KPMG

Tax Alert

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GCT v Comptroller of Income Tax [2020] SGITBR 3: Payments made under a Separation Agreement

Why this matters

In general, payments that are made to compensate for the loss of an income source are regarded as capital receipts and not taxable in Singapore.

The Board of Review (the Board) has in this case held that where termination clauses stipulating such payments are included in an employment contract, it is not conclusive that such payments are taxable. Whether such payments are considered capital receipts is a question of fact which needs to be reviewed carefully in the context of the circumstances leading to the receipt of the payment.

In view of the current economic challenges that businesses are facing due to the pandemic, the outcome of the case is timely as a reference where the tax impact of redundancies would be of key concern to employers and affected employees.

The Facts

The above is a case before the Board between an ex-employee who was the Appellant in the case and the Comptroller of Income Tax (CIT).

The Appellant had served an executive role as Managing Director with a Singapore-incorporated company (the Company), which was subsequently wound down in August 2018.

In his Employment Agreement, specific clauses provided for termination and ex-gratia payments in the event of the termination of the Appellant's employment with the Company. In particular reference to the ex-gratia payment, it was specifically mentioned in the Employment Agreement that the Appellant would upon executing a deed of release, receive payment amounting to six months' base salary and a pro-rated sum of bonus - the latter being contingent upon the Appellant's length of service.

The Appellant

In 2016, the Appellant was notified by the Company of the impending termination of his employment due to the intended closure of the Company and portfolio entities. To effect the termination of the appellant's employment in 2016, no deed of release was executed pursuant to the Employment Agreement. Instead, a Separation Agreement which has the effect of extinguishing the employee's right under the Employment Agreement was entered into, which provided that the Appellant and the Company had mutually agreed to his resignation from his position and employment with the Company. This was done to avoid adverse market impact due to the impending closure of the Company. Pursuant to the Separation Agreement, a discretionary ex-gratia severance payment in two unequal instalments would be received by the Appellant.

The Appellant submitted that the entire severance payment is a compensation for loss of office and should not be taxable.

The CIT

Generally, payments that are made in respect of an employee's past, present or future services or services that are to be rendered under a contract of service, would be considered as taxable employment income of the employee.

In raising the tax assessment, the CIT had bifurcated the severance payment into two portions:

- Part of the payment was treated as taxable employment income pursuant to the termination clause for ex-gratia payment as it was provided in the Appellant's Employment Agreement;
- The remaining was treated as compensation payment for termination of employment as provided for in the Separation Agreement and deemed not taxable.

The Board

In reviewing the case, the Board anchored its analysis strictly from the taxing statute:

- Is the payment under the Separation Agreement "paid or granted in respect of the employment" under Section 10(2) of the Singapore Income Tax Act (SITA); and
- What is the character of the ex-gratia payment in the Employment Agreement, i.e. whether the payment is for services performed or as compensation for loss of office.

In determining the true nature of the payment, the Board is of the view that one needs to look beyond the label into the true character of the payment, in order to determine whether it falls within the ambit of Section 10(2) of the SITA. The Board is of the view that whether or not a payment is specified in the Employment Agreement is a factor, but is not conclusive, in determining its nature. An examination of the relevant clause on ex-gratia payment in the Employment Agreement makes it clear that the payment is only payable on the termination of employment by the Company and that the payment does not relate to any past, present or future services rendered or services to be rendered by the appellant under the term of the contract. Hence, the payment would not be in the character of "wage" or "salaries" paid or granted in respect of an employment under the SITA.

The Board also found that the ex-gratia sum would not have been payable in the event of a voluntary resignation by the Appellant, even though the services performed by the Appellant would have been the same, whether he voluntarily resigned or had his services terminated. It also did not find that there were any other services performed by the Appellant which would have been uncompensated. All services have already been adequately compensated.

Separately, the deed of release as prescribed in the Employment Agreement appears to be in the nature of a restrictive covenant and any payment made pursuant to the deed would also generally be capital in nature

In the circumstances, the Board held that the entire payment was not taxable, as it constitutes compensation for loss of office and for a non-competition covenant.

Our views

The views held by the Board are equitable, upholding the long-held substance over form doctrine of giving due consideration to substance of the nature of the receipt over the form it takes.

The Board's view is also aligned to the Respondent's Practice Note on its website "Retrenchment Pay That Constitutes Payment for Loss of Employment is Not Taxable" where the practice note, states: "…*that whether a payment is for loss of office or simply for services rendered is largely a question of fact.*"

The Board noted the Respondent's stand that practice is not law, where statements on its website are concerned. Notwithstanding, based on the facts of the case, the Board concluded that the termination pay in issue is a capital receipt in its entirety which arises from the loss of office by the appellant and for a non-competition covenant. The character of the payment remains unchanged regardless of whether they are categorized under the terms of the Separation Agreement or Employment Agreement of the appellant.

How KPMG in Singapore can help

As severance payment may include various components, it is imperative that the nature of the components be examined to determine the taxability of the payment. This is regardless of the terminology adopted for the payment or if it is included in the Termination Agreement or an Employment Agreement. To mitigate adverse tax outcomes due to different interpretations of intentions, it would be pertinent that employers review Employment Agreements and Termination Agreements for its tax implications before finalization.

KPMG in Singapore would be able to assist with an analysis of the termination payment, including a review of the agreements, and provide our recommendations on appropriate tax treatment.

To uncover more insights on the global tax implications of COVID-19, read our COVID-19 Global Tax Developments Summary

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