TAX ASPECTS OF WRONGFUL DISMISSAL AWARDS
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I. INTRODUCTION

The taxability of wrongful dismissal awards and settlements is dependent upon whether the amount, received by the dismissed employee is considered to be "income or a benefit from employment", and therefore taxable under subsection 5(1), of the Income Tax Act, or a "retiring allowance", taxable under paragraph 56(1)(a)(ii).

Because the characterization of the payment has different tax consequences to the dismissed employee, it is prudent to bear this in mind when effecting a settlement of, or preparing pleadings regarding, a wrongful dismissal claim.

In this paper, the author proposes to consider what constitutes a "retiring allowance" under the provisions of the Tax Act and why it is taxed differently than "income, or a benefit, from an office or employment"; what can be done to reduce the incidence of tax; what are the withholding requirements regarding payment of a retiring allowance; and the treatment of legal fees incurred in relation to a wrongful dismissal claim.²

II. HISTORICAL

Prior to 1978, no income tax was payable on damages received by a wrongfully dismissed employee.

The Federal Court of Appeal in The Queen v. Atkins ³ held that payments received as a result of an employer's breach or cancellation of the employment contract did not constitute income tax.

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1 Income Tax Act, RSC 1985, c. 1(Supp.), as subsequently amended (herein referred to as the "Act"). Unless otherwise expressly stated, all statutory references are to provisions of the Act.


3 76 DTC 6258.
from an office or employment under then section 5(1) of the Act. The court, in confirming
the Federal Court Trial Division decision,\(^4\) indicated:

Once it is conceded ... that the respondent was dismissed "without notice", monies
paid to him (pursuant to a subsequent agreement) "in lieu of notice of dismissal"
cannot be regarded as "salary", "wages" or "remuneration" or as a benefit
"received or enjoyed by him ... in respect of, in the course of, or by virtue of the
office or employment". Monies so prayed (i.e., "in lieu of notice of dismissal")
are paid in respect of the "breach" of the contract of employment and are not paid
as a benefit under the contract or in respect of the relationship that existed under
the contract before that relationship was wrongfully terminated. The situation is
not altered by the fact that such a payment is frequently referred to as so many
month's "salary" in lieu of notice. Damages for breach of contract do not become
"salary" because they are measured by reference to the salary that would have
been payable if the relationship had not been terminated or because they are
colloquially called "salary". The situation might well be different if an employee
was dismissed by a proper notice and paid "salary" for the period of the notice
even if the dismissed employee was not required to perform the normal duties of
his position during that period.\(^5\)

The foregoing observations were considered by the Supreme Court of Canada in *Schwartz v. The Queen*\(^6\) wherein the court commented that:

> The principle laid down in *Atkins* ... was therefore accepted as authoritative both
> by the courts and commentators ...?\(^7\)

In providing a concise and useful history of developments leading up to the current taxability
of retiring allowances, the court went on to note:

> P.W. Hogg and J.E. Magee, in their recent textbook *Principles of Canadian Income Tax
> Law* (1995), at pp. 164-65 address this historical reality in these words:

> Before 1978, if the departing employee sued the employer for wrongful
dismissal and recovered damages, then the damages would be received free of
tax. This was because an award of damages for breach of contract (or for a
tort or other cause of action) is not income for tax purposes. This was so,
even though the amount of the damages award for wrongful dismissal would
be computed by reference to exactly the same considerations (that is, the
amount of salary that would have been paid during a required period of notice)

\(^4\) 75 DTC 5263.

\(^5\) Supra footnote 3, at p. 6258.

\(^6\) 96 DTC 6103 (SCC).

\(^7\) Ibid., at p. 6108.
as would be applied to the computation of a consensual severance payment. Since court-awarded damages were free of tax, it was also held that an out-of-court settlement of a wrongful dismissal action also escape tax.\textsuperscript{8}

and conclude that:

... at the end of the 1970s, it had been settled and accepted by all, including the Minister of Revenue, that damages received by an employee, from his ex-employer, as a result of the latter's cancellation of the employment contract, did not constitute income from office or employment under s. 5(1) or a retiring allowance taxable under s. 56(1)(a)(ii) of the Act.\textsuperscript{9}

The Act was amended in 1979 to introduce the concept of taxability of a "termination payment", and further amended in 1983 to repeal the "termination payment" definition and amend the definition of a "retiring allowance" to read substantially as it does to-day. As a result, damage awards and settlements for wrongful dismissal became taxable under the Act.

III. RETIRING ALLOWANCE vs. INCOME FROM EMPLOYMENT

A. THE ACT

1. Retiring Allowance

A retiring allowance is defined in s. 248(1) as:

an amount (other than a superannuation or pension benefit, an amount received as a consequence of the death of an employee or a benefit described in subparagraph 6(1)(a)(iv)) received

(a) on or after retirement of a taxpayer from an office or employment in recognition of the taxpayer's long service; or

(b) in respect of a loss of an office or employment of a taxpayer, \textit{whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal},

by the taxpayer or, after the taxpayer's death, by a dependant or a relation of the taxpayer or by the legal representative of the taxpayer. (emphasis added)

\textsuperscript{9} Ibid., at p. 6109.
\textsuperscript{9} Ibid., at 6110.
Generally, an amount paid to compensate a wrongfully dismissed employee for the loss sustained as a result of the dismissal will constitute a retiring allowance within the meaning of s. 248(1). Whether paid to satisfy a judgment (or an award), or pursuant to a settlement agreement, the amount so paid is taxable under the provisions of paragraph 56(1)(a)(ii) which provides:

56.(1) Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year,

(a) any amount received by the taxpayer in the year as, on account or in lieu of payment of, or in satisfaction of,

(ii) a retiring allowance, other than an amount received out of or under an employee benefit plan, a retirement compensation arrangement or a salary deferral arrangement.

