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Special Global Employer Services (GES) Tax Alert: Tax treatment of payments made under a separation agreement clarified (updated)

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On 25 November 2020, the High Court decision in Comptroller of Income Tax v Forsyth, John Russell [2020] SGHC 258 was issued. This was an appeal by the Comptroller of Income Tax (Comptroller) on the Singapore Income Tax Board of Review (board)'s decision in GCT v Comptroller of Income Tax [2020] SGITBR 3 (GCT).

Briefly, the issue centred on the payments made under a separation agreement entered 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 in GCT held that the payments were not taxable in the hands of the employee, after considering the facts and circumstances of the case.

Our previous GES Tax Alert dated 16 June 2020 provided the background and the board's decision in respect of the case of GCT. However, for easy reference, we have outlined the salient facts of the case below and the earlier decision of the board, followed by the latest High Court judgment.

Background and facts of the case

Mr. Forsyth was a foreign individual who was employed as managing director of Rising Tide Asia Pte Ltd (the company) for the period from 1 August 2013 to 31 December 2016. He 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 subsequently mutually agreed that Mr. Forsyth's employment with the company would formally end on 31 December 2016.

Clause 9 of Mr. Forsyth's employment agreement with the company provided that in the event of termination of employment by the company in accordance with clause 15 of the employment agreement other than for cause, 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;
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 Mr. Forsyth 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, Mr. Forsyth 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 him in two instalments as a "discretionary ex-gratia payment." Two clauses of the separation agreement are of a particular relevance:

Clause	Details
Clause 2 (Remuneration and benefits)	Under Clause 2, Mr. Forsyth would continue to receive his full annual salary of S$675,000 for the 2016 calendar year.
Clause 3 (Severance payment)	Under Clause 3, a severance payment of S$2.475 million, described as 'discretionary ex-gratia payment' would be made to Mr. Forsyth. 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 Mr. Forsyth in accordance with the employment agreement.

In its assessment, the Comptroller bifurcated 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 the balance of S$1.125 million from tax as capital in nature, on the basis that it represented

compensation with respect to the conditions of confidentiality and non-solicitation which were contained in the separation agreement. The tax authorities asserted that the S$1.35 million represented an ex-gratia payment paid in accordance with the terms of the employment contract (i.e., a contractually agreed sum).

Mr. Forsyth 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.

Decision of the board in GCT (first appeal)

The board in GCT held that the payment of S$2.475m million was partly compensation for loss of office and partly for a restrictive covenant. With respect to the former and explaining why the sum was not a reward for services, the board appeared to have placed some weight on the fact that the ex gratia sum would not have been payable in the event of a voluntary resignation by the taxpayer. Curiously, the board (at para 46) recorded a submission from the Comptroller that the company had 'confirmed that (the payment) was made in recognition of the services' rendered by the taxpayer, but did not further discuss the implications of this statement suggesting that the payments might have been a gratuity.

The board held that the termination payment was 'undoubtedly' given in respect of the employment, but did not fall within the ambit of section 10(2)(a) of the ITA, which specifies exhaustively what constitutes gains or profits from employment that would be taxable under section 10(1)(b) of the ITA.

The board also held that 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, and hence 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 also concluded that the character of the payments remained the same, regardless of whether they were categorised under the terms of the separation agreement, or under the terms of the original employment agreement.

The appeal was accordingly allowed by the board.

Judgement by the High Court (second appeal)

Following the board's decision, the Comptroller appealed to the High Court. The High Court dismissed the appeal by the Comptroller.

The Judge noted that the Comptroller's case was that as the amount of S$1.35 million was paid pursuant to the company's obligations in the employment agreement, it should be deemed as taxable income. However, the judge noted that on the facts, payment under Clause 9 of the Employment Contract was never triggered. Although the company could have terminated the

employment by making payment to the taxpayer in lieu of notice under Clause 15 of the employment, the company did not indicate that it was so doing. As such, the payment was not made in accordance with the employment contract at all, but was a distinct and separate payment which the Judge considered to be compensation for loss of the taxpayer's employment.

The Judge further held, agreeing with the position taken by the board earlier, that income must fall within the definition in section 10(2)(a) of the ITA relating to 'gains or profits from any employment' for the income to be taxable as employment income. Redundancy payments or compensation for loss of office are not included as the definition of section 10(2)(a) of the ITA is exhaustive in nature.

The Judge further elaborated that the severance payment and the ex-gratia payment under Clause 9 were distinct and this was evidenced by the fact that the ex-gratia payment was a sum that would be immediately due and payable, whereas the severance payment was a conditional sum which could be clawed back in the event of a breach of the employee's obligations.

The Judge thus disagreed with the board's earlier conclusion that the severance payment could be bifurcated as no part of it actually comprised the ex-gratia payment under Clause 9 of the employment agreement.

The Judge also noted that there was no evidence that the company had used the taxpayer's salary and bonus entitlements as part of the formula for calculating the severance payment, but even if it did, this would not make the severance payment income that was taxable.

Deloitte Singapore's views

While the conclusion reached by the High Court with regard to the non-taxability of the payment is the same as that of the board, interestingly, the rationale and arguments to arrive at the conclusion appears to have some material differences.

The board had placed weight on the fact that a payment for loss of office was capital in nature and that, in the present case, this conclusion applied whether or not the payments were regarded as arising under the original employment contract or the separation agreement.

