CASE NOTES

THE GOLDEN HANDSHAKE AND THE INLAND REVENUE

H.M.T. v. *Director-General of Inland Revenue*[1]

Since the publication of *Income Tax Liability of Terminal Payments* (Jaginder Singh, [1974] J.M.C.L. 72) the courts have had occasion to pronounce on the assessability of a payment made to an employee by his employer at the end of his period of employment once again. This case warrants consideration as a sequel to *H.* v. *Comptroller-General of Inland Revenue* ([1973] 2 M.L.J. 40) if only because it was decided on the same basis.[2] The one difference between the two cases is that whereas *H's Case* was decided under the Income Tax Act, 1967, the present case was decided under the Income Tax Ordinance, 1947.

The facts in *H.M.T.* are very similar to *H's Case*. The taxpayer was employed by United Plantations Limited under three separate contracts of service which ran consecutively from January 16, 1955 to August 3, 1965. His last contract was for 3 years from April 28, 1962. Whilst on leave towards the expiry of the contract he was informed by his employers that his contract of service was being terminated. On April 14, 1966 the appellant was paid $74,954.32 "as gratuity on retirement". The question was whether this sum was in fact a gratuity received "in respect of the employment" within the provisions of S.10(2)(a) of the 1947 Ordinances as being a "gain or profit from employment." S.13(1)(a)(i) of the 1947 Ordinance exempts from tax "sums received by way of retiring gratuities." Abdul Hamid, J. held that the sum was in fact received in respect of the employment and hence was taxable.

The taxpayer's appeal was based on three main contentions. Firstly, it was contended that the sum received was a capital sum being compensation for loss of employment. Compensation for loss of employment was not taxable under the 1947 Ordinance, but this gap has been plugged by S.13(1)(e) of the 1967 Act. The taxpayer sought to bring himself within the second of the two propositions stated by Lord Wilberforce in delivering the judgment of the Privy Council in *Comptroller-General of Inland Revenue* v. *T.* (Knight's Case) ([1972] 2

[1] [1974] 1 M.L.J. 211.

[2] It is of interest to note that Counsel, both for the Inland Revenue and the taxpayer, were the same in both cases.

M.L.J. 73 at p. 74. This case was also decided under the 1947 Ordinance):

> "[W]here 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".

In that case it was held that the sum received was in fact compensation for loss of employment and hence not taxable. In the present case Abdul Hamid, J. distinguished *Knight's case* on the facts. In *Knight's Case* the employment was not for any fixed period and was in the nature of a general hiring terminable by either party upon three months's notice in writing. Hence the taxpayer's employment was likely to continue up to retiring age so long as the taxpayer dutifully performed his services. On the other hand in the present case the taxpayer was employed under three separate contracts of service for a specified number of years. At the expiration of the last contract the employer simply did not renew the contract of service.

> "The appellant could not therefore reasonably assume that he would enjoy a continuous service . . . ." (at p. 213).

In this respect the case is similar to *H's Case*.

> "In that case the taxpayer was employed under five separate contracts for fixed periods and his final contract of service was terminated by three months' notice in writing."

It is respectfully submitted that on this score the case cannot be impugned. The payment cannot be regarded as compensation as the taxpayer has not been deprived of anything to which he would otherwise have been entitled.[3]

The taxpayer's second contention in the present case was that the payment was exempt from income tax by virtue of S.13(1)(a)(i) of the 1947 Ordinance as being a retirement gratuity. This contention too was rejected by the Court. The finding of the Special Commissioners that the taxpayer did not retire from the service but rather that his contract of employment was not renewed was affirmed by the High Court. The Federal Court in *Knight's Case* said that to constitute a retirement the taxpayer need not stop working altogether; he may take up another employment at the termination of the previous employment. Furthermore, a retirement need not be a voluntary one.[4]

The taxpayer's third contention was that this was a voluntary payment

[3] See Romer, L.J., in *Henry* v. *Foster* (1932) 6 T.C. 605 at p. 634. See also decision of Privy Council in *H* v. *Comptroller of Inland Revenue* [1974] 2 M.L.J. 136 and note thereon in [1974] JMCL. *infra*.