2. Income From Employment

Income and benefits from employment are included in income through the operation of section 3, and subsections 5(1) and 6(1), which provide in part:

3. The income of a taxpayer for a taxation year for the purposes of this Part is the taxpayer's income for the year determined by the following rules:

(a) determine the total of all amounts each of which is the taxpayer's income for the year ... from a source inside or outside Canada, ... including ... the taxpayer's income for the year from each office, employment ...

5(1) Subject to this Part, a taxpayer's income for a taxation year from an office or employment is the salary, wages and other remuneration, including gratuities, received by the taxpayer in the year.

6(1) There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment such of the following amounts as are applicable

(a) the value of ... benefits of any kind whatever received or enjoyed by the taxpayer in the year in respect of, in the course of, or by virtue of an office or employment ...
The distinction between a "retiring allowance" and "income from employment" has significance under the Act as:

(a) the tax payable on a retiring allowance may be deferred by the transfer of the eligible portion of a retiring allowance to a registered pension plan or a registered retirement savings plan under paragraph 60(j.1);

(b) pre-judgment interest on a retiring allowance is not taxable, whereas pre-judgment interest on employment income is taxable.

B. REVENUE CANADA ADMINISTRATIVE POLICIES

Revenue Canada's administrative policies regarding retiring allowances are primarily contained in Interpretation Bulletin IT-337R3.10

1. Income From Employment

Revenue Canada takes the position that the following amounts are to be considered as income from employment under either subsections 5(1) or 6(3) of the Act:

(a) a payment for accumulated vacation leave; 11

(b) a payment received upon or after retirement, or in respect of a loss of employment, pursuant to the terms of an employment contract with a former employer; 12

(c) salary, wages and payments in lieu of earnings for the period of reasonable notice of termination by virtue of the terms of the taxpayer's employment (explicit or implied). 13

11 Ibid., para. 5.
12 Ibid., para. 7.
13 Ibid., para. 7.
Revenue Canada also takes the position that retirement, or loss of an office or employment, does not include:

(a) transfer from one office or position to another with the same employer (or an affiliate) in a different capacity (including one with diminished responsibilities);

(b) termination of employment with an employer followed by re-employment with the employer (on a full or part-time basis) or employment with an affiliate of the employer, pursuant to an arrangement made prior to the termination of employment; or

(c) termination of employment where salary and benefits continue to accrue until a later date (in such a situation, Revenue Canada considers the retirement or loss of employment to take place only at the later date); 14

with the result that any amounts received by a taxpayer in respect of the forgoing would not, from Revenue Canada's perspective, constitute a "retiring allowance".

2. Payment in lieu of Reasonable Notice

Of particular interest is Revenue Canada's view that an amount paid in lieu of reasonable notice is income from employment rather than a retiring allowance. This seems to be contrary to the position of the Federal Court of Appeal expressed in Atkins 15 wherein the court held that damages calculated by reference to months of salary in lieu of notice did not constitute, nor was it to be considered, income from employment. While the Supreme Court of Canada in Jack Cewe Ltd. v. Jorgenson 16 expressed doubt as to the reasoning followed in Atkins 17, the Federal Court of Appeal affirmed its reasoning in The Queen v. Pollock. 18

14 Ibid., para. 3.
15 Supra footnote 3.
17 Ibid., obiter of Pigeon, l. at pp. 815-16 SCR, or p. 6234 DTC.
18 84 DTC 6370.
C. RETIRING ALLOWANCE or INCOME?

The significance of the distinction between a retiring allowance and income or "remuneration" for services rendered during employment was considered by the Federal Court - Trial Division in *The Queen v. Albino*19. While a resident of Canada, the taxpayer's employment was terminated on October 30, 1987. In June, 1998, the taxpayer received a lump-sum payment of $603,753.90 from his former employer's "Incentive Performance Plan". The taxpayer treated the payment as a "retiring allowance" subject only to a 25% withholding tax under paragraph 212(1)(a)20.

The Minister took the position that the lump-sum payment was "remuneration" for services rendered during employment under paragraph 6(3)(b)21 thereby subjecting the payment to tax at the applicable full marginal rate. The thrust of the Minister's argument was that the amount paid should be considered remuneration from employment as it reflected contributions which the employee made to the success of the employer during the term of employment. In the Minister's view, it did not matter that the plan required a term of service to be concluded before an employee became entitled to receive a payment under the plan. The court came to the conclusion that the amount received by the taxpayer was in respect of long service and could reasonably be considered to be a "retiring allowance" within the meaning of the Act22.

