

## **Technical Group Discussion**

### **Compensations: Ins & Outs of Giving and Receiving**

16 August 2013, Wednesday



*Participants were all ears as Accredited Tax Advisor S Sharma, Consultant at ATMD Bird & Bird LLP examined the tax issues in the receipts and payments of Compensations.*

Compensation issues arise in various situations and have tax implications. Most often, these situations are not clear-cut.

Clearing the air and providing essential insights on this topic at a packed seminar of tax professionals and concluding with a case study was Accredited Tax Advisor S Sharma, Consultant at ATMD Bird & Bird LLP. Mr Sharma examined compensation issues relating to employment, business, damages awarded by the

Court, claims for deductions for compensations paid, and cross-border compensations. Analyses of the various tax cases were made during his presentation at a technical discussion organised by the Singapore Institute of Accredited Tax Professionals.

#### **Taxation of Compensations**

“Compensation” may be defined as a “payment to make amends for loss or injury to person or property, or as recompense for some deprivation”<sup>1</sup>.

Basically, compensations of an income nature are taxed under section 10(1) of the Income Tax Act (ITA) while section 14(1) as limited by 15(1), allows tax deduction for compensations paid or incurred.

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<sup>1</sup> Osborne's Concise Law Dictionary (11<sup>th</sup> edition), 2009: Sweet & Maxwell

## Compensations Relating to Employment

In examining compensations relating to employment, inducement payments, rewards for services and termination payments are usual areas of contention.

For inducement payments, two English cases involving chartered accountants who received inducements, *Pritchard (Inspector of Taxes) v Arundale* and *Glanre Engineering Ltd v Goodhand (Inspector of Taxes)*, with different outcomes, were compared and contrasted by Mr Sharma. The tax principle here is that for the payment to be taxable, it must be “from” the employment, and not “for” undertaking the employment.

On rewards for services, payments in the form of salaries, bonuses, allowances, benefits and gratuities in respect of services are taxable while gratuities at retirement, upon death or at termination of employment such as loss of office, may not be taxable.

Moving on to termination payments, one must determine whether the money was paid in respect of employment or a loss of employment as the latter is not taxable. The tax decisions in *HMT v DGIR*, *CGIR v T*, *Wajshel v CIT* and *H v CIR* were analysed.

An important point to note is an element of bonus in a lump sum payment made upon termination of employment, as an *ex gratia* payment, may cause the entire sum to be taxable as shown in *Wajshel v Comptroller of Income Tax*. Therefore, it is advisable to specify the bonus separately from the total payment to distinguish it from compensation which is capital in nature.

Care must be taken in distinguishing an allowance from a reimbursement as the latter is non-taxable. Diligent checks prior to payment are advised as allowances may be easily overlooked as reimbursements.

## Compensations Relating to Business

In this area, tax professionals need to understand whether compensations are capital or revenue in nature in various situations, namely the loss of business structure, substantial impairment of business activities, loss of business profits and deprivation of the use of money.

Based on the several tax cases discussed by Mr Sharma, payments received for losing the whole and essential part of the profit-making apparatus in some of the cases, and payment in another case for the taxpayer to abstain from seeking to make a profit from using his property, have been determined to be capital and are thus not taxable. This is in contrast to compensation received for termination of a contract which is incidental to the normal course of the business, which is taxable.

Compensation for the loss of rental income was held to be taxable. However, the assessment should be at the time of receipt, in order for the assessment to be valid.

Compensation for the deprivation of use of money meant to give the lender a reasonable rate of return on his capital, whether termed interest or premiums, is taxable. The essence of interest, as reflected in *Riches v Westminster Bank per Lord Wright*, is payment which becomes due because the creditor did not receive his money at the due date.

In a Singapore High Court case, *Chng Gim Huat v Public Prosecutor*, the appellant who had extended a loan, allegedly interest-free to a borrower, Ong, argued that the payments he received from Ong did not amount to interest income but were compensation for the costs of funds incurred. The Court applied the test in *Riches v Westminster Bank*, considered the meaning of “interest” and established three guiding principles – firstly, whether a payment constitutes “interest” depends on the substance of the transaction; secondly, the essence of “interest” is compensation for the deprivation for the use or delayed in payment received, and

thirdly, there must be a principal sum of money by reference to which the interest payment is to be ascertained, which sum of money must be due to the person entitled to the interest.

