INCOME TAX LIABILITY OF TERMINAL PAYMENTS

This article has been prompted by the recent decision of the Federal Court in *H.* v. *Comptroller-General of Inland Revenue*[1] on the application of S.13 of the Income Tax Act, 1967 (Revised 1971) to redundancy payments. However, in view of the importance and scope of this subject the opportunity is taken to examine the assessability of terminal payments not only in relation to employments but also in relation to the cancellation of agency contracts.

Income tax was first introduced in Malaya on 1st January, 1948 by the Income Tax Ordinance, 1947; and in Sabah and Sarawak by the Income Tax Ordinance, 1956, and the Inland Revenue Ordinance, 1960, respectively. After the formation of Malaysia it was found convenient to formulate a uniform income tax system for the Federation. Accordingly, the Income Tax Act, 1967[2] was enacted. Income Tax, under the 1967 Act is assessed on a residential basis and is a tax purely on income, capital receipts being excluded from assessability except where expressly provided for by the 1967 Act, as for example in the case of compensation for loss of employment under S.13(1)(e).

The form of the income tax system in Malaysia is fundamentally different from that in the United Kingdom. The United Kingdom uses the Schedular System, under which income is only assessable if it falls within the provisions of one of the Schedules and the tax on that income is then computed under the provisions of that Schedule. Each schedule is mutually exclusive. In Malaysia, on the other hand, income tax is imposed on the net assessable income from all sources, there being no special provisions to compute the tax liability on income from any particular source. Australia uses a similar system of income tax in which all assessable income is charged to tax without rigid separations between different sources of income. Inspite of the difference in the machinery of income tax imposition between the United Kingdom and Malaysia there is a close similarity in their substance in a number of areas, including income tax on terminal payments, as the remainder of this article will clearly demonstrate. Hence reliance on United Kingdom precedents is appropriate to assist in the

[1] [1973] 2 M.L.J. 40.

[2] All references to "the 1967 Act" hereinafter shall be to the Income Tax Act, 1967 (Revised 1971) and references to "the 1947 Ordinance" shall be to the Income Tax Ordinance, 1947, unless otherwise stated.

interpretation of substantive provisions in the 1967 Act.

I. COMPENSATION FOR LOSS OF OFFICE

(A) *Before 1967*

Before discussing the relevant provisions of the 1967 Act it may be useful to summarise the position as it existed under the 1947 Ordinance in order to compare and examine the changes made by the 1967 Act in the same area. Under S.10(1)(b) of the 1947 Ordinance income tax was chargeable on "gains or profits from any employment." And S.10(2)(a) went on to explain "gains or profits from employment" as meaning: "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." S.13(1)(i) then proceeded to exempt from tax "sums received by way of retiring or death gratuities or as consolidated compensation for death or injuries."

Hence, under the 1947 Ordinance, compensations paid for the loss of office escaped income tax altogether unless the payment could be shown to have been made "in respect of the employment."

Lord Wilberforce commented:

> "Two propositions are accepted as common ground in the present case. First, where a sum of money is paid under a contract of employment, it is taxable, even though it is received at or after the termination of the employment (see for example *Henry* v. *Foster* (1932) 16 T.C. 605). Secondly, where a sum of money is paid as consideration for the abrogation of a contract of employment, or as damages for the breach of it, that sum is not taxable (see for example *Henry* v. *Murray*, [1950] 1 All E.R. 908)."[3]

The type of situation falling within the first proposition above would be, for example, where the contract of employment itself makes provision for the payment of a sum of money in the event of termination of employment before the expiration of the period of service under the contract.[4] The sum paid in such a case is treated as deferred remuneration and hence can be said to be "in respect of the employment." "The taxpayer surrendered no rights. He got exactly what he was entitled to get under the contract of employment. Accordingly, the payment . . .falls within the taxable class."[5] The type of situation falling within the second proposition is where the contract of service itself makes no provision for the payment

[3] *Comptroller General of Inland Revenue* v. *T.* [1972] 2 M.L.J. 74, 74.

[4] See *Dale* v. *De Soissons* (1950) 32 T.C. 118; *Hofman* v. *Wadman* (1946) 27 T.C. 192.

[5] Roxburgh J., cited with approval by Lord Evershed, M.R. in *Dale* v. *De Soissons*, *ibid.*, p. 128.

of compensation upon premature termination of contract. The payment here is regarded as a capital sum being damages arising upon the abrogation of the contract.[6] The sum here does not arise under the contract; it is received for the surrender of a capital asset viz. the right to earn remuneration under the contract.

(B) *After 1967*

Under the 1967 Act the second of the two propositions no longer applies. S.4(b) charges tax on income in respect of "gains or profits from an employment." S.13(1) provides that "gross income of an employee in respect of gains or profits from an employment includes –

(a) any wages, salary, remuneration, leave pay, fee, commission, bonus, gratuity, perquisite or allowance (whether in money or otherwise) in respect of having or exercising the employment.

(b) any amount received by the employee, whether before or after his employment ceases, by way of compensation for loss of employment. . . "

A measure of relief from S.13(1) is provided by Schedule 6 of the 1967 Act. Sch. 6, para. 15 provides that where a sum is paid as compensation for loss of office by an employer to an employee, that sum is exempted from tax to the extent of two thousand dollars multiplied by the number of completed years of service with that employer; Sch. 6, para, 25 exempts from tax sums received by way of gratuity on retirement from an employment when the employee is more than fifty-five years old if male, or fifty years old if female, at the time of retirement, provided that the employee has been with the same employer for at least ten years. The relief granted by S.13(1)(i) of the 1947 Ordinance, i.e. the exemption from tax on death gratuities or consolidated compensation for death or injuries, is retained by Sch. 6, para. 14 of the 1967 Act.

