KPMG

Tax Alert

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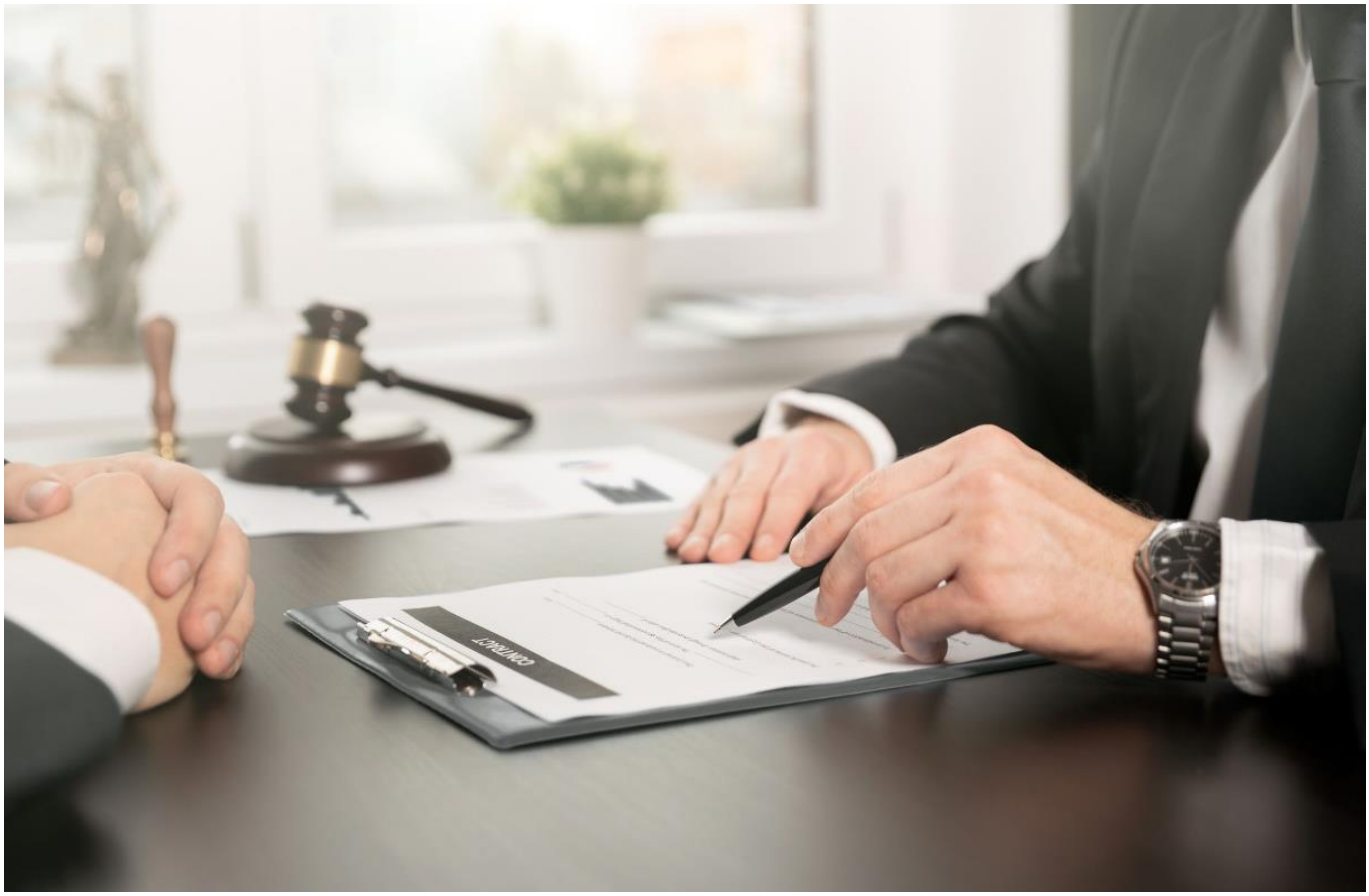
Comptroller of Income Tax v Forsyth, John Russell [2020] SGHC 258: Payments made under a Separation Agreement



In our Tax Alert Issue 12 | July 2020, the case of *GCT v Comptroller of Income Tax* [2020] SGITBR 3 was discussed wherein the Income Tax Board of Review (the Board) ruled in favour of the Appellant and held that the ex-gratia payment made to him under the Separation Agreement between him and his ex-employer was a capital receipt and hence not taxable. The decision centres on the principle of "looking beyond the label into the true character of the payment".