19 94 DTC 6071.
20 212(1) Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to him as, on account of, or in satisfaction of,
   (j.1) a payment of any allowance described in subparagraph 56(l)(a)(ii) ...
21 6(3) An amount received by one person from another
   (b) on account of or in lieu of payment of, or in satisfaction of, an obligation arising out of an agreement made by the payor with the payee immediately prior to, during or immediately after a period that the payee was an officer of, or in the employment of the payor,
   shall be deemed for the purposes of section 5 to be remuneration for the payee's services rendered as an officer or during the period of employment, unless it is established that, irrespective of when the agreement, if any, under which the amount was received was made or the form or legal effect thereof, it cannot reasonably be regarded as having been received
   (d) as remuneration or partial remuneration for services as an officer or under the contract of employment, ...
22 Supra footnote 19, at pp. 6074 and 6075.
The court also considered whether a "retiring allowance" could be considered to come within the more general term "remuneration" in paragraph 6(3)(b) and concluded, applying the rule *generalia specialibus non derogant*, that a "retiring allowance" would not be included in "remuneration" under paragraph 6(3)(b). The court also noted that this was consistent with then paragraph 7 of IT-337R2; which has been carried forward to paragraph 7 of IT-337R3 and provides in part as follows:

7. The payment of an amount *pursuant to a contractual obligation may, in some cases*, be treated as a retiring allowance. A payment received upon or after retirement or in respect of a loss of employment pursuant to the terms of an employment contract with a former employer is generally viewed as remuneration from the former office or employment. However, *in circumstances where the payment could also be regarded as being in recognition of long service or as compensation for loss of office ... it is considered to be a retiring allowance.* (emphasis added)

IV. INTEREST

A. PRE-JUDGMENT INTEREST

Whether an amount is considered a retiring allowance or as income from employment affects the taxability of pre-judgment interest received in respect of the payment. In 1991, Revenue Canada expressed the view that "a former employee who receives damages for wrongful dismissal is not required to include in income any pre-judgment interest awarded, and ... tax is not required to be withheld on pre-judgment interest paid".23

The Department's view was confirmed in 199824 when it indicated that pre-judgment or pre-settlement interest with respect to an award for damages for personal injury, death or

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23 Technical Interpretation Business and General Division, January 18, 1991, as reported in *Window on Canadian Tax*, CCH Canadian Limited at ¶1095. In Revenue Canada Access Letter No. 9203975, March 25, 1992, the department reiterated its position regarding pre-judgment interest in the following terms:
Pre-judgment interest awarded or agreed upon in respect of employment income is included in income as interest under paragraph 12(1)(c) of the Act in the same manner as any other amount recovered on an obligation that is in arrears. With respect to pre-judgment interest awarded or agreed upon in respect of personal injury or wrongful dismissal however, it is our position that such amounts need not be included in income. (emphasis added)

24 Technical Interpretation, Business and Publications Division, May 11, 1998, Revenue Canada File No. 9821465, as reported in *Window on Canadian Tax*, ¶5297.
wrongful dismissal, and WCB awards may be excluded from income, while pre-judgment interest on an award for salary is taxable. 25

B. POST-JUDGMENT INTEREST

Post-judgment interest on both retiring allowances and income from employment, from the date of settlement or judgment, is required to be included in income pursuant to paragraph 12(1)(c).26

V. EFFECT OF REINSTATEMENT

Where a dismissed employee receives a lump-sum payment together with reinstatement, it is likely that Revenue Canada will treat the payment as income from the taxpayer's employment, and not as a retiring allowance.

As noted earlier?, Revenue Canada is of the view that re-employment following termination of employment (or employment with an affiliate following termination) does not constitute retirement or loss of an office or employment, with the result that any amounts received in these circumstances should not be considered a retiring allowance.

Although the foregoing comments in IT-337R3 do not expressly relate to wrongful dismissals, they are consistent with earlier comments made by the Department to the effect that:

Where a taxpayer receives an amount in recognition of the common law entitlement for wrongful dismissal, the department's position is as follows:

1. In case of reinstatement of employment status on a retroactive basis, the amounts received in settlement of the foregone salary, wages or other benefits are to be treated as income from employment rather than a retiring allowance.

26 Supra footnote 24.
27 In IT-337R3, supra footnotes 10 and 14.
2. The position in I above is also applicable where reinstatement was awarded, but the taxpayer did not return to work for his or her former employer.

3. Where a taxpayer sued for wrongful dismissal and the court or a negotiated settlement has awarded an amount and no mention is made that the person is to be reinstated, the amount arrived at will probably be viewed as a retiring allowance as defined in subsection 248(1) of the *Income Tax Act*. 28

What of the situation where the negotiated settlement includes the continuation of certain health or other benefits a period of time following the termination? Will that taint the settlement amount received?

It may not. Revenue Canada has indicated:

Continued participation in a former employer's health plan (for example providing medical, dental and long-term disability coverage) for a restricted period of time would not, in itself, indicate that employment has not terminated, particularly if the employer's plan specifically permits former employees to be covered under the plan; however, if pension benefits continue to accrue to the individual the accrual indicates that there is an employment relationship, since such benefits only accrue to employees. 29

In situations where the dismissed employee is to receive benefits following the dismissal, care should be taken to ensure that the settlement agreement, or the award, is drafted to recognize the fact that the employment has been terminated, any lump-sum amount being paid is in respect of the employee's loss of employment, and the continuing benefits being provided are in accordance with the settlement agreement (or award), and are not to be construed as

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29 IT-337R3, supra footnote 10, at para. 4. That position is consistent with the earlier view expressed by Revenue Canada in *Access Letter* No. 9426035, November 1, 1994, wherein it stated: "With respect to the continuation of benefits in situations of loss of employment, the department has taken the position that in a case where pension benefits continue to accrue or normal employee benefits continue to be enjoyed by an individual, it is unlikely that employment has ceased even though the individual is not required to report to work. It is the department’s view that amounts received in lieu of earnings during this period of leave from employment would be considered employment income and therefore would not be a retiring allowance. However, it is the department's opinion that continued participation in the former employer’s health plan (i.e. drug, dental, long-term disability plan) for a restricted period of time would not, in itself, indicate that employment has not been terminated, particularly when the employer’s plan specifically permits former employees to be covered under the plan."
continuing, or creating, an employment relationship between the former employer and the employee.