Generally speaking, although there is some difference in the wording of the 1967 Act, S.13(1)(a) of the 1967 Act covers the same ground as S.10(2)(a) of the 1947 Ordinance. Accordingly, any sums paid *under* a contractual obligation whether upon premature termination of contract or otherwise, will be charged under S.13(1)(a) as being sums received "in respect of having or exercising the employment".[7] Hence the first

[6] *I.R.C.* v. *Brander and Cruishshank* [1971] 1 All E.R. 36; *Duff* v. *Barlow* (1941) 23 T.C. 633, *Du Cross* v. *Ryall* (1935) 19 T.C. 444; *Cowan* v. *Seymouv* [1920] 1 K.B. 500.

[7] This general statement is subject to qualification. A contractual right to the sum is "a strong ground for holding that, from the standpoint of the recipient, it does accrue to him by virtue of his employment, or in other words by way of remuneration for his services" per Jenkins L.J. in *Moorhouse* v. *Dooland* [1955] Ch. 284.; 1 All E.R. 93,104.

proposition stated by Lord Wilberforce in *Comptroller-General of Inland Revenue* v. *T*[8] still holds good under the 1967 Act. However, the second proposition is abrogated by S.13(1)(e) of the 1967 Act, so that any sum paid *as compensation for loss of employment* would be assessable under this provision. Furthermore, it is submitted that any sum paid under a contractual obligation *in respect of loss of employment* would be assessable under S.13(1)(e) and not under S.13(1)(a) even though the sum *prima facie* also falls within the terms of S.13(1)(a). Since there is an express provision dealing with the tax liability on sums paid as compensation for loss of employment, there is no reason why the sum should be charged under S.13(1)(a). This interpretation is obviously more favourable for the taxpayer because where the sum is found to fall within S.13(1)(e) relief is available under Sch. 6, Para. 15; no such relief is available under S.13(1)(a).

"Compensation for loss of employment" is not defined in the 1967 Act but it is envisaged that any sum paid by an employer to an employee upon a termination of employment which is in breach of contract would fall within S.13(1)(e). Thus, for example, salary or wages in lieu of notice, *ex-gratia* or contractual redundancy payments, or payments for breach of contract would fall within S.13(1)(e). However, there are situations in which the employer may make a payment on the expiration of a contract or for variation of the contract of employment which will not constitute compensation for loss of employment. This is the very sort of problem that arose in *H. v. Comptroller-General of Inland Revenue.*[9]

> The appellant was employed by Sime Darby Malaysia Bhd. under five separate contracts of employment. The first, for four years, was dated April 24, 1951, at the end of which he was entitled to eight months leave. The following three contracts were for three years each followed by six months leave at the end of each period. The respective dates of commencement of each of these contracts were February 16, 1956, August 21, 1959 and March 27, 1963. His fifth and final contract was for 2 years, commencing October 26, 1966. A further written agreement between the parties dated March 27, 1962 provided that upon the expiration of the contract commencing on the last date of return to Malaysia for service, all future engagements were to be deemed to be from year to year determinable at any time by three months notice on either side. On July 31, 1968, the appellant received a letter giving him three months notice of termination of employment (his contract was due to terminate on October 26, 1968 at any event). The letter also stated that "as

[8] *Op. cit.* n. 3.

[9] *Op. cit.* n. 1.

compensation for loss of employment you have been accorded a sum of $32,000 *ex gratia.*" This sum had been paid to him under a scheme of "Proposed Compensation in Cases of Possible Amalgamation", which scheme had been voluntarily drawn up by the employers.

The question before the court was whether the sum was a gratuity in respect of having or exercising an employment, and hence assessable under S.13(1)(a), or whether it was compensation for loss of employment falling within S.13(1)(e). If it was the latter, Sch. 6, Para. 15 would be applicable and the whole sum would be exempt from tax.

The Federal Court, affirming Gill F.J. at first instance, held that the sum was not compensation for loss of employment, but was in fact a gratuity in respect of having or exercising the employment and accordingly chargeable as a gain or profit from employment by virtue of S.13(1)(a).

Suffian F.J. delivering the judgement of the Federal Court, applied the test of compensation enunciated by Romer L.J. in *Henry* v. *Foster.*[10]

> " 'Compensation for loss of office' is a well-known term, and, as I understand it, it means a payment to the holder of an office as compensation for being *deprived* of profits to which as between himself and his employer he would, but for an act of deprivation by his employer or some third party, such as the Legislature, have been entitled."[11]

Applying this test Suffian F.J. said:

> "The taxpayer here was under contract to serve until 26th October 1968. He was given due notice under which his service was to end not earlier than, but exactly on 26th October 1968. In the circumstances we do not think that he has been deprived of anything to which he was entitled, for which deprivation the $32,000 represented compensation. We would therefore hold that that money was not compensation for loss of employment."[12]

In arriving at this conclusion Suffian F.J. rejected the taxpayers contention based on a dictum by Rowlatt J. in *Chibett* v. *Joseph Robinson and Sons* that "... compensation for loss of an employment *which need not continue but which was likely to continue,* is not an annual profit within the scope of the Income Tax at all."[13] The taxpayer contended

[10](1932) 6 T.C. 605, p. 634.

[11] Emphasis by Suffian F.J.

[12] *Op. cit.* n. 1, p. 46.

that since he had already been in the employment of the company for seventeen and one half years it was likely that his employment would have continued up to the retiring age of fifty five years. The Special Commissioners found as facts that the taxpayer had been employed under five separate contracts of employment, that there was no obligation by the employer to renew the contract each time it expired, and that he should not have relied on his contract being renewed each time it expired. Therefore the taxpayer merely got what he bargained for under the contract when it was not renewed upon its expiry on October 26, 1968.

It is respectfully submitted that the above reasoning is correct and hence the $32,000 could not possibly be regarded as compensation for loss of employment. In *Chibett* v. *Robinson*[14] itself Rowlatt J. explained the circumstances in which a sum paid upon termination of employment could be regarded as compensation for loss of office.

