The Taxation of Retroactive Lump-Sum Payments: The Practice and the Policy

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PRÉCIS

Le présent article porte sur l’imposition des paiements forfaitaires rétroactifs, qui sont essentiellement des paiements reçus au cours d’une année d’imposition mais qui ont trait à une ou à plusieurs années d’imposition antérieures. Les dispositions de la Loi de l’impôt sur le revenu qui traitent précisément des paiements forfaitaires rétroactifs visent à imposer ces paiements comme s’ils avaient été reçus au cours de l’année ou des années précédentes qui sont visées plutôt qu’au cours de l’année à laquelle ils ont été reçus. Par conséquent, on s’attendrait à ce que les dispositions donnent lieu à une situation après impôt du bénéficiaire pour l’année de réception du paiement qui soit équivalente à celle qu’il aurait eu si le paiement avait été effectivement assujetti à l’impôt de l’année précédente. En outre, puisque les dispositions imposent effectivement les paiements au taux d’imposition en vigueur l’année précédente, on devrait s’attendre à ce qu’elles aient toujours une fonction d’allègement dans la mesure où le taux d’imposition de l’année précédente du bénéficiaire est inférieur à son taux pour l’année au cours de laquelle le paiement a été reçu. Grâce à une série de propositions qui illustrent l’imposition appropriée des paiements forfaitaires rétroactifs, le présent article montre que les dispositions législatives ne comblent pas ces attentes et n’atteignent pas les objectifs appropriés de la politique fiscale. L’étude arrive notamment à la conclusion que le résultat réel des dispositions consiste à assujettir la composante des intérêts des paiements forfaitaires rétroactifs à une double imposition.

ABSTRACT

This article discusses the taxation of retroactive lump-sum payments, which are essentially payments received in one taxation year that relate to one or more previous taxation years. Provisions of the Income Tax Act that deal specifically with retroactive lump-sum payments are intended to tax the payments as if they had been received in the previous year(s) to which they relate, rather than in the year of receipt. Accordingly, one would expect the provisions to result in an after-tax income position for the recipient in

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the year of receipt equivalent to that which would have resulted had the payment actually been subject to tax in the previous year. Furthermore, since the provisions effectively tax the payment at the previous year’s rate of tax, one would expect that they would always be relieving in nature to the extent that the recipient’s rate of tax in the previous year was less than his rate of tax in the year of receipt. Through a series of propositions illustrating the appropriate taxation of retroactive lump-sum payments, this article shows that the statutory provisions do not fulfill these expectations or the appropriate tax policy objectives. In particular, the analysis leads to the conclusion that the effective result of the provisions is to subject the interest element of retroactive lump-sum payments to double taxation.

KEYWORDS: DEFERRED INCOME ■ INTEREST ■ PAYMENTS ■ RETROACTIVE ■ TAX POLICY ■ TIMING

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INTRODUCTION

I am inclined to agree with the Appellant that this appears to be a disparity between the Legislation and what appears to have been an intent of Parliament to offer some relief to people such as the Appellant.¹

In its 1999 budget,² the federal government introduced a new tax regime applicable to retroactive lump-sum payments, which are certain types of payments received in one taxation year that relate to one or more previous taxation years. The statutory rules that were subsequently enacted—sections 110.2 and 120.31 of the Income Tax Act³—are intended to tax the recipient of a retroactive lump-sum payment as if the

¹ Miller J in Milliken v. The Queen, 2002 DTC 1510, at 1512 (TCC). Milliken is one of the first reported decisions involving the retroactive lump-sum payment provisions. The application of the provisions in that case would have resulted in significantly more tax and interest payable than the amount of tax that the taxpayer paid without the application of the provisions.

² Canada, Department of Finance, 1999 Budget, Budget Plan, February 16, 1999.

³ RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act and regulations thereunder. Sections 110.2 and 120.31 were enacted by SC 2000, c. 19, sections 17 and 30.
payment had been received in the previous year to which it relates. Thus, the statutory rules should be relieving in nature if the recipient’s marginal rate of tax in the previous year was lower than the recipient’s marginal rate of tax in the year of receipt. For example, the rules should be beneficial if the payment relates to several previous years and would otherwise lead to the “bunching” of income if included entirely in the year of receipt, such that a higher rate of tax would apply owing to the progressivity of the income tax system. That is, if a taxpayer receives a retroactive lump-sum payment that relates to several previous taxation years, the effective spreading out of the taxation of the payment over those previous years should result in a saving of tax relative to the inclusion of the entire payment in the year of receipt if such inclusion would move the taxpayer into a higher tax bracket.

The application of the retroactive lump-sum payment statutory provisions (herein “the RLSP provisions”) is in effect optional, in that they apply only if the recipient deducts the lump-sum payment (excluding any interest portion) in computing taxable income in the year of receipt. If the deduction is claimed, each portion of the lump-sum payment is effectively taxed as if it had been received in the year to which it relates, and notional interest is charged on the resulting tax up to the year of receipt. The deduction of each such portion in computing taxable income in the year of receipt ensures that it is not subject to further tax under the regular tax rules. If the deduction is not claimed, the RLSP provisions do not apply and there is no offset to the inclusion of the lump-sum payment in the year of receipt under the provision that otherwise applies to the type of payment. The Canada Revenue Agency (CRA) performs the necessary calculations under the RLSP provisions, allowing taxpayers to compare the amount payable with and without the application of the provisions and therefore decide whether to proceed under the provisions.  

As noted, one would expect the RLSP provisions to be beneficial if the recipient’s marginal rate of tax in the previous year to which the payment relates is lower than the recipient’s marginal rate of tax in the year of receipt. If those tax rates are the same, one would expect the RLSP provisions to be neutral in terms of providing an equivalent tax result to that seen in the absence of their application. In contrast, this article illustrates that the RLSP provisions are beneficial only if the recipient’s marginal rate of tax in the year of receipt is significantly higher than that of the previous year, and that the provisions are never neutral if the marginal tax rates are the same in those years. As discussed in the article, the reason why the RLSP provisions do not provide the appropriate results is that they effectively subject the interest element of lump-sum payments to double taxation.

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4 The CRA will make the calculations if the recipient taxpayer files form T1198, “Statement of Qualifying Retroactive Lump-Sum Payment” with the recipient’s tax return for the year of receipt.

5 I became interested in the RLSP provisions after being asked by a labour lawyer to review certain calculations that involved the taxation of retroactive lump-sum payments received by employees pursuant to the settlement of a pay equity proceeding. Most of the lump-sum payments related
THE PRACTICE: THE APPLICATION OF THE RLSP PROVISIONS

The RLSP provisions in sections 110.2 and 120.31 were passed into law in 2000 and apply to retroactive lump-sum payments made after 1994 that relate to taxation years ending after 1977. As noted in the introduction, the provisions are intended to provide relief to the potential problem of a higher marginal tax rate in the year of receipt of a retroactive lump-sum payment relative to the previous year or years to which it relates. In the explanatory notes to section 110.2, the Department of Finance summarized the issue as follows:

For individuals, income from most sources is taxable in the year in which it is received. As a result, individuals are generally taxable on retroactive lump-sum payments in the year they are received, even though a significant portion may relate to prior years. Due to the progressive rate structure of the income tax system, the tax payable on those lump-sum payments may, therefore, be significantly higher than it would have been if payments had been received and taxed on an on-going basis from the date of eligibility.6

The RLSP provisions can apply if a lump-sum payment is a “qualifying amount” received by an individual taxpayer (other than a trust) in a taxation year. A “qualifying amount” received by an individual in a taxation year7 is generally the principal portion of the lump-sum payment (that is, not including the portion of the payment that is, or is on account of, in lieu of payment of, or in satisfaction of, interest) that is included in the individual’s income in the year and that is either

- income from employment or damages in respect of the loss of an employment received pursuant to a court order or judgment, an arbitration award, or a contract that terminates a legal proceeding;
- superannuation or pension benefits received on account of, in lieu of, or in satisfaction of a series of periodic payments;

6 Canada, Department of Finance, Legislative Proposals and Explanatory Notes Relating to Income Tax, September 1999 (Ottawa: Department of Finance, 1999), clause 10.