VI. REDUCING THE INCIDENCE OF TAX

A. TRANSFER TO A REGISTERED RETIREMENT SAVINGS PLAN

The most commonly used method to reduce the incidence of tax in relation to a wrongful dismissal award is to transfer a portion of the proceeds of the settlement, or judgment, to a registered retirement savings plan (under which the employee is the annuitant) or a registered pension plan pursuant to the provisions of paragraph 600.1 of the Act, which provides for a deduction in respect of that part of the retiring allowance (included in a taxpayer's income under subparagraph 56(1)(a)(ii)) that is so transferred. In general terms, the deduction under paragraph 600.1 is limited to:

(a) $2,000 for each year or part of a year before 1996 that the employee was employed by the employer, or a person related to the employer;

plus

(b) $1,500 for each year or part of a year, of that employment, prior to 1989 during which no pension or deferred profit sharing plan contributions had vested in the employee.  

30 For those interested in the specific provisions of the Act, 60G.i) provides as follows:

60. There may be deducted in computing a taxpayer's income for a taxation year such of the following amounts as are applicable:

G.i) such part of the total of all amounts each of which is an amount paid to the taxpayer by an employer, or under a retirement compensation arrangement to which the employer has contributed, as a retiring allowance and included in computing the taxpayer's income for the year by virtue of subparagraph 56(l)(a)(ii) or paragraph 56(l)(x) as

(i) is designated by the taxpayer in the taxpayer's return of income under this Part for the year,

(ii) does not exceed the amount, if any, by which the total of

(A) $2,000 multiplied by the number of years before 1996 during which the employee or former employee in respect of whom the payment was made (in this paragraph referred to as the "retiree") was employed by the employer or a person related to the employer, and

(B) $1,500 multiplied by the number by which the number of years before 1989 described in clause (A) exceeds the number that can reasonably be regarded as the equivalent number of years before 1989 in respect of which employer contributions under either a pension plan or a deferred profit sharing plan of the employer or a person related to the employer had vested in the retiree at the time of the payment

exceeds the total of
For the purposes of determining the number of years of employment, Revenue Canada has recognized that the employment need not be continuous and there is no restriction on the length of a break between periods of service. As well, the number of years during which an employee was employed includes a part of a year as one year.

Under subparagraphs 600.1)(iv) and (v):

(a) any person whose business was acquired or continued by the employer, and

(b) any previous employer of the retiree (employee) whose service therewith is recognized in determining the retiree's pension benefits,

are considered to be "a person related to the employer" for the purposes of 600.1), thereby

(C) all amounts deducted under this paragraph in respect of amounts paid before the year in respect of the retiree
   (I) by the employer or a person related to the employer, or
   (II) under a retirement compensation arrangement to which the employer or a person related to the employer has contributed,

(C. 1) all other amounts deducted under this paragraph for the year in respect of amounts paid in the year in respect of the retiree
   (I) by a person related to the employer, or
   (II) under a retirement compensation arrangement to which a person related to the employer has contributed, and

(D) all amounts deducted under paragraph (t) in computing the retiree's income for the year in respect of a retirement compensation arrangement to which the employer or a person related to the employer has contributed, and

(iii) does not exceed the total of all amounts each of which is an amount paid by the taxpayer in the year or within 60 days after the end of the year in respect of the amount so designated
   (A) as a contribution to or under a registered pension plan, other than the portion thereof deductible under paragraph (j) or 8(l)(m) in computing the taxpayer's income for the year, or
   (B) as a premium (within the meaning assigned by section 146) under a registered retirement savings plan under which the taxpayer is the annuitant (within the meaning assigned by section 146), other than the portion thereof that has been designated for the purposes of paragraph (j) or (l),
   to the extent that it was not deducted in computing the taxpayer's income for a preceding taxation year

and for the purposes of this paragraph, "person related to the employer" includes

(iv) any person whose business was acquired or continued by the employer, and

(v) a previous employer of the retiree whose service therewith is recognized in determining the retiree's pension benefits;

31 IT-337R3, supra footnote 10, para. 13.
increasing the period for determining eligible contributions to the dismissed employee's RRSp. 32

Revenue Canada has also confirmed that for the purposes of calculating the portion of a retiring allowance that can be transferred to an RRSP, an employee may include years of service outside Canada with companies related to the employee's Canadian employer. 33

Appendix A contains an example of the calculation under paragraph 600.1).

B.  STRUCTURING THE CLAIM

While the transfer to an RRSP provides for a deferral of tax, there will be no tax payable where the amount received is not considered to be either a retiring allowance or a payment with respect to the employee's former employment. Where the facts warrant, an amount paid for mental or emotional distress, loss of self-respect, mental anguish, humiliation or hurt feelings may not be taxable. 34

1.  Revenue Canada Position

To be treated as non-taxable, it appears that Revenue Canada may require a linkage between these heads of damages and a human rights award. In paragraph 9 of IT-337R3, the department indicates:

An amount paid on account of or in lieu of general damages, that is, damages for loss of

32 Ibid., para 13(b). See also Window on Canadian Tax, ¶4679, Revenue Canada Technical Interpretation, Financial Industries Division, January 28, 1997, Revenue Canada File No. 9637715, wherein it was noted that "where a person has been employed by two or more school boards which participate in the same pension plan, the service with both school boards would be taken into account when determining the number of years of service for the purpose of the deduction (subparagraph 60G.1(b))." It was also noted that although the service with the two boards can apply to determine the retiring allowance for transfer to the RRSP, each school board could be an autonomous entity and not an affiliated employer with the result that a teacher who ceased to be employed by one board and became an employee of another, could receive a retiring allowance when leaving the first board.