> "If it was a payment in respect of the termination of their employment I do not think that is taxable. It seems to me that a payment to make up for the cessation of future annual taxable profits is not itself an annual profit at all. . . I should not have thought that either damages for wrongful dismissal or. . . a voluntary payment in respect of breaking an agreement which had some time to run. . . would be taxable profits. . . "[15]

It may be noted that the above passage shows the sort of payments not taxable under Schedule E of the U.K. legislation because they are compensations for loss of office.[16] In *Henley* v. *Murray*[17] Lord Evershed M.R. said that where a bargain between employer and employee brings about an end to the contract of employment and some sum is paid as consideration for the total abandonment of all contractual rights under the contract that sum would be damages not assessable under Schedule E.[18] Such a sum would however be assessable under S.13(1)(e) of the 1967 Act as compensation for loss of employment.

[13] (1924) 9 T.C. 48, p. 61. Emphasis by Suffian F.J.

[14] *Op. cit.* n. 13.

[15] *Ibid.*, p. 61.

[16] Sch. E., S.181 of the Income and Corporation Taxes Act 1970, in the U.K., charges to tax all emoluments derived from an office or employment. Compensation for loss of employment is not assessable under Sch. E. but is brought into charge by the "golden handshake" provisions, of SS.187-188. These provisions were first introduced in SS.37-38 of the Finance Act 1960, and are only applicable when the sum in question would not otherwise be assessable under Sch. E.

[17] [1950] 1 All E.R. 908.

[18] *Ibid.*, p. 909.

It can therefore be said that any sum paid to an employee for the breach of any contractual term which results in the premature termination of the employment would amount to compensation for loss of employment assessable under S.13(1)(e). S.13(1)(e) would apply even though the payment of compensation or damages in the event of premature termination was provided for in the contract itself. Hence cases such as *Dale* v. *De Soissons*[19], and *Hofman* v. *Wadman*[20] would now come under S.13(1)(e) and not under S.13(1)(a). This would also mean that the sum would be exempted from income tax to the extent provided for by Sch. 6 para. 15 of the 1967 Act.

The second ground of the decision in *H.* v. *Comptroller-General of Inland Revenue*[21] is best discussed under the next heading.

III. GRATUITY OR PERQUISITE IN RESPECT OF HAVING OR EXERCISING THE EMPLOYMENT

It will be recalled that the Federal Court held that the $32,000 was assessable even though it did not constitute compensation for loss of employment because it was a *gratuity* received in respect of having or exercising the employment. In arriving at this conclusion Suffian F.J. dismissed the taxpayer's contentions that (a) the payment was made to him without the employer being under any legal obligation to do so and (b) the payment was not being made to the *holder* of an office but to a *former* employee.

His Lordship said:

> ". . . There is clear evidence that the payment, though not of a contractual nature to which the taxpayer was entitled, was made *in reference to and by* virtue of his employment, especially when it is remembered that the quantum was related to the total period of his service.
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> "It is clear as stated by Gill F.J. that in the present case the payment to the taxpayer was made in reference to the services rendered by the taxpayer by virtue of his office, and that it was something in the nature of a reward for his services, that the scheme of compensation drawn up by the company was in reality a scheme for the payment of a gratuity to its staff on the basis of age and years of service and that therefore it is liable to tax as a gratuity in

[19] *Op. cit.* n. 4.

[20] *Op. cit.* n. 4.

[21] *Op. cit.* n. 1.

respect of having or exercising his employment within the meaning of paragraph (a) of subsection (1) of section 13."[22]

It is obvious that Suffian F.J. reached this conclusion on the evidence and facts of the case. Regrettably however His Lordhip did not point out what the specific evidence was or the exact facts were on which he based his conclusion. Accordingly, before it is possible to determine the correctness of the decision in law, it will be necessary to examine the true meaning of the phrase "in respect of having or exercising the employment," for it is on the true interpretation of this phrase that the outcome of any case based on S.13(1)(a) of the 1967 Act will turn.

A case decided by the Privy Council under the Income Tax Ordinance 1947, with facts very similar to *H.'s Case*, is *T. v. Comptroller-General of Inland Revenue.*[23]

> The taxpayer was employed as a staff surveyor by the Malaya Borneo Society Ltd. from 23 August, 1954. The contract of service was terminable by three calendar months' notice by either party. In February, 1960, the management of the Company wrote a letter to its staff surveyors including the taxpayer, informing them of a redundancy pay scheme. Under the scheme any staff surveyor becoming redundant was to be entitled to one month's pay for each completed year of service subject to a maximum of 12 months' pay and a minimum of 3 months' pay. In 1965 the taxpayer was made the chief staff surveyor. On 2nd November 1965 the board of directors of the company passed a resolution declaring the taxpayer redundant and granting him the maximum benefit under the redundancy pay scheme.
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> The question before the Privy Council was whether the $28,050 given to the taxpayer under the scheme was a gratuity paid or granted in respect of the employment.
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> The Privy Council held that the sum did not arise in respect of the employment and hence was not taxable under S.10(2)(a) of the Income Tax Ordinance 1947.

