

Payroll Basics - What You Need to Know

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Introduction

Are your employees working too many hours in contravention of the *Employment Standards Act, 2000* (the “ESA”)? Are they being provided with proper overtime? What wage deductions are permissible in Ontario? How do you fill out a Record of Employment? How does one address the tax implications that arise from a termination of employment? These are some of the issues which arise in virtually every workplace on a regular basis. This paper is intended to be a general summary of some of those issues and a starting point for figuring out how to deal with them as they arise.

It is assumed that the reader of this paper will already be aware of many of the basic principles of employment law in Ontario, including the concepts of reasonable notice of termination at common law, mitigation of damages, the treatment of benefits and the like. This paper is instead intended to address some of the finer points of payroll basics that arise under the ESA and other applicable statutes and it will address some of the most significant factors which should be kept in mind by employers when it comes to: (a) the termination of employment; and (b) ensuring that statutory deductions and paperwork are properly maintained. To this end, this paper will address the following:

1. notice of termination under the ESA;
2. special considerations regarding lump sum termination payments;
3. special considerations regarding records of employment and employment insurance appeals;
4. hours of work and overtime provisions under the ESA;
5. permissible wage deductions; and
6. tax considerations upon termination.

1. Notice of Termination

General contract law applies to the formation of an employment contract. An employer will offer a prospective employee an employment opportunity. This offer may be verbal or in writing. An employment contract will be created once the employee accepts all the terms in the employer’s offer of employment. Unlike unionized

employers, an individual contract of employment will be created every time an employer hires an employee.

Once the contract has been created, it can only be terminated if there is “cause” for terminating the contract or if the employer provides reasonable notice of the termination (or pay in lieu of reasonable notice). This notice is calculated by reviewing the ESA, the common law, and the employee’s employment contract (if any). This paper will examine only the notice requirements set out under the ESA; not common law or contractual requirements.

(i) Statutory Entitlements under the ESA

Statutory notice of termination entitlements are easy to determine, as they are clearly set out in the ESA. Employers should note that failure to provide an employee with his or her statutory minimums can result in an employer being found guilty of violating the ESA and as a result, which can lead to the imposition of fines.¹

(ii) Individual or Mass Notice of Termination

Employers should note that an employee’s first statutory entitlement on termination of employment is individual notice of termination. This entitlement is generally one week per year of employment to a maximum of 8 weeks.² That being said, employers should be aware that an employee may be entitled to mass notice of termination instead of individual notice of termination. Notice of mass termination is not based on an employee’s length of employment but rather, on the number of employees who have been terminated by the same employer within a particular period of time. Mass notice of termination is triggered in the event that 50 or more employees are terminated in any 4 week period or less at the same establishment.³ Specifically, an employer must give⁴:

1 *Employment Standards Act*, s. 132.

2 *Employment Standards Act*, ss. 57.

3 *Employment Standards Act*, ss. 58.

4 *Employment Standards Act* Regulation 327, ss. 3(1).

- 8 weeks' notice if 50 to 199 employees have their employment terminated;
- 12 weeks' notice if 200 to 499 employees have their employment terminated; and
- 16 weeks' notice if 500 or more employees have their employment terminated.

Employers in mass termination situations must file a "Form 1" with the Ministry of Labour and post it conspicuously in the workplace.⁵ Employers should note that notice may be ineffective until the Ministry of Labour receives the Form 1.⁶ It is important to keep employee resignations in mind when making the calculation as to whether or not your workplace may have a mass termination obligation, as resignations which have the potential to become constructive dismissal claims may need to be factored into the calculation.

(iii) Severance

In addition to individual notice of termination or notice of mass termination, employers should be aware that employees may be entitled to severance pay. To be eligible for severance pay, an employee must have worked a minimum of 5 years with an employer who: (i) has a payroll in Ontario of at least \$2.5 million; or (ii) who has terminated 50 or more employees in a six-month period because all or part of the business was permanently discontinued.⁷ The entitlement is 1 week of regular wages for each completed year of employment up to a maximum of 26 weeks.⁸ Severance pay is prorated for completed months in any partial final year. For example, if an employee worked for 7 years and six months, the employee would be entitled to 7 weeks' notice of termination or payment in lieu thereof and 7.5 weeks of severance pay under the ESA.

