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Allocation of settlement funds in wrongful dismissal claims

General damages, reimbursement of legal fees and RRSP contributions can be used to reduce the amount of taxes and repayment of EI benefits required

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By Stuart Rudner

Imagine this scenario, which will not be foreign to many readers:

You are involved in a wrongful dismissal claim and you find yourself at mediation. At the outset, both parties explain why they are right — the employee's lawyer sets all of the reasons why a huge amount of money is owed to his client, while defence counsel rejects the notion her client has any liability. Ultimately, they both conclude their presentation by confirming that, despite everything



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they have said, their client is there in good faith, hoping to reach a reasonable resolution.

While there may be some tangential issues, such as provisions of references and agreements not to solicit clients, the biggest issue is almost always money. At some point, if there is a reasonable prospect of settlement, an issue may arise that confuses many parties: How do we allocate the payments?

The question often draws a blank stare from the parties. It is often at this point the employee begins to understand he will not get the full amount that has been discussed. First, taxes must be withheld. Second, employment insurance benefits must be repaid. And third, they must pay their lawyer. As an aside, I encourage counsel to have this discussion with their clients before the mediation, starting with the fact that although the claim may be for \$500,000, they may be looking at a lot less in reality.

Once the employee has come to realize he may not end up with as much money “in his pocket” as expected, then discussions will proceed regarding potential allocation. By default, all money paid in a wrongful dismissal claim is income and therefore subject to taxation. In addition, if the employee has received EI benefits, he will likely have to repay some of those. Service Canada must be contacted and advised of the settlement terms. They will then respond and confirm the amount to be repaid. As a result, a portion of the settlement may often have to be withheld until confirmation from Service Canada is received.

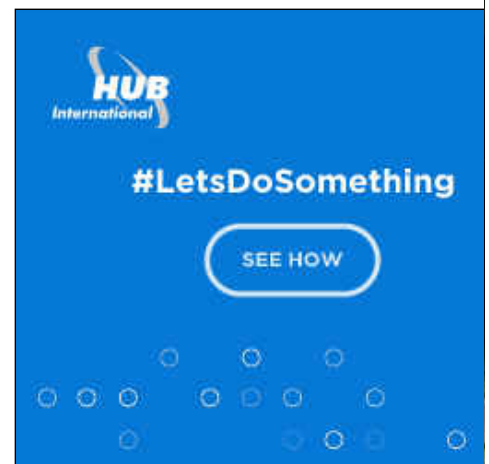
There are a few ways to characterize some of the settlement funds in order to avoid tax and EI implications. Primarily, they are general damages and reimbursement of legal costs. As above, by default, damages in a wrongful dismissal claim are deemed to be income. Some can be allocated as “general damages,” however, if there is a legitimate basis for doing so. General damages are not taxable and do not impact EI benefits. The most common basis is an allegation the employee's human rights were breached. Punitive damages are similar, as are damages for bad faith in the course of dismissal. There should always be a reasonable basis for the proposed allocation, however.

The other common allocation is reimbursement of legal fees. There will have to be some confirmation the amount being allocated does not exceed the actual legal costs, and it is advisable to have the amount paid by the defendant directly to the employee's counsel.

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With respect to the remaining “income,” when paid as a lump sum this can be treated as a “retiring allowance” pursuant to the Income Tax Act. As a result, the tax withholding rate that applies will be different (and lower) than the amount usually applied to paycheques, and “usual” deductions such as EI or CPP do not apply.

If the plaintiff has room available in an RRSP account, some or all of the settlement can be paid directly into the RRSP without being taxable (at least until it is taken out). The employer must make reasonable efforts to confirm there is sufficient room available — often, they will require the employee's most recent Notice of Assessment and confirmation the room indicated in the assessment remains the same. The employer should obtain the account information and make the payment directly to the financial institution.

In addition, for employees with fairly lengthy tenure, they may be entitled to make additional RRSP contributions even if they don't have room available. Specifically, pre-1996 employment entitles the employee to contribute \$2,000 per year, and pre-1989 employment another \$1,500 per year.

Typically, the allocation discussion is a way for the employer to make their offer more attractive. The proposition is fairly simple — the employer will not pay any more, but the employee will receive more. However, it is important to ensure any allocation is reasonable. Otherwise, the Canada Revenue Agency (CRA) or Service Canada may question the employee and pursue either (or both) of the parties. It is common for the defendant to insist the employee provide an indemnity in the event of such a development.

Mediation is an incredibly effective tool to help the parties reach a resolution. However, parties often come to the process uninformed or with unreasonable expectations. It is important they speak with their counsel beforehand so at they have a realistic notion of what they can expect, as well as an understanding of the options and choices they may be presented with.

Stuart Rudner is a leading HR Lawyer and a partner in the Labour & Employment Law Group of Miller Thomson LLP, a national law firm. He provides clients with strategic advice regarding all aspects of the employment relationship, and represents them before courts, mediators and tribunals. He is author of [You're Fired: Just Cause for Dismissal in Canada](#), published by Carswell. He can be reached at (416) 595-8672 or srudner@millerthomson.com. You can also follow him on Twitter [@CanadianHRLaw](#) and join his Canadian HR Law Group on LinkedIn.

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