In arriving at this conclusion the Privy Council rejected the contention that the letter containing the redundancy pay scheme became part of the contract of employment between the company and the taxpayer. Lord Wilberforce, delivering the judgement of the Privy Council, said that the latter was nothing more than an expression of the company's intent. The terminology of the letter was inappropraite to constitute

[22] *Ibid.*, p. 46; emphasis by Suffian F.J

[23] [1972] 2 M.L.J. 73.

a variation of the contract, and silence by the taxpayer could not be taken as assent to a contractual change.[24]

In considering the words "in respect of the employment" Lord Wilberforce said that "[i]f the fact is that it was paid in respect of *loss* of the employment, it does not come within the taxing words."[25] His Lordship continued:

> ". . . in order to be taxable, a gratuity must be paid in respect of the employment – many gratuities are so paid such as 'tips' and these are no doubt taxable. If the gratuity is not so paid, but is paid in respect of the termination of his employment, it is not taxable."[26]

Suffian F.J. in *H.'s Case* distinguished *T.'s Case* on the basis that in *T's Case* the company was under a legal obligation to give the tax-payer three months' notice before it could terminate his services and this had not been done. The sum paid in *T.'s Case* would therefore amount to compensation for loss of employment and would be assessable under S.13(1)(e) of the 1967 Act. In *H's Case*, on the other hand, adequate notice had been given, and the $32,000 was an additional voluntary payment.[27] In *T.'s Case* the Privy Council refused to draw a distinction between that type of case and cases where the payment is made expressly as consideration for abrogating a service agreement, which sum is not taxable as it falls outside the words "in respect of his employment" in S.10(2)(a) of the Income Tax Ordinance, 1947.[28]

Although the distinction drawn by Suffian F.J. between the *H. Case* and the *T. Case* is valid on the facts, it is respectfully submitted that essentially there is no difference between the two cases and that the decision in *H's Case* should have been the same as in *T.'s Case*. The Privy Council in *T's Case* approved *Chibbett* v *Robinson*,[29] in which the compensation paid to a firm of ship managers for loss of office was held to be not taxable even though there was no express agreement that the sum was paid as compensation for abrogating the employment. The same conclusion was reached by the House of Lords in *I.R.C.* v. *Brander and Cruickshank*.[30] After finding that the profits from registrarships and

[24] *Ibid.*, p. 74.

[25] *Ibid.*

[26] *Ibid.*

[27] *Op. cit.* n. 1, p. 46.

[28] *Op. cit.* n. 23, p. 75.

[29] *Op. cit.* n. 13.

[30] [1971] 1 All E.R. 36.

secretaryships held by a firm of solicitors were assessable under Schedule E as profits from an employment, the House of Lords held that voluntary compensation paid by two companies upon the termination of the taxpayer's services were not assessable under Schedule E, but came within the "golden handshake" provisions of the U.K. legislation.[31] In this case too there was no express agreement that the sum was paid in consideration of the abrogation of the contract of service. In fact there was no express contract between the companies and the taxpayers, the appointment being made from year to year. Furthermore, the taxpayers did not expect any compensation, the sum paid by the company being only due to the personal friendship between the directors of the company and one of the partners of the taxpayer firm. In the same way, in *H's* Case there was no legal obligation on the part of the employer to make the payment. Yet in those cases the sum was held not assessable whereas in *H's* Case it was held to be assessable. Although it is accepted that in *H's* Case there was no loss of employment for which compensation was paid as the contract expired in the normal course of events, yet, it is respectfully submitted that the payment was not paid in respect of *having or exercising* an employment but in respect of the *termination* of employment. It is submitted that there was indeed a *termination* of employment. Applying the "likely" test in *Chibbett* v. *Robinson*,[32], there was a likelihood that the taxpayer's contract would be renewed, as it had been over the past seventeen and one half years. Although the taxpayer had no *right* to a further contract of service due to past practice he could reasonably expect to be continued to be employed by the same employer. It is appreciated that this submission is made in the face of an adverse finding of fact by the Special Commissioners, but that finding can be restricted to deciding that the sum paid could not be regarded as compensation for loss of employment; that does not mean that there was no termination of employment.

As will be recalled, Lord Wilberforce in *T's Case* stated that a sum paid *in respect of termination of employment* was not assessable as being paid *in respect of employment*. Furthermore, in an Australian case, *Barncastle* v. *Commissioner of Taxes* (N.S.W.),[33] it was said that words "in respect of or in relation to the employment" referred to an existing employment

[31] S.187 of the Income and Corporation Taxes Act, 1970. In fact the whole sum paid was exempted in this case as it was below £5,000. See Schedule 8 paragaph 3. See *op. cit.* n. 16.

[32] *Op. cit.* n. 13.

[33] (1936) 36 N.S.W. State Reports, 338.

and did not extend to a former employment. In *Hochstrasser* v. *Mayes*;[34] in the Court of Appeal, Jenkins L.J. said:

> "... the profits of an office or employment include every sum in money or money's worth paid by an employer to an employee *during his employment* in his capacity as employee and for no consideration moving from the employee other than the services which he renders..."[35]

It is respectfully submitted that there is yet another basis on which the outcome of *H's Case* can be impugned. The sum can be regarded as having been paid on personal grounds, as a gesture of appreciation by the former employers. An examination of the case-law elucidating what constitutes a payment made on personal grounds demonstrates that in *H.'s Case* there are ample grounds to make the payment personal and not one "in respect of having or exercising the employment." This necessitates an exploration of the English authorities on the subject. Schedule E of the U.K. Income Tax Act, 1952 was substantially similar to the present S.13(1)(a) of the 1967 Act until its amendment in 1956 by the repeal of the Rules under Schedule E. The ninth Schedule, Rule 1, so far as material stated that "tax under Schedule E shall be annually charged on every person *having or exercising* an office or employment of profit... in respect of all salaries, fees, wages, perquisites or profits whatsoever *therefrom*..." Despite the difference in wording between the 1967 Act and Rule 1 above, it will be seen that under both enactments the source of the profit must be the employment. The difference between the two enactments is that under the U.K. formula the taxpayer must be *having or exercising* an employment and the profit must be *therefrom*, whereas under the Malaysian formula the profit must be *in respect of having or exercising* the employment. It is submitted that in view of the word "therefrom" in the U.K. Act and "in respect of" in the corresponding section in the Malaysian Act, there is no material difference in the essence of the two formulae. In passing it may be noted that after the repeal of the Rules to Schedule E by the Finance Act 1956 in the United Kingdom, the taxing formula of gains or profits from employment is that the emoluments must be "in respect of any office or employment." This is similar to the formula used in S.10(2)(a) of the 1947 Ordinance which charged to tax gains or profits "in respect of the employment." The English cases have interpreted the pre-1956 and post-1956 formulae as being the same in their operation, and it is accordingly submitted that the difference in wording between the 1947 and 1967 Malaysian legislation does not alter the essential meaning of the formula.[36]

[34] [1958] 3 All E.R. 285.

