some of the options available:

- Use ITA 60(j) and rollover $84K directly into the RRSP. This will result in deferring taxes until such time as it is actually removed from the registered plan.
- Assuming a non-working spouse, pension splitting of the $24K company pension will further reduce income taxes.

On the remaining $246K, things become a little more difficult and require some thought and planning prior to accepting the severance package.

- Can the remaining payment be spread out over two or three tax years?

- Is there past pension credits that can be bought back?
- Should tax sheltering investments; such as Canadian Exploration Expense flow-through shares be considered?

Deferring payment over two or three years may make sense if the company is willing to participate. Are they going to pay you interest on the deferred payments? Will the spreading out of payments result in lowering your effective tax rate? Will a deferral allow you to take advantage of tax credits that you may not currently be eligible for, such as the Old Age Exemption?

One thing to watch for on deferred payment. If, by deferring payment you continue to accrue company pension credits, CRA will consider you to be still employed, whether you actually show up for work or not. This would result in the Eligible Retiring Allowance becoming Employment Income and not eligible for RRSP rollover.

Purchasing past pension credits will affect the amount of pension you are going to receive and potentially affect past RRSP contributions. This needs to be investigated as over contributions to RRSPs carry a 12% "penalty" tax.

Flow through shares in Canadian Exploration companies have the effect of "converting" ordinary income into capital gains income which will result in reduced tax. Investigation and research in partnership with your financial planner will help to determine if this type of investment is right for you.

In the event that the departure from the company has been, let's say, "less than amicable", legal costs to collect or establish a right to severance allowances, including wrongful dismissal, are tax deductible, up to the amount of income received and reported on your tax return.

The "golden handshake" may be well earned, but investigation and research into how it is paid can result in keeping the maximum amount where it belongs, in your pocket!

Alan Rowell is a Tax Services Specialist and President of The Accounting Place. Alan can be reached at www.theaccountingplace.net