



Retiring allowances

While the Canadian population ages and many individuals take early retirement, a number of employees are receiving retiring allowances. Careful application of some tax-planning techniques could potentially minimize the tax consequences of receiving a retiring allowance.

What is a retiring allowance?

A retiring allowance is an amount received on or after the retirement of an employee in recognition of long service or as compensation for loss of employment. It is generally considered termination pay that is provided either voluntarily or involuntarily (as a requirement of law or as a result of a court settlement). A loss of employment usually refers to the elimination of a particular position; for example, the downsizing of a job or position for economic reasons. However, a loss of employment may also refer to the loss of income of an employee who is let go. Early retirement incentive plans are generally designed to reduce the number of positions and the payments made in respect of these “retirements” are generally considered to be retiring allowances.

Miscellaneous Payments Upon Termination

Payments for sick leave are normally considered to be employment income and are taxable in the year they are received. However, an amount received on or after retirement for unused sick leave credits qualifies as a retiring allowance.

Amounts received in lieu of notice or in respect of unused vacation are considered to be employment income and therefore do not qualify as a retiring allowance.

Transfer to a Registered Retirement Savings Plan (RRSP)

The advantage of having a payment classified as a retiring allowance is that it may be eligible to be transferred to the employee's RRSP without affecting the employee's RRSP deduction limit and without immediate taxation. In order for the employee's RRSP deduction limit not to be affected, the eligible amount of the retiring allowance must be transferred to an RRSP on which the employee is the annuitant. Therefore a spousal plan on which the employee's spouse or common-law partner is the annuitant would not qualify. The rules state that a taxpayer can transfer limited amounts received as a qualifying retiring allowance to an RRSP or Registered Pension Plan (RPP).

The non-eligible amount of the retiring allowance (the amount in excess of the eligible amount) can be transferred as a contribution to the employee's RRSP without withholding tax, provided the employer is satisfied that the employee will be able to use the full amount transferred as an RRSP deduction in the tax year of the transfer. The employee may also choose to contribute this amount to his or her spouse or common-law partner's spousal RRSP. The employee would initially include the retiring allowance in his or her income. He or she can then take an offsetting deduction for the amount transferred to his or her RRSP or RPP, thus avoiding immediate tax.

The maximum amount eligible to be contributed to an RRSP is equal to a combination of:

- \$2,000 per year of service with the employer before 1996 and
- An additional \$1,500 per year for years of service before 1989, for which employer pension plan or deferred profit sharing plan (DPSP) contributions, if any, have not yet vested

Note that the years of employment that qualify for the transfer must be before 1996. This is a result of the 1995 federal budget, which eliminated post-1995 employment years from the calculation of the amount eligible for transfer, as calculated above.





T4A slips

The employer is responsible for preparing a T4A slip to indicate the amounts eligible and ineligible for the RRSP transfer. The employee will then report the full amount of the retiring allowance from box 26 of the T4A as “other income” on his or her personal income tax return. Assuming the eligible portion is transferred directly to the employee’s RRSP, the employer is not required to withhold any tax at source. An RRSP contribution slip – sometimes referred to as a 60(j.1) receipt – would then be issued to the employee to claim an offsetting deduction on his or her return. Note that the employee should also complete Schedule 7 to designate the amount that is being transferred into the RRSP. If a portion of the non-eligible amount is contributed to the RRSP, an RRSP contribution receipt will be issued to the employee which would be used to offset the retiring allowance income.

Another option available is for the employer to pay the employee the retiring allowance directly, and have the recipient transfer the funds into an RRSP. The employer is required to withhold taxes and would report both the retiring allowance and the tax withheld on a T4A slip. The employee would show both the income as well as the amount of tax withheld on his or her personal income tax return, in addition to the offsetting deduction for the contribution to his or her RRSP. The designation of the transfer would also be reported by completing Schedule 7. This will allow the employee to get back some or all of the tax previously withheld on the retiring allowance by his or her employer. Note that the contribution into an RRSP must be made no later than 60 days after the year in which the retiring allowance was received (generally March 1).

