

## **Accounting for Pensions: Addressing Employees' Pension Entitlements in Wrongful Dismissal Litigation and Settlement Negotiations**

**By Mitch Frazer and Tara Sastri,<sup>1</sup> Torys LLP**



Ontario Bar Association CLE -  
8th Annual Current Issues in Employment Law

Wednesday, February 25, 2009

---

<sup>1</sup> The authors would like to thank Molly Reynolds and Adrienne DiPaolo, students-at-law, Torys LLP, for their contributions to this paper.

## **PRÉCIS**

When terminating an employee, an employer must be cognizant of its responsibilities to the employee, including its obligation to provide notice of termination or payment in lieu thereof. The minimum standards legislation requires that benefits be continued during the notice period, including continued contributions to pension benefits. At common law, although there is no obligation to continue participation during the notice period, the calculation of a payment in lieu of notice will include amounts for pension benefits. If the employer does not meet its obligations under minimum standards legislation or provide payment in lieu of pension benefits for the common law notice period, the employee generally has a right to seek damages for pension loss. The court's valuation of damages will vary depending on the type of pension plan and damages may be grossed-up to account for adverse tax consequences.

Pension plan administrators have statutory, professional and common law duties to communicate information and assist employees in making informed decisions about their pensions upon termination of employment.

In this paper, the authors will also address how pension entitlements are affected by the particular payment structure agreed on in a wrongful dismissal settlement. Also discussed are other important factors in achieving comprehensive settlement terms that reduce the likelihood of unintended tax, financial and other consequences.

## **INTRODUCTION**

An individual's employment may be terminated without cause as long as he or she is given appropriate notice of termination or payment in lieu thereof.<sup>2</sup> Where payment in lieu of notice is provided, the employer must compensate the employee for all aspects of compensation that would have otherwise accrued during the notice period, including cash compensation such as salary, and group health and pension benefits. Employers must understand their obligations and potential liabilities when offering a severance package to a dismissal employee at the time of dismissal or during subsequent settlement negotiations. In particular, all aspects of compensation should be considered and the employer should ensure that the employee understands the offer. If the parties are unable to reach a full and final settlement, and the matter proceeds to litigation, a court may ultimately be required to determine the quantum of damages payable in lieu of notice. This damage award may include an amount for the loss of pension benefits.

This paper examines employer obligations on dismissal, the valuation methods used by courts to quantify damages for a loss of pension benefits, pension administrator obligations and pension related considerations in structuring a severance package in settlement discussions.

---

<sup>2</sup> We note that the employer's ability to dismiss an employee without cause is more constrained with respect to employees covered by collective agreements and with respect to federally regulated employees covered by the unjust dismissal provisions of the *Canada Labour Code*, R.S.C. 1985, c. L-2. This paper does not address those employees, but rather addresses the issues surrounding pension benefits losses in the context of dismissed employees in Ontario who are not covered by a collective agreement.

## **EMPLOYER OBLIGATIONS**

### **(a) Continuing Contributions**

In Ontario, the employer has an obligation to provide notice of termination of employment without cause under the *Employment Standards Act, 2000*<sup>3</sup> and at common law. The *ESA* sets out the minimum notice periods, calculated on the basis of the employee's years of service with the employer.<sup>4</sup> The *ESA* requires the employer to pay all aspects of compensation during the notice period, including continued pension contributions. Unless the parties have entered into a contract limiting the employee's notice entitlements to the minimum amounts set out in the *ESA*, an employee is also entitled to seek common law "reasonable" notice.<sup>5</sup> Common law reasonable notice is the notice that courts determine is appropriate in the circumstances. Where a payment in lieu of this notice is made, the payment would generally include amounts for pension benefits.

### **(b) ESA Notice Period**

Subsection 60(1)(c) of the *ESA* requires the employer to continue to make all benefit plan contributions necessary to maintain the employee's benefits until the end of the statutory notice period. Subsection 61(1) permits an employer to pay the amount of wages the employee would have received in lieu of providing working notice as long as all benefit contributions are paid until the end of the period. If the employer fails to make these contributions, the *ESA* permits the amount that would have been contributed by the employer on the employee's behalf to be treated as unpaid wages for

---

<sup>3</sup> S.O. 2000, c.41, s. 54 [*ESA*].

