Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Retiring allowances

Leaving an employer can often be an emotional time. Whether you're leaving your employment voluntarily or involuntarily, you may be offered a retiring allowance. This article discusses the taxation of retiring allowances and the rules that may allow you to contribute your retiring allowance to your registered retirement savings plan (RRSP) without using RRSP contribution room.

Please contact us for more information about the topics discussed in this article.

What is a retiring allowance?

A retiring allowance is an amount the employer pays to an employee upon termination of employment. The amount of your retiring allowance is usually based on your length of service and position within the organization. It's common to hear the terms "retiring allowance" and "severance package" being used interchangeably but they are different. A retiring allowance is one component of a severance package which may also include other payments, benefits and incentives.

Payments that qualify as part of the retiring allowance include:

- Payments for unused sick leave credits on termination; and
- Amounts individuals receive when their office or employment is terminated, including amounts for damages (such as wrongful dismissal) when the employee does not return to work.

Payments that do not qualify as a retiring allowance include:

- Salary, wages, bonuses, overtime and reimbursement of legal fees;
- A superannuation or pension benefit;
- An amount an individual receives as a result of an employee's death (these payments may be treated as death benefits);
- A benefit derived from certain counselling services;
- Unused vacation;
- Pay in lieu of termination notice; and,
- Damages for violations or alleged violations of an employee's human rights awarded under human rights legislation that are not taxable.

Taxation of retiring allowances

A retiring allowance is taxable to you as income. In addition, your employer may need to charge withholding tax on the retiring allowance payment. When withholding tax is required, the withholding rate is as follows:

Retiring allowance amount	Province other than Quebec	Province of Quebec*
$0–$5,000	10%	20%
$5,001–$15,000	20%	25%
$15,001 and over	30%	30%

* For Quebec, the withholding tax comprises a provincial amount of 15% for all withdrawal amounts plus a federal amount that varies to equal the totals shown.

The withholding taxes charged on your retiring allowance payment is not your final tax liability. Your total taxable income will determine your total taxes payable. The withholding taxes act as a credit towards your total taxes payable. If the amount of withholding taxes you paid is greater than your tax liability, you will receive a tax refund.

The withholding taxes charged on your retiring allowance payment is not your final tax liability. Your total taxable income will determine your total taxes payable.

You may be able to defer the taxes payable on your retiring allowance by transferring or contributing the retiring allowance to an RRSP. A tax-deferred transfer may also be made to a registered pension plan (RPP). Such transfers are uncommon because of adverse implications with respect to the individual's pension adjustment or past service pension adjustment.

Eligible retiring allowance

You may be able to transfer the portion of your retiring allowance that qualifies as an "eligible" retiring allowance to your RRSP without using unused RRSP contribution room.

The eligible portion of your retiring allowance is calculated as the lesser of the two following amounts:

i) The actual amount you receive as a retiring allowance; and

ii) The sum of:

  a) $2,000 for each year or part of a year before 1996 where you worked for the employer; and

  b) $1,500 for each year or part of a year before 1989 of that employment in which none of your contributions to your pension plan or deferred profit sharing plan (DPSP) were vested in your name when the retiring allowance is being paid (generally, if you were not a member of a pension plan or DPSP for years before 1989, you may be eligible for this additional $1,500 per year).

An eligible retiring allowance may be paid to you, in whole or in part, directly or transferred to your RRSP. When it's transferred to your RRSP, your employer is not required to withhold tax on the payment. Your employer does not need confirmation of your RRSP deduction limit when they transfer the eligible part of a retiring allowance to your RRSP.

If the retiring allowance is instead paid to you directly, you can still contribute the eligible retiring allowance to your RRSP without contribution room, provided you make a contribution to your RRSP within 60 days from the end of the year you received it. However, since the employer may need to charge withholding tax if the payment is made to you directly, you may need to supplement the contribution with other sources of funds in order to contribute the gross amount to your RRSP (so that you can maximize the amount contributed without using unused RRSP contribution room).

To qualify for a contribution that does not use RRSP contribution room, you must contribute to an RRSP where you are the annuitant. You cannot make the contribution to a spousal RRSP.

Non-eligible retiring allowance

If you want to defer the taxes payable on the non-eligible portion of your retiring allowance, you can contribute the amount to your own RRSP or to a spousal RRSP, provided you have sufficient unused RRSP contribution room and the contribution is made within 60 days from the end of the year you received it. Your unused RRSP contribution room will be reduced by the amount of the contribution.