[35] *Ibid.*, p. 290; emphasis added.

[36] In *H.* v. *Comptroller-General of Inland Revenue* [1973] 2 M.L.J. 40 43 At first

In view of the substantial similarity between the legislation in both countries it is felt that U.K. cases can be used to trace the true scope of the Malaysian legislation.[37]

The courts, in interpreting the U.K. legislation have used diverse terminology to explain the meaning of Rule 1. For example, it has been said that to be assessable a sum must arise by *virtue* of the office, or it must be in consideration for *services rendered or to be rendered*, or that the sum must *arise from* the employment. However, in looking at these interpretations it must be remembered that they do not displace the words of the statute itself. In *Hochstrasser v. Mayes*[38] Lord Radcliffe said:

> ". . . it is not easy in any of these cases in which the holder of an office or employment receives a benefit which he would not have received but for his holding of that office or employment to say precisely why one considers that the money paid in one instance is, in another instance is not, a 'perquisite or profit. . . therefrom'
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> "The test to be applied is the same for all. It is contained in the statutory requirement that the payment, if it is to be the subject of assessment, must arise "from" the office or employment. In the past several explanations have been offered by judges of eminence as to the significance of the word 'from' in this context. It has been said that the payment must have been made to the employee 'as such'. It has been said that it must have been made to him 'in the capacity of employee'. It has been said that it is assessable if paid 'by way of remuneration for his services' and said further that this is what is meant by payment to him 'as such'. These are all glosses and they are all of value as illustrating the idea which is expressed by the words of the statute. But it is, perhaps worth observing that they do not displace those words. For my part I think that their meaning is adequately conveyed by saying that, *while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it is paid to him in return for acting as or being an employee.*"[39]

The final sentence above, it is submitted, places a restriction on the

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instance, Gill F.J. said that there was no difference between a "gratuity in respect of employment" and a "gratuity in respect of having or exercising an employment."

[37] Although this article is concerned only with the tax liability of terminal payments, in interpreting S.13(1)(a) of the 1967 Act it will be necessary to refer to U.K. cases on voluntary payments made to an employee during the subsistence of his employment.

[38] [1960] AC 376; [1959] 3 All E.R. 817, p. 823.

[39] Emphasis added.

scope of the word "having" in S.13(1)(a) of the 1967 Act. If the word is given its literal meaning, then every sum paid to an employee would fall within the tax net where the sum is paid to the employee because he holds that employment and not because he has done something in that employment. The sum paid to the employee is only assessable if he has "acted" in that employment; that is he has performed services for which he is being remunerated by a sum to which he is not necessarily entitled under his contract of service. The word "being" does not derogate from the principle above. It would cover such voluntary payments as are made to all the employees or to a particular class of employees on a certain occassion regardless of any services rendered by them. Thus, for example, Easter offerings to an incumbent benefice,[40] discretionary bonuses to employees,[41] gift vouchers to all employees of the firm at Christmas[42] a gift of a suit to all employees at Christmas.[43] In short, all benefits given to an employee outside his entitlement under the contract of employment have been held to be assessable on employees. In these cases the benefits are given to an employee by reason of his *being* an employee as there is no selection as to which employee or which employees within a given class is to receive the gift.

All the various glosses used by the courts in interpreting Rule 1 to Sch. E of the U.K. Income Tax Act, 1952 boil down to one thing; the payment, to be assessable, must be referable to services. The most comprehensive statement to this effect was made by Upjohn J. at first instance in *Hochstrasser* v. *Mayes*[44] which was subsequently approved by Viscount Simonds in the House of Lords.

> "In my judgement, the authorities show this, that it is a question to be answered in the light of the particular facts of every case whether or not a particular payment is or is not a profit arising from the employment. Disregarding entirely contracts for full consideration in money or money's worth and personal presents, in my judgement not every payment made to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgement, the authorities show that, to be a profit arising from the employment, *the payment must be made in reference to the service the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future.*"[45]

[40] *Blakiston* v. *Cooper* [1909] A.C. 104.

[41] *Denny* v. *Reed* (1935) 18 T.C. 254.

[42] *Laidler* v. *Perry* [1965] A.C. 16.

[43] *Wilkins* v. *Rogerson* [1961] Ch. 133.

[44] [1959] Ch. 22 33.

[45] Emphasis added.

Viscount Simonds, in accepting the above statement only doubted the word "past".[46]

Sums paid to an employee by way of gift due to the personal relationship between the employee and the employer are not assessable. The leading statement enunciating the test to be applied in deciding whether a particular voluntary payment is not assessable as being a gift is contained in *Seymour* v. *Reed*. Viscount Cave L.C. said:[47]

> "... it must now (I think) be taken as settled that they include all payments made to the holder of an office or employment as such, that is to say, by way of remuneration for his services, even though such payments may be voluntary, but that they do not include a mere gift or present (such as a testimonial) which is made to him on personal grounds and not by way of payment for his services. The question to be answered is, as Rowlatt J. put it: 'Is it in the end a personal gift or is it remuneration?' If the latter, it is subject to the tax; if the former, it is not."