7 See the definition of “qualifying amount” in subsection 110.2(1). A qualifying amount does not include an amount that the individual recipient may deduct for the year under paragraph 8(1)(b), (n), or (n.1), 60(n) or (o.1), or 110(1)(f).
spousal support payments;
- employment insurance benefits; or
- benefits paid under wage loss replacement or disability insurance plans.

The RLSP provisions work as follows. Each portion of a qualifying amount of a lump-sum payment received in a taxation year is effectively allocated to the previous taxation year to which it relates; the previous year is defined and referred to as the “eligible taxation year.” The portion is considered a “specified portion” in relation to the eligible taxation year to the extent that the taxpayer’s eligibility to receive the portion existed in that year. Each specified portion of the qualifying amount does not include any interest portion of the lump-sum payment, which is included in income in the year of receipt under the regular interest inclusion rules of paragraph 12(1)(c). The specified portion is subject to tax as if it were included in income in the eligible taxation year: the tax effectively equals the additional tax that would have been paid by the taxpayer in the eligible taxation year had the specified amount been included in income in that year. The additional tax is added to the taxpayer’s part I tax payable for the year of receipt, and does not affect the return of the taxpayer’s eligible taxation year or the returns of other taxpayers. The taxpayer also pays non-deductible notional interest calculated on the additional tax up to the year of receipt to account for the effective deferral of the payment of that tax. (The additional tax is in

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8 See the definitions of “eligible taxation year” and “specified portion” in subsection 110.2(1).
9 See the definition of “specified portion” in subsection 110.2(1).
10 Interest is required to compensate the recipient for the time value of money, namely, the difference in the value of money between the eligible taxation year and the year of receipt. The interest is excluded from the “qualifying amount” and therefore the “specified portion” of the qualifying amount pursuant to the definitions of those terms in subsection 110.2(1).
11 Paragraph 12(1)(c) includes in income an amount “as, on account of, in lieu of payment of or in satisfaction of, interest.” See also CRA document no. 2002-0168757, December 4, 2002: “The interest portion of any lump-sum amount is taxable in the year received, and is not eligible for the special tax calculation [under the RLSP provisions].”
12 Subsection 120.31(2). The “notional tax payable” in respect of the eligible taxation year that is utilized in subsection 120.31(2) is computed under subsection 120.31(3).
13 Subsection 120.31(2).
14 The notional interest is computed under paragraph 120.31(3)(b) and added to the “notional tax payable” and therefore the amount of tax payable under subsection 120.31(2). The rate of interest for these purposes equals the prescribed rate applicable to refunds provided by the CRA under regulation 4300(b), which is 2 percent higher than the prescribed rate of interest that applies to other provisions of the Act (other than the rate of interest charged for late payments of amounts owing to the receiver general). The current wording of paragraph 120.31(3)(b) appears to indicate that the notional interest is calculated on the entire tax payable in respect of the eligible taxation year, rather than on only the additional tax payable in respect of that year. An amendment to clarify that the interest is calculated on the additional tax only was proposed in section 114(1) of Bill C-10, Income Tax Amendments Act, 2006. That bill ceased to exist when Parliament was dissolved on September 7, 2008 and therefore will have to be reintroduced in Parliament.
respect of the eligible taxation year but is paid in or after the year of receipt.) The notional interest is apparently not considered interest for the purposes of the Act,\textsuperscript{15} and therefore will continue to be referred to as notional interest in this article. The specified portion of the qualifying amount is deducted in computing taxable income in the year of receipt,\textsuperscript{16} such that it is not subject to further tax in that year. As noted earlier, the application of the RLSP provisions is effectively optional, in that the provisions apply only if the recipient deducts the specified portion in computing taxable income in the year of receipt.\textsuperscript{17}

The objective of the RLSP provisions is to tax the recipient taxpayer as if the specified portion of the lump-sum payment had been received and taxed in the eligible taxation year. Accordingly, the tax policy goal should be to produce an after-tax amount for the taxpayer in the year of receipt equal to the amount that would have resulted had the specified portion been taxed in the eligible taxation year. Unfortunately, the RLSP provisions do not achieve this policy goal because they effectively subject the interest portion of lump-sum payments to double taxation. This particular point is illustrated in the next section of the article.

However, on a more basic level, it should be obvious why the RLSP provisions are typically not beneficial and often lead to excessive taxation relative to the situation where they do not apply. When the RLSP provisions apply, the recipient (1) includes in income each specified portion of the lump-sum payment, which is subject to the rate of tax of the eligible taxation year; (2) includes in income the interest portion of the lump-sum payment in the year of receipt; and (3) pays notional interest computed on the specified portion. When the RLSP provisions do not apply, the recipient (1) includes in income each specified portion of the lump-sum payment, which is subject to the rate of tax of the year of receipt; and (2) includes in income the interest portion of the lump-sum payment in the year of receipt. In other words, in both cases the recipient includes in income the specified portion and the interest portion of the lump-sum payment, although the specified portion is subject to the rate of tax of the eligible taxation year when the RLSP provisions apply, whereas the specified portion is subject to the rate of tax of the year of receipt when the provisions do not apply. Of course, the notional interest charge is paid only in the RLSP scenario. As a result, one would expect the RLSP provisions to typically result in an excess amount payable by the recipient (tax on the entire lump-sum plus notional interest) relative

\textsuperscript{15} Legislative Proposals and Explanatory Notes Relating to Income Tax, supra note 6, clause 23.

\textsuperscript{16} Subsection 110.2(2). Since the amount is deducted in computing taxable income rather than income, the deduction will have no effect on income-based credits or other amounts that are similarly based on income.

\textsuperscript{17} Specifically, the tax under subsection 120.31(2) applies in respect of a specified portion of a qualifying amount received in the year only to the extent that an amount is deducted in computing taxable income under section 110.2 in respect of the specified portion in the year. Also, the RLSP treatment applies only if the total of all amounts each of which is a specified amount received in the year of receipt is $3,000 or more (subsection 110.2(2)).
to the result where they do not apply (tax on the entire lump-sum but no notional interest).