[4] Per Gill, P.J., [1970] 2 M.L.J. 35 at p. 41. Although the Privy Council on appeal approved this reasoning, the Board refused to express a final opinion on the exact scope of "retiring gratuities."

not paid in respect of the employment. The judge rejected this contention as well in the following words:

> ".....Even though the company described it as 'gratuity on retirement' such payment was not paid following any particular scheme drawn up by the company and neither was it paid pursuant to any provision in the service agreement. The appellant was clearly employed by the company for fixed terms under the contract of service which imposed no obligation on the company to make any payment. The decision to pay the appellant the sum of $74,954.32 was not made by the company until March 1966, presumably after the board of the company had taken into account the number of years' service the appellant had rendered the company. Although the company made the payment on its own accord it was clearly meant to be an *ex-gratia* payment made in reference to the services rendered by the appellant in the nature of a reward at the end of the contract period. ..... it was a payment made in recognition of the appellant's past services with the company – for his loyalty and good service. To my mind the payment was in fact made to the appellant solely in respect and for reason of his employment with the company for over ten years and such payment was therefore gains or profits from an employment in respect of which tax is assessable." (at p. 216).

It is respectfully submitted that this reasoning is both self-contradictory to a certain degree and open to question as a matter of law and fact. The fact that the sum was not paid under any special scheme drawn up by the company, that the taxpayer at the time of termination of his contract had no expectation of the sum received and that it was paid well after the employment terminated, all support a conclusion that this was a windfall as far as the taxpayer was concerned. It is accepted that the sum is a "gratuity", but is it a gratuity "in respect of the employment"? In *H's Case* the company had in operation a redundancy pay scheme under which the taxpayer received his gratuity. Although the scheme did not form part of the taxpayer's contract, yet he was aware of the scheme and could expect to receive the sum under it. In the present case there was no such scheme, nor any knowledge or expectation of the sum by the taxpayer until he actually received it. Furthermore, the judge proceeded on the hypothesis that the company, in paying the sum, took into account the number of years service rendered by the taxpayer. This was not found as a fact by the Special Commissioners. Even if this was so and the number of years service was taken into account to compute the sum payable, the manner in which the sum is arrived at does not determine the nature and quality of the sum.[5]

[5] See *Hunter* v. *Dewhurst* (1930) 16 T.C. 605; *Glenboig Union Fireclay Co.* v. *I.R.C.* (1922) 12 T.C. 427.

In finding that the sum was paid in respect of the employment the judge merely accepted the submission of Counsel for the Revenue. From the report of the case there does not appear to be any evidence presented to show that the sum was in fact paid in recognition of the appellant's past services.[6] It is now well established that for a sum "to be a profit arising from 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." (*Per* Upjohn, J. in *Hochstrasser* v. *Mayers* [1959] Ch. 22 at p. 33; approved by the House of Lords, Viscount Simmonds, [1960] A.C. 379). It is therefore respectfully submitted that the court in following *H's Case* has failed to consider the merits of its own case carefully enough.

Finally, the Judge rejected the taxpayer's contention that a payment made to a former holder of an office is not a profit of the office. In *Knight's Case* Lord Wilberforce said that a sum paid in respect of *loss* of the employment is not encompassed by the statute. The sum is not taxable under the 1947 Ordinance if it is paid in respect of the termination of the employment (at p. 74). In the present case it is arguable that the sum was in fact received in respect of the termination of the employment and not in respect of the employment in spite of the finding that there was no loss of employment. The taxpayer had been employed by the company for over ten years and he was given a return ticket when he went on leave at the end of this third contract. Although the taxpayer had no right to have his contract renewed, yet he could reasonably expect that it would be. In fact the General Manager of the company had made proposals to the Chairman that the taxpayer be appointed to a post in the management of the company (at p. 214). Accordingly, it is arguable that the sum was received in respect of the *termination* of his employment. It is true that the *Court* rejected the taxpayer's submission, based on *Benyon* v. *Thorpe* ((1928) 14 T.C. 1), that a payment made to an ex-employee for the reason that he is no longer in the office is not a profit of the office or employment. However the question whether the sum could be regarded as being in respect of the termination of the employment was not canvassed.

