Income Tax and Unemployment

With hundreds of thousands of jobs having been lost in Canada over the past six months or so, a lot of people are currently out of work, either on a temporary layoff or on a more long-term basis, as the result of a business downsizing or closure. The loss of a job, whether on a temporary or a permanent basis, has an impact that goes far beyond the financial hit, but finances are typically the most immediate concern of the newly unemployed. Finances, of course, involve taxes, and many people who file a return this month for the 2008 tax year will be including amounts received as a consequence of being out of work during that year.

Those who become unemployed usually have two or three short- or medium-term sources of income. The first is the lump sum usually received by an employee at the time of termination, representing accrued vacation pay and/or a severance amount. The second, medium-term source of income for those who qualify is employment insurance received from the federal government. In some cases, former employees may also qualify for supplemental unemployment benefits (SUB), usually through a SUB plan negotiated as part of a collective agreement. When the period of unemployment is protracted, and those sources of funds run out, it's usually necessary to draw on any available short-term savings to meet expenses and, eventually, to withdraw funds from long-term savings, often from retirement savings accounts. Unfortunately, with the exception of short-term savings, each of these sources of income is included in income and taxed as received at the generally applicable tax rate. In other words, there is no tax exemption or break provided for income received by the unemployed, nor are they eligible for any reduced or preferential tax rates while they are unemployed.

Employment insurance benefits are paid by the federal government on a biweekly basis, representing about 55% of the employee's former wages, up to a current statutory maximum of about $450 in benefits per week. All employment insurance benefits received must be reported as income on line 119 of the income tax return. The federal government will deduct income tax payable from the benefit amount, but as outlined below, that deduction may not accurately represent the recipient's tax bill for the year. Those who are eligible to receive supplemental unemployment (SUB) benefits must also report those benefits as "other income" on line 130 of the return.

At least, there are generally no tax consequences where savings are withdrawn from a source that is not a registered plan (such as a registered retirement savings plan (RRSP), a registered retirement income fund (RRIF), or a registered education savings plan (RESP)). So funds withdrawn from bank savings accounts, GICs, or Canada Savings Bonds cashed in are not considered taxable income when liquidated. Where the source of income is a GIC or some type of bond, there will be tax payable on any income received that represents interest on the original investment, but the invested amount itself is not taxed when returned to the taxpayer. And where taxpayers who set up a tax-free savings account early in 2009 find that they need to withdraw funds from that account later in the year, for whatever reason, neither the funds withdrawn nor any investment income earned on those funds is taxable.

The lump sum often received by an employee at the time of termination usually represents accrued vacation pay and, often, a severance amount. Both types of payments must be included in income and taxed at the recipient's usual rates.

In some cases, a severance amount, particularly where the employee is departing because he or she has accepted a buyout or early retirement package, can be very substantial. Substantial severance amounts may also be paid to long-term non-unionized employees, who may receive the equivalent of several months' income as part of a severance agreement with the employer. Many Canadian taxpayers have thousands of dollars of carryforward room in their RRSPs, and severance amounts received that are not needed to meet current expenses can be contributed to the RRSP within the limits of any carryforward amount. In some cases, for longer-term employees, some of the severance payment received can be characterized as a retiring allowance and contributed to the former employee's RRSP on that basis. The amount that may be contributed as a retiring allowance depends on the length of the employee's time with the employer and when that employment began. Whatever the basis for the RRSP contribution, no tax will be payable on amounts received that are contributed to the RRSP during the year or within 60 days after year end. In all cases, taxpayers who are in a position to receive substantial severance amounts, for whatever reason, should consult with professional advisors to determine the most tax-effective way to structure those payments.

While it is almost always a last resort, those who are out of work for a lengthy period may have to withdraw funds from their retirement savings — generally from an RRSP. As would be the case with any withdrawal from an RRSP, the amounts withdrawn are taxed in the year of withdrawal. Where withdrawals are made, tax will be deducted from the amount withdrawn, at a fixed percentage rate. That percentage rate, which ranges from 5% to 20%, rises as the withdrawal amount increases.

Most employees are accustomed to having income taxes deducted from their paycheques by their employer and remitted to the Canada Revenue Agency on their behalf. The amount deducted and remitted is based on an estimate of the employee's total tax liability for the year, and assuming that the employee's salary is his or her only source of income, the amount withheld usually represents a fairly accurate estimate of the ultimate tax payable for the year. If you're unemployed, though, you might have several sources of income over the course of the tax year (as outlined above), and it is easy, in those circumstances, for any withholdings not to reflect the actual tax liability for the year. The worst-case scenario in such circumstances is to discover, when it is time to file a return for the year, that a substantial amount of tax is owed — this is the last thing anyone trying to meet expenses on a reduced income needs. Consequently, it is advisable for anyone who is receiving income from multiple sources (including, but not limited to, those who are unemployed) to make sure either that the amounts being withheld from those income sources are sufficient to cover the tax bill for the year or that funds are being set aside to make the tax payment on filing as required. As a very general rule of thumb, those whose income for the year will be less than about $40,000 will pay federal tax at a rate of 15%. The rate of provincial tax payable will, of course, depend on the province in which the taxpayer is living: a listing of provincial individual tax rates for 2009 can be found on the Canada Revenue Agency Web site at http://www.cra-arc.gc.ca/tx/ndvdls/fq/txrts-eng.html.