In particular, the RLSP provisions will not be beneficial for the recipient unless the total notional interest charge is less than the amount by which the tax that would be payable on the specified portion without the application of the RLSP provisions (applying the tax rate of the year of receipt) exceeds the tax payable on the specified portion with the application of the RLSP provisions (applying the tax rate of the eligible taxation year). Stated as a more general proposition, the RLSP provisions will be beneficial only if the recipient’s marginal rate of tax in the year of receipt is significantly higher than the recipient's marginal rate of tax in the eligible taxation year. A series of numerical examples provided in appendix 1 to this article confirms the general proposition in cases where the period of time between the relevant taxation years is 5 years, 10 years, and 12 years, respectively. The actual difference in marginal tax rates, where the RLSP provisions will be beneficial, will depend on the prescribed rate of interest and the period of time between the eligible taxation year and the year of receipt.

Not surprisingly, in practice, it appears that many taxpayers have found no relief in the RLSP provisions. In court cases dealing with the RLSP provisions, the application of the provisions was not beneficial to certain taxpayers notwithstanding that the lump-sum payments they received related to a dozen or more eligible taxation years. In other words, each taxpayer was better off with the full inclusion of the lump-sum payment in the year of receipt relative to the effective spreading out of the inclusion of the payment over several eligible taxation years. Although the cases do not indicate the specific reason for these seemingly anomalous results, it no doubt relates to the deficiency in the RLSP provisions as noted above and as further analyzed in the remainder of the article.

THE POLICY: THE APPROPRIATE TAX TREATMENT OF RETROACTIVE LUMP-SUM PAYMENTS

The Tax Deferral Analogy Applied to the Tax Policy Goal

An income tax system must sometimes deal with the issue of taxing an amount in the year in which it is received or realized, notwithstanding that it relates to a previous year and should have been included in the tax base in that previous year as a matter

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18 See also part A, “Tax Practice Analysis,” of appendix 1 to this article, where this proposition is reflected in the form of alternative algebraic expressions.

19 Milliken, supra note 1; Anderson v. The Queen, 2003 DTC 572 (TCC); and Stuart v. The Queen, 2009 DTC 1309 (TCC). In each case, the application of the RLSP provisions would have resulted in the taxpayer paying more in tax and notional interest than he or she paid in tax without the application of the provisions. The lump-sum payment in each case related to a significant number of previous eligible taxation years—12 years in the Milliken case, 15 years in the Anderson case, and 14 years in the Stuart case. Nonetheless, the full inclusion of the lump-sum payment in the year of receipt was beneficial to each taxpayer relative to the application of the RLSP provisions.
of policy. In this regard, the term “tax deferral” is often used to describe an inclusion of an amount in income in one year that should have been included in income in a previous year. Owing to the time value of money, a tax deferral reduces the value of the tax liability in respect of the amount—that is, tax paid in one year is less than the present value of the same dollar quantum of tax paid in a previous year. However, the effects of a tax deferral can be rectified by applying time value of money adjustments or equivalencies to account for the deferral, thus subjecting the deferred income to the proper amount of tax (the amount that would have been paid but for the deferral). These adjustments or equivalencies can be employed to properly account for retroactive lump-sum payments, which, similar to tax deferrals, involve the recognition of an amount in one year that relates to one or more previous years.

The basic financial equivalency that can be employed in these cases is well known in the academic tax literature: the inclusion of an amount in a taxpayer’s income in one taxation year is the financial equivalent of the inclusion of the amount, grossed up by the taxpayer’s after-tax rate of return, in the taxpayer’s income in a subsequent year. In other words, the inclusion of the amount in one year is the financial equivalent of including the after-tax future value of the amount in a subsequent year. From a retroactive perspective, the equivalency holds that the inclusion of an amount in the current year is the financial equivalent of including in income the after-tax value of the amount as of a prior year in that prior year, and taxing the income earned by investing that amount from the prior year to the current year.

As noted earlier, the tax policy goal of the RLSP provisions should be to produce an after-tax amount for the recipient in the year of receipt equal to the amount that would have resulted had the specified portion of the lump-sum payment been received and taxed in the previous eligible taxation year. The basic financial equivalency therefore can be employed to obtain the desired tax policy goal. The propositions that follow illustrate how the financial equivalency (and a variation thereof) can produce the tax policy goal and, conversely, why the RLSP provisions generally result in excessive taxation and therefore do not fulfill the tax policy goal. (Readers interested in the algebraic analysis relating to the propositions should refer to part B of appendix 1 to the article.)

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Proposition: Including the lump-sum payment in taxable income in the year of receipt will achieve the tax policy goal if the recipient’s marginal tax rate is constant.\(^{21}\)

This proposition and those that follow will be illustrated using the following example:

*Example*

A taxpayer and her employer have settled a pay equity dispute in respect of $10,000 of employment income that should have been paid to the taxpayer on January 1, year 1. It is now January 1, year 3, and the parties have agreed that the employer will pay the taxpayer a lump-sum payment equal to the current value of the $10,000 amount that should have been paid in year 1. Using the RLSP terminology, the $10,000 amount is the “specified amount” in relation to year 1.

Assume that

1. the taxpayer’s annual pre-tax rate of return on investment (or pre-tax discount rate) is 5 percent;
2. the taxpayer has a marginal tax rate of 40 percent, which remains constant over time;
3. the taxpayer’s after-tax rate of return is therefore 3 percent; and
4. the taxpayer credits annual interest on the $10,000 amount at the rate of 3 percent.

In the discussion of this example, to be consistent with the RLSP terminology, year 1 will also be referred to as “the eligible taxation year” and year 3 will also be referred to as “the year of receipt.”

In order to replicate what would have been a $10,000 receipt and inclusion for the taxpayer in year 1, the lump-sum payment in year 3 should equal the after-tax value of that $10,000 amount as of year 3. Thus, the payment should equal $10,000 grossed up by the taxpayer’s annual after-tax rate of return of 3 percent, as assumed in the example. The payment in year 3 will therefore equal $10,609—that is, $10,000 × (1.03)^2. (All figures herein are rounded to the nearest dollar.) The taxpayer will pay 40 percent tax on that amount ($4,244), leaving her with $6,365 after tax in year 3. Note that the after-tax amount of $6,365 equals the amount that the taxpayer would have retained as of year 3 had she received the $10,000 amount on January 1, year 1, paid 40 percent tax on that amount, and invested the after-tax portion for two years at 5 percent per year and paid 40 percent tax each year on that annual return.\(^{22}\)

\(^{21}\) See also rule A in part B of appendix 1.

\(^{22}\) The taxpayer would have netted $6,000 after tax in year 1 ($10,000 net of $4,000 tax). As noted in the example, with a 40 percent rate of tax, the annual after-tax rate of return equals 3 percent. After two years of investment and therefore as of year 3, the taxpayer would have $6,000 × (1.03)^2, or $6,365.

Similarly, assuming that the year 3 payment is deductible for the employer, the employer will, if also subject to a 40 percent tax rate, effectively pay $6,365 after tax in year 3 ($10,609 net of the 40 percent tax saving). This amount equals the after-tax value as of year 3 of the amount that would have been the employer's after-tax liability in year 1 if it had paid the $10,000 in year 1 and deducted that amount in computing its income in that year. The numerical calculation
In short, this treatment of the $10,609 payment in year 3 puts the taxpayer in an after-tax and time-adjusted position equivalent to that seen with the receipt and inclusion of the $10,000 specified amount in year 1, thus satisfying the tax policy goal.\[23\] The additional $609 portion of the lump-sum payment in year 3 is, of course, the after-tax interest element of the payment.

