The Navigator

RBC WEALTH MANAGEMENT SERVICES

Rolling a Severance over to an RRSP

Eligible vs. Ineligible Retiring Allowance and Special Rollovers to RRSP

If you receive a severance payment it may be considered as a retiring allowance under Canadian income tax rules. This article explains the special tax rules for retiring allowances and ways to reduce the withholding taxes that may apply.

A retiring allowance is generally an amount paid to an employee upon termination of employment or early retirement. There are special Canadian tax rules that apply to the eligible portion of a retiring allowance. As a result, an employer is required to determine the "eligible retiring allowance" and "non-eligible retiring allowance".

Eligible retiring allowance

Special tax rules allow the transfer of an eligible retiring allowance to your own RRSP without affecting your regular RRSP contribution room. Your employer is not required to withhold tax on any portion of the eligible retiring allowance that is transferred directly to your RRSP. Therefore, you should consider advising your employer to make a direct transfer of the eligible retiring allowance to your RRSP. Any portion of the allowance received in cash will be subject to withholding tax between 10% - 30% (21% - 31% in Quebec).

Even if you receive the allowance in cash net of withholding tax, you can still benefit from the special rollover rules. You can make an RRSP contribution for the gross amount of the eligible retiring allowance, however, you must make this contribution to your own RRSP within 60 days from the end of the year you received your eligible retiring allowance; otherwise, this opportunity is lost forever.

How is the eligible retiring allowance calculated?

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:

The smaller of the two following amounts:

i) The actual amount you receive as a severance

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 contributions are not vested at termination (i.e. generally if you were not a member of a pension plan 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.

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 provided you have sufficient RRSP contribution room.

If your employer is willing, you can advise them to make a direct RRSP contribution based on your RRSP contribution room. A direct transfer avoids the requirement of your employer to deduct withholding tax. However, your RRSP contribution room will be reduced by the amount of the contribution.

Your employer may require reasonable proof that you have available RRSP contribution room in order to feel comfortable with not 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, it is at your employer's discretion on whether they are willing to make a direct transfer to your RRSP.

Even if you receive the non-eligible portion of your retiring allowance in cash you can still reduce your taxable income if you contribute the net amount to your RRSP provided you have sufficient RRSP contribution room and you make the RRSP contribution within 60 days from the end of the year you received the allowance.

If you have withholding tax deducted and you make an RRSP contribution, you will receive a refund of the withholding tax, or it will offset the tax owed on other income resulting in less taxed owed on your personal income tax return.

Tax reporting

When your employer initially advises you of the value of your severance payment, 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 and report them on a 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 Canada Revenue Agency (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 or 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 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 11 of schedule 7 of your personal income tax return.

Financial Planning Considerations

Even if a portion or all of the retiring allowance qualifies for the rollover, you do not have to roll it over to your RRSP. You can request that it be paid out in cash, subject to withholding tax, if you have other needs for it. You may wish to take the eligible portion in cash if you need it to live on before finding a new job, to pay down debts or to fulfil another goal. 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 deregistering the RRSP funds as necessary. This may allow you to take advantage of the tax-deferred growth of the funds.

Your employer may 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 and if your income is expected to be lower in the future.

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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. The essential point here is that you are not obligated to make use of the eligible retiring allowance if it is not advantageous to you.

Other Important Facts on Retiring Allowances

- Only once you have been terminated or have retired are you eligible for an eligible retiring allowance. If you terminate your employment but are re-employed with the same company soon after, even as a consultant, you could jeopardize the status of your retiring allowance.
- The eligible retiring allowance amount cannot go into a spousal RRSP.

› Rolling over your eligible retiring allowance is not permitted if you are turning 72 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.

› Pay in lieu of notice and vacation pay that your may receive are not considered as a retiring allowance.

› Any unused sick leave credit payment upon termination that you received may be considered a retiring allowance.

› 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.

› You cannot designate any portion of the amount of the retiring allowance that was rolled over, as a home buyers plan repayment.

› Please contact us for more information.