Example One

Jeff began work at ABC Co. in 1983 and was laid off on April 3, 2003. ABC Co. did not have a pension plan or a DPSP for its employees. On leaving the company, Jeff received \$40,000 as termination pay, an additional \$2,500 for unused sick leave credits, and \$1,500 for unused vacation leave.

Termination pay	\$40,000
Unused sick leave credits	<u>2,500</u>
Total retiring allowance*	<u>\$42,500</u>
13 years of employment before 1996 @ \$2,000 per year =	26,000
6 years (1983-1988) before 1989 @ \$1,500 per year =	<u>9,000</u>
Total eligible for transfer to an RRSP	<u>\$35,000</u>

Therefore, \$35,000 can be transferred into an RRSP and the remaining \$7,500 of the retiring allowance (plus the unused vacation leave payment) will be subject to immediate taxation.

* Note: Unused vacation leave does not qualify as a retiring allowance.



Alternative Minimum Tax (AMT)

AMT is a separate way of calculating income to ensure that high income earners, who may use tax-preferred vehicles to greatly reduce or avoid taxes, still pay their share of taxes.

Since 1998, all RPP and RRSP contributions that are deducted in computing a taxpayer's ordinary income can also be deducted from the income subject to AMT. Prior to 1998, this was not the case.

Payment of retiring allowance in instalments

Often an employer may offer retiring employees the option of receiving the allowance either as a lump sum at the time of termination or in instalments over a number of years. This benefits the employer because the organization does not have to come up with the cash all at once. It also helps the employee because he or she can often split income over a number of years and take advantage of graduated tax rates in each year.

If an employee receives a retiring allowance in instalments, they are taxable in the year received. Some or all of each instalment may be transferred to an RRSP up to the maximum eligible amount, as discussed above.

Note that if the instalments received reflect an amount of interest income earned on the outstanding balance of a retiring allowance, the interest income is not considered to be a retiring allowance and therefore cannot be used to increase the amount eligible for transfer to an RRSP or RPP.

Example Two

Jessica is to receive a \$40,000 retiring allowance payable annually in \$10,000 instalments over the next four years. The maximum eligible to be transferred to Jessica's RRSP is \$20,000. She may therefore transfer up to \$10,000 in any of the four years as long as the total amount transferred does not exceed \$20,000 (the maximum eligible amount).

Death

A retiring allowance is generally included in computing the income of a taxpayer when it is received. If an individual dies before receiving all of the retiring allowance to which he or she was entitled, any subsequent payments of the retiring allowance made to a dependant or to the individual's estate will normally be included in the recipient's income as a retiring allowance.

An alternative is that the value of the retiring allowance to be received at the time of death may be included in the retired employee's income for the taxation year of death as a "right or thing." A "right or thing" is an amount owed to you at the time of death but not paid to you (i.e., to your estate) until after death. It may be beneficial to report "rights or things" on a separate tax return for the year of death, as outlined in example three.



If an employee retires and then dies before receiving a retiring allowance to which he or she was entitled, the amount received after death is not considered to be a death benefit. However, if the employee dies before becoming entitled to a retiring allowance, the amount will be considered a death benefit and therefore the first \$10,000 can be received tax-free.

For more information about the tax consequences of death, ask for our tax & estate info page on *Death and taxes*.

Example Three

Daniel was employed with a company for many years before retiring in December 1999. As part of his retirement package, he received a retiring allowance of \$40,000. He was to receive \$10,000 per year for four years. Unfortunately, Daniel passed away in March 2003, before receiving his final retiring allowance instalment. Daniel has other income that puts him in the highest marginal tax rate for 2003 on his terminal tax return.

Daniel's estate elects to include the final retiring allowance instalment on a "rights or things" return to take advantage of graduated tax rates and personal tax credits on each return. Daniel has no other "rights or things." If Daniel's estate does not elect to file a separate "rights or things" return, the retiring allowance would be taxable in full at the highest marginal rate along with his other income on his terminal return.