The above example is relatively straightforward because the payment in year 3 relates to one eligible taxation year only. However, the analysis would be similar and the conclusions the same if a lump-sum payment related to a number of previous eligible taxation years. For example, if the lump-sum payment in year 3 related to five $10,000 specified portions, each of which should have been received in year 1, 0, −1, −2, and −3, respectively, the inclusion of the lump-sum payment in year 3 would provide an equivalent result to that seen with the inclusion of each $10,000 specified portion in its respective eligible taxation year.\[24\] However, in order to keep the calculations simple, the above example involving one previous eligible taxation year will continue to be employed in this article.

\[23\] If the taxpayer received the pre-tax future value of the $10,000 specified amount in year 3, rather than the after-tax future value as in the example, she would receive $11,025 ([($10,000 \times (1.03)^3]) and pay 40 percent tax on that amount, which equals $4,410, leaving her with $6,615 after tax in year 3. Note that this would be the equivalent of the taxpayer's including the $10,000 amount in her income in year 1 but subsequently excluding from income the 5 percent return from investing the amount retained after tax. That is, the inclusion in year 1 would leave the taxpayer with $6,000 after tax, which, if invested at 5 percent without further tax, would net her $6,615 as of year 3 ([($6,000 \times (1.05)^3)]). Since the payment would similarly cost the employer $6,615 after tax in year 3 ($11,025 assuming a net 40 percent tax saving), rather than the $6,365 after-tax amount in the example, it might be said that the employer in such case would be taxed as a “substitute” for the taxpayer in respect of the 5 percent annual return; see Halperin, supra note 20, at 521-23. For this reason, of course, the employer would not normally agree to make such a payment and would normally insist on a payment equal to the after-tax future value of $10,000, as in the example. On the other hand, if the employer (or other payer, such as a pension plan) were tax-exempt, it might agree to such a payment because the $11,025 payment in year 3 would simply equal the year 3 value of the $10,000 amount in year 1, using the 5 percent (tax-exempt) return. This possible scenario is explored in appendix 2 to the article. Alternatively, the employer might agree to a payment somewhere between the before-tax and the after-tax future value of the $10,000 amount.

\[24\] The eligible taxation years, which would be years 1, 0, −1, −2, and −3, are two, three, four, five, and six years before year 3, respectively. The after-tax value of $10,000 received in each of those eligible taxation years as of year 3 would therefore equal $56,325, calculated as follows:

\[
\begin{align*}
[&$10,000 \times (1.03)^3] + [$10,000 \times (1.03)^4] + [$10,000 \times (1.03)^5] + [$10,000 \times (1.03)^6] = $56,325. \text{Assuming the lump-sum payment received in year 3 equalled this amount, with a 40 percent rate of tax the taxpayer would net $33,795 after tax in year 3 ([($56,325 \times (1 - 0.4)).
\end{align*}
\]

If the taxpayer had received a specified portion of $10,000 in each of those five eligible taxation years, paid the 40 percent tax, and invested the $6,000 after-tax amounts, the value of those investments similarly would have grown, at the after-tax annual rate of return of 3 percent, to $33,795 as of year 3, calculated as follows: $[6,000 \times (1.03)^3] + [6,000 \times (1.03)^4] + [6,000 \times (1.03)^5] + [6,000 \times (1.03)^6] = $33,795.$
Proposition: Including the lump-sum payment in taxable income in the year of receipt but using the marginal tax rate of the eligible taxation year will achieve the tax policy goal even if the marginal tax rate changes over time\textsuperscript{25}

The financial equivalency illustrated above assumes constant tax rates. Hence, a higher rate of tax in the year of receipt than the rate in the eligible taxation year would subject the recipient taxpayer to a greater amount of tax in the year of receipt. As noted earlier, this potential problem with different rates of tax in different taxation years, owing to the progressive nature of the tax system, was the reason why the federal government enacted the RLSP provisions in the first place. The progressivity issue is particularly relevant if the lump-sum payment relates to several previous eligible taxation years, because the inclusion of the payment would otherwise have been spread out over those several years, as compared with the inclusion of the entire payment in the year of receipt.

One way of dealing with the progressivity issue is to tax the entire lump-sum payment (including the interest portion of the payment) in the year of receipt but use the taxpayer’s marginal tax rate of the eligible taxation year. As noted above, the inclusion of an amount in the eligible taxation year at a certain rate of tax is the financial equivalent of the inclusion of the after-tax future value of the amount in the year of receipt at the same rate of tax. Under this approach, the financial equivalency would provide the appropriate result simply because the approach would mandate using a constant rate of tax, namely, the marginal rate of tax applicable to the eligible taxation year. In the above example, the $10,609 amount would be carved out from the taxpayer’s other income in year 3 (which would be subject to the taxpayer’s tax rate in year 3) and would be taxed at the year 1 tax rate of 40 percent, albeit in year 3. As noted above, this would leave the taxpayer with $6,365 after tax in year 3 in respect of the $10,609 payment\textsuperscript{26}.

\textsuperscript{25} See also rule B in part B of appendix 1.

\textsuperscript{26} If the taxpayer were subject to a different tax rate in year 3 without taking into account the lump-sum payment, the amount of the payment might be adjusted accordingly, because the interest element (or return) in respect of year 3 would otherwise be subject to that different rate of tax. Applying the marginal rate of tax for year 1 would still provide the appropriate result. For example, assume that the taxpayer’s marginal tax rate was 50 percent in year 3 (before the inclusion of the lump-sum payment) and 40 percent in years 1 and 2. In this case, the after-tax value of the $10,000 amount would equal $10,558 as of year 3—that is, $[10,000 \times 1.03 \times 1.025] = 10,558. Assuming that the lump-sum payment also equalled $10,558, applying the year 1 tax rate of 40 percent on that amount ($4,223) in year 3 would leave the taxpayer with $6,335 after tax in year 3. This is the same amount that the taxpayer would have retained after tax had she received the $10,000 in year 1 and invested the after-tax proceeds until year 3. That is, she would have netted $6,000 after tax and earned an after-tax return of 3 percent in year 2 and 2.5 percent in year 3, resulting in a total of $6,335 as of year 3 ($6,000 \times (1.03)) \times (1.025) = 6,335).
Proposition: Notionally calculating tax for the eligible taxation year and charging notional interest on that tax will achieve the tax policy goal if the notional interest rate (the prescribed rate) equals the taxpayer's after-tax rate of return

An alternative method of dealing with the progressivity issue is an “interest charge” approach. Under this method, the transaction would be taxed as if the payment had been received in the year to which it related, namely, the eligible taxation year, and interest would be charged on the resulting tax up to the year of receipt. Turning to the example, instead of including the $10,609 payment in regular year 3 income, the taxpayer would include the present value of that amount as of year 1, namely, the $10,000 specified portion of the payment, as if it had been received in year 1. This would require a payment of $4,000 of tax. However, since the payment of the tax would be made in year 3 rather than in year 1, the government should charge interest on the tax from the due date until year 3. Assume that the interest rate used by the government is the same as the taxpayer's after-tax rate of return (which, in turn, is the rate of interest credited by the payer in respect of the amount). The taxpayer would pay an annual rate of interest of 3 percent on the $4,000 of tax, which would equal $244 as of year 3. Thus, she would pay a total amount of tax and interest of $4,244 in year 3 ($4,000 tax relating to year 1 plus the $244 interest). Subtracting this from the $10,609 payment received in year 3, the taxpayer would be left with $6,365, the same amount as that determined above.