To decide in each case whether a particular payment is made on personal grounds or not the facts and evidence of each case will have to be carefully scrutinised. In *Seymour* v. *Reed*[48] itself it was held that a benefit granted to a cricketer was a testimonial and not assessable. The factors taken into consideration in arriving at this conclusion were: (a) a benefit was only granted towards the close of a cricketer's career as an endowment for his retirement; (b) it was not granted more than once; (c) it was an expression of the gratitude of his employers and the cricket loving public for his *past performances* and it was not meant to spur him to greater exertions in the future; (d) the employee under his contract of employment did not have a right to a benefit.[49]

The doubt cast by Viscount Simonds in *Hochstrasser* v. *Mayes*[50] on the word "past" is borne out by *Seymour* v. *Reed*.[51] This is particularly so where the past services have already been adequately remunerated. Furthermore, a sum given as a personal gift is not deprived of that quality because the donor makes himself liable under contract to pay the sum. In *Bridges* v. *Hewitt*,[52] shares were transferred to directors of a company by the company's shareholders because of the work done by the

[46] *Op. cit.* n. 38, [1959] 3 All E.R. 817, 84.

[47] [1927] A.C. 554 559.

[48] *Ibid.*

[49] *Ibid.*, pp. 559-560.

[50] *Op. cit.* n. 46.

[51] *Op. cit.* n. 49.

[52] [1957] 2 All E.R. 281.

directors in making the company successful. The shareholders bound themselves contractually to make the transfer and the directors undertook to continue to serve the company for at least four years from the date of the deed. The Court of Appeal held that the value of the shares was not assessable on the directors as the shares were a personal gift and not remuneration. Morris L.J. said:[53]

> ". . . it seems to me that a payment which has the attributes of being a personal gift does not necessarily lose those attributes merely because the donor agrees to bind himself so as to be compellable at law to make the payment. . . "

An illustration of the point that a sum paid as remuneration for future services will be assessable is *Cameron* v. *Prendergast*.[54] The taxpayer, a director of a company, wished to resign as director but he was persuaded to stay on the understanding that henceforth he would only act in an advisory capacity. In consideration thereof he was given £45,000 but his salary was reduced from £1,500 p.a. to £400 p.a. The Houses of Lords held that the £45,000 was assessable as it constituted an inducement to remain in office; money paid as consideration for continuation of employment is a profit from employment.

Jenkins L.J. in *Moorhouse* v. *Dooland*,[55] having reviewed all the earlier authorities, summarised the principles under which a sum would be assessed under Schedule E as follows:

> "(i) The test of liability to tax on a voluntary payment made to the holder of an office or employment is whether from the standpoint of the person who receives it, it accrues to him by virtue of his office or employment, or in other words by way of remuneration for his services. (ii) If the receipient's contract of employment entitles him to receive voluntary payment, whatever it may amount to, that is a ground, and I should say a strong ground, for holding that, from the standpoint of the receipient, it does accrue to him by virtue of his employment, or in other words by way of remuneration for his services. (iii) The fact that the voluntary payment is of a periodic or recurrent character affords a further, but I should say a less cogent ground for the same conclusion. (iv) On the other hand, a voluntary payment made in circumstances which show that it is given by way of present or testimonial on grounds personal to the recipient, as for example a collection made for the particular individual who is at the time vicar of a given parish because he is in straitened circumstances, or a benefit held for a professional

[53] *Ibid.* p. 298.

[54] [1940] A.C. 549; see also *Tilley* v. *Wales* [1943] 1 All E.R. 386.

[55] [1955] Ch. 284; [1955] 1 All E.R. 93, 204.

cricketer in recognition of his long and successful career in first-class cricket. In such cases the proper conclusion is likely to be that the voluntary payment is not a profit accruing to the recipient by virtue of his office or employment but a gift to him as an individual paid and received by reason of his personal needs in the former example and by reason of his personal qualities or attainments in the latter example."

Having reviewed the principles of law applicable in deciding the taxability of a "gratuity" under S.13(1)(a) it is now possible to apply those principles to *H.* v. *Comptroller-General of Inland Revenue*.[56] The relevant circumstances of that case are as follows: (a) The taxpayer had no entitlement under contract to receive the sum. It was found as a fact that the letter setting out the proposal did not form part of the contract of service. This shows therefore that the sum received was not in fact received *under* any contract[57]. (b) Upon receipt of the sum the taxpayer's employment was terminated. Therefore the sum could not in any way be referable to services to be rendered.[58] (c) Although the sum may have been paid in recognition of past services, this does not *ipso facto* make the sum assessable. He was adequately remunerated during the currency of his employment, and the fact that the sum is referable to past services can be regarded as demonstrating that the sum was a token of appreciation for services already rendered.[59] (d) The fact that the *ex gratia* payment is calculated by reference to the number of years of service rendered by the taxpayer ought not to be taken as a cogent factor in determining the essential nature of the payment.[60] In the light of the above factors it is respectfully submitted that the sum paid to the taxpayer in *H's Case* was not a gratuity paid "in respect of having or exercising the employment." The sum was merely a personal gift, a token of appreciation from the employers. There was nothing about the circumstances of the sum that makes it referable to the services of the employment.

By way of conclusion on the application of S.13(1)(a) and S.13(1)(e) to a terminal payment from employment, it may instructive to analyse a U.K. case, *Hunter* v. *Dewhurst*,[61] in the light of the Malaysian legislation.

[56] *Op. cit.*, n. 1.

[57] *Seymour* v. *Reed*, *op. cit.* n. 47.

[58] *Cameron* v. *Prendergast*, *op. cit.* n. 54.

[59] *Seymour* v. *Reed*, *op. cit.* n. 47, *Bridges* v. *Hewitt*, *op. cit.* n. 52.

[60] *Hunter* v. *Dewhurst* (1930) 16 T.C. 605; *Gelnboig Union Firclay Co.* v. *I.R.C.* (1922) 12 T.C. 427, in which the House of Lords said that the manner of calculating the sum payable as compensation for sterilising an asset should not affect the question as to whether such sum was a capital or an income receipt.