33 Technical Interpretation, Reorganizations and International Division, Revenue Canada, December 13, 1996, Revenue Canada File No. 9532795, referred to in Window on Canadian Tax, ¶4541.

34 For a more extensive discussion of the taxability of aggravated damages and punitive damages, see Lisa M. Collins, "The Terminated Employee: Minimizing the Tax Bite", supra footnote 2, pp. 31: 15-28
self-respect, humiliation, mental anguish, hurt feelings, etc., or pursuant to an order or judgment of a competent tribunal may be a retiring allowance if the payment arises from a loss of office or employment of a taxpayer. However, if a human rights tribunal awards a taxpayer an amount for general damages, the amount is normally not required to be included in income. When a loss of employment involves a human rights violation and is settled out of court, a reasonable amount in respect of general damages can be excluded from income. The determination of what is reasonable is influenced by the maximum amount that can be awarded under the applicable human rights legislation and the evidence presented in the case.

2. Defamation

The Tax Court of Canada has recognized that where a portion of a lump-sum settlement payment constitutes damages for defamation, the damages do not come within the definition of a "retiring allowance" and are not taxable.

In Bedard v. MNR, the court was required to consider whether any portion of a $32,000.00 settlement payment, stated to be "by way of compensation for damage suffered", was damages for defamation and, if so, whether that amount was taxable as a "retiring allowance". The taxpayer had been dismissed from his employment and the reasons for his dismissal eventually became public. Under the terms of the settlement reached between the taxpayer and the employer, and approved by an arbitrator, the taxpayer was to receive six months salary together with the $32,000.00 payment. The Minister included the $32,000.00 in the taxpayer's income as a retiring allowance.

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35 1T-337R supra footnote 10, para. 9.
See also William E. Crofford, FCA, "Executive and Employee Considerations – I: Domestic" in Income Tax and GST Planning for the Purchase, Sale and Canada/US Expansion of a Business, supra footnote 2 at p. 12 wherein he notes the following Departmental position from Access Letter No. 9530217, December 20, 1995: "The purpose of the review was to clarify whether the use of the word 'damages' in the definition of 'retiring allowance' would include general damage awards for a loss of self-respect, mental anguish, humiliation or hurt feelings, etc. arising from violations or alleged violations of an employee’s human rights. It was our conclusion that, generally, amounts in respect of general damages in such situations would not form part of the retiring allowance and would not otherwise be subject to tax.”
36 (1990),91 DTC 573 (TCe)
The court concluded that $16,000.00 out of the $32,000.00 payment constituted damages for defamation and ought not to have been included in the taxpayer's income, as it did not constitute a retiring allowance. In the court's view:

... the lawmakers obviously did not, in adopting the definition of "retiring allowance" intend it to include damages for defamation that might be suffered by the occasional victim of a dismissal. The cause linking the loss of employment to the granting of damages must be efficient [sic] and not purely occasional. In short, while an amount granted to an employee after his dismissal may include damages for defamation, it is clear to the court that any such part of the compensation granted belongs to an entirely different order of compensation that is manifestly not covered by the definition of "retiring allowance". 37

3. Mental Distress

In Mendes-Raux v. The Queen38, the taxpayer had claimed damages for wrongful dismissal and thereafter received a lump-sum payment which the court determined was comprised of: (a) an amount for lost wages, earned overtime, earned vacation and earned sick leave, and (b) an amount for damages for mental distress and costs. The court held that the damages for mental distress and costs (determined to be one-half of the amount received) did not come within the definition of a retiring allowance in subsection 248(1) and the amount received in respect thereof was not taxable.

Perhaps more perplexing is the Tax Court decision in Young v. MNR39 wherein an agreed statement of facts was filed with the court which included an acknowledgement that as a result of the taxpayer's successful suit against his former employer, the Supreme Court of Ontario had awarded to the taxpayer identifiable amounts for damages for wrongful dismissal, exemplary damages and damages for mental distress. The taxpayer did not include in income the damages received for mental distress or exemplary damages. The Minister reassessed on the basis that the amounts constituted a retiring allowance. Notwithstanding what might otherwise have been a logical conclusion on the part of the court to exclude the damages for mental distress and the exemplary damages, the court held that on the evidence

37 Ibid., at p. 576.
before it - the agreed statement of facts - the separate damage awards were not shown by the taxpayer to be outside the parameters of subsection 248(1).40

In commenting on Young, the court in Bedard indicated:

... in the Court's opinion, Taylor. J.T.C.C. did not in the Young case ... rule out the possibility that amounts granted as compensation for the "mental distress" suffered by the appellant might not be regarded as [sic] retiring allowance. Taylor, J.T.C.C. merely stated that the evidence adduced by counsel for the appellant was insufficient to show how the amount received had been granted as compensation for a type of damage other than that resulting from the loss of his employment.41

4. Evidentiary Foundation

To succeed in establishing before the Tax Court that a portion of damages awarded, or a settlement amount received, does not constitute a retiring allowance, it is necessary to have the evidentiary foundation on which the court may base its finding.