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27 See also rule C in part B of appendix 1.
28 If the interest is not deductible for the taxpayer (as is the case with the notional interest charge under the RLSP provisions), the appropriate rate of interest should reflect an after-tax rate of interest; see Hanna, “Demystifying Tax Deferral,” supra note 20, at 393-95.
29 See the text accompanying notes 21 to 22 supra.
30 The calculation is as follows: \[\left\{4,000 \times (1.03)\right\}^2 - 4,000 = 244\].
31 As discussed in note 26 supra, if the taxpayer were subject to a different tax rate in year 3 without taking into account the lump-sum payment, the amount of the payment might be adjusted accordingly. In theory, the amount of interest charged for year 3 under the interest charge approach should take that different tax rate into account because the interest should reflect an after-tax rate of interest. For example, assume that the taxpayer's rate of tax was 50 percent in year 3 (before the inclusion of the lump-sum payment) and 40 percent in years 1 and 2. In this case, as shown in note 26 supra, the after-tax value of the $10,000 amount as of year 3 would equal $10,558. Under the interest charge approach described in the text, the taxpayer would pay the $4,000 of tax applicable to year 1. The after-tax rate of non-deductible interest charged on the tax would equal 3 percent for year 2, but in this scenario it should equal 2.5 percent for year 3, owing to the 50 percent tax rate in year 3—that is, \[5\% \times (1 - 0.5)\]. The total tax plus interest would therefore equal \[4,000 \times (1.03)\] \times (1.025), or $4,223, as of year 3. Assuming that the payment received in year 3 was adjusted to $10,558, as described above, the taxpayer would net $6,335 after tax in year 3 ($10,558 - $4,223), the same amount that she would have netted as of year 3 had she received $10,000 in year 1 and invested the after-tax proceeds as shown in note 26 supra. Of course, the practical problem with this treatment is that the government would presumably use a standard rate of interest, such as the prescribed rate that it currently uses under the RLSP provisions; it would not be very practical to change that rate each year as an individual taxpayer's marginal tax rate changed.
Summary of Equivalencies and Propositions,
and Concluding Proposition

In summary, there are at least two methods that an income tax system could employ to properly account for retroactive lump-sum payments. Under the first method, the lump-sum payment including the after-tax interest element of the payment would be included in the taxpayer's income in the year of receipt but would be subject to the taxpayer's marginal tax rate of the eligible taxation year. Under the second method, the transaction would be taxed as if the “principal” portion of the lump-sum payment (not including the interest element), namely, the specified portion, were included in the taxpayer's income in the eligible taxation year, and interest equal to the taxpayer's after-tax rate of return would be charged on the resulting tax up to the year of receipt. As illustrated above, each method would provide the taxpayer with an amount equivalent to that which would have resulted had the taxpayer received and included in income the specified portion in the eligible taxation year, invested the after-tax amount, and been subject to tax on the income earned by investing that amount from the eligible taxation year up to the year of receipt.

Concluding proposition: The RLSP provisions do not achieve the tax policy goal

The RLSP provisions follow an approach similar to the interest charge method described above, using a prescribed rate of interest as the applicable rate. However, the interest element of the lump-sum payment is also included in income in the year of receipt under paragraph 12(1)(c) of the Act. Effectively, this treatment means that the interest element is taxed twice. Turning back to the example, a notional interest charge on the tax in respect of the $10,000 specified portion from year 1 results in interest of $244 being payable as of year 3. However, if the $609 after-tax interest element is also included in income in year 3, another $244 of tax is payable in that year (40% × $609), which nets the taxpayer $6,121 after tax instead of $6,365 (that is, $244 less). This treatment is the equivalent of the taxpayer's including the $10,000 specified portion in income in year 1, paying 40 percent tax on that amount, investing the after-tax portion of $6,000 for two years at 5 percent per year, but paying 80 percent tax each year on the interest income or return. The application

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32 See also rule D in part B of appendix 1.
33 See supra note 14 and the accompanying text regarding the prescribed rate of interest and the notional interest charge.
34 The 1999 federal budget documents indicate that this is the intended result where the RLSP provisions apply: “The interest portion of the lump-sum payment will continue to be taxed in the year in which it is received.” Supra note 2, annex 7, “Tax Measures: Supplementary Information,” 201.
35 See supra note 30 and the surrounding text.
36 The before-tax rate of return or interest is 5 percent, such that an 80 percent rate of tax on the interest element would leave an after-tax rate of return of 1 percent ([5% × (1 − 0.8)]). The after-tax $6,000 amount in year 1, if invested at 1 percent per year after tax, would net $6,121 after tax as of year 3 ([$6,000 × (1.01)^2] = $6,121).
of the RLSP provisions effectively results in the double taxation of the interest element.\textsuperscript{37}

Owing to the double taxation of the interest element of lump-sum payments, the application of the RLSP provisions will normally be beneficial only if the taxpayer’s marginal rate of tax in the year of receipt is significantly higher than that in the eligible taxation year. The actual difference in marginal tax rates, where it will be beneficial, will depend on the prescribed rate of interest and the period of time between the eligible taxation year and the year of receipt.\textsuperscript{38} In particular, the higher the interest rate and the longer the period of time, the greater the extent of the double taxation of the compounding interest, such that the difference in tax rates required for the RLSP provisions to be beneficial is increased accordingly. For example, if the after-tax interest rate and the prescribed rate of interest in the above example were 5 percent and the year of receipt were nine years after the eligible taxation year (that is, year 10), the RLSP provisions would be beneficial only if the taxpayer’s rate of tax in the year of receipt were higher than 58 percent (which, of course, is more than the highest marginal rate that currently applies in any province or territory in Canada).\textsuperscript{39} Any lower tax rate in the year of receipt would result in less tax payable without the application of the provisions.

\textsuperscript{37} The extent of the double taxation is alleviated somewhat because the RLSP provisions apply the notional interest charge as of May 1 in the year following the eligible taxation year (subparagraph 120.31(3)(b)(i)), rather than as of the eligible taxation year.

\textsuperscript{38} For an algebraic analysis indicating in more specific terms when the RLSP provisions will be beneficial, see part A of appendix 1.

\textsuperscript{39} The after-tax value of the $10,000 specified portion as of year 10 using the interest rate of 5 percent would equal $15,513 ([$10,000 \times (1.05)^9]) , the interest element of which would equal $5,513 ($15,513 − $10,000). Assuming that the marginal rate of tax in year 1 was 40 percent, the RLSP provisions would result in $4,000 of tax relating to the $10,000 specified portion, plus notional interest on that $4,000 tax starting with May 1, year 2, through to the beginning of year 10, which is approximately 7\frac{2}{3} years. The total notional interest as of year 10, using a prescribed rate of 5 percent, would equal $1,815 ([$4,000 \times (1.05)^{7\frac{2}{3}}] − $4,000), which, when added to the $4,000 of tax, would equal $5,815. Furthermore, the after-tax interest element of $5,513 received in year 10 would be subject to tax at the year 10 rate of tax, denoted herein as rate $t$. The taxpayer would pay a total of $5,815 + $5,513t. If the RLSP provisions did not apply, the entire $15,513 payment would be subject to tax at the year 10 rate of tax $t$, such that the taxpayer would pay $15,513t$.