Employers should note that employees are entitled to statutory notice and severance as a lump sum,

unless the employee agrees to accept payment in installments.⁹ As a result, unless structured properly, a salary continuance in lieu of reasonable notice may not satisfy the severance pay requirement if the employer does not obtain the employee's agreement for such a payment plan.

2. Lump Sum Payments

There are a myriad of options available to an employer in deciding how to provide an employee with notice of termination of his or her employment. Lump sum payments, salary continuation, working notice, bridging payments and a combinations of these options are things that an employer should consider before terminating an employee. That being said, the most frequently used option is the lump sum payment in lieu of notice. A specified lump-sum severance settlement is preferable to many employees as it provides them with funds during the period of unemployment and may even provide an opportunity for a windfall profit in the event of a quick re-employment. Accordingly, an employer can normally obtain a quicker settlement by providing employees with a lump sum payment in lieu of notice.¹⁰ In light of the above, the following subsection of this paper will examine the employer's obligation to make statutory deductions, income tax considerations, employment insurance considerations and the impact of the duty to mitigate damages all in regard to lump sum payment in lieu of notice.

(i) Statutory Deductions

An employer must remit statutory deductions from wages. Required federal statutory deductions consist of deductions for employee remittances under the *Canada Pension Plan*¹¹ (the "CPP"), the *Employment Insurance Act*¹² (the "EIA") and the *Income Tax Act*¹³

⁹ *Employment Standards Act*, ss. 66(1).

¹⁰ That being said, we remind employers that they cannot withhold payments of statutory entitlements under the *Employment Standards Act* in order to obtain a settlement. Employers have an obligation to provide employees with their statutory entitlements upon termination by no later than: (a) 7 days after the employment ends; and (b) the employer's next pay day.

¹¹ *Canada Pension Plan*, R.S.C. 1985, c. C-8.

¹² *Employment Insurance Act*, R.S.C. 1996, c. 23.

¹³ *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.).

⁵ *Employment Standards Act*, ss. 58(2).

⁶ *Employment Standards Act*, ss. 58(4).

⁷ *Employment Standards Act*, ss. 64(1).

⁸ *Employment Standards Act*, s. 65.

(the “ITA”). When an employer provides an employee with notice of termination or pay in lieu of notice of termination, whether it be the amounts required under the ESA or amounts under an employment contract or reasonable notice at common law, the payment is considered employment income. As such, remittances under the CPP, the EIA and the ITA must be deducted.¹⁴ Failure to do so can result in significant fines and penalties under CPP, the EIA and/or the ITA.

(ii) Employment Insurance Considerations

Subject to the discussion below, benefits received by an employee from employment insurance cannot be deducted by the employer from the amount that the employer is required to provide the employee for the benefit of the employer.¹⁵ Instead, where an employee who has become entitled to pay in lieu of reasonable or statutory notice has already collected benefits under the EIA in respect of the period of reasonable or statutory notice, he or she is liable to repay to Human Resources and Skills Development Canada (“HRSDC”) the benefits received.¹⁶

An employer who has been found liable to pay remuneration to a former employee pursuant to a labour arbitration award, court judgment or otherwise and has reason to believe that benefits under the EIA have been paid to the former employee in respect of the period for which remuneration is owed shall determine if an amount would be repayable if the earnings were paid to the former employee and if so, shall deduct the amount from the earnings and remit it to the Receiver General as a repayment of overpayment of benefits.¹⁷ Given the foregoing, when faced with circumstances such as these, an employer should contact HRSDC to obtain confirmation of repayment obligations (if any) before remitting the cheque to the employee.