<sup>4</sup> *ESA*, s. 57.

<sup>5</sup> Note that if the employer provides common law notice, it is said to satisfy the *ESA* obligation.

the purposes of enforcement and collection.<sup>6</sup> The *ESA* further protects employees by deeming them to be actively employed during the notice period if they receive pay in lieu of notice.<sup>7</sup> This is important in the context of pension plans, as employees must be actively employed to be eligible for plan membership. Further, if an employee's pension vests between the date of termination and the last day of the statutory notice period, he or she is treated like any other employee who leaves the plan with a vested pension.<sup>8</sup>

(c) **Common Law**

Unlike the notice period under the *ESA*, there is no deemed active employment during a common law notice period. Accordingly, once the *ESA* notice period has expired, the employer is not obligated to continue pension contributions or require the plan administrator to continue the employee's membership during the notice period. However, the employer may permit continued participation in the pension plan, allow pensionable service to accrue and continue contributions on the employee's behalf, provided that the pension plan does not prohibit the continued membership of "inactive" employees.<sup>9</sup> However, if the employer does not continue pension benefits, the employee may seek damages for failure to provide compensation for all aspects of remuneration during the notice period. The damages sought would likely include the value of all components of the employee's remuneration, including pension benefits. These losses may be a key issue in settlement discussions between a former employee and employer. Where the matter is not resolved in settlement discussions, it may proceed to litigation and ultimately be determined by a court. In assessing damages, a

---

<sup>6</sup> *Ibid.*, s. 60(3).

<sup>7</sup> *Ibid.*, s. 62(1).

<sup>8</sup> Ari N. Kaplan, *Pension Law*, Toronto: Irwin Law Inc., 2006 at 230 [Kaplan].

<sup>9</sup> *Ibid.*

court may be asked to consider the issue of pension benefits entitlements and losses. These issues are discussed in the following section. Entitlements and valuation considerations in the context of settlement discussions are addressed later in this paper in the section entitled “Negotiating Severance Packages”.

## **DAMAGES FOR PENSION LOSS**

Damages for wrongful dismissal are designed to compensate an employee for both the salary and the value of benefits lost by reason of employment termination without notice.<sup>10</sup> If damages are determined by a court, the following factors will be considered: (i) whether the employee’s benefits have vested; (ii) whether the employee had a right to continued participation in the plan during the notice period; and (iii) the appropriate valuation method for quantifying the losses. The approach of courts to each of these issues is detailed below.

### **(a) Unvested and Vested Benefits**

The first step in the evaluation of lost benefits is to determine whether the employee’s pension has vested. An employee with a vested pension has a statutory right to receive the accrued value of his or her pension upon termination. The *Pension Benefits Act* (Ontario)<sup>11</sup> states that, post-1987, an employee’s pension vests after two years of continuous membership in the plan (pensionable service between 1965 and 1987 vests once an employee over age 45 accumulates 10 years of continuous membership).<sup>12</sup> However, a pension plan may explicitly provide for a shorter vesting period.<sup>13</sup> An employee whose pension is not vested by the end of the reasonable notice period is only

---

<sup>10</sup> *Wright v. Kimberly-Clark Canada Inc.* [1995] O.J. No. 1566 (Ct. J. (Gen. Div.)) at para. 36 [*Wright*].

<sup>11</sup> R.S.O. 1990, c. P.8 [*PBA*].

<sup>12</sup> Kaplan, *supra* note 8 at 220.

<sup>13</sup> *ESA*, *supra* note 3, s. 64(1).

entitled to a refund of his or her contributions, plus interest. A notice period which ends just prior to the vesting of an employee's pension is likely to be contested as unreasonable in light of the significant effect of vesting on the employee's entitlements upon employment termination.