The Judge, however, decided the case on the ground that the payments were not made under the original employment contract but were separate payments of compensation for loss of employment. The Judge did not venture any view as to what would have been the treatment had the payments been payments made in accordance to the original employment contract.

Interestingly also, on the facts, the Judge's observation that the company did not purport to make a payment-in-lieu of notice suggests that the taxpayer's initial dismissal was possibly a breach of contract, so that the subsequent compensation was damages or akin to it. Under the case law framework mentioned by the Comptroller and referred to in paragraph 47 of the board's decision, this would in fact have made the payment non-taxable (see in particular the case of Henley v Murray 31 TC 251). In this regard, therefore, the present case was thus arguably simple to decide and not one which actually placed the treatment of contractual termination payments squarely at the front and centre before the Court.

However, the Judge did provide some interesting comments about the tax consequences of making substitute payments in expressing the view (albeit only in obiter dicta) that even if the taxpayer's salary and bonus entitlements had been used to calculate the severance payments, this would not make the severance payments taxable.

In the same vein, the Judge declined to bifurcate the sum on the ground that because Clause 9 of the employment agreement was not triggered, the ex gratia payment envisaged under that clause could not have actually comprised a part of the Severance Payment. This is quite an interesting point (perhaps one not entirely consistent with past practice) to the extent that it may suggest that an investigation into the underlying basis for calculating the severance payment made is usually less relevant or even irrelevant.

The factual position in this case may also be striking contrasted with the two leading Hong Kong Court of Final Appeal's decisions, one in Fuchs v Commissioner of Inland Revenue (FACV No. 22 of 2009), where a termination agreement referred to three sums (A, B and C) and described their nature explicitly by reference to the underlying contractual payments, and where the sums were held taxable, and the other in Poon Cho-Ming, John v Commissioner of Inland Revenue [2019] HKCFA 38 where a sum of EUR500,000 paid in a separation agreement 'in lieu of a discretionary bonus' but which was arrived at by arbitrary negotiation was held not taxable. The extent to which a 'substitution principle' that a payment made in substitution of another takes its character from the character of the original payment (as noted in cases such as Mairs v Haughey [1994] 1 AC 303) was also seemingly not part of the Comptroller's case and was not discussed in the judgments—although interestingly the Judge in the High Court did make the point that the severance payment was subject to more onerous conditions; suggesting that even if the severance payment is a substitute payment, it was a not a close or direct substitute.

Also, the board and the High Court placed weight on the fact that the definition of 'gains or profits from any employment' in Section 10(2)(a) of the ITA was exhaustive and did not include redundancy payments or payments for loss of office.

This is undoubtedly correct, and is one of 3 hurdles to across in order for a payment to be employment income, i.e. it must be:

a. Income in nature and not capital;
b. Paid "in respect of ... employment"; and
c. Fall within the following words listed in Section 10(2)(a) of the ITA : wages, salary, leave pay, fee, commission, bonus, gratuity, perquisites or allowance.

In addition to its analysis based on the listed words in Section 10(2)(a) of the ITA, the board did go on to describe the payments as 'undoubtedly' being 'in respect of the employment' (which is also part of the definition in Section 10(2)(a) of the ITA) and also 'capital' in nature. In other words, the board directly addressed all three of the hurdles listed above. The Judge, by contrast, did rely on the list of words in Section 10(2) of the ITA, but did not address the 'in respect of' point nor did he expressly say that he considered payments falling outside the listed words in Section 10(2)(a) to be capital in nature. However, implicitly he must have done so, because the ITA does have a catch all clause in Section 10(1)(g) which captures all residual income not covered within any of the other expressly enumerated heads of charge.

In summary, the High Court decision is both narrower and wider than the board's.

It is narrower in the sense that High Court's decision focused on the character of the payments under the separation agreement, and the Judge did not comment on the tax character of the underlying contractual payment. Conversely, the Judge seemed to think that the fact that an underlying income amount (e.g. salary or bonus) was used to compute a separation payment did not make it an income.

In our view, the position should be that payments for loss of office, whether contractually mandated or not, are not taxable, as they do not pass any of the three hurdles : they are capital in nature, they are arguably not payments 'in respect of' employment either (see e.g. Comptroller-General of Inland Revenue v Knight [1973] AC 428, and with respect to the board's view), and they do not fall within any of the words listed in Section 10(2)(a) of the ITA.

In the present case, the Comptroller appears (based on both the board's decision (para 45) and the High Court judgment (para 8)) to have run a particularly narrow argument, i.e. that the payments were made pursuant to the original employment agreement, and this argument was on the facts quite easily defeated.

However, given the importance and prevalence of termination payments, this case is unlikely to be the last word, whether or not the Comptroller has lodged a further appeal in this case. The issues relating to termination payments are of public importance and would, in our view, benefit from ventilation before the Court of Appeal. The drafting of the termination clause, and the manner of handling the termination, can also have a material impact on the final tax outcome.

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 contacts below, or any member of the Singapore Tax & Legal team.

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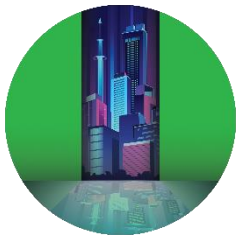

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