The following equation can be used to determine the “breakeven” rate of tax in year 7, where the application of the RLSP provisions would result in the same amount payable as that without their application:

\[5,815 + 5,513t = 15,513t, \text{ or} \]
\[5,815 = (15,513 − 5,513)t = 10,000t. \] (1)
\[5,815 = (15,513 − 5,513)t = 10,000t. \] (2)

The rate $t$ is 58.15 percent, meaning that a tax rate higher than that in year 10 is required in order for the RLSP provisions to be beneficial, while a lower tax rate in year 10 results in less tax payable without the application of the provisions. Note that if the parties grossed up
CONCLUSION
The application of the RLSP provisions effectively subjects the interest portion of a retroactive lump-sum payment to double taxation. A simple solution to the double taxation problem would be an amendment to the Act providing that when the RLSP provisions apply, the interest portion of the lump-sum payment is not included in income. However, for reasons discussed in the article, such an amendment would provide an ideal result from a policy perspective only if the actual rate of interest included in the lump-sum payment equaled the prescribed rate of interest used for the notional interest charge under the RLSP provisions. In those cases where the actual rate of interest exceeds the prescribed rate of interest, that excess should be subject to taxation in the year of receipt. Therefore, a more appropriate amendment to the Act would provide that when the RLSP provisions apply, the tax payable on the interest portion of the lump-sum payment is reduced by the amount of the notional interest charge applied under those provisions.

APPENDIX 1 ALGEBRAIC ANALYSIS OF ALTERNATIVE METHODS OF TAXATION
A. Tax Practice Analysis
Assume for simplicity that a lump-sum payment relates to one eligible taxation year only, such that the qualifying amount and the specified portion of the payment are the same, being amount $A$. The eligible taxation year is year 0. The amount $A$, together with interest computed by the payer at rate $r$, is paid $n$ years later. Thus, the total lump-sum payment received by the taxpayer in year $n$, being the year of receipt, is

$$A (1 + r)^n.$$

Assume that the marginal tax rate in year $n$ is $u$. If the taxpayer does not elect to use the RLSP provisions, his after-tax income in year $n$ is the amount of the lump-sum payment less the tax on that amount:

$$A (1 + r)^n - A (1 + r)^n u. \quad (1)$$

Assume that the taxpayer’s marginal tax rate in year 0 is $t$. If the taxpayer elects to use the RLSP provisions, his after-tax income in year $n$ is the amount of the

the payment even more to account for a higher rate of tax in year 10, the analysis should not change because each additional dollar of gross-up would be subject to the same year 10 rate of tax with or without the application of the RLSP provisions. See table 1 and the related text in appendix 1 for an analysis of other breakeven rates in the year of receipt assuming different tax rates in the eligible taxation year and different rates of interest.
lump-sum payment less (1) year \( n \) tax on the interest portion of the lump-sum payment, and (2) year 0 tax on the specified portion of the lump-sum payment, together with interest on this tax from year 0 to year \( n \), computed at the government’s prescribed interest rate \( g \):

\[
A (1 + r)^n - [A (1 + r)^n - A] u - t A (1 + g)^n.
\]  

(For simplicity, the above expressions assume that both the payer and the government compound interest annually.)

The RLSP provisions will be beneficial only if expression 2 is greater than expression 1. This is true if

\[
u > t (1 + g)^n
\]  

or, equivalently, if

\[
(u - t) / t > (1 + g)^n - 1.
\]  

As can be seen, the RLSP provisions will be beneficial only if the rate of tax \( u \) in the year of receipt is higher, and generally significantly higher, than the rate of tax \( t \) in the eligible taxation year. More precisely, the inequality illustrated in expression 3 holds that the RLSP provisions will be beneficial only if the rate of tax \( u \) is greater than the rate of tax that would result by increasing the rate of tax \( t \) annually by a percentage equal to the prescribed rate of interest \( g \). The inequality illustrated in expression 4 states that the RLSP provisions will be beneficial only if the percentage increase in the taxpayer’s marginal tax rate from year 0 to year \( n \) exceeds the percentage by which the prescribed interest increases the unpaid tax in year 0.

Effectively, the decision to utilize the RLSP provisions or not is reduced to a comparison of two choices: (1) paying tax on the specified portion in year \( n \) at rate \( u \), or (2) paying the tax on the specified portion at rate \( t \) in year 0, together with interest at the prescribed rate \( g \) on this unpaid tax from year 0 to year \( n \). Note that the decision is not affected by the interest portion of the lump-sum payment, on the assumption that in either case it is taxed in year \( n \) at the tax rate \( u \).

Table 1 illustrates the “breakeven” tax rate in various scenarios—that is, the tax rate \( u \) in year \( n \) that will leave the taxpayer with the same after-tax income in year \( n \) under the RLSP provisions as that which would result without their application. The first two rows of the table are based on a marginal tax rate \( t \) in year 0 of 30 percent and the last two rows are based on a 40 percent rate. Thus, for example, with a 5 percent prescribed interest rate, a 10-year period between the eligible taxation year and the year of receipt, and a marginal tax rate of 30 percent in the eligible taxation year, the breakeven rate \( u \) in the year of receipt \( n \) is 49 percent. In other words, in this scenario, the RLSP provisions will be beneficial only if the marginal tax rate in year 10 (year \( n \)) is greater than 49 percent.
B. Tax Policy Analysis

As discussed in the main text of the article, the tax policy goal of the RLSP provisions should be to make the recipient taxpayer indifferent as between a hypothetical situation where he or she received and paid tax on each specified portion of the lump-sum payment in the eligible taxation year, and an actual situation where the taxpayer receives the entire lump-sum payment and pays tax in the year of receipt. The yardstick used to determine this indifference is the after-tax amount available to the taxpayer in the year of receipt \( n \) in the two situations. In the hypothetical situation, this amount is the after-tax accumulation in year \( n \) that the taxpayer could have achieved by paying tax on the specified portion \( A \) in year 0 at rate \( t \), investing the after-tax portion, and paying tax on the resulting interest income or other return each year. Denoting the taxpayer's after-tax rate of return as \( i \), this after-tax accumulation is

\[
A (1 - t)(1 + i)^n. \tag{5}
\]

This result can be compared with the results under four possible actual tax rules.

Under rule A, the total lump-sum amount paid to the taxpayer (the specified portion plus interest computed at the payer’s rate \( r \)) is included in income in year \( n \) and taxed at the marginal tax rate \( u \) in that year. The after-tax income in year \( n \) is

\[
A (1 + r)^n (1 - u). \tag{6A}
\]

Under rule B, the total lump-sum amount paid to the taxpayer is included in income in year \( n \) but taxed at the marginal tax rate applying in year 0 (that is, \( t \)). The after-tax income in year \( n \) is

\[
A (1 + r)^n (1 - t). \tag{6B}
\]

Under rule C, tax on the specified portion \( A \) is calculated in year 0 but not paid then. Instead, interest is charged on the specified portion at the prescribed government interest rate \( g \) and paid by the taxpayer in year \( n \). The after-tax income in year \( n \) is

\[
A (1 + r)^n - tA (1 + g)^n. \tag{6C}
\]
Under rule D, which is the rule that governs when the RLSP provisions apply under current law, the after-tax income in year $n$ is the amount noted in expression 2 above (reproduced here for ease of reference):

$$A (1 + r)^n - [A (1 + r)^n - A] u - tA (1 + g)^n.$$  \hfill (6D)

Note that the only difference between rule D and rule C is that rule D taxes the interest portion of the lump-sum payment.