In Niles v. MNR42, the taxpayer, after being laid off, filed a formal complaint with the Ontario Human Rights Commission. Following the Commission's investigation, the taxpayer's former employer paid a lump-sum amount to the taxpayer which the Minister included in income on the basis that the payment was a "retiring allowance". From the evidence before the Tax Court, it was apparent that there had been no evidence to support the taxpayer's claims before the Human Rights Commission for general damages for mental trauma or embarrassment resulting from loss of employment. The evidence indicated that the Commission's investigator determined that the claims could not be substantiated. It was therefore open to the Tax Court to conclude that the damages were received "in respect of" a loss of employment. In considering the meaning of this phrase, the court referred to earlier Supreme Court decisions:

39 86 DTC 1567.
40 Ibid., at p. 1568.
41 Supra footnote 35, at p. 577.
42 91 DTC 806 (TCc).
In interpreting the words "in respect of", the Court was referred to The Queen v. Savage, 83 DTC 5409 (SCC). There at page 5414 Dickson, J., as he then was, cited Nowegijick v. The Queen, 83 DTC 5041 (SCC) where the Court dealt with those words as follows:

The words "in respect of" are, in my opinion, words of the widest possible scope. They import such meanings as "in relation to", "with reference to" or "in connection with". The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters. 43

The combined comments of the Tax Court in the Young and Bedard cases underscores the importance of establishing a solid evidentiary foundation to support the taxpayer's appeal.

5. Unsuccessful Taxpayers

There have been a number of cases in which taxpayers have been unsuccessful in their attempts to establish that an amount received following a wrongful dismissal was other than a "retiring allowance". Generally, the tax courts have applied the Supreme Court decisions in Nowegijick v. The Queen 44 and The Queen v. Savage 45 regarding the interpretation of the phrase "in respect of" contained in the definition of a retiring allowance in s. 248(1) to establish a direct connection between amounts received by a taxpayer and the taxpayer's loss of employment.

For example, in Anderson v. The Queen 46 an amount received by the taxpayer from his former employer for real estate commission, legal fees, and moving expenses incurred following the termination of employment, was held by the court to be a retiring allowance. Although characterizing the amounts received as "damages", the court concluded that:

The damages received by Mr. Anderson [the taxpayer] arise from his loss of employment, and the incidental damages related to that loss of employment. This is not a case where damages were received extraneous to the loss of employment, such as where the taxpayer was defamed, as in Bedard v. M.N.R. ... or for mental and physical injuries suffered during employment ..."

43 Ibid., at p. 808.
44 83 DTC 5041 (SCC).
45 83 DTC 5409 (SCC).
46 (1997), 98 DTC 1190 (TCC), Rip, TCCJ.
In *Merrins v. The Queen*\(^7\), the court rejected the taxpayer's attempt to characterize as a capital gain a lump-sum arbitrator's award following grievance proceedings. The amount received was held to be a retiring allowance.

It has also been confirmed that severance pay received on retirement constitutes a retiring allowance within the meaning of the Act.\(^8\)

6. The "But/For" Test

Even where a taxpayer has demonstrated that an amount received was not in settlement of a wrongful dismissal claim, it has been held that the amount received was a "retiring allowance". In *Overin v. The Queen*\(^9\), the court considered the nature of a lump-sum amount paid by the Province of British Columbia to former employees of Cassiar Mining Corporation following its receivership. The evidence indicated that neither Cassiar nor the receiver paid any severance or termination pay and the Province made the payments to former employees in the nature of a "political bailout". The taxpayer therefore took the position that the payment received from the Province was proceeds of disposition of a capital asset, namely his right of action against his former employer. In considering the use of the words "in respect of" the court formulated a "but/for" test to determine whether or not an amount is a retiring allowance:

> ... In determining the limit to be placed on the connection between a payment and a loss of employment, the appropriate test is to ask "but for the loss of employment would the amount have been received?" If the answer to that question is in the negative, then a sufficient nexus exists between the receipt and the loss of employment for the payment to be considered a retiring allowance. "

It is quite clear then that in addition to the "but/for" test, where the purpose of a payment is to compensate a loss of employment it may be considered as having been received "with respect to" that loss.\(^50\)

In applying this test, the court concluded that because the appellant would not have received the payment from the Province "but for the loss of employment", the payment could

\(^7\) 94 DTC 6669 (FC-TD).

\(^8\) *Adler v. The Queen*, 94 DTC 6605 (FCA).

\(^9\) (1997),98 DTC 1299 (TCc).

\(^50\) Ibid., at 1302.
reasonably be considered to be a "retiring allowance" within the meaning of subsection 248(1).

With respect, it is suggested that the "but/for" test fails to recognize that compensatory amounts received by a wrongfully dismissed employee do constitute separate heads of damages. Although they may arise out of circumstances in relation to the employee's employment, any such damages are not compensation for the loss of employment.

VII. DEDUCTIBILITY OF LEGAL FEES

A. RETIRING ALLOWANCE

A taxpayer may deduct legal expenses paid to collect or establish a right to a pension benefit or retiring allowance within the limits set out in paragraph 60(0.1)51. There is a

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60. There may be deducted in computing a taxpayer's income for a taxation year such of the following amounts as are applicable:

(0.1) the amount, if any, by which the lesser of

(i) the total of all legal expenses (other than those relating to a division or settlement of property arising out of, or on a breakdown of, a marriage) paid by the taxpayer in the year or in any of the 7 preceding taxation years to collect or establish a right to an amount of

(A) a benefit under a pension fund or plan (other than a benefit under the Canada Pension Plan or a provincial pension plan as defined in section 3 of that Act) in respect of the employment of the taxpayer or a deceased individual of whom the taxpayer was a dependant, relation or legal representative, or

(B) a retiring allowance of the taxpayer or a deceased individual of whom the taxpayer was a dependant, relation or legal representative, and