(b) **Contractual Provisions**

In *Taggart v. Canada Life Insurance Co.*,<sup>14</sup> the Ontario Court of Appeal held that employees are entitled to claim damages to compensate for a loss of pension benefits during the common law reasonable notice period. The mere existence of an employment agreement does not prohibit a claim for damages for pension loss; this right may only be limited by an express term in the agreement.<sup>15</sup> Taggart was an employee with 30 years of service and who was a member of the defendant's defined benefit plan. When his employment was terminated as a result of restructuring, Taggart was offered 24 months' notice, comprised of 2 months' working notice and 22 months' pay in lieu thereof. However, the offer provided that pension contributions were only to be continued for the period of working notice. This prevented him from meeting the threshold for an unreduced pension at age 60 and this resulting pension loss was not compensated for in the defendant's severance offer. Canada Life (the defendant) contested the claim for damages for pension loss on the grounds that the pension plan was a contract collateral to Taggart's employment contract. The terms of the plan prohibited pension benefits from being used to increase damages resulting from dismissal or from enlarging any rights of employees which arise outside of the plan. The trial judge held that without establishing that clear, unequivocal terms binding Taggart to accept the limitation of

---

<sup>14</sup> [2006] O.J. No. 310 (C.A.) [*Taggart*].

<sup>15</sup> *Ibid.* at para. 15.

pension accrual to the working notice portion of his severance package, the clauses in the pension plan could not prevent him from claiming damages for pension loss.<sup>16</sup> The Court of Appeal further held that a pension plan is a unilateral contract, the terms of which are not negotiated, and that clauses limiting liability are to be strictly interpreted against the party seeking to endorse the clause, under the principle of *contra proferentum*.<sup>17</sup>

Since the claim before the Court of Appeal was for damages to compensate for pension loss, not for pension benefits themselves, Taggart's rights could not be determined solely by reference to the pension plan text. Relying on *Bardal v. The Globe & Mail Ltd.*<sup>18</sup> and *Rivers v. Gulf Canada Ltd.*<sup>19</sup>, the Court of Appeal held that pension entitlements are not collateral to employment contracts and that employees may seek damages for lost pension benefits which accrued during the reasonable notice period. The Court of Appeal noted that this principle had been recognised by the British Columbia Court of Appeal<sup>20</sup> and implicitly accepted in Ontario since the 1970s.<sup>21</sup> In order to restrict this right, the pension plan had to explicitly prohibit a claim for damages for lost benefits. On the facts, the language of the plan did not meet this test and thus, it could not be used to limit Taggart's common law right to claim damages.<sup>22</sup>

---

<sup>16</sup> *Ibid.* at para. 7.

<sup>17</sup> *Ibid.* at para. 18.

<sup>18</sup> (1960), 24 D.L.R. (2d) 140 (Ont. H.C.J.).

<sup>19</sup> (1986), 13 C.C.E.L. 131 (Ont. H.C.J.) [*Rivers*].

<sup>20</sup> *Durrant v. British Columbia Hydro and Power Authority* (1990), 49 B.C.L.R. (2d) 263 (C.A.).

<sup>21</sup> *Taggart*, *supra* note 14 at para. 14.

<sup>22</sup> *Ibid.* at para. 22.

(c) **Quantifying Damages**

Once a court has determined that the employee has a claim for pension losses during the reasonable notice period, the damages to be awarded must then be calculated.

For defined contribution plans, the damages are the contributions that would otherwise have been made during the notice period, and may also include the investment return that would otherwise have been earned.

For defined benefit plans, damages are generally equal to the present value of the difference between: (i) the value of the pension at the date of termination of employment; and (ii) the value of the pension at the end of the reasonable notice period.<sup>23</sup> However, there are a number of practical issues that must be addressed to translate this theoretical entitlement into a dollar value. Some of the challenging valuation issues related to defined benefit pension plans are discussed below.

(d) **Defined Benefit Pension Benefits and Early Retirement**

In some cases, a dismissed employee may begin receiving pension payments before the reasonable notice period, and accompanying benefits, have been conclusively determined. The courts historically took an inconsistent view on whether payments already made to a former employee could be deducted from the damages owed for wrongful dismissal. The Court in *Rivers* ruled that the employer was entitled to credit for the pension payments made before trial,<sup>24</sup> but the Court in *Chandler v. Ball*

---

<sup>23</sup> *King v. Gulf Canada Ltd.* [1989] O.J. No. 13 0 (Dist. Ct.), aff'd [1992] O.J. No. 2761 (C.A.). See also *Wright*, *supra* note 9 at para. 51.