[61] *Ibid.*

The facts of the case are as follows:

> The taxpayer was the Chairman of a company. He wished to retire from active management of the company but since he had been instrumental in attaining the prosperity of the company the board of directors wished to be able to consult him from time to time. Under the Articles of the Company, Article 109 provided that in the event of the death, resignation, cessation of office for any reason other than misconduct, bankruptcy, lunacy, or incompetence, of a director who had held office for more than 5 years, the company would pay by way of compensation a sum equal to the total remuneration received by him in the preceeding 5 years. The taxpayer agreed to resign as Chairman and became an ordinary director at a much reduced salary. In consideration for giving up his rights under Article 109 the company granted him £10,000 as compensation. The House of Lords held that in the circumstances of the case the £10,000 was not taxable.

It will be noted that if the taxpayer resigned while he was an ordinary director, the sum receivable by him under Article 109 would be drastically less than the amount he would be entitled to by resigning altogether from the company while Chairman. The £10,000 was paid to him to cover the loss he would have thereby suffered. Lord Warrington of Clyffe said that the sum was not referable to services already performed or services to be performed; the sum was to enable the taxpayer to give occasional attendance at the board, and to enable the company to retain the benefit of his help.[62] Lord Atkin said:[63]

> "... The £10,000 was not paid for past remuneration for the condition of its becoming payable, for instance, loss of office, never was performed. It was not paid for future remuneration, for that was expressed to be £250, p.a. which was the sole remuneration. It seems to me that a sum paid to obtain a release from a contingent liability under a contract of employment cannot be said to be received 'under' the contract of employment, it is not remuneration for services rendered or to be rendered under the contract of employment, and is not received 'from' the contract of employment."

The references to "past services" in the judgement of their Lordships relate to the situation where the right of compensation upon termination of employment is contained in the contract of employment itself. This situation has already been dealt with.[64]

[62] *Ibid.*, pp. 643-644.

[63] *Ibid.*, p. 645.

[64] *Supra*, p. 73 *et seq.*

Considering the assessability of the above case under S.13(1)(e) of the 1967 Act, it is submitted that the sum would not be assessable under that provision for there has in fact been no loss of employment. In the present case the taxpayer has surrendered one office and taken up another office with the same employer. Since a promotion from an ordinary directorship to an executive directorship in the same company has been held to be a continuation of the same employment,[65] what in effect amounts to a demotion should also be regarded as a continuation of the same employment. It should be borne in mind that a Chairman or any other executive director can only be appointed from the board of directors and hence there is no reason why a shift from chairman to director should be regarded as the termination of one employment and commencement of another. The only way a sum can be brought within the provisions of S.13(1)(a) is by showing that the sum was paid in consideration of services. The one factor against the taxpayer for purposes of S.13(1)(a) is that the sum is payable under a contract, but this contract, however, is not the contract of employment. It is a new contract entered into between the parties, and accordingly, applying the principle laid down by Morris L.J. in *Bridges* v. *Hewitt*,[66] the fact that the donor has bound himself by contract to make the payment does not *ipso facto* make the sum assessable. Two questions should be asked in this connection. First, was the sum referable to past services? Lord Atkin answered this in the negative, because the condition for its becoming payable under the Article was never performed; and besides, the past services had been adequately remunerated. Secondly, was the sum referable to future services? Probably not, because the taxpayer was to receive a fixed salary as an ordinary director. This case is distinguishable from *Cameron* v. *Prendergast*[67] because in that case the office of the taxpayer remained the same; he continued to serve the company as a director. In the present case however, the taxpayer stepped down from his position as Chairman to become an ordinary director, and as ordinary director he received a proper salary.

III. TERMINAL PAYMENTS UPON CANCELLATION OF AGENCY CONTRACTS

The problem to be considered here is whether S.13(1)(a) or S.13(1)(e) of the 1967 Act are applicable to sums paid by a principle upon the cancellation of an agency contract held by an agent under which the agent pertorms services for the principal or sells the principal's goods It will be

[65] *May* v. *Falk* 17 T.C. 218.

[66] *Op. cit.* n. 52.

[67] *Op. cit.* n. 54.

remembered that S.13(1) covers only "gross income of an *employee* in respect of gains or profits from an *employment*." Therefore the primary question is whether the agency contract creates an employment. S.2 of the 1967 Act defines "employment" as meaning:

"(a) Employment in which the relationship of master and servant subsists;

(b) Any appointment or office, whether public or not any whether or not that relationship subsists for which remuneration is payable."

Definition (a) above gives rise to no difficulty. Generally speaking it is relatively easy to recognise a situation where a master-servant relationship exists. However, it is often difficult to distinguish an appointment or office which is an employment from one which is a profession. Rowlatt J. in *Great Western Railway* v. *Bater*[68] defined an office or employment of profit as ". . . a subsisting, permanent, substantive position, which had an existence independent of the person who filled it, and which went on and was filled in succession by successive holders. . ." The difficulty in distinguishing between employment and profession or vocation is accentuated when the taxpayer holds a multiplicity of posts. It is possible for a person, while carrying on a profession, to be employed at the same time. Thus a solicitor having a large general practice will be carrying on a profession, and if he also acts as a secretary or registrar for a company, he will also be engaged in an employment at the same time.[69] Similarly, a consultant radiologist who has private patients of his own and who is also a part-time consultant to a hospital, will be carrying on a profession and an employment respectivelv.[70]

The basic test for distinguishing between profession and employment is whether the taxpayer is subject to a *contract of service* or *a contract for services*, the former being an employment and the latter a profession. A taxpayer carrying on a profession ordinarily does work for a number of different persons in the course of the year, and the nature of the work is such that one particular person would not require the exclusive services of the taxpayer throughout the year. It makes no difference that only a restricted number of persons may engage the services of the taxpayer. Furthermore, the degree of skill of the taxpayer is not a relevant consideration. Whereas a professional would be remunerated in accordance with the amount of work done by him, an employee would normally be remunerated by a fixed sum even though this sum may be augmented by

[68] [1920] 3 K.B. 266, 274.