(ii) the amount, if any, by which the total of all amounts each of which is

(A) an amount described in clause (i)(A) or (B)

(1) that is received after 1985

(II) in respect of which legal expenses described in subparagraph (i) were paid, and

(III) that is included in computing the income of the taxpayer for the year or a preceding taxation year, or

(B) an amount included in computing the income of the taxpayer under paragraph 56(1)(1.1) for the year or a preceding taxation year, or

(exceeds the total of all amounts each of which is an amount deducted under paragraph (j), (j.1) or (j.2) in computing the income of the taxpayer for the year or a preceding taxation year, to the extent that the amount may reasonably be considered to have been deductible as a consequence of the receipt of an amount referred to in clause (A),)

(iii) the portion of the total described in subparagraph (i) in respect of the taxpayer that may reasonably be considered to have been deductible under this paragraph in computing the income of the taxpayer for a preceding taxation year;
corresponding requirement to include in income any amounts received as an award or reimbursement of legal expenses.\footnote{52}

However, legal fees paid to collect or establish the right to a retiring allowance may not fully be deductible. The amount of the deduction in a particular year is limited to the total of the amount required to be included in income for legal fees received plus the amount of the retiring allowance, less any portion of the allowance transferred to a registered retirement savings plan or registered pension plan under \textit{600.1}).

Any non-deductible portion of qualifying legal expenses may be carried forward and deducted in any of the seven subsequent taxation years, to the extent that the taxpayer receives a further retiring allowance.\footnote{53}

B. \textbf{EMPLOYMENT INCOME}

Where an employee has incurred expenses to collect salary or wages owing to the employee, paragraph 8(1)(b) permits a deduction for the legal expenses so incurred.\footnote{54} As noted in IT-99R5\footnote{55}, the deduction under paragraph 8(1)(b) is only allowed in respect of an amount

\footnotesize{\textit{\textsuperscript{52}} 56. (1) Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year,

(1.1) amounts received by the taxpayer in the year as an award or a reimbursement in respect of legal expenses (other than those relating to a division or settlement of property arising out of, or on a breakdown of, a marriage) paid to collect or establish a right to a retiring allowance or a benefit under a pension fund or plan (other than a benefit under the Canada Pension Plan or a provincial pension plan as defined in section 3 of that Act) in respect of employment.

\footnotesize{\textit{\textsuperscript{53}} IT-337R3, supra, footnote 10, at para. 10 which also provides an example of the operation of the deduction, which is included in Appendix B to this paper.

See also \textit{Interpretation Bulletin} IT-99R5, “Legal and Accounting Fees”, December 11, 1998, paras. 25 and 26, and the example in para. 27.

\footnotesize{\textit{\textsuperscript{54}} 8. (1) In computing a taxpayer's income for a taxation year from an office or employment, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

(b) amounts paid by the taxpayer in the year as or on account of legal expenses incurred by the taxpayer to collect or establish a right to salary or wages owed to the taxpayer by the employer or former employer of the taxpayer.

\footnotesize{\textit{\textsuperscript{55}} Supra, footnote 53, at para. 23.}}
"owed" to the taxpayer. If the taxpayer has not been successful in court or otherwise fails to establish that an amount is so owed, no deduction for expenses is allowed.\textsuperscript{56}

To the extent that a taxpayer is successful in recovering legal expenses for collecting or establishing the taxpayer's right to salary or wages, paragraph 6(1)(j) requires the amount so received to be included in the income.\textsuperscript{57}

\textbf{C. OTHER DAMAGE AWARDS}

Legal expenses incurred to establish damages (such as for mental distress or a human rights violation, or for exemplary or punitive damages) that do not constitute a retiring allowance will not be deductible to the dismissed employee under the provisions of paragraph 60(0.1). Correspondingly, any costs recovered in relation to those damages should not be included in income under paragraph 56(1)(1.1). In such a situation, the practitioner may be faced with the difficulty of determining the extent to which the expenses are attributable to the damages or the wrongful dismissal claim.

\textbf{VIII. WITHHOLDING}

Subsection 153(1) imposes an obligation on the payor of a retiring allowance to withhold and remit tax in accordance with the regulations. Where a retiring allowance is paid, the

\textsuperscript{56} See Turner-Lienaux \textit{v. The Queen}, 97 D.e.T. 5294 (F.e.A.) wherein the taxpayer was not permitted to deduct legal expenses incurred in unsuccessful proceedings relating to her unsuccessful competition seeking a job promotion. The court held that the proceedings had not been instituted to collect salary or wages "owed" to the taxpayer within the meaning of 8(1)(b) with the result that no deduction was available.

\textsuperscript{57} Paragraph 6(1)(j) provides:

6. (1) There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment such of the following amounts as are applicable:

\begin{itemize}
  \item[(j)] amounts received by the taxpayer in the year as an award or reimbursement in respect of an amount that would, if the taxpayer were entitled to no reimbursements or awards, be deductible under subsection 8(1) in computing the income of the taxpayer, except to the extent that the amounts so received
  \begin{itemize}
    \item[(i)] are otherwise included in computing the income of the taxpayer for the year, or
    \item[(ii)] are taken into account in computing the amount that is claimed under subsection 8(1) by the taxpayer for the year or a preceding taxation year.
  \end{itemize}
\end{itemize}
withholding rate is 10% of payments under $5,000.00, 20% for payments between $5,000.00 and $15,000.00, and 30% on payments over $15,000.00.\footnote{Regulation 103(4).}

