Clarifications regarding the application of mandatory disclosure rules to severance agreements

November 21, 2023

On November 2, 2023, in response to certain controversy, the Canada Revenue Agency ("CRA") sought to clarify the application of the new disclosure rules, in force since June 22, 2023. The CRA's comments relate, in particular, to the impact of reporting obligations on severance agreements, a topic we initially covered a few weeks ago[1]. We believe it is appropriate to go over these clarifications.

As a reminder, the disclosure rules generally apply to so-called avoidance transactions carried out to obtain a tax benefit and presenting one of the following three generic hallmarks: contingent fee arrangements, confidential protection or contractual protection. At first glance, the interpretation of these hallmarks suggests that severance agreements involving an employee's undertaking to indemnify their employer are subject to reporting obligations.

However, in response to questions from a number of legal experts, the CRA commented on the disclosure rules, specifying, in particular, that a tax indemnity granted under a severance agreement is not subject to the reporting obligation where it occurs in a business or financial context between persons dealing at arm's length, and acting freely and prudently. In this regard, the CRA pointed out that the contractual protection included in such an agreement would not be considered a generic hallmark insofar as it does not cover a tax treatment giving rise to an unwarranted benefit. The CRA gave as an example a settlement reached between an employer and employee further to dismissal, harassment complaints or other employment-related recourses, providing for severance pay or warranted damages. Even if the employee were to undertake to reimburse the employer in the event of unexpected tax treatment, this type of agreement would not give rise to reporting obligations.

Although the CRA's clarifications were meant to clear things up, they did not definitively establish how the mandatory disclosure rules apply to severance agreements. A certain level of uncertainty remains with regard to severance agreements with no real legal basis awarding tax-free damages to an employee. In such a case, it would be difficult to argue that the business context warranted a favourable tax treatment for the employee. In the case of an agreement providing for the payment of unwarranted damages, and where contractual protection extends to the tax treatment of the amount paid, the avoidance transaction may, despite the CRA's comments, require disclosure to the tax authorities.

One thing is certain: tax indemnity clauses may well disappear from severance agreements.

Ultimately, the new rules reinforce the principle that the granting of tax-free damages should be

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limited to circumstances that warrant it. Quebec case law has long established that the mere fact of losing one's job does not give rise to damages, barring exceptional circumstances.

In short, the CRA's guidelines do not have the force of law, and may be amended or revoked at any time. Consequently, maintaining a cautious and conservative approach will be crucial when determining whether the new mandatory disclosure rules apply to severance agreements.

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

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1. Termination agreements: New reporting requirements apply!

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