<sup>24</sup> *Supra* note 19 at para. 7.

*Packaging Products Canada Ltd.* held that no deduction could be made.<sup>25</sup> In *Wright*, the Court of Appeal noted that the comments of the Court in *Rivers* were made in *obiter* but the *Chandler* decision was binding on the Court. Accordingly, the Court in *Wright* held that previous payments could not be credited against the damages awarded.<sup>26</sup>

In *Peet v. Babcock & Wilcox Industries Ltd.*,<sup>27</sup> the Ontario Court of Appeal clarified the approach to be used in assessing damages for pension loss where pension payments have commenced. A court must consider the commencement of payments at the front end of the analysis, when it is determining whether a pension loss has occurred at all. Peet was a member of the defendant employer's non-contributory defined benefit plan who exercised his option to begin receiving early retirement benefits immediately upon termination, but contested the length of notice provided by his employer. At trial, the defendant's actuarial expert testified that, in using a commuted value methodology to calculate pension value, the early commencement of a reduced pension resulted in a higher present value than the pension that would have been paid at the end of the reasonable notice period. Even if the plaintiff was entitled to 24 months' notice (the longest period generally provided at common law), his pension would have a lower present value than the one he had actually received.<sup>28</sup>

Affirming the commuted value methodology of calculating pension loss, the Court of Appeal held that it could not disregard payments made during the notice period which may alter the difference in the value of the pension at termination versus at the end of

---

<sup>25</sup> [1992] O.J. No. 3114 (Ct. J. (Gen. Div.)) [*Chandler*].

<sup>26</sup> *Supra* note 10 at para. 54.

<sup>27</sup> (2001), 53 O.R. (3d) 321 (C.A.) [*Peet*].

<sup>28</sup> *Ibid.* at para. 16.

the reasonable notice period.<sup>29</sup> If payments made during the notice period were ignored, the purpose of damages for wrongful dismissal would be undermined because the employee would be in a better position than if he or she had not been dismissed. Therefore, rather than deducting any amount previously paid from an award of damages, early pension payments should only be taken into account by a court to determine whether there were pension losses incurred by a former employee because of insufficient notice.

In *Doran v. Ontario Power Generation Inc.*,<sup>30</sup> Doran was an employee and a member of the company's defined benefit plan and was eligible to receive an unreduced pension on the date his employment was terminated. Doran brought a claim against the employer for constructive dismissal. After determining that Doran had in fact been constructively dismissed, the Superior Court accepted expert evidence that the present value of Doran's current pension was higher than it would have been had he continued working until the end of the 24-month notice period. In fact, Doran received \$118,000 more than he would have received if his pension had continued to accumulate for two years, taking into account the employee contributions which would have been required.<sup>31</sup> Following *Peet*, the Superior Court did not award damages for pension loss because Doran was in a better overall position as a result of receiving early pension payments. It was further noted that *Peet* binds Ontario courts to consider previous payments *only* at the stage of determining whether a loss has occurred and that the value of the pension benefits

---

<sup>29</sup> *Ibid.* at para. 31.

<sup>30</sup> (2007), 61 C.C.E.L. (3d) 232 (Ont. S.C.J.).

<sup>31</sup> *Ibid.* at para. 81.

received cannot be deducted from total wrongful dismissal damages.<sup>32</sup> However, the value of any employee contributions which would have been required during the notice period, but were not actually made, should be deducted from the award.<sup>33</sup> While the improved position of an employee as a result of early retirement payments must be considered in evaluating damages for pension loss, it is not a relevant factor in determining the total amount payable under all heads of damages.