(iii) Duty to Mitigate

Employees have a duty to mitigate damages upon termination. An employee’s entitlement to common law notice of termination can be reduced if he or she fails to mitigate damages by finding reasonable alternate employment. Moreover, remuneration earned by the terminated employee may be deducted from an award for wrongful dismissal damages. In light of the above, lump sum payments become more attractive to employees than salary continuation, especially in cases where the employee is likely to quickly find reasonable alternate employment. Therefore, it is generally agreed that the employer is justified in paying a sum less than the maximum common law entitlement in order to reflect this possibility.

Another alternative is to provide a terminated employee with an incentive to quickly find alternate employment, by offering the terminated employee notice on a salary continuance basis to the date of alternate employment followed by a lump sum payment representing ½ of the outstanding balance from the date of re-employment to the end of the notice period. In that way, a motivated employee can earn salary-and-a-half during part of his or her notice period and the employer can limit its exposure in terms of pay in lieu of notice.

3. Records of Employment (ROE) & EI Appeals

ROEs and responses to EI applications are often perceived by employers as routine aspects of human resource management. That being said, employers should note that ROEs and EI proceedings have hidden liabilities which can potentially cause an employer significant financial cost.

(i) Records of Employment

Employers are obligated to complete a ROE within five calendar days of an interruption of earnings or the date the employer becomes aware of the interruption. On the ROE, the employer is obligated to provide a reason for its issuance. The reasons range from shortage of work and illness to retirement, dismissal and leave of absence. In addition, the employer also has the option of entering a code for the designation “other”, in which case the employer is required to provide an explanation.

14 Canada Customs and Revenue Agency, *Employers Guide: Payroll Deductions (Basic Information)*, T4001 at page 31.

15 *Dyer v. Mekinda Snyder Partnership Inc.* (1998), 35 C.C.E.L. (2d) 290 (Ont Gen. Div.) at p.303.

16 Section 45 of the *Employment Insurance Act*.

17 Section 46 of the *Employment Insurance Act*.

Employees often want a designation inserted which will allow them to recover EI benefits. The employer should be very wary in complying with such a request from the employee. Employers should note that the person signing the ROE must certify that all statements on the form are true. An employer cannot collude with an employee in order to allow an employee to obtain employment insurance benefits when they should be disqualified or not entitled. Employers who engage in employment insurance “fraud”, such as making false or misleading declarations, are liable for a penalty.¹⁸

In addition to avoiding liability for making a false statement, the reasons given on the ROE might become important in a wrongful dismissal action commenced by the employee. For example, if the employer claims to have cause for the dismissal but, in an effort to permit the employee to collect EI benefits, categorizes the termination as being on account of “shortage of work”, the employer may be bound by such a representation and be unable to prove cause for the dismissal.

(ii) Employment Insurance Appeals

Employers often wonder whether they should participate in Employment Insurance appeals launched by former employees. The issue usually arises when an employee who has been fired for cause appeals the denial of EI benefits from the government. The employer is then asked if it wishes to participate.

Although employers have an obligation to provide HRSDC with information regarding the designation set out on the ROE, they do not have an obligation to participate in the appeal process. Although it will be determined on a case by case basis, employers must generally be wary of participating in EI appeals. Galling though it may be to see an undeserving employee receive EI benefits, an employer generally has little or no legal or financial interest in the outcome of an EI appeal. More important, participating in the appeal creates the risk of raising “issue estoppel” if the employer loses.