In this Issue, we examine the further development of the case arising from the Comptroller's appeal to the High Court (the Court) against the Board's decision. The dismissal of the appeal by the Court has further affirmed the importance of a contextual analysis beyond literal interpretation of the terms stipulated in one's employment or severance contracts.

Background

Mr. Forsyth was appointed the Managing Director (MD) of Rising Tide Asia Pte Ltd (the Company) under the employment contract dated 23 August 2013. In particular, two of the clauses (Clauses 9 and 15) in the contract were of relevance to the case:

Clause 9 (Ex-gratia)

In the event that the Agreement is terminated under Clause 15, and provided that Mr. Forsyth executes a deed of release, he would be paid an ex-gratia amounting to:

a) 6 months' base salary and a pro-rated sum of the annual bonus within the first year of employment
b) 6 months' base salary and a pro-rated sum of the annual bonus after the first year of employment

The bonus is determined at the sole discretion of the Company (and without obligation) and the Employee shall have no claim whatsoever for any bonus (whether any such bonus is paid or unpaid) in the event of termination.

Clause 15 (Termination of Employment)

Each party may terminate the Agreement in writing by giving notice to the other Party as of the end of each month within:

a) 7 calendar days during the probation period of 3 months
b) within 3 months after the probation period

The Company shall be entitled at its sole discretion:

a) to give payment in lieu of any notice of termination; or
b) to require Mr. Forsyth not to attend work during any period of such notice.

In the event that Mr. Forsyth is not required to work during the notice period, he will not be entitled to receive any damages or compensation for the relevant period during the notice period that he is not required to work.

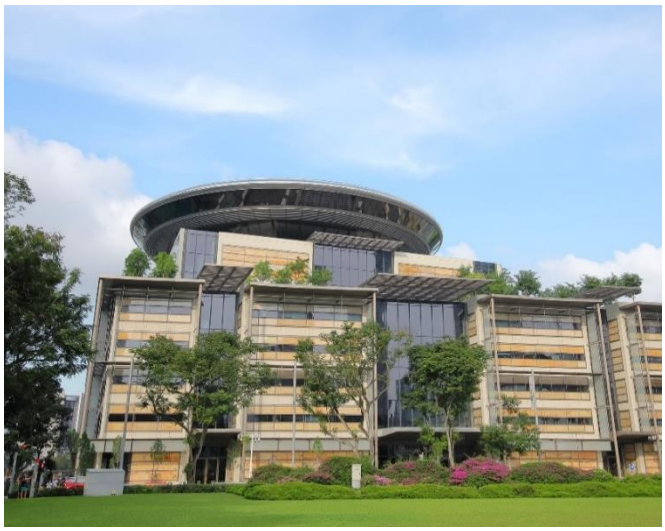
About three years later, on 24 August 2016, Mr. Forsyth's employment with the Company was abruptly terminated without warning. Instead of executing the deed of release, Mr. Forsyth was required to sign a Separation Agreement as of 1 September 2016 that extended a severance payment to him subject to him fulfilling all conditions in the Separation Agreement. The Severance Payment, amounting to $2,475,000, would be made to him in two instalments:

a) $1,900,000 (payable on 31 December 2016)
b) $575,000 (payable on 31 July 2017)

It was further stated that the severance payments include any and all entitlements which may have been due to him from the Employment Agreement (as provided for in Clause 9 (Ex-Gratia) and Clause 15 (Termination of Employment).

In its final assessment of Mr. Forsyth's taxes, the Comptroller bifurcated the Severance Pay and raised the tax assessment as follows:

a) $1,350,000 being ex-gratia payment contractually provided for in Clause 9 of the Employment Contract and hence, taxable as income as part of the terms of employment.
b) Balance of $1,125,000 was regarded as non-income in nature and hence, not taxable.