	Taxed on terminal return	Taxed on "rights or things" return
Retiring allowance	\$ 10,000	\$10,000
Federal tax (29% / 16%) ¹	\$2,900	\$1,600
Personal tax credit	NIL ²	(\$1,241)
Net federal tax	\$ 2,900	\$359
Provincial tax (assume 15% / 9%) ³	\$1,500	\$900
Personal tax credit	NIL ²	(\$750) ⁴
Net provincial tax	\$1,500	\$150
Total tax	\$4,400	\$509
Less: tax on "rights or things" return	(\$509)	
Tax savings	\$3,891	

By filing a "rights or things" return, Daniel's estate pays only \$509 in tax on the final \$10,000 instalment of the retiring allowance, resulting in a tax savings of \$3,891.

Non-resident recipients

An employer who pays a retiring allowance to a non-resident is normally required to withhold 25 per cent of the retiring allowance and to forward this amount to the Receiver General on behalf of the non-resident. However, the withholding tax may be waived if all of the following conditions are met:

- The amount is contributed directly to an RRSP or RPP where the non-resident is the annuitant
- The amount does not exceed the maximum eligible amount that would have qualified for the transfer (as discussed above)
- The amount would have been taxable had the employee been a resident in Canada

¹ 29 per cent and 16 per cent are the highest and lowest federal income tax rates respectively.

² Assumes that the personal tax credit has already been applied against taxes owing on other income reported on the terminal return.

³ 15 per cent and 9 per cent are the average highest and lowest provincial income tax rates respectively, ignoring surtaxes.

⁴ \$750 is the average value of the provincial personal tax credit.



This waiver can be obtained by completing Form NRTA1, *Authorization for Non-Resident Tax Exemption*. Note that, although rare, the 25 per cent rate of withholding may also be reduced by a provision of a tax treaty with Canada.

A non-resident may elect to pay tax on a retiring allowance at the normal Canadian marginal tax rates. This election (a Section 217 filing) may benefit a non-resident whose effective personal rate of tax, if he or she could file as a Canadian resident, is lower than the withholding rate Canada would otherwise apply.

Legal costs

If an employee must go to court or obtain legal representation to collect or establish a right to a retiring allowance, the employee can deduct any legal expenses paid. The amount of the deduction in a year, however, is limited to the amount of the retiring allowance received in the year and included in income, less any amount transferred to the employee's RRSP. Any legal expenses above what can be deducted in a year may be carried forward and deducted in the same way in any of the seven following taxation years, to the extent that the employee receives a further retiring allowance.

Conclusion

The recent increase in the number of retiring employees has resulted in a lot of interest in the tax-planning opportunities available to the recipients of retiring allowances. With adequate planning, opportunities exist to minimize and/or defer tax.

The information provided is general in nature and is provided with the understanding that it may not be relied upon as, nor considered to be, the rendering of tax, legal, accounting or professional advice. Readers should consult with their own accountants and/or lawyers for advice on the specific circumstances before taking any action.

Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus before investing. Copies are available from your advisor or from AIM Funds Management Inc.

† AIM, the chevron logo and all associated trademarks are trademarks of A I M Management Group Inc., used under licence.

* TRIMARK and all associated trademarks are trademarks of AIM Funds Management Inc.

Designed and paid for by AIM Trimark Investments. ©AIM Funds Management Inc., 2003. TBRETAE(02/03)

For more information about this topic, contact your advisor, call us at **1.800.874.6275** or visit our website at **www.aimtrimark.com**

AIM Trimark Investments is one of Canada's largest mutual fund companies with over \$33 billion** in assets under management. A subsidiary of U.K.-based AMVESCAP PLC, one of the world's largest independent investment managers, AIM Trimark employs more than 900 people in its Calgary, Montreal, Toronto and Vancouver offices.

AMVESCAP is dedicated to helping people worldwide build their financial security, offering a broad array of investment solutions and services to individuals and institutional investors in 150 countries. Its securities trade on the London, Frankfurt, New York, Paris and Toronto stock exchanges. AIM Trimark and its associated companies under the AMVESCAP umbrella draw on the talents and expertise of more than 550 investment professionals in more than 25 countries to manage over \$500 billion** in assets worldwide.

**As at December 31, 2002

5140 Yonge Street, Suite 900 Toronto, Ontario M2N 6X7

Tax & Estate InfoService

Telephone: 416.590.9855 or 1.800.874.6275

Facsimile: 416.590.9868 or 1.800.631.7008

inquiries@aimtrimark.com www.aimtrimark.com



AIM TRIMARK™