(e) **Grossing-up Damage Awards**

The plaintiff in *Peet* argued that his damage award should be grossed-up to account for the tax consequences of receiving the amount as a lump-sum rather than in regular instalments. The Ontario Court of Appeal stated that courts must simply determine the commuted value of the pension loss and order the corresponding quantum of damages.<sup>34</sup> However, the issue was revisited in *Dowling v. Ontario (Workplace Safety and Insurance Board)*<sup>35</sup> with a focus on the purpose of damage awards. Damages are intended to make an employee whole by compensating for the losses he or she sustained as a result of being given insufficient notice of dismissal. In *Dowling*, the trial judge had determined that this principle would not be upheld if he ignored the tax consequences that arose from receiving a one-time compensation award for pension benefits rather than instalments over multiple taxation years. The Ontario Court of Appeal upheld this decision because a failure to gross-up the award would deny the plaintiff the full benefit

---

<sup>32</sup> *Ibid.* at para. 86.

<sup>33</sup> *Ibid.* at para. 87.

<sup>34</sup> *Peet*, *supra* note 27 at para. 38.

<sup>35</sup> (2004), 246 D.L.R. (4th) 65 (Ont. C.A.) [*Dowling*].

of the damages awarded.<sup>36</sup> Accordingly, damages for wrongful dismissal may be grossed up if they are compensation for a benefit that is not itself subject to income tax,<sup>37</sup> or if the award will be taxed differently than the benefit it is intended to replace.

## **ADMINISTRATOR OBLIGATIONS**

### **(a) PBA**

The *PBA* requires a pension plan administrator to be appointed before a pension plan can be registered. Although the formal administrator may be the employer,<sup>38</sup> many companies delegate these complex duties to third party administrators. One of the central responsibilities of a plan administrator is to communicate relevant information to the plan members.<sup>39</sup> When an employee ceases to be a member of a pension plan because he or she has been dismissed, the administrator must outline the individual's rights and obligations in writing within 30 days of the termination date.<sup>40</sup> This document must include: (i) the name and registration number of the plan; (ii) the name and birth date of the member; (iii) the date of enrolment and years of credited employment under the plan; (iv) the normal retirement date; (v) all available options and relevant dates regarding the pension and other benefits to which the member is entitled; (vi) the names of the member's spouse and designated beneficiary; (vii) the benefits to be provided on death; (viii) the formula for integrating a deferred pension with Canada Pension Plan or Old Age Security benefits; (ix) the duration of any bridging or special allowance to be paid; (x) the indexation provisions applicable to a deferred

---

<sup>36</sup> *Ibid.* at paras. 77-79.

<sup>37</sup> *Alcatel Canada Inc. v. Egan* (2006), 47 C.C.E.L. (3d) 87 (Ont. C.A.).

<sup>38</sup> *Supra* note 11, s. 8(1)(a).

<sup>39</sup> *Canadian Employment Benefits and Pension Guide Reports*, North York: CCH Canadian Limited, 2008, s. 3371.

<sup>40</sup> *Supra* note 11, s. 28.

pension; (xi) any options to transfer and the transfer value of a deferred pension; (xii) any deadlines for exercising options; and (xiii) the amount of any refund to which the member is entitled.<sup>41</sup> The administrator must provide a refund to an eligible member within 60 days of receiving his or her direction.<sup>42</sup>

Importantly, the *PBA* deals with the portability of an employee's pension upon termination. Members with vested pensions whose employment has been terminated must be given the option either to: (i) transfer the commuted value of their pensions to another plan or a locked-in retirement savings fund; (ii) purchase a deferred life annuity in the amount of the pension; or (iii) leave their contributions in the employer's plan as a deferred pension payable at the age of retirement.<sup>43</sup> An employee who is dismissed before vesting is entitled to a refund of contributions, but not to transfer his or her pension to another fund.<sup>44</sup> Further, an employee who is eligible to receive an unreduced pension, regardless of whether he or she wishes to begin payments, does not have portability rights unless they are explicitly provided in the plan text.<sup>45</sup>

(b) **CAP Guidelines**

The Capital Accumulation Plan Guidelines (CAP Guidelines) were established by the Joint Forum of Financial Market Regulators to create best practices for defined contribution pension plans, which are lacking in the *PBA*. The CAP Guidelines emphasise the importance of communication of relevant information to members because, unlike defined benefit plans, employees bare the risks of poor pension fund

---

<sup>41</sup> *Pension Benefits Act*, R.R.O. 1990, Regulation 909, ss. 41-44.

<sup>42</sup> *Ibid.*, s. 42(4).