In reviewing the case, the Board has taken a strict interpretation of the taxing statute to determine if the severance pay indeed falls within the ambit of S10(1)(b) of the Singapore Income Tax Act (SITA) and the circumstances leading to the Severance Payment. An examination of the wordings in Clause 9 clarifies that the "ex-gratia" is only payable on the termination of the employment by the Company. Further, the deed of release in Clause 9 appears to be in the nature of a restrictive covenant. Whilst the Board agreed with the Comptroller that the Severance Payment may be bifurcated into two parts, the entire sum of severance pay is capital in nature and not taxable to Mr. Forsyth.

The Comptroller appealed against the Board's decision and maintained that the amount of $1,350,000 is taxable as payment granted in respect of an employment stipulated in the Employment Agreement.

Judgement by High Court

The issue before the Court was therefore to determine how the amount of $1,350,000 was derived and the nature of the payment.

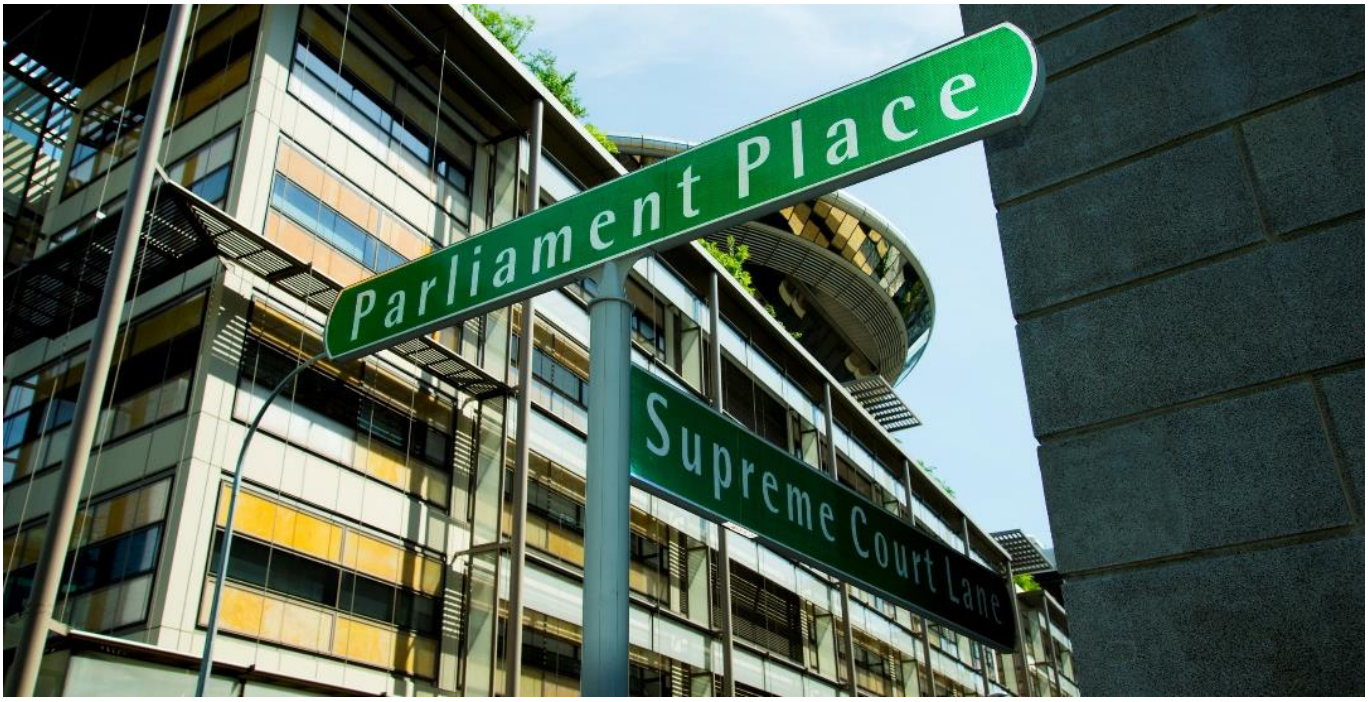
The Comptroller explained that it was computed in accordance to Clause 9 of the Employment Agreement wherein Mr. Forsyth would be entitled to twelve months' of base salary ($675,000) as well as the full sum of his annual bonus ($675,000). This added up to $1,350,000.

The Court agreed with the Board that the taxability of the payment should be determined based on strict interpretation of the taxing statute. The payment should fall within the ambit of the charging section for it be taxable. Redundancy payment or compensation for loss of office does not fall within the exhaustive list provided in the section.

