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Special GES Tax Alert: Tax treatment of payments made under a separation agreement clarified

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On 21 May 2020, the Singapore Income Tax Board of Review issued its decision in the case of GCT v Comptroller of Income Tax [2020] SGITBR 3. The case centred on the issue of payments made under a separation agreement entered into between an employer and employee, and whether such payments were taxable in the hands of the employee as employment income under section 10(1)(b) of the Income Tax Act (ITA). The board held that, having regard to the particular facts and circumstances of the case, the payments were not taxable on the employee.

Background and facts of the case

The taxpayer was a foreign individual who was employed as managing director of a Singapore incorporated company for the period from 1 August 2013 to 31 December 2016. The taxpayer was unexpectedly informed via a video call with the company on 24 August 2016 that his appointment with the company would cease on 31 August 2016, and he would be released from his duties on the same day. He also was informed of the amount of the redundancy payment he would receive in connection with the termination. The parties mutually agreed that the taxpayer's employment with the company would cease on 31 December 2016.

The taxpayer's employment agreement with the company provided that in the event of termination of employment, an ex-gratia payment would be made to him on condition that he executed a deed of release. The ex-gratia payment would be calculated as follows:

a) Six months' base salary and a pro-rated sum of the annual bonus within the first year of the employment; or
b) Six months' base salary and a pro-rated sum of the annual bonus after the first year of employment.

The company reserved the sole discretion to determine the bonus amount (on which the ex-gratia payment was based), and the individual would have "no claim whatsoever" on the eventual amount of the bonus upon termination.

However, no deed of release was executed in accordance with his employment agreement; instead, the taxpayer subsequently was asked to sign a separation agreement to relinquish his rights under the original employment agreement. The separation agreement provided for a lump sum severance payment to be made to the taxpayer in two instalments as a "discretionary ex-gratia payment." Two clauses of the separation agreement are of a particular relevance:

(i) Clause 2 (Remuneration and benefits); and
(ii) Clause 3 (Severance payment).

Under Clause 2, the taxpayer would continue to receive his full annual salary of S$675,000 for the 2016 calendar year. Under Clause 3, a severance payment of S$2.475 million, described as "discretionary ex-gratia payment" would be made to the taxpayer. The amount would be paid in two unequal instalments of S$1.9 million (payable on 31 December 2016), and S$575,000 (payable on 31 July 2017). The severance payment was intended to include all entitlements (including any ex-gratia payment) that may have been due to the taxpayer in accordance with the employment agreement.

The company filed the original and additional tax clearance returns (Forms IR21, Notification of a Non-Citizen Employee's Cessation of Employment or Departure from Singapore), on 8 December 2016 and 12 July 2017, respectively, to report the first and second instalments of the severance payment in addition to his regular employment remuneration. The tax authorities originally assessed to tax the full severance payment of S$2.475 million in the year of assessment 2017 (income year 2016). Subsequently, on 13 April 2018, the tax authorities raised an amended tax assessment, bifurcating the lump sum severance payment into two components, treating S$1.35 million as taxable employment income in accordance with section 10(1)(b) of the ITA, and exempting from tax the balance of S$1.125 million as "non-income" in nature, on the basis that it represented compensation for loss of office.

The taxpayer contended that although the separation agreement made reference to a mutual agreement to end the employment relationship, it was in fact a retrenchment or redundancy imposed on him. The separation agreement was worded as such to manage the market sensitivity and reputational impact surrounding his departure from the company. He therefore appealed against the assessment on the basis that the full severance payment of S$2.475 million represented compensation for loss of office and hence should not be taxable.

Issue before the board

The issue before the board was whether the entire lump sum payment in the separation agreement related to compensation for loss of office, and consequently was not taxable as employment income. The board also had to consider whether the tax authorities were correct to bifurcate the lump sum payment and subject a portion of the payment to tax as employment income, while not assessing the remainder to tax on the grounds that it was non-income.

Key arguments presented

The key arguments presented by the parties are set out below.

Submissions/points of argument

Taxpayer

The retrenchment and redundancy was imposed on him, and the separation agreement was an agreement for a separation between him and the company, and to compensate him for his resultant loss of office. He was informed that he had been terminated with immediate effect, and would cease to be involved in the company or its operations (including at the portfolio companies level). Consequently, the severance payment made to him by the company, although described as a "discretionary ex-gratia payment" in the separation agreement, was intended to compensate him for the loss of his office.

The company's refusal to acknowledge a redundancy arose from their concerns about the reputational impact that an announced redundancy of a key executive would have in the market.

The separation agreement had not intended to bifurcate the severance payment, and the entire amount of the payment should not be taxable on the basis it was compensation for loss of office.

The separation agreement had "imposed additional and more onerous obligations" on the taxpayer than the employment agreement, since it included clauses on potential clawbacks if the terms of the separation agreement were not complied with.

Tax authorities

Part of the lump sum payment under the separation agreement (S$1.35 million) represented an ex-gratia payment, computed in accordance with the terms of the employment contract (i.e., a contractually agreed sum). Any payment stipulated under an employment contract should be taxable, and the amount of S$1.35 million was, therefore, taxable as employment income. The company also had confirmed that the payment was made to recognise the services rendered by the taxpayer, and hence would be taxable.