<sup>43</sup> Kapla n, *supra* note 8 at 237.

<sup>44</sup> *PBA*, *supra* note 11, s. 63(3).

<sup>45</sup> Kapla n, *supra* note 8 at 246.

performance under defined contribution plans.<sup>46</sup> The CAP Guidelines also apply to plans such as group Registered Retirement Savings Plans (RRSP), group Registered Educational Savings Plans and deferred profit sharing schemes. Upon termination of an employee's membership, CAP Guideline 7.2.1 requires a plan sponsor to inform him or her of the available options and applicable defaults, any required action and deadlines, and the impact of termination on the individual's investment options.<sup>47</sup>

(c) **Common Law**

The importance of an administrator's duty of communication is also evident in the jurisprudence. An administrator must not only provide relevant information to a departing employee, it must also ensure that the employee understands the content and effect of the information.<sup>48</sup> In *Deraps v. Labourer's Pension Fund of Canada and Eastern Canada*,<sup>49</sup> the employee and his wife met with a union pension counsellor, who was acting as an agent for the administrator, to discuss the employee's pension options upon dismissal. The Ontario Court of Appeal held that the counsellor possessed specialised skills, knowledge and expertise, and therefore had a duty to advise members about the nature of the available options. Although the counsellor did not misstate the required information, his failure to advise the employee about his pension options constituted a misleading representation for which the administrator was liable. This

---

<sup>46</sup> *Ibid.* at 106.

<sup>47</sup> Canadian Association of Pension Supervisory Authorities, *Guideline No. 3: Guidelines for Capital Accumulation Plans*, May 28, 2004.

<sup>48</sup> *Supra* note 39, s. 3378a.

<sup>49</sup> (1999), 21 C.C.P.B. 304 (Ont. C.A.) [*Deraps*].

obligation extends to providing competent and thorough advice to employees regardless of whether they request it.<sup>50</sup>

In *Allison v. Noranda Inc.*,<sup>51</sup> Allison was asked to choose between the following two severance packages: (i) a lump sum payment with employment ending on the termination date; or (ii) a series of instalments with employment terminating after the last payment, by which time he would be 55 years old. Noranda, the employer and the plan administrator, advised Allison to get independent advice but did not inform him that his pension payments under the first package would be one third of those available under the second package. After receiving advice from a life insurance agent, Allison elected the first package and signed a release in favour of the employer. When Allison applied for his pension at age 55, he discovered the immense reduction in his entitlement and sued Noranda for negligent misrepresentation. The trial judge dismissed the action on the basis that Allison had not established a misrepresentation. Further, Allison had executed a release of claims against Noranda. The New Brunswick Court of Appeal applied the *Cognos* test for negligent misrepresentation, which requires as follows: (i) a duty of care based on a special relationship between the parties; (ii) an untrue, inaccurate or misleading representation; (iii) negligence in making the misrepresentation; (iv) reliance on the negligent misrepresentation; and (v) damage to the representee.<sup>52</sup> In examining the third factor, the Court noted that the requisite standard of care is the exercise of such reasonable care as the circumstances require to ensure that representations are accurate and not misleading. Although this

---

<sup>50</sup> *Spinks v. Canada* (1996), 134 D.L.R. (4th) 223 (F.C.A.).

<sup>51</sup> 2001 NBCA 67 [*Noranda*].

<sup>52</sup> *Queen v. Cognos Inc.*, [1993] 1 S.C.R. 87 at 110.

encompasses the obligation to disclose highly relevant information, there is no general, overriding obligation to make full disclosure of items such as plan changes which are merely under consideration.<sup>53</sup> Echoing the *Deraps* approach, the Court held that the administrator had control over specialised information which was not subject to multiple interpretations, and thus had a responsibility to help Allison make an informed decision. The employer knew the pension consequences of both severance options and failed to disclose them, constituting negligence.<sup>54</sup> Further, the Court ruled that the release limited Noranda's liability for wrongful dismissal claims but not for negligent misrepresentation.<sup>55</sup> Pension plan administrators must ensure that employees are able to make informed decisions about their pensions upon termination because the courts will not likely accept that the administrator met the minimum statutory requirements if the employee has been disadvantaged by its conduct.