[69] *I.R.C.* v. *Brander and Cruickshank* [1971] 1 All E.R. 36.

[70] *Mitchell & Edon* v. *Ross* [1962] A.C. 814.

commissions and the like.[71]

When a sum is paid as compensation upon termination of a professional contract then that compensation cannot come within S.13(1). In *Walker* v. *Carnaby, Harrower Barham and Pykett*,[72] a firm of chartered accountants had been engaged as auditors to a group of companies for a period ranging from 27 years to 59 years. The group installed centralised machine accounting and accordingly terminated the firm's engagement. The company paid the equivalent of one year's fees as auditors to the firm as *solatium* for loss of office. Pennycuick J. held that the firm was carrying on a profession and accordingly the sum was not assessable under Schedule E. It was also held that the sum could not be treated as a business receipt assessable as a gain or profit from a profession as it was paid by way of recognition for services rendered or as consolation for the termination of a contract.

Although it is clear that a voluntary payment upon termination of a professional contract is not assessable under S.13(1), the sum will nevertheless be assessable if it can be shown to be a normal business receipt. In *Walker* v. *Carnaby*, Pennycuick J. said:[73]

> " "There is, as is well known, a great volume of authority on voluntary payments made to the holder of an office. There is no doubt that in many circumstances a payment, although voluntary, may yet when looked at from the point of view of the recipient be regarded as a payment arising from that office. There is curiously little authority on voluntary payments made to someone who is carrying on a trade or profession. . . It may be that traders do not frequently receive voluntary payments from their clients or customers or from former clients or former customers. The test must be whether a voluntary payment made to someone carrying on a trade or profession is properly to be regarded as a receipt to be taken into account in computing the profit of that trade or business. ... "

The 1967 Act, S.22(2)(b), provides that the gross income of a person from any source includes any sums receivable in the basis period for the year of assessment as "compensation for loss of income from that source." Hence, a receipt will have to be taken into account as a profit of the business where it is received as compensation for loss of income from that source. So, although *Walker* v. *Carnaby* will still escape assessment as the sum was not paid as compensation for loss of income, it may well be that sums paid upon the termination of other contracts of service or agency

[71] See *Davies* v. *Braithwaite* [1931] 2 K.B. 628, in which Rowlatt J. discusses the distinction between profession and employment.

[72] [1970] 1 All E.R. 502.

[73] *Ibid.*, p. 507.

contracts will be assessable when the sum is paid to compensate the taxpayer for the profit he would have earned if the contract had continued. In order to decide whether a sum paid upon the termination of an agency contract is covered by S.22(2)(b) of the 1967 Act the basic test to be applied is whether the sum is in fact a capital receipt or an income receipt. If it is a capital receipt then it cannot be regarded as compensation for loss of income from that source.

In the case of a receipt received upon the cancellation of an agency contract, the receipt will be regarded as a capital receipt if it affects the whole *profit-earning structure of the business.* If the receipt is received as a mere incident to the carrying on of that particular type of business then it will be regarded as compensation for loss of income. This test was enunciated by the House of Lords in *Van den Berghs Ltd.* v. *Clark.*[74] Lord Macmillan said that if a sum is received as an aggregate of the profits which would otherwise have been earned over the years then the lump sum too would be regarded as profit. But simply because a sum is measured in terms of profits, it does not thereby itself become a profit.

His Lordship continued:

> "... the cancelled agreements related to the whole structure of the Appellents' profit-making apparatus. They regulated the Appellants' activities, defined what they might and what they might not do and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure, or money received for the cancellation of so fundamental an organisation of a trader's activities can be regarded as an income disbursement or an income receipt."[75]

The operation of this test can be seen in two contrasting cases. In *Kelsall Parsons and Co.* v. *I.R.C.*[76] the taxpayers were commission agents for the sale of the products of various manufacturers in Scotland. One of the agency agreements, which was to last for three years, was terminated after the second year in consideration for which the taxpayers received £1,500 as compensation. It was held that the sum constituted a business receipt of the taxpayers. It was a normal incident of the business that its contracts might be altered or cancelled from time to time, and the business of the taxpayers was designed to absorb such shocks. The contract was also not an enduring asset or the business. In Malaysia, apart from being regarded as an ordinary business receipt the sum in the above case would also fall within S.22(2)(b). On the other hand, in *Barr, Crombie, and Co. Ltd.* v. *I.R.C.*[77] the taxpayers carried on the business of ship

[74] [1932] AC 431.

[75] *Ibid.*, pp. 442-443.

[76] (1938) 21 T.C. 608.

[77] (1945) 26 T.C. 406.

managers. The taxpayers had a contract with a shipping company to manage their ships for 15 years. This contract constituted well over 90 per cent of the taxpayers source of income. The shipping company went into liquidation when the contract still had 9 years to run. In consideration for the cancellation of the contract the taxpayers received £16,000. It was held that this was a capital sum and not assessable. The contract was practically the only asset of the taxpayer and the compensation received was regarded as being received for the surrender of a capital asset.

A payment such as in the second case, it is submitted, cannot be regarded as compensation for loss of income from a source. S.22(2)(b) is restricted to such sums as are received in the normal course of business, either as damages for loss of anticipated profits or in lieu of the right to earn profits under a contract which is thereby terminated. When the contract forms an integral part of the business and in fact amounts to a fixed capital asset of the business, then any sum received for the termination of that contract is itself a capital sum and not compensation for loss of gross income from that source. Such contracts stand on the same footing as a sum received upon the sale of a fixed capital asset of a business. The profit obtained from such a sale is a capital profit and not subject to income tax.

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