The tax authorities drew on prior case law to distinguish the taxability of a lump sum payment received in respect of termination of employment, in particular to illustrate that payments made in accordance with the terms of an employment contract are taxable, compared to compensation payments for termination of employment which are not taxable.

The case of ABB v Comptroller of Income Tax [2012] 2 SLR 837 was cited in support of this submission.

Since payments made under the separation agreement were stated to include any payments due to the employee in accordance with the employment agreement, the tax authorities determined that it would be equitable to bifurcate the payment into two components, and assess the taxability of each component separately.

Accordingly, the tax authorities had determined that a portion of the lump sum payment in the amount of S$1.35 million represented the ex-gratia payment to which the taxpayer would have been entitled under the terms of the employment agreement, and thus should be taxable as employment income under section 10(1)(b) of the ITA. The balance of S$1.125 million represented the "non-contractual, ex-gratia discretionary payment" mentioned in the separation agreement. Since this amount was compensation for the restrictive covenants in the separation agreement, it was not taxable on the basis that the payment was capital in nature.

Legal principles and evidence presented

The board drew on relevant legislation in determining whether the payment was taxable, in particular, section 10(2)(a) which provides that "gains of profits from employment" include "any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance ..... paid or granted in respect of the employment whether in money or otherwise."

The board highlighted the following points as key to their decision:

- A strict interpretation of section 10(2)(a) should be adopted. For a receipt to be taxed as "gains or profits from employment," the character of the receipt (regardless of its description) must fall strictly within the definition of any of the nine categories of payment identified in the section, and the payment should be made in recognition of past, present, and future services. Payments that fall outside the definition (i.e., redundancy payments or compensation for loss of office), would not constitute gains or profits from employment.
- The Inland Revenue Authority of Singapore confirms on its website and in one of its practice notes that payments made to compensate for the loss of employment are not taxable as they are regarded as capital receipts.
- A key factor to determine the taxability of the lump sum payment made under the separation agreement was to ascertain whether it had been "paid or granted in respect of the employment." Although the board agreed that the tax authorities could bifurcate the lump sum payment to determine the taxability of the components, the board noted that it was unclear how the final lump sum amount initially was determined. Nevertheless, the board acknowledged that it was likely that the ex-gratia payment as indicated in the employment agreement was a component of the lump sum payment. Notwithstanding that this payment may be part of the lump sum amount, it should nevertheless retain its original character as per the employment agreement.
- To determine the taxability of the ex-gratia payment (notwithstanding that it was given in respect of employment), the question was whether the payment related to services performed, or was given as a compensation for loss of office. It was necessary to determine the true nature of the payment and the board cited the practice note that stated that "whether a payment is for loss of office or simply for services rendered is largely a question of fact."
- Since the individual had to execute the deed of release to become eligible for the ex-gratia payment in his employment contract, it would appear that the deed prescribed under the contract was in the nature of a restrictive covenant, which generally is capital in nature. Furthermore, the ex-gratia payment was payable only where the company terminated the employment, and not in the event of a voluntary resignation. Thus, it did not constitute "wages" or "salaries" paid or granted in respect of an employment under section 10(2)(a).

Decision of the board

The board held that the payment of S$1.35 million (which was the subject of the appeal) was in fact compensation for a noncompetition covenant, arising from the termination of the taxpayer's employment. In this regard, the payment should not be assessed as employment income chargeable to tax under section 10(1)(b) or section 10(2)(a) of the ITA. Since payments in respect of a restrictive covenant and compensation for loss of office both are in the nature of capital receipts that are not taxable, there was no necessity to bifurcate the lump sum amount to determine the precise amount of each payment, although in principle this could be done.

The board concluded that:

- i) The taxpayer's employment was terminated, and the taxpayer suffered a loss of office;
- ii) The separation agreement arose from the termination, and the payments made under the agreement were in the nature of compensation for loss of office, as well as for a noncompetition covenant; and
- iii) The character of the payments remained the same, regardless of whether they were categorised under the terms of a separation agreement, or under the terms of an employment agreement.

The appeal was allowed and the tax authorities were ordered to revise the tax assessment on the basis that the S$1.35 million was not taxable.

Deloitte Singapore's views

This is a landmark case, providing much sought-after clarity on the tax principles applicable when determining the taxability of payments made under a separation agreement. In particular, the board has emphasised the importance of ascertaining the true nature or character of a payment to determine the specific tax treatment, regardless of the description ascribed to the payment.

The board also has refuted the tax authorities' long-held position that any payment that is stipulated or specified in an employment agreement would necessarily be taxable.

It is reassuring that substance over form prevails and that a payment, even though described as an "ex-gratia payment," and included in the terms of an employment contract, should not be taxable if the true character and intent of the payment is in the nature of a capital receipt.

Contacts

We hope that you find this newsletter useful and welcome your feedback.

Should you have any comments or questions arising from this newsletter, please contact either the listed names below, or any member of the Singapore Tax & Legal team.

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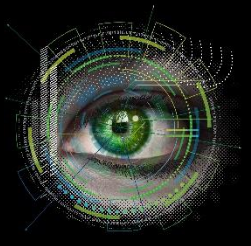

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