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Employment bar fires back at columnist's claim their settlements often 'pretty close to tax fraud'

Howard Levitt criticized the way lawyers allocate damages in employment dispute settlements

Erin Kuzz, Howard Levitt, Jennifer Mathers McHenry

16 Oct 2023 / Share

Many in the labour and employment bar have responded to a prominent employment law columnist who said that the way they typically allocate types of damages in employment dispute settlements is “pretty close to tax fraud” and claimed that recent tax changes would put an end to the practice.

In the Sept. 8 *Financial Post* column, “The CRA has closed a

loophole that will transform severance settlements," Howard Levitt, an employment lawyer and Law Society of Ontario Bencher, described what he called the employment bar's "dirty little secret." Employee-side lawyers have been routinely settling their cases by illegitimately allocating the settlement amount to non-taxable damages awards, he said.

The column describes what he said is a typical employment dispute: Lawyers "make vicious claims" of which they seldom believe a word, and the employer chooses to "defend the case at all costs" because they would rather pay a lawyer than pay anything to the employee slandering them. Even though the allegation will create financial and reputational risk for the employee, their lawyers pursue this strategy because the allegations "attract punitive or other damages that are not taxable." He said they hope to settle the case with an agreement for these general, non-taxable damages. He adds that this also benefits the employer, who can pay less in severance while giving the employee the same return.

In Levitt's telling, the employer also gets an indemnity in return for protection if a CRA audit reveals the non-taxable payment was not bona fide but a "disguised severance." The employer insists on the indemnity, he said, because "95 percent of the time," the payment is not bona fide.

But the jig is up, said Levitt. As of June 22, the Canada Revenue Agency has made these indemnity agreements reportable transactions that the employer and the employee must disclose. "Wrongful dismissal cases in Canada have just become more difficult to settle," he said.

Following the publication of Levitt's column, employment lawyers Erin Kuzz and Jennifer Mathers McHenry co-authored a response on LinkedIn that 36 other lawyers co-signed. According to the response, there is "considerable basis to conclude" that Levitt's take on the CRA's rule change was "completely wrong."

When negotiating a settlement, the authors write, parties to employment disputes consider the potential liability if they were unsuccessful in court, including the risk of general damages that the judge could award against them. They said it has long been permissible to pay a portion of the settlement as general damages. But the general damages "must be reasonable, commensurate to the claim, and can't be inflated

simply to avoid the payment of income tax."

If the amount paid as general damages is excessive, the party that structures the settlement has always been at risk of the CRA ordering remittance of additional taxes, and "employment lawyers providing good advice" advise against "unsupported allocation as payments as general damages," said Kuzz and Mathers McHenry.
Noting that they are not tax lawyers, they said the recent CRA changes mean that when the CRA considers a general-damages amount in a settlement unreasonable, and there is an indemnity provision, there is "some risk" that the CRA will consider the settlement as a reportable transaction. The authors said this does not mean that every settlement with general damages or an indemnity provision must be reported.

The new rules still require clarity, and Levitt was not conducting himself "in a manner that encourages the public trust and confidence in our profession" in making "disparaging and sensational statements, rather than providing thoughtful, accurate information," concluded Kuzz and Mathers McHenry.

"Their suggestion that I'm incorrect and making unjust aspersions on the employment law bar? Well, it's not unjust. It's a fact, and they're being disingenuous in suggesting otherwise," Levitt told *Canadian Lawyer*.

"You want to ascertain whether what I'm saying is correct… you need merely compare the percentage of settlements that are settled with general damages, as opposed to court judgments that result in general damages." He says he would suspect that more than half of wrongful dismissal and constructive dismissal settlements have a component of general damages, whereas the courts award general damages in less than 10 percent of those cases.

Levitt, a senior partner at Levitt Sheikh, says he was using "rhetorical license" in calling the practice a "dirty little secret." It's not a secret, but a "fact" that many employment lawyers use general damages as a tool to settle cases when there is "no legal basis for general damages."
Levitt is incorrect about the new CRA requirements, and painting a large swatch of the bar as engaging in wrongdoing is "deeply concerning," says Kuzz, a founding partner of Sherrard Kuzz LLP

There is no "loophole" to close or "dirty little secret," says Kuzz. It has always been the case that the CRA could take issue with the allocation of general damages in employment dispute

settlements, and employment lawyers have always had to advise their clients that if they allocate more than the CRA would consider reasonable, there is a chance it could come back on them, she says.

Lawyers can never predict with certainty what the CRA will believe about a particular settlement, says Mathers McHenry, founder of Mathers McHenry & Co. Lawyers have different approaches to what can be deemed general damages, partly informed by decisions where the court has awarded them, she says.

“You can take some guidance from the case law in terms of what damages could conceivably be awarded, in the same way that you would with respect to assessing the risk on any other type of settlement.”

Mathers McHenry says the article created an issue where there wasn’t one.

“One good thing that's come out of this,” says Kuzz, “it's a good thing for us all to be thinking about this and making sure that we are doing this right, that we are protecting the interests of our clients and making sure that they comply with their obligations under the Income Tax Act.”