

Tax implications of a Severance Payout



EAGLE RIVER

What is severance pay?

It is paid to eligible employees and is based on continuous years of service. Severance is typically 1 week of current pay for each continuous year of service; however you should contact your HR department directly to help you calculate your continuous service and severance.

Are these funds taxable?

Severance is taxed the same as employment income. Typically, the amount withheld at source will be arbitrarily determined, and may not reflect your actual tax rate. It is the responsibility of the employee to know if the taxes withheld are sufficient. If taking severance as taxable income, it is best to try and determine the appropriate taxes that should be paid based on anticipated earnings in order to set the additional funds aside if necessary.

Can taxes be avoided?

While not completely avoidable, taxes can be deferred by rolling severance directly into an RRSP. This will grant RRSP receipts which will offset the earnings incurred by receiving severance. This option can be chosen when receiving severance so that no taxes are withheld on the transfer, provided that the funds are transferred directly to an RRSP for the same tax year you receive the severance pay.

What are the benefits of deferring taxes?

Given that the severance payable is being paid during working years, it would likely be the case that the current tax bracket is higher than later in retirement. Deferring taxes can allow for smaller amounts to be withdrawn at lower tax rates rather than a lump sum at a higher tax rate.

How does severance transfer to RRSP work?

Severance can be transferred to your own RRSP, or a spousal RRSP, but requires that you have sufficient carry forward space to contribute. Typically, an employer will require proof that there is sufficient space, so it is best to have a full copy of your most recent Notice of Assessment, or a printout of your carry forward space printed from CRA's "self-service" site.

If you are taking the severance as taxable income, you should do the following:

- 1) Find out the amount of your severance, and the amount of taxes that will be withheld by your employer.
- 2) Try to estimate your **Marginal Tax Rate** based on your expected income without severance. (there are online calculators, and tax rates are posted on the CRA website)
- 3) Estimate your **Marginal Tax Rate** based on adding your severance to your expected income.
- 4) If your rate is the same either way, you can just apply that rate to the severance to get a very good indication of the actual tax burden. If this additional taxable income puts you into the next bracket, use the higher rate to figure out the tax burden. Compare this to the taxes withheld by your employer and set aside the difference to be safe. Also, if your Marginal Tax Rate increases drastically, you should discuss options with a Financial Planner or Accountant to see what the best course of action is for your situation.

If you are planning to roll the severance to an RRSP, you should do the following:

- 1) Find out the amount of your severance.
- 2) Print, or keep a copy of your most recent Notice of Assessment, which should include your carry forward RRSP contribution space. You can also get and print this information from CRA's self- service Website. Most Employers will not do a direct transfer of the non-eligible portion without proof that enough RRSP space exists to shelter the amount.
- 3) You can use either an existing RRSP or create a new one. Either way, have your RRSP provider (Credit Union, Financial Planner, etc.) help you fill out the document so that the correct account information and address are used. The non-eligible portion can go to your RRSP or to a spousal RRSP.

Contact us

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Are you looking for a trusted Financial Planner?

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