The Navigator

Early Retirement Part 1 – Retiring Allowance Planning

Early retirement is something you may strive for, if it is your decision and made voluntarily. Whether you are retiring early, starting a new job or taking time off, leaving an employer can often be an emotional time. In recent years, early retirement has become synonymous with termination, or involuntary retirement, due to corporate restructuring and downsizing.

Whether you are leaving your employment voluntarily or involuntarily, there are generally three main issues that need to be considered: 1) retiring allowance planning, 2) pension plan options and 3) company benefits. Deciding what to do with options presented involves many variables and can be quite confusing. And, once you make a decision, it is often irreversible.

To assist you with your decision making, a three-part series of articles will discuss the following:

Part 1: Retiring allowance planning;

Part 2: Pension plan options; and,

Part 3: Company benefits options.

This article (part 1 of the series) will discuss retiring allowance planning and the special tax rules provided in the Canadian Income Tax Act, (the Act) that may allow for a tax deferral through a rollover to your RRSP.

This article outlines several strategies, not all of which will apply to your particular financial circumstances The information is not intended to provide legal or tax 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 advisor before acting on any of the information in this article.

What is a Retiring Allowance?

Some retirees are eligible for a retiring allowance. A retiring allowance is an amount paid to an employee upon termination of employment or early retirement. The amount of your retiring allowance is usually based on your length of service and the level that you are at within the organization. It is common to hear the terms retiring allowance and severance package being used interchangeably but they are different. A retirement allowance is just one component of a severance package which may also include other payments, benefits and incentives.

The distinction is important because payments that meet the definition of retiring allowance may qualify for the special tax treatment the Act provides.

Payments that qualify as a retiring allowance include:

- payments for unused sick leave

RBC Wealth Management

credits on termination; and

- amounts individuals receive when their office or employment is terminated, even if the amount is for damages (such as wrongful dismissal) when the employee does not return to work.

Payments that do not qualify as a retiring allowance include:

- 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 to the extent these damages are not taxable.

Tax-Deferred Transfer to RRSP

Special tax rules contained in the Act allow the portion of the retiring allowance that qualifies as an eligible retiring allowance to be transferred to your RRSP on a tax-deferred basis without requiring RRSP contribution room. The portion that does not qualify, the non-eligible retiring allowance, can only be contributed to your RRSP up to your RRSP contribution room.

Eligible Retiring Allowance

The eligible portion of your retiring allowance is determined by your employer using the following formula, which is based on years of service as follows:

Eligible Retiring Allowance = the smaller of the two following amounts:

i) The actual amount you receive as a retirement allowance; or,

ii) The sum of:

   a) $2,000 per year of service up to and including 1995,

   plus

   b) $1,500 per year of service up to and including 1988 that your pension or deferred profit sharing plan (DPSP) contributions are not vested at termination (i.e. generally if you were not a member of a pension plan or DPSP for years before 1989 then you may be eligible for this additional $1,500 per year).

Note: any partial years of employment count as full years for the purpose of this calculation.

An eligible retiring allowance may be paid to you, in whole or in part, directly or transferred to your RRSP. When it is transferred directly to your RRSP, your employer is not required to withhold tax on the payment. However, if it is paid to you directly the amount paid will be net of withholding tax.

You can still benefit from the special rollover rules if the eligible retiring allowance is paid to you directly provided you make a contribution to your RRSP within 60 days from the end of the year you received it. However, since there was withholding tax on the amounts received, in order to contribute the gross amount to your RRSP (so that you can maximize the amount contributed without using RRSP contribution room) you will need to supplement the contribution with other sources of funds.

Note: to qualify under the special rules that allow the transfer without using RRSP contribution room, the eligible retiring allowance must be transferred to the RRSP of the individual receiving it (i.e. an RRSP where that individual is the annuitant). Eligible retiring allowances cannot be transferred to a spousal RRSP under the special rules.

Non-Eligible Retiring Allowance

Although the non-eligible retiring allowance does not qualify under the special rollover rules, you can still make an RRSP contribution to your own RRSP or to a spousal RRSP to shelter the payment from tax, provided you have sufficient RRSP contribution room and the contribution is made within 60 days from the end of the year you received it. Your RRSP contribution room will be reduced by the amount of the contribution.

Your employer may be willing to contribute the gross amount, in whole or in part, directly to your RRSP or to a spousal RRSP based on your RRSP contribution room. This can be done without withholding tax by means of a direct transfer. Your employer may require reasonable proof that you have available RRSP contribution room in order to forego withholding tax. A copy of your Notice of Assessment for the previous year showing your RRSP deduction limit might be sufficient for this purpose. Even if you provide this proof, your employer may exercise its discretion not to make a direct transfer to your RRSP.