**Results**

Setting expression 5 equal to the expressions generated by the four rules (6A to 6D), the conditions under which each rule will achieve the tax policy goal are as follows:

- **Rule A**: $(1 - t) (1 + i)^n = (1 + r)^n (1 - u)$.
- **Rule B**: $r = i$.
- **Rule C**: $(1 - t) (1 + i)^n = (1 + r)^n - t (1 + g)^n$.
- **Rule D**: $(1 - t) (1 + i)^n = (1 + r)^n - [(1 + r)^n - 1] u - t (1 + g)^n$.

At first glance, these results are generally difficult to interpret. However, let us take the analysis a step further and consider the likely pattern of interest rates. Fairness to the recipient would dictate that the payer credit an interest rate on award amounts that is least as high as the after-tax rate of return that can be earned by the recipient. Furthermore, it is in the payer’s interest to pay no more. Thus, it seems reasonable to assume that the government should devise policy rules on the basis that these two interest rates are equal; that is, $r = i$. With this additional assumption, the four rules will achieve the policy goal under the following conditions:

- **Rule A**: $t = u$.
- **Rule B**: Always.
- **Rule C**: $g = i$.
- **Rule D**: $u = t \ [(1 + r)^n - (1 + g)^n] / [(1 + r)^n - 1]$.

The above results constitute the main results discussed in the text of the article. In particular:

- The rule A result is the proposition that including the lump-sum payment in taxable income in the year of receipt will achieve the tax policy goal if the recipient’s marginal tax rate is constant (see the text accompanying notes 21 to 23 in the article).
- The rule B result is the proposition that including the lump-sum payment in taxable income in the year of receipt but using the recipient’s marginal tax rate of the eligible taxation year will achieve the tax policy goal even if the tax
The taxation of retroactive lump-sum payments

rate changes over time (see the text accompanying notes 25 to 26 in the article).

- The rule C result is the proposition that notionally calculating tax in the eligible taxation year and then charging notional interest on that tax will achieve the tax policy goal if the notional interest rate (the prescribed rate) equals the taxpayer’s after-tax rate of return, which is assumed to be the rate of interest credited by the payer (see the text accompanying notes 27 to 31 in the article).
- The rule D result is the proposition that the application of the RLSP provisions (taxing \( A \) as if received in year 0, applying the notional interest charge, and further taxing the after-tax interest portion of the lump-sum payment in year \( n \)) can achieve the policy goal only by chance. In particular, if the government attempts to set an interest rate on unpaid taxes that is equal to the taxpayer’s after-tax rate of return \((r = g)\), that result cannot occur for any positive current-year marginal tax rate.

Another way to make this last point is that in the \( r = g \) situation, the difference between the after-tax accumulation under the policy goal and under rule D (expression 6D minus expression 5) is

\[
[ A (1 + r)^n - A] u. 
\]

In other words, the income inclusion for the interest element of the payment is the reason why rule D does not achieve the policy goal. This is the double taxation argument made in the main body of the article.

APPENDIX 2 COMPUTATION OF TAX USING A PRE-TAX RATE OF INTEREST OR RETURN

In the section of the article entitled “The Policy: The Appropriate Tax Treatment of Retroactive Lump-Sum Payments,” it was assumed that a retroactive lump-sum payment will normally equal the amount of the specified portion grossed up using an after-tax rate of interest (or return) from the eligible taxation year up to the year of receipt. The after-tax rate assumption was made for reasons discussed in the article, which can be summarized as follows. First, if the recipient taxpayer had received the specified portion in the eligible taxation year and saved or invested the after-tax amount of that portion, she normally would have been subject to tax on any interest or other income subsequently earned on the amount.\(^{40}\) A second reason, which largely flows from the first, is that assuming constant tax rates, the inclusion of the after-tax value of the specified portion in the year of receipt would provide the equivalent result as the inclusion of the specified portion in the eligible taxation year,\(^ {41}\) a result

\(^{40}\) See the text accompanying note 22 supra.

\(^{41}\) See the text accompanying notes 22 and 23 supra.
that the parties would presumably attempt to replicate. Furthermore, a taxable employer or other payer would not normally agree to pay a larger amount than the after-tax value of the specified portion as of the year of receipt, simply because it would cost the payer more on an after-tax and time-adjusted basis relative to the payment of the specified portion in the eligible taxation year.\footnote{See supra note 23.}

This short analysis considers the situation where, for whatever reason, the specified portion is grossed up using a pre-tax rate of interest or return.\footnote{For example, the payer might agree to gross up the payment using a pre-tax rate of return if the payer was tax-exempt; see supra note 23.} In the example used in the main text of the article, the payment of the $10,000 specified amount grossed up by the pre-tax rate of interest of 5 percent from year 1 to year 3 would equal $11,025 ([$10,000 × (1.05)^2]).

As before, the taxation of the payment in year 3 should provide the same after-tax amount that would have resulted had the taxpayer received the $10,000 specified portion in year 1, paid 40 percent tax on that amount, invested the after-tax proceeds at 5 percent per year, and paid 40 percent tax thereon each year, for an annual after-tax return of 3 percent. Therefore, as in the example used in the article, the taxpayer should net $6,365 after tax as of year 3 ([$10,000 × (1.03)^2]).

If the RLSP provisions did not apply, the taxpayer in this scenario would include the $11,025 amount in income in year 3,\footnote{The $10,000 specified portion would be included under the provision otherwise relevant to the type of payment (income from employment, a pension benefit, etc.) while the $1,025 interest element would be included under paragraph 12(1)(c).} and (assuming a 40 percent rate of tax), would pay $4,410 of tax and retain $6,615 (rather than $6,365 as noted above). Thus, it appears that the taxpayer would be undertaxed.\footnote{Assuming that the payer was in the position to do so, it presumably would demand to pay less than $11,025 in year 3, owing to the fact that the recipient taxpayer was undertaxed in the manner described. For example, if the payment were midway between $11,025 determined using the before-tax rate assumption and $10,609 determined using the after-tax rate assumption (that is, $10,817), the payer and the recipient would effectively share in the tax savings. The recipient would still come out ahead after tax relative to receiving and being taxed in respect of the $10,609 amount, while the payer would obviously pay less than $11,025.} Of course, the difference between this scenario and the example used in the main text of the article is that the interest element in this case is before tax rather than after tax, such that it equals $1,025 as of year 3.\footnote{Annual compounded interest at 5 percent on the $10,000 specified portion from year 1 to year 3 equals $1,025. The calculation is \([\$10,000 \times (1.05)^2] - \$10,000 = \$1,025.\)} Using a tax deferral analogy, there are effectively two deferrals under this scenario: first, the $10,000 specified portion is taxed in year 3 rather than year 1; and second, since the interest element is before tax, the portion of the interest element that relates to year 2—namely, $500 (5 percent) of interest that accrues from year 1 to year 2 in respect of the $10,000 specified portion—is taxed as of year 3 rather than as of year 2. More significantly, unlike the initial scenario in the main text, in
this scenario the effects of the deferrals are not rectified through the application of a financial equivalency or otherwise.\(^{47}\) In this regard, it is well known that the deferral of the inclusion of an amount is the equivalent of properly including that amount (without deferral) but exempting from taxation the income earned by investing the amount over the period of deferral.\(^{48}\) To illustrate, the above tax treatment is the financial equivalent of including the specified portion of $10,000 in year 1, subjecting it to 40 percent tax, but allowing the $6,000 after-tax proceeds to grow and compound tax-free up to year 3: $6,000 earning 5 percent compounded interest over two years equals $6,615.\(^{49}\) Effectively, the interest element is exempt from taxation.\(^{50}\)