A recent English decision, while not directly relevant to the issue at hand, is useful as illustrative of the approach that might be taken in cases dealing with 'golden handshakes'. In *Simpson* v. *John Reynolds & Co. (Insurances) Ltd.*, ([1974] 2 All. E.R. 545) the taxpayer company, a firm of insurance brokers, had for many years advised Carrington & Dewhurst Limited (Carrington) on all its insurance matters. Carrington was subsequently taken-over by another company as a result of which Carrington was required to place all its insurance business with another

[6] As to the circumstances in which a sum may be said to be "in respect of the employment" or merely a gift, the reader is referred to Jaginder Singh, *Income Tax Liability of Terminal Payments* [1947] JMCL, 72, pp. 78–89.

firm. Carrington then volunteered to pay the taxpayer company £1,000 p.a. for five years "in recognition of the long period during which [the taxpayer company] have acted as broker and adviser on all insurance matters to Carrington and Dewhurst Limited". Pennycuick, V.C., held that the £1,000 p.a. received by the taxpayer was not assessable. He said:

> ". . . . . the promise to pay £5,000 and the subsequent payment of £1,000 in each year represented a purely voluntary disposition on the part of Carrington Dewhurst; in other words, each payment represented a gift to the company, the motive for the gift being as is stated in letter of 21st, September 1965, 'recognition of the long period during which you have acted as broker and adviser on all insurance matters to Carrington and Dewhurst Limited' . . . . . It seems to me that this payment is not a receipt which on the proper principles of commercial accounting should be broguht into account in calculating the profit of the trade, which consists in rendering services for reward. . . . . .
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> . . . . . unless one is constrained to hold that a gift by a customer to a trader as such –i.e. there being no other relevant connection between them – must *ipso facto* be treated as a receipt of the trade then there is no reason why this receipt should be so treated." (at pp. 559–560).

The sum in the above case was assessable (if at all) under Schedule D. of the U.K. legislation as a trading receipt. If the same issue were to arise in Malaysia the assessability of the sum would be determined not under S.4(b) and S.13(1) but under S.4(a) and S.22(2)(b) of the 1967 Act which provides that 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." The sum being wholly voluntary in the present case it would be outside the scope of the charge. The above case is nevertheless useful in the present context as illustrating why the sum was regarded as a gift. (1) The taxpayer company had no right to or expectation of, such a sum. (2) The fact that it was paid in recognition of a long period of service made no difference. (3) The method of quantification did not derogate from the quality of the sum. (4) The services had already terminated when it was decided to pay the sum. All these factors were equally present in the *H.M.T. Case*.

One may bear in mind the remarks of Pennycuick, V.C., in *Simpson's* case:

> "No Schedule E case has been cited to me in which it has been held that a voluntary payment made to the holder of an office on the termination of that office merely by way of *gift or consolation, or the like*, and for no other reason, has been held to be chargeable as a profit from the office. On the contrary . . . . . such payments did not fall to be brought into charge under Schedule E. One must of course

distinguish cases in which a payment has been made by way of compensation for premature determination of a contract and the like." (at p. 559).

Similarly, under Malaysian legislation, for a gratuity to be chargeable to income tax, it must be received by the employee "in respect of having or exercising the employment."

Jaginder Singh

THE FINAL EPISODE?

H. v. Comptroller of Inland Revenue.[1]

The taxability of the "golden handshake" under the Income Tax Act, 1967 (hereinafter referred to as the 1967 Act) has finally received consideration from the Privy Council in *H. v. Comptroller of Inland Revenue.* The case was decided by the Privy Council after the publication of *Income Tax Liability of Terminal Payments* (Jaginder Singh, [1974] JMCL 72), and the writer notes with some pride that the Privy Council endorsed some of the arguments put forward in that article. The material facts of the case were as follows: 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. Cl.2 of 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 in any event). The letter also stated that "as 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

[1] [1974] 2 M.L.J. 135.