Revenue Canada provides administrative relief from withholding for that portion of a retiring allowance paid by a former employer direct to a registered pension plan or registered retirement savings plan. It is no longer necessary to file a TD2 form to obtain that relief.\footnote{Although 1T-337R3, para. 15, indicates that form TD2 is required to obtain a waiver of the withholding tax requirement, Revenue Canada representatives have provided telephone confirmation that it is no longer required. Revenue Canada guide \emph{T4100 - 1997/98 Employers' Guide to Payroll Deductions} also provides at page 54: \begin{quote} Note - If an employee wants to transfer an eligible amount [of a retiring allowance] to an RPP or RRSP, he or she is not required anymore to complete Form TD2, \emph{Tax Deduction Waiver for a Direct Transfer of an Eligible Retiring Allowance}\end{quote}}

A failure to withhold tax as required under subsection 153(1) will subject the payor to a penalty under subsection 227(8)\footnote{Which provides: ... every person who in a calendar year has failed to deduct or withhold any amount as required by subsection 153(1) or section 215 is liable to a penalty of (a) 10% of the amount that should have been deducted or withheld; or (b) where at the time of the failure a penalty under this subsection was payable by the person in respect of an amount that should have been deducted or withheld during the year and the failure was made knowingly or under circumstances amounting to gross negligence, 20% of that amount.}. A failure to comply with subsection 153(1) may be an offence under subsection 238(1) of the Act.\footnote{Prior to the 1998 budget, the alternative minimum tax calculation under section 127.51 required the exclusion (under section 127.52) of amounts paid to registered retirement savings plans or registered pension plans. In certain circumstances, this could have an adverse affect on taxpayers receiving severance amounts for wrongful dismissal. If a significant portion of the retiring allowance qualified for, and was transferred to, a registered retirement savings plan, section 127.52 excluded the amount transferred from the calculation of adjusted taxable income for the purposes of determining the alternative minimum tax liability. As a result, the taxpayer was faced with...}
the prospect of paying alternative minimum tax on all, or a portion of, the transferred amount - with no funds available to pay the tax as they had been transferred to the RRSPI!

The 1998 budget proposes to amend section 127.52 to repeal the paragraph that excludes transfers to registered retirement savings plans and registered pension plans from the alternative minimum tax calculation. As a result, any amounts so transferred will be deductible for determining adjusted taxable income for the purposes of the alternative minimum tax calculation. The budget also proposes a transitional rule for years 1994 to date. Taxpayers who have been unable to totally recover any additional tax paid as a result of their inability to take into account the amount transferred to an RRSP or RPP, will now be entitled to recover that tax. 62

61 See also Canadian Tax Reporter Commentary, CCH Canadian Limited, at ¶22,357.
APPENDIX A

Facts:

- Retiring allowance received in 1997 $30,000
- Contribution to registered retirement savings plan (RRSP) in 1997 $24,000
- Contribution to registered pension plan (RPP) in 1997 and deducted in that year $3,000
- The taxpayer was employed from October 1985 to June 1997 when he retired. The taxpayer's employer made RPP contributions on the taxpayer's behalf starting in 1987.

The amount deductible under paragraph 60(j.1) is as follows:

Solution:

Least of (a), (b) and (c):

(a) retiring allowance included in income $30,000

(b) amount by which the aggregate of:

(i) $2,000 x 11 years(*) $22,000
(ii) $1,500 x (4 years - 2 years) $3,000 $25,000

exceeds the aggregate of:

(iii) 60(j.1) deduction - claimed in previous year NIL
(iv) 60(j.1) other deduction for the year NIL
(v) 60(t) deduction for the year NIL NIL $25,000

(c) aggregate of:

(i) RPP contribution 3,000
less: 8(1)(m) deduction (3,000) NIL
(ii) total RRSP contribution 24,000
less: 60(j) or (l) deduction NIL 24,000 $24,000

Maximum designated amount under paragraph 60(j.1) $24,000

(*) While there are 13 years between 1985 and 1997, it is the number of years before 1996 that are relevant in this calculation.

63 IT-337R3, supra footnote 10, para. 12.
In 1995, Mr. Plaintiff incurred legal expenses of $2,000 in an attempt to establish a right to a retiring allowance. In 1996, he incurred additional legal expenses of $7,000 to establish a right to, and to collect, the retiring allowance. In 1996, Mr. Plaintiff received a $10,000 retiring allowance and a $5,000 reimbursement in respect of legal fees paid in connection with the retiring allowance. In the year, he transferred $7,000 of his retiring allowance to his registered retirement savings plan ("RRSP") pursuant to paragraph 600.1).

In 1995, Mr. Plaintiff was not entitled to any deduction with regard to the $2,000 of legal expenses that he incurred to establish a right to a retiring allowance because he had not yet received the reimbursement of legal expenses or the retiring allowance.

In 1996, Mr. Plaintiff is required to include the $5,000 reimbursement of legal expenses in income pursuant to paragraph 56(1)(1.1). While he has incurred legal expenses of $9,000 ($2,000 in 1995 and $7,000 in 1996) in establishing the right to, and collecting the retiring allowance, his deduction under paragraph 60(0.1) is limited to $8,000 - the aggregate of the retiring allowance ($10,000) and the reimbursement of legal expenses ($5,000), less the amount transferred to his RRSP ($7,000). The amount of legal expenses not currently deductible ($1,000) may be carried forward and deducted in later years to the extent that Mr. Plaintiff receives a further retiring allowance or reimbursement of legal expenses that is associated with the legal expense incurred in 1995 and 1996.

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64 Ibid., para. 10.