Issue estoppel is a term which means that if the outcome of the EI appeal is a finding that the employee

was not guilty of misconduct, then the employer may be stuck with that finding in another legal proceeding involving the employee where the employer has a legal or financial interest, such as a wrongful dismissal case or a grievance arbitration. Specifically, in regard to wrongful dismissal litigation, an award of EI benefits to the employee may result in the employer being prevented from raising the defence of just cause or resignation in a subsequent wrongful dismissal action by the employee. However, if the employer does not participate, the issue of estoppel will generally not arise.¹⁹

4. Hours of Work and Overtime Provisions under the ESA

(i) Hours of Work

Under the ESA, an employee generally cannot work in excess of: (a) 8 hours per day, or the number of hours in a “regular work day” where the employer establishes a regular work day of more than 8 hours; and (ii) 48 hours per week. In addition, employees must be given at least 11 consecutive hours off each day (other than for ‘on call’ employees), 24 consecutive hours off per week and 48 consecutive hours off in each period of 2 consecutive work weeks.²⁰

The exceptions to the above rules include: (a) an emergency; (b) dealing with something unforeseen in a situation where the continued delivery of essential public services is required; (c) dealing with something unforeseen in a situation where continuous processes or seasonal operations cannot be interrupted; and (d) the carrying out of urgent repair work to the employer’s premises or equipment.²¹ There are additional exceptions to the provisions regarding hours free from work, which can be applicable to employees working on an ‘on call’ basis.

There are also exemptions for certain types of employees, including: (a) those employees whose

19 See discussion in *Minott v. O’Shanter Development Co.* (1999) 42 O.R. (3d) 321 (Ont. C.A.), *Schweneke v. Ontario* (2000) 47 O.R. (3d) 97 (Ont. C.A.) (leave to S.C.C. refused, [2000] S.C.C.A. No. 168) and more in recently *D’Aoust v. 13742002 Ontario Inc. (c.o.b. Automotive Edge)*, [2003] O.J. No. 2642 (Sup. Ct.).

20 Sections 17 & 18 of the *Employment Standards Act*.

21 Section 19 of the *Employment Standards Act*.

18 Section 29 of the *Employment Insurance Act*.

work is 'supervisory or managerial in character'²² (b) information technology professionals²³; (c) teachers; (d) duly qualified or registered practitioners of various professions including medicine, law, professional engineering, pharmacy and public accounting; (e) police officers; (f) fire fighters; (g) salespersons; and (h) several other groups, including farmers. For the most part, employees who are exempt from the hours of work provisions of the ESA are also exempt from its overtime provisions, as discussed below.

If an employer and non-exempt employee wish to have the employee work more than the hours permitted under the ESA, they may enter into a written agreement. However, in order for the agreement to be valid, it must abide by the following rules: (a) the employee must agree to work the hours stated; and (b) the maximum amount of hours which may be worked per week is 60. In order for an agreement in excess of 60 hours per week to be valid, it must be specifically approved by the Director of Employment Standards (the "Director"). Any such agreement can be revoked by the employee on two weeks' written notice.

(ii) Overtime

Overtime for hourly employees is calculated by multiplying the hourly rate of the employee by one and one-half the overtime hours worked. Overtime pay must be paid on that basis for each hour worked by a non-exempt employee in excess of 44 hours per week unless the employee has contractually agreed to a lower standard for overtime, in which case that threshold will apply. If a company's employment contracts or employee manual refers to an overtime entitlement at a threshold lower than 40 hours (ie.

after 40 hours per week), the calculation above must be performed for all hours worked in excess of that 40 hour per week threshold.

With respect to the issue of which employees are exempt from the overtime provisions of the ESA, as stated above they closely mirror those employees who are exempt from the hours of work provisions of the ESA.

Employees are permitted to take time off in lieu of overtime pay, provided however that: (i) both employer and employee agree to the arrangement in writing; (ii) the time off is at the same rate of one and one-half hours off with pay for each hour of overtime worked; and (iii) the time is taken within 3 months of the overtime or, where the employee agrees to a longer period, within 12 months.

As well, employers and employees may agree to average hours of work over a period of up to 4 weeks in order to determine overtime pay entitlement. An averaging agreement of this nature must: (i) have an expiry date; and (ii) in the non-labour union context, be for less than 2 years in duration.

Finally, if an employee's job ends before he or she has taken the paid time off, the employee must receive overtime pay, no later than seven days after the date the employment ended, or on what would have been the employee's next pay day, whichever is later.