## **NEGOTIATING SEVERANCE PACKAGES**

In considering the difficult entitlement and valuation issues in quantifying damages for loss of pension benefits, the courts have developed a fairly consistent approach to valuation issues. This is instructive to employees and employers in addressing pension benefits during employment termination settlement discussions. However, pension benefits are only one of a number of factors that the parties may consider in structuring a severance package. While other factors may ultimately prove more compelling, the parties should nonetheless be aware of the impact of the particular settlement structure

---

<sup>53</sup> *Hembruff v. Ontario Municipal Employees Retirement Board*, 2005 C.B.P.G. 8170 (Ont. C.A.).

<sup>54</sup> *Noranda*, *supra* note 51 at para. 30.

<sup>55</sup> *Ibid.* at para. 42.

on the employee's pension benefits. Some of the key considerations in determining an appropriate settlement structure are addressed below.

(a) **Working Notice versus Payment in Lieu**

In some circumstances, the employer and employee are amenable to a working notice arrangement. Typically, this type of arrangement will only be possible where the employer trusts the employee and the employee feels comfortable to continue working after receiving notice of termination. Where part or all of the notice period is structured as working notice, an employee's participation in a pension plan may be continued.

Working notice may not be an option in many dismissals, and as a result, compensation in lieu of notice will instead be provided, either as a lump-sum or in the form of continuing payments, as discussed below.

(b) **Lump-Sum versus Continuing Payments**

The structure of a severance payment as either a lump-sum or as continuing payments not only affects when the employee receive the amounts, but also may affect the employee's tax position and his or her pension benefits. Accordingly, the parties should carefully consider the impact of a particular settlement payment structure well in advance of making any payments. If continuing payments are provided and are treated as employment income, these payments will be paid over a period of time potentially spanning more than one taxation period. In contrast, a one-time, lump-sum severance payment could result in a substantial increase to an employee's income in the year it is received, creating an unexpected tax liability which may ultimately reduce the value to the employee. Although a retiring allowance may be paid in instalments, if an employer withholds and contributes amounts in respect of Employment Insurance,

Canada/Quebec Pension Plan, benefits plan or pension calculations, the amount will be classified as employment income in the employee's hands, and not a retiring allowance.<sup>56</sup>

Employees will have different preferences depending on individual circumstances. For example, one employee may prefer to receive severance over the full notice period but another may have sufficient tax room and cash flow to invest the lump-sum in an RRSP or other eligible tax deferral vehicle.

(c) **Retiring Allowances**

Employees may be able to structure their severance payments as retiring allowances and avoid taxation as income from employment. Section 248(1)(ii) of the *Income Tax Act* (Canada)<sup>57</sup> defines a retiring allowance as an amount received after retirement in recognition of service, or in respect of a loss of office or employment, even if this amount is received as damages. An amount cannot be a retiring allowance if the employment relationship continues to exist, meaning that severance payments to an individual who is deemed to be an active employee for the purposes of pension accrual will not fall within this definition. The rationale for this position is that ongoing pension accrual is conclusive evidence that the employee has not retired.<sup>58</sup> The jurisprudence has established the following two-part test for classifying a retiring allowance: (i) but for the loss of employment would the amount have been received? and (ii) if not, was the purpose of the payment to compensate for loss of employment? If so, the amount may

---

<sup>56</sup> *Ibid.* at para. 17.

<sup>57</sup> R.S.C. 1985, c. 1 (5th Supp.).

<sup>58</sup> M.N.R., Interpretation Bulletin IT-337R4, "Retiring Allowances" (22 February 2006) at para. 4 [IT -337R4].

be characterised as a retiring allowance.<sup>59</sup> Termination pay under the *ESA* is considered employment income even if it satisfies the test, however, additional severance amounts which compensate for loss of employment may properly be considered retiring allowances.<sup>60</sup>

Part of a retiring allowance may be transferred into a Registered Pension Plan (RPP) or an RRSP, thereby deferring tax until a withdrawal is made. The portion of an allowance eligible for transfer is calculated on the basis of the employee's years of service prior to 1996.<sup>61</sup> Although of limited use to individuals who commenced employment post-1996, all employees have the ability to contribute the retiring allowance to an RRSP or RPP if they have sufficient annual contribution room.