If your employer withholds tax on payments made, you may wish to consider filing Form T1213 – *Request to Reduce Tax Deductions at Source for Year(s)*, with the Canada Revenue Agency (CRA) to ask for approval for no withholding. Once the application is approved by the CRA, you can provide your employer with the approval. This will allow your employer to make the payment without withholding tax. Filing form T1213 should be considered if you have sufficient time before the payment will be made since it could take several weeks to receive the approval.

If your employer withholds tax and you make a contribution to your RRSP or to a spousal RRSP, you will receive a refund of the withholding tax when your personal income tax return is assessed, or the amount will offset the tax owed on other income on your tax return, thus resulting in less taxes owed on your assessment.

Tax Reporting

When withholding tax is required, the tax rate is the same as it is for RRSP withdrawals made by Canadian residents and is shown in the table below.

RETIREMENT ALLOWANCE AMOUNT	PROVINCE OTHER THAN QUEBEC	PROVINCE OF QUEBEC*
$0 - $5,000	10%	21%
$5,001 - $15,000	20%	26%
$15,001 and over	30%	31%

* For Quebec the withholding tax is composed of a provincial amount of 16% for all withdrawal amounts plus a federal amount that varies to equal the totals shown.

When your employer initially advises you of the value of your retirement allowance, you may not be told what amount is an eligible retiring allowance. 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 allows the special tax treatment only for the eligible retiring allowance reported by your employer, you should ensure this amount was correctly reported on the T4 slip.

The retiring allowances (eligible and non-eligible) reported on your T4 slip are included on your personal tax return on line 130 as other income. However, an RRSP contribution receipt will be issued for any direct contributions to your RRSP or spousal RRSP by your employer or any RRSP contributions you make afterwards.

To use the special tax provision allowing the direct rollover of the eligible retiring allowance without using up RRSP contribution room, you must report the RRSP contribution for the eligible retiring allowance as a transfer on line 14 of schedule 7 of your personal income tax return.

Financial Planning Considerations

It is not necessary to transfer the eligible retiring allowance to your RRSP under the special tax rules. There may be other more important 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 there are other more important needs for the funds. For example, you may require the amounts to live on before finding a new job, to pay down debts or to fulfill other goals. Speak to your RBC advisor and your tax advisor for assistance in determining the best use of the funds. If you are unsure whether you will require the retiring allowance to support your current expenses, there still may be some value in making the rollover while you can and then withdrawing or deregistering the RRSP funds as necessary. This may allow you to take advantage of the tax-deferred growth of the funds.

Income Splitting

One of the goals in financial planning is for couples to try to equalize their total incomes to be the most tax-efficient. Sometimes being able to transfer 50% of your retirement income to your spouse under the pension income splitting rules may not be enough to achieve an equal split of total income. This is usually the case where one spouse has a larger amount of non-registered assets than the other. A spousal RRSP allows you to split future income without the limitations imposed by the retirement income splitting rules, but this strategy requires thinking ahead. If you have a large RRSP contribution limit that you may not otherwise be able to utilize and you would 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 split the future income and the resulting tax savings of this strategy may outweigh the benefit of transferring eligible retiring allowance to your RRSP without using RRSP contribution room. Speak to your tax advisor for assistance.

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

Delaying 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 you cannot roll all of the retiring allowance into an RRSP under the special tax rules or with RRSP contribution room and if your income is expected to be lower in the future. However, if the company you are leaving is in any financial difficulty, or its future viability is questionable, it may be advisable to receive the whole payment now to avoid any risk for non payment.

Other Important Facts on Retiring Allowances

- You may only be entitled to an eligible retiring allowance once you have been terminated or have retired. If you terminate your employment but are re-employed with the same company soon after, even as a consultant, the status of the payment as a retiring allowance may be jeopardized.
- Rolling over your eligible retiring allowance is not permitted if you are turning 72 or older in the year of receipt and are thus not permitted to have an RRSP.
- 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 is not rolled into your RRSP before the deadline, the ability to make this special contribution to your RRSP is lost forever.
- It is important to note that amounts you receive as a retiring allowance from a former employer are NOT considered as earned income for the purpose of calculating your next year's RRSP contribution limit. This applies to the whole amount of the retiring allowance whether or not it is actually rolled over to an RRSP.
- The retiring allowance you receive, whether transferred to an RRSP or not, may delay the receipt of Employment Insurance (EI) benefits, if you qualify for them.
- You cannot designate any portion of the amount of the retiring allowance that was rolled over, as a home buyers plan repayment.

NAV0141-EN (07/2014)