(iii) Bill 63 – The *Employment Standards Amendment Act (Hours of Work and Other Matters)*, 2004

On April 26, 2004, the Ontario government introduced new legislation which is scheduled to come into effect on January 1, 2005 – the *Employment Standards Amendment Act*. The new legislation will modify the above hours of work and overtime provisions in the following ways:

- (a) Under the current legislation, an employee who works more than 48 hours per week but less than 60 hours per week can enter into an agreement with his or her employer with respect to same. Approval of the Director of Employment Standards is not required for hours worked less than 60 per week. Under the new legislation however, written

²² Under section 4(1)(b) of Ont. Reg. 285/01 of the *Employment Standards Act*, an employee whose work is supervisory or managerial in nature as can be defined as such even where he or she "may perform non-supervisory or non-managerial tasks on an irregular or exceptional basis".

²³ Section 1 of Ont. Reg. 285/01 of the *Employment Standards Act* defines an information technology professional as "an employee who is primarily engaged in the investigation, analysis, design development, implementation, operation or management of information systems based on computer and related technologies through the objective application of specialized knowledge and professional judgment".

approval of the Director of Employment Standards will be required for all non-exempt employees who work more than 48 hours per week. Employers can apply in advance beginning on October 1, 2004 for written approvals in respect of hours of work;

- (b) Under the current legislation, Director approval is not required for overtime averaging agreements over a four week period. Under the new legislation however, written approval of the Director will be required for all overtime averaging agreements, no matter what the averaging period; and
- (c) Employers will be required to maintain hours of work and overtime records for employees for a period of three years after the work was last performed. Furthermore, employers will be required to post a sign in their workplace, outlining the rights of employees with respect to these new provisions.

5. Permissible Wage Deductions

The ESA provides that an employer cannot withhold wages payable to an employee unless: (i) a statute or court order authorizes it; or (ii) the employee provides the employer with written authorization.²⁴ Under the ESA, the term ‘wages’ includes “any payment required to be made by an employer to an employee under [the ESA]” and therefore, includes statutory notice, statutory severance and pay to the date of termination.

(i) Deductions Authorized by the Employee

Employers often ask if they can set-off against an employee’s final paycheck any outstanding loans, advances on vacation or other amounts owed by the employee. The short answer is no, unless the employee has specifically provided the employer with written authorization. That authorization must be voluntary. With that in mind, employers who provide employees with advances, loans and the like should make those payments subject to a written repayment agreement which provides, among other things, that the employer can specifically offset outstanding

amounts against wages, whether owed at the time of termination or otherwise. Additionally, the ESA provides that the written authorization must set out either the specific amount to be deducted or the formula by which the employer will calculate the amount.²⁵

Even where an employer obtains a written authorization from an employee, it will not be valid where: (i) the claim is for faulty work; or (ii) where the claim relates to a cash shortage or loss of property for the employer in a situation where a person other than the employee at issue had access to the missing cash or property.²⁶

(ii) Deductions Authorized by Statute

The most common and well-known statutory deductions are those made by employers for income tax, Canada Pension Plan (“CPP”) and Employment Insurance (“EI”). These deductions are made on a per paycheque basis on account of all employees; however, they are not taken for independent contractors.

If an employer misses collecting CPP and/or EI premiums, it is limited to collecting those missed premiums from the previous twelve months of the employee’s wages. Moreover, the employer can deduct only one outstanding premium per pay in addition to the current premium. The reason for these rules is to prevent employers from capitalizing on their errors to the detriment of employees.

(iii) Deductions Authorized by Court Order

The most common deductions authorized by a court order are with respect to child support payments. Since 1992, Ontario has been subject to automatic support deduction legislation.²⁷ Under the legislation, whenever a court makes an order for payment of child support on a periodic basis, it also issues a Support Deduction Order which, if served on an employer, requires the employer to make automatic deductions

²⁴ Sections 13(1)(2) & (3) of the *Employment Standards Act*.