If a retiring allowance is paid to an employee, there are several additional considerations which should be contemplated at the outset. An employer must withhold tax on any portion of a retiring allowance not transferred to a RPP or RRSP and any allowance paid to a non-resident.<sup>62</sup> The parties should confirm that a payment is a retiring allowance in advance because an employee who rolls it into a registered plan and subsequently has his or her deduction disallowed will be subject to double taxation, first as income from employment in the year received and again upon withdrawal from the fund.<sup>63</sup>

---

<sup>59</sup> *Ahmad v. R.*, [2002] 4 C.T.C. 2497 (T.C.C.).

<sup>60</sup> IT-337R4, *supra* note 58 at para. 13.

<sup>61</sup> *Ibid.* at para. 19.

<sup>62</sup> *Ibid.* at para. 25.

<sup>63</sup> *Whitecap Ltd. v. R.*, [2005] 4 C.T.C. 2204 (T.C.C.).

(d) **Releases**

It is evident from cases such as *Taggart* and *Noranda* that courts take a very strict approach to interpreting contracts which limit an employee's rights upon termination. The content and scope of a release of employer liability should be discussed during settlement negotiations to ensure that both sides clearly understand its effect. It should be apparent whether the employer is released only from liability for wrongful dismissal or from all potential claims and whether the severance package constitutes the employee's total entitlements to salary and benefits. In *Atlantic Oil Workers Union, Local 1 v. Imperial Oil Ltd.*,<sup>64</sup> all the company's employees were dismissed as a result of the sale of the business and given a severance package in exchange for signing a release of claims "arising out of his or her separation from employment." One category of employees (those aged 49 and under whose age and years of service totalled 55 or more) applied to the Nova Scotia Superintendent of Pensions for a partial wind-up of the pension plan. The partial wind-up liquidated the applicants' portion of the pension fund and provided them with better benefits than those paid under their non-contributory defined benefit plan.<sup>65</sup> The employer sued these former employees for breach of contract and unjust enrichment on the basis that the payments made under the severance program and the partial wind-up constituted double recovery at its expense.

The Nova Scotia Court of Appeal ruled that the release related only to claims against the employer arising out of an individual employee's separation from employment and that the partial wind-up was neither a claim against the company nor a result of a particular

---

<sup>64</sup> 2006 NSCA 100 [*Atlantic Oil*].

<sup>65</sup> *Ibid.* at paras. 7-9.

employee's dismissal, but was a statutory right arising from the sale of the business.<sup>66</sup> The argument that the employees had been unjustly enriched by receiving both severance pay and benefits from the partial wind-up was rejected because there was a juristic reason for the benefit; wind-up payments were only made to the category of employees whose entitlements under the pension plan fell short of those required by statute.<sup>67</sup> The Court held that the severance packages were not funded by the pension plan and were only intended to provide pay in lieu of notice; they could not substitute for the employees' pension entitlements. *Atlantic Oil* demonstrates the courts' lack of sympathy for employers whose superior bargaining power results in inadequate employee compensation. A clear, explicit release is the necessary corollary to a well-planned settlement. Litigation may be avoided if both sides have considered the employee's pension entitlements upon termination and fairly provided for them in any severance payment and release of claims.

## **CONCLUSION**

Employers who dismiss employees without cause should be aware of the complex considerations involved in meeting their obligation to provide notice of employment termination. In settlement negotiations, not only must the length of notice be agreed on, an employer and employee must determine how the notice obligation will be discharged and how all components of compensation, including pension benefits, will be treated. Many employees are concerned about protecting their pensions, but do not understand how employment termination before retirement may affect their current entitlements or

---

<sup>66</sup> *Ibid.* at paras. 56, 68.

<sup>67</sup> *Ibid.* at para. 80.

future payments. Employers and pension plan administrators must understand their obligations and provide departing employees with the appropriate information so that employees can make informed decisions. This in turn will promote achievement of finality between the parties, as reflected in comprehensive settlement terms and releases which are more likely enforceable.