Your employer may be willing to contribute the gross amount of the retiring allowance (without charging withholding tax) directly to your RRSP or to a spousal RRSP based on your unused RRSP contribution room. Your employer may require reasonable proof that you have available RRSP contribution room. A copy of your Notice of Assessment for the previous year showing your RRSP deduction limit might be sufficient for this purpose or your employer may require you to complete the CRA form T1213 – *Request to Reduce Tax Deductions at Source* and have it certified by the Canada Revenue Agency (CRA). Even if you provide this proof, your employer may exercise its discretion not to make a direct transfer to your RRSP and therefore withhold taxes on the payment. You should contact your employer to determine what options are available to you.

If your employer withholds taxes and you make a contribution to your RRSP or to a spousal RRSP, your tax liability for the year may be less than the withholding taxes charged by your employer. If this is the case, you will receive a tax refund for any excess withholding.

Tax reporting

When your employer initially advises you of the amount of your retiring allowance, you may not be told what amount is eligible. However, your employer is required to determine the eligible and non-eligible retiring allowance amounts for reporting on your T4 slip. Your employer must issue this slip to you no later than the last day of February following the year the allowance is paid. Since the CRA will assess your return based on what's reported on the T4 slip, you should ensure the eligible and non-eligible amounts are correctly reported on the T4 slip.

You will need to report the retiring allowance (eligible and non-eligible) as income on your tax return.

You should receive an RRSP contribution receipt for any contributions of the retiring allowance you made to your RRSP or spousal RRSP. The RRSP contributions can be used as a deduction to offset the income reported from the retiring allowance.

If you're taking advantage of the tax rules that allow you to contribute an eligible retiring allowance to your RRSP without using RRSP contribution room, be sure to report it as a transfer on Schedule 7 on your personal income tax return in order to help ensure the contribution does not use your RRSP contribution room.

Financial planning considerations

You do not have to contribute the eligible retiring allowance to your RRSP as a transfer that doesn't use RRSP contribution room. There may be other uses for the funds or there may be other tax planning strategies to consider.

Other uses for the funds

You can request that all or part of the eligible retiring allowance be paid out in cash, subject to withholding tax, if you have an immediate need for the funds. For example, you may require the amounts to fund your expenses while you search for a new job or you may want to pay off debt. Also keep in mind that your final tax liability may be greater than the taxes withheld, so be sure to set aside some funds for your taxes.

Income splitting

A common tax planning strategy involves equalizing a couple's income. The ability to transfer 50% of qualifying income to your spouse under the pension income splitting rules may not be enough to achieve an equal split of retirement income between you and your spouse. A spousal RRSP allows you to split future income without the limitations imposed by the pension income splitting rules. If you have a large unused RRSP contribution limit that you may not otherwise be able to utilize and you'd like to take advantage of a spousal RRSP, you may want to transfer as much of your retiring allowance as your unused RRSP contribution limit will allow directly into a spousal RRSP, even if some of your retiring allowance is an eligible retiring allowance. The ability to have the future withdrawals from the spousal RRSP taxed in your spouse's hands may outweigh the benefit of transferring eligible retiring allowance to your RRSP without using RRSP contribution room.

Deferring the payment

For tax planning purposes, your employer may be willing to allow you to defer the receipt of your retiring allowance to a future tax year, which may be beneficial if a portion or all of the retiring allowance is non-eligible and you don't have unused RRSP contribution room, or you choose not to contribute the payment to your RRSP. The deferral will be beneficial if your total income is lower in the future tax year in which the payment is received. However, if the company you're leaving is in any financial difficulty or if there's any other reason to question whether payment will be received, it may be advisable to receive the whole payment now to avoid any risk of non-payment in the future.

Other considerations

- Contributing your eligible retiring allowance to your RRSP is not permitted if you're turning age 72 or over in the year you receive the retiring allowance, since you can no longer have an RRSP; if you have a younger spouse and have RRSP contribution room, you can make a spousal RRSP contribution;
- Your eligible retiring allowance must be contributed to your RRSP on or before 60 days after the end of the year that the retiring allowance was received. If it's not contributed to your RRSP before the deadline, the ability to make the contribution without using unused RRSP contribution room is lost;

You do not have to contribute the eligible retiring allowance to your RRSP as a transfer that doesn't use RRSP contribution room. There may be other uses for the funds or there may be other tax planning strategies to consider.

- It's important to note that amounts you receive as a retiring allowance (eligible or non-eligible) are not considered as earned income for the purpose of calculating your RRSP contribution limit for the following year;
- The retiring allowance you receive, whether contributed to an RRSP or not, may delay your ability to receive Employment Insurance (EI) benefits, if you qualify for them; and
- You cannot designate any portion of the eligible retiring allowance contribution that you claimed as an RRSP deduction as a home buyers' plan or lifelong learning plan repayment.

Consider your options and plan accordingly

Careful planning can help you maximize the use of your retiring allowance. Take into consideration your cash flow needs (immediate and long-term) and remember to maintain flexibility, as your circumstances may change. Your RBC advisor can assist you in determining your cash flow and other financial needs.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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