²⁵ Section 13(5)(a) of the *Employment Standards Act*.

²⁶ Section 13(5)(b) of the *Employment Standards Act*.

²⁷ *Family Responsibility and Support Arrears Enforcement Act*, S.O. 1996, c. C-31.

from the affected employee's wages and other income sources. The amount of support set out in the Support Deduction Order, up to 50% of the employee's net income, must be submitted by the employer to the Family Responsibility Office of Ontario.

Interestingly, under section 7 of the *Wages Act*²⁸, 80% of an employee's net wages (ie. wages after income tax, CPP and EI have been deducted) are exempt from garnishment. The exception to that rule is the garnishment of support orders, as described in the paragraph immediately preceding. The rationale, of course, is that although employees' wages are generally sacrosanct and it is recognized that employees need a base minimum to live on, support obligations are deemed to be more important.

If your company is served with a garnishment order, you must ensure that your employee's net pay is large enough to cover the required deduction. If not, determine which voluntary deductions may be suspended. Notify your employee about the deduction and then ensure that the relevant cheque(s) are sent to the court or the office listed in the garnishment order.

6. Tax Considerations Upon Termination

Generally speaking, most amounts obtained by a terminated employee are taxable as employment income. Certainly that is the case for pay in lieu of notice. Many departing employees are interested in reducing their tax liability and, with a little assistance from their employer, it is sometimes possible for them to do so.

There are a couple of ways in which income tax on termination of employment can be reduced. First, the ITA permits an award of damages for wrongful dismissal to be treated as a retiring allowance. The ITA defines a retiring allowance as an amount received on or after the retirement of an employee in recognition of long service or in respect of a loss of an office or employment. Generally speaking, long service or the elimination of a position is enough to meet the definition. If an employee's situation is such that he or she can qualify under the retiring allowance regime, he or she can transfer \$2,000 per year of employment into an RRSP on a tax-free basis for the years 1989 through 1995. For any years worked prior to 1989, the

employee can transfer \$1,500 per year of employment. It is important to note that: (i) this provision does not apply for years of employment from 1996 onwards; and (ii) the provision applies only to the extent that the employee has sufficient RRSP contribution room. In that regard, pension monies must be factored into the calculation of eligibility.

If such a transfer is to be effected, the employer must prepare a T4A form. Any monies that are to be transferred directly to the employee's RRSP do not require tax withholdings at source by the employer. If funds are instead to be paid directly to the employee and then transferred into his or her RRSP, the employer is required to withhold taxes.

Second, employers are required to withhold income tax on lump sum payments as follows:

- 10% on payments equal to or less than \$5,000
- 20% on payments of more than \$5,000 but equal to or less than \$15,000
- 30% on payments of greater than \$15,000

An employee who receives pay in lieu of notice on the basis of more than one lump sum payment spread out over two different calendar years may, by virtue of the above calculations, be able to have taxes withheld at different rates in different years, in order to suit his or her cash flow needs.

Third, certain payments sometimes made on account of wrongful dismissal claims are not subject to tax. The most well-known such payment is the reimbursement of legal costs. Although interest on wrongful dismissal judgments is now taxable, legal costs are not and accordingly, it is to the benefit of terminated employees to have a cheque directed to their lawyer on account of costs. Rather than the employee paying those costs out of his or her own pocket, using after-tax money, the costs are paid directly by the employer without deduction. Additionally, it is sometimes possible in cases where a wrongful dismissal claim includes heads of damage other than income, to structure a settlement on the claim such that the majority of monies received by the employee are in respect of those non-income heads of damage and therefore are not subject to deductions. That being said however, these arrangements are open to review by Canada Revenue Agency and accordingly, they are not recommended

28 Section 7 of the *Wages Act*, R.S.O. 1990, c. W.1.

unless the non-income claims are valid ones. In cases such as this, it is always in the employers' best interests to obtain a release from the employee which contains an indemnity clause such that if CRA challenges the lack of withholdings, the employee will be responsible for any reassessment.