If instead a tax regime such as the RLSP provisions applied in this scenario, the taxpayer would pay $4,000 tax (40 percent) on the $10,000 specified portion, plus $410 tax (40 percent) on the $1,025 interest portion of the payment included in

\(^{47}\) In this scenario, the taxpayer simply includes the $11,025 payment in income in year 3. Of that amount, $1,025 is the before-tax interest element; since it has not yet been effectively subject to tax, it must be included and taxed in year 3. This leaves the other portion of the payment, namely, the $10,000 specified porton, which is included in year 3 but without any time value adjustment as in the example in the article (that is, the inclusion of its after-tax value as of year 3) to account for the effective deferral. Furthermore, although the deferred $500 interest element that relates to year 2 is included in income year 3 (as part of the $1,025 interest inclusion noted above), it similarly is not subject to a time value adjustment to account for its effective deferral. In sum, the effects of the deferrals of both the $10,000 specified portion and the interest element in respect of year 2 are allowed to stand. As noted in the text above and with reference to note 48 infra, the deferrals are equivalent to the exemption from tax of the interest element. For a similar example, see Hanna, “Demystifying Tax Deferral,” supra note 20, at 406-11.


\(^{49}\) That is, $6,000 \(\times (1.05)^2\) = $6,615.

\(^{50}\) If the payer in this scenario were fully taxable, it could be argued that the payer was taxed as a “substitute” for the recipient in respect of the interest element; see Halperin, supra note 20, at 521-23. For example, if the payer also had a 40 percent tax rate and the $11,025 payment was deductible, it would effectively cost the paye $6,615 in year 3 after-tax dollars (net of the 40 percent tax saving), whereas the $10,609 payment using the after-tax rate assumption in the initial scenario would have cost the payer $6,365 in year 3 after-tax dollars (net of the 40 percent tax saving). The $250 difference in after-tax dollars paid by the payer ($6,615 — $6,365) exactly equals the value of the additional tax in year 3 dollars that would have been payable by the recipient had he made an investment of $6,000 in year 1, earned 5 percent annual compounded interest on that amount through to year 3, and been taxed on that interest. That is, as of year 2, the investment would have generated $300 of interest ($6,000 \(\times 0.05\)), and as of year 3, it would have generated a further $315 of interest ($6,300 \(\times 0.05\)). Tax on the year 2 interest of $300 at 40 percent would equal $120, which equals $124 in terms of year 3 after-tax dollars ($120 \(\times 1.03\)), while tax on the year 3 interest of $315 at 40 percent would equal $126, for total tax on the interest of $250. (As in the text, all numbers are rounded to the nearest dollar.) For this reason, as discussed in the text above, a taxable payer would not normally agree to pay $11,025 computed using the pre-tax rate of return, and instead would normally insist on paying only $10,609 computed using the after-tax rate of return.
year 3, for a total tax payment of $4,410. Furthermore, notional interest at the rate of 3 percent would be charged on the $4,000 of tax payable in respect of the $10,000 specified portion from year 1 to year 3, amounting to $244 as of year 3.\textsuperscript{51} As a result, the taxpayer would net the after-tax amount of $6,371 as of year 3 ($11,025 − [($4,410 + $244) = $6,371]. Note that there would be no notional interest charged on the $200 of tax payable in respect of the $500 interest element that related to year 2 (40 percent × $500)—that is, the deferred tax from the second “deferral” described in the paragraph above. As a result, the taxpayer would be undercharged or undertaxed by 3 percent of $200, or $6, which is the notional interest that should be charged on such tax. Applying the financial equivalency described in the preceding paragraph,\textsuperscript{52} failing to account for the deferral of the interest element means that the income earned in respect of the interest element—namely, the compound interest element—would be effectively exempt from taxation. As noted above, $6,000 earning 5 percent compounded interest from year 1 to year 3 would equal $6,615. Of this amount, $15 would be compound interest.\textsuperscript{53} Applying the 40 percent tax rate to $15 equals $6 of tax, the amount of the undertaxation: the taxpayer would net $6,371 after tax as of year 3, rather than the appropriate amount of $6,365 as noted earlier.

In summary, without the application of the RLSP provisions and assuming constant tax rates, if the specified portion of the lump-sum payment is grossed up using a pre-tax rate of interest or return, the recipient is effectively exempt from tax on the interest element.\textsuperscript{54} If the RLSP provisions are applied, the recipient is effectively exempt from tax on the interest element.

\textsuperscript{51} See supra note 30 and the accompanying text.

\textsuperscript{52} See the text accompanying note 48 supra.

\textsuperscript{53} From year 1 to year 2, simple interest of 5 percent on the $6,000 amount would equal $300. From year 2 to year 3, a further 5 percent interest on that $300 interest (namely, the compound interest) would equal $15 ($300 × 0.05).

\textsuperscript{54} Under certain circumstances, it might be argued that the interest element should be partly or even wholly exempt from taxation. For example, it might be assumed that, had the taxpayer received the specified portion in the eligible taxation year, she would have contributed at least some of it to her registered retirement savings plan (RRSP) or other deferred-income plan and therefore earned tax-deferred interest or other income up to the year of receipt. For example, assume that the taxpayer in the scenario in the text would have contributed the entire $10,000 specified portion to her RRSP in year 1 if she had received it in that year. As with the result described in the text, she would have netted $6,615 after tax if she had withdrawn the amount from the RRSP in year 3: with a 40 percent tax rate, she would have retained $11,025 × 0.60 after tax, or $6,615. Likewise, for specified portions received in 2010 and future taxation years that relate to eligible taxation years after 2008, it might be assumed that a recipient taxpayer could have invested at least some of the specified portion in a tax-free savings account (TFSA). (The TFSA provisions in section 146.2 of the Act apply beginning with the 2009 taxation year.)

For wrongful dismissal awards made before 2004, it was the CRA’s administrative position that pre-judgment interest was not subject to tax. Presumably, therefore, for such awards, the portion of the interest element representing pre-judgment interest would normally have been grossed up using a before-tax rate of return, and that portion would have been exempt from tax. For wrongful dismissal awards made after 2003, the CRA’s current administrative position
subject to tax on the simple interest element but exempt from tax on the compound interest element. Therefore, similar to the conclusion reached in the main text of the article (but for a completely different reason), where a pre-tax rate of interest or return is used to compute the tax payable, the recipient of the lump-sum payment will typically pay less tax without the application of the RLSP provisions relative to the tax and notional interest that would be payable with the application of those provisions.55

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55 The RLSP provisions could be beneficial for the recipient if the rate of tax in the year of receipt was significantly higher than that in the eligible taxation year.