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Termination agreements: New reporting requirements apply!

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On June 22, 2023, the federal government significantly expanded the reporting requirements for certain so-called avoidance transactions, in particular with respect to termination agreements.[1] The new rules will make it easier for the Canada Revenue Agency (CRA) to detect certain avoidance schemes, conduct tax audits and issue notices of assessment and penalties more quickly when warranted.

The reporting requirements now apply to reportable transactions defined as avoidance transactions, which are primarily aimed at obtaining a tax benefit. If these avoidance transactions involve one of the three markers set out by the Minister of Finance: contingent fee arrangement, confidential protection or contractual protection, they must be reported to the CRA in accordance with the rules in force.

These enhanced rules cover a large number of transactions, in particular those which are part of agreements made specifically in the context of end-of-employment negotiations. In settlements between an employer and an employee following termination, harassment complaints or other employment-related disputes, damages may be awarded as part of the negotiation process. However, the award of these damages, which are normally granted in situations where the employee has suffered personal or moral harm, may not always have a strong legal foundation. In some cases, these damages may be part of a tax-driven strategy: while severance payments are taxable as employment income or as a retirement allowance, damages may be tax-exempt. This type of agreement allows the employer to pay less while maximizing the net amount for the recipient. An agreement providing for the payment of a tax-free amount for damages usually includes an undertaking by the employee to indemnify the employer when a tax audit concludes that the payment should be taxable.

The new reporting requirements are likely to prevent these types of settlements in cases where it is reasonable to conclude that their main purpose is to obtain an unfair tax benefit. These avoidance transactions also exhibit the hallmark of contractual protection, which refers to a protection or guarantee against any failure of the transaction to produce a tax advantage. This is the case when the employee agrees to compensate the employer following a tax recalculation. Such contractual agreements now meet the new reporting criteria.

In these transactions, the reporting obligation is incumbent on the employee (i.e., the person who obtains the tax benefit), the employer (i.e., the person who completes the transaction), and the advisor who obtains fees for setting up the transaction. They have 90 days from the time they entered into the transaction to submit Form RC312 to the CRA.

Failure to do so will result in penalties and an extension of the normal reassessment period. As a

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result, it is inevitable that these updated rules will be taken into account when negotiating termination settlements, and it will be particularly important to review all agreements made since June 23, 2023.

Our team of employment law and tax professionals is available to answer your questions about this major change and help you make informed decisions when negotiating termination agreements.

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1. *Bill C-47: An Act to implement certain provisions of the budget tabled in Parliament on March 28, 2023*

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