It further states its observations of the case as follows:

a) Clause 15 of Employment Agreement provided that either party could terminate the Agreement by serving notice to the other party. Mr. Forsyth was however, terminated without notice. Although the clause permitted the Company to give payment in-lieu-of notice, the Company did not expressly indicate it was doing so or inform Mr. Forsyth it was relying on the clause. Hence, Clause 15 was never triggered.
b) Clause 3 of the Separation Agreement merely states that Severance Payment includes any and all entitlements which "may" be due to Mr. Forsyth but does not confirm the entitlements were indeed due.
c) The ex-gratia payment in the Employment Agreement was expressed as a sum that was immediately due and payable but the Severance Payment was expressed as a conditional payment subject to clawbacks by the Company if Mr. Forsyth breaches his obligation under the Separation Agreement. The nature of the two payments were therefore distinct from each other.
d) There was no evidence that the Company had computed the Severance Pay using Mr. Forsyth's salary and bonus entitlement, but even if it did, this does not render the Severance Pay to be taxable.
e) The Board may have erred in bifurcating the Severance Pay. The payment could be bifurcated if it had expressly included payment of income, then that portion would be taxable. However, as Clause 9 was never triggered, the ex-gratia envisaged in the clause could not have formed part of the payment. The payment was made in two instalments as the Company had wanted to ensure no misconduct on Mr. Forsyth's part prior to the deadline of 31 July 2017 for the second instalment.

Based on the above, the Court ruled that the entire sum of $2,475,000 was Compensation for Loss of Office and hence, not taxable in the hands of Mr. Forsyth.



Our views

Indeed, whether a payment is made in respect of an employment or loss of office is largely a question of fact. A careful examination into the context and underlying circumstances leading to the payment is critical in determining the taxability thereof.

The Comptroller has centred its argument on Clause 15 of the Employment Agreement and opined that the Severance Payment (or "ex-gratia) was made pursuant to the clause and hence, a payment made in respect of employment. While the Comptroller may be right in its literal interpretation of the wordings in the clause, an examination into the circumstance of the payment could have provided further insights into the true character of the payment.

On this point, it is notable that although both the Board and the Court had gone beyond the literal context and taken into account the circumstances leading to Mr. Forsyth's receipt of this payment in their analysis, both have provided their judgments from different perspectives.

The Board had focused on (i) the interpretation of the charging section and (ii) circumstance leading to the "ex-gratia" stipulated in Clause 9 of the Employment Contract. It was noted that the "ex-gratia" would only become payable upon termination of employment by the Company, hence the payment would not have been for past, present or future services Mr. Forsyth was obligated to render. The payment would not fall under the ambit of S10(1)(b). Further, the deed prescribed under Clause 9 is more of a restrictive covenant. Henceforth, both elements of "ex-gratia" stipulated under Clause 9 were capital receipts, being Compensation for Loss of Office and Restrictive Covenant.

The Court has ruled that the payment was in its entirety a Compensation for Loss Office and it was not necessary to bifurcate the payment as Clause 9 was never triggered on the following grounds:

a) Mr. Forsyth was terminated without notice (instead of being served the notice period stated in Clause 9) and payment-in-lieu of notice was not explicitly communicated to him.
b) The "ex-gratia" and Severance Payment both bear different traits and are distinctive payments; the former being immediately due and payable while the latter is subject to clawbacks in the event of a breach in obligations by Mr. Forsyth.

Accordingly, the Court has provided a different perspective in discerning the nature of the payment in this case. Interpretations on the true character of a payment is one that may not always be straightforward. Each case should be considered and interpreted based on the "substance over form" doctrine.

Why is this important?

Given the complexities that surround termination payments, tax ramifications may arise due to different interpretations on the intentions of the payments.

It is imperative that the contracts are constructed effectively to mitigate ambiguity and the potential tax exposure for a termination payment, which more often than not, is a considerable sum payable to the employee as compensation for the anticipated loss of income due to the premature termination of employment. The facts and circumstances surrounding the payment should also be reviewed carefully to ensure the character of the payment is what it purports to be.

How we can help

KPMG would be able to assist with an analysis of facts and circumstances to determine the character of the payments including a review of the supporting documentation and providing our recommendations.

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