Severance choices

It's not often we receive a lump sum of cash, but if you should receive a severance package, you might be wondering what to do with it, i.e. what is, the most tax-efficient way to structure it and how to spend it.

Whether or not you can take advantage of structuring your severance tax-effectively depends on one simple factor: how long you've been at your company.

Dan Hallett, president of Dan Hallett & Associates Inc. in Windsor, Ontario, says the days of tax-effective severance structuring are slowly coming to an end thanks to a 1995 change in the tax rules.

"Prior to 1996, you could roll over up to $2,000 per year of service directly into your RRSP without affecting your contribution room," says Hallett. "In 1995 they discontinued that rule, so as time goes by, fewer and fewer people will benefit from it."

That's because you can still roll over $2,000 per year for years of service worked at your company up to 1995, but not for any years after that[1]. So depending on how long you've been with your current employer, you may not be eligible.

In that case, the best you can do instead is to arrange, through your employer, for a partial rollover without having any withholding tax applied at source, says Hallett. In that case you can roll over as much as your remaining RRSP contribution room will allow, but you'll pay tax on the rest.

Investing your severance

Then the question becomes: How should you invest the rest?

"It's hard to offer advice on this question that would apply to everyone," says Hallett. "It really depends on so many individual factors, such as whether the amount will supplement other retirement income sources, how much time is left until you retire, whether or not you'll continue working after this, and what other savings exist."

Generally speaking, the closer you are to being fully retired, the more conservative your investments should be so that you don't set yourself up for any rude shocks just as you begin to rely on your investments for income.

Depending on your age, interests, energy level and finances, you may consider starting a consulting business or looking for another job rather than simply retiring. You may be able to turn a hobby or extracurricular interest into a small business idea, or start teaching.

If that's your plan, and you think you'll work another 10 years before fully retiring, then you can choose slightly more aggressive investments because they still have some time to grow.

Whatever you do, think strategically before you act — it could save you money.

1 ***You can also roll over $1,500 for each year or part of a year with the company prior to 1989 in respect of which the employer's contributions under a pension plan or deferred profit sharing plan did not vest in you, the employee.***