Recently, the meaning of “interest” was reconsidered by the High Court in *ACC v Comptroller of Income Tax* with reference to the above guiding principles. A Singapore company (ACC), together with special purpose companies (SPCs), engaged in aircraft leasing business and entered into interest arrangements with banks in Singapore using fixed and floating interest rates. The Comptroller determined that tax should have been withheld on what were considered as interest payments under Section 12(6), ITA, and that withholding applied to payments made by ACC (resident in Singapore) to SPCs (non-resident) under Section 45(1).

The crux of the application of Section 45(1) lay in whether the SPC Payments were characterised as “interest, commission, fee or any other payment in connection with any loan or indebtedness” under Section 12(6)(a). The Court decided that the SPC Payments were neither commission nor fee as they were not paid in consideration for any service rendered nor interest under Section 12(6)(a) because they were not intended to compensate ACC for deprivation for use of money; and there was no principal sum of money which was owing to SPCs in relation to the SPC Payments.

### **Damages Awarded by Court as Compensations**

The legal principle governing damages, expressed in *Livingstone v Rawyards Coal Co*, is to give the claimant compensation for the damage, loss or injury suffered. The measure of damages is the sum of money which will put the party which has been injured or suffered, in the same position as he would be if he had not sustained the wrong for which he is being compensated.

The landmark decision in *British Transport Commission v Gourley* (*Gourley's case*) and its subsequent application in Singapore in *Teo Sing Keng v Sim Ban Kiat* provided guidance on whether the tax element should be taken into account in damages awarded as compensation for loss of earnings or loss of earning capacity.

The *Gourley* principle which took the tax element into account in assessing damages attributable to loss of earnings, is established from *Gourley's case*. In this case, *Gourley*, a senior partner of a firm of civil engineers was injured and his earnings were substantially reduced. The majority view held that compensation awarded by the Court should be net earnings after deducting tax since everybody was obligated to pay tax.

Conversely, the minority view was the tax obligation of the claimant should not be a concern of the wrongdoer and be used to reduce an award of damages in his favour. In addition, if the case were to involve a foreigner being injured in the country, complications would arise when taking tax element into account as foreign income tax would have to be taken into consideration. Similar cases in Canada and Australia have since adopted the minority view.

In *Teo Sing Keng v Sim Ban Kiat*, a motorcyclist was left permanently disabled after being hit by a motor bus. Liability was settled at 90%-10% in favour of the motorcyclist. The High Court took the view that it was doubtful if pre-trial loss of earnings was taxable in Singapore, except by reference to the rule in *Gourley's case* which did not go so far as to say that damages are taxable notwithstanding the Income Tax Act. The Court also noted that it had not had the benefit of legal submissions on the Income Tax Act. However, the Court concluded that as far as the calculation of damages was concerned, it accepted the deduction made by counsel for expenses which took the tax element into account.

This decision was appealed. The Court of Appeal referred to the sections 10(1) and 13(1)(i) of ITA as well as various cases which applied the rule in *Gourley's case*. The Court concluded that while the earnings of the motorcyclist would be subject to income tax as such damages represented compensation for non-receipt of a taxable income, it also stated that

compensation awarded for loss of earning capacity was meant to compensate for loss of a capital asset which was non-taxable.

### **Cross-Border Compensations**

Principles of double taxation and relief available under specific articles in a Double Taxation Agreement (DTA) determine the international tax treatment of compensations. Alternative paths to dispute resolution, by appeal to the Board of Review and under a DTA's Mutual Agreement Procedure, were elaborated on by Mr Sharma.

In conclusion, compensations which appear to be a simple topic at first glance have significant tax issues that could trap the unwary.

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### **About SIATP's Technical Discussions**

SIATP's technical discussions have continually been very well received by accredited tax professionals. Unlike the run-of-mill Continuing Professional Educational courses which typically cover tax fundamentals, SIATP's interactive technical discussions are designed to cover tax issues that do not have clear-cut solutions or situations that may have different interpretations. Over time, these discussions contribute in boosting the overall tax standards in Singapore.

### **About Mr S Sharma**



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Sharma has been identified as a leading tax advisor and dispute resolution specialist in Singapore, having first worked with the tax authorities at IRAS and with major law firms in private practice. He advises on a range of tax issues spanning corporate and personal income taxes, including withholding tax, goods & services tax, stamp duty as well as on international tax issues. In dispute resolution, Sharma's practice extends beyond court litigation to arbitration and mediation in tax and non-tax areas. He has represented clients in tax audits and tax investigations by IRAS. While in private practice, Sharma was Adjunct Faculty at the Singapore Management University, teaching the course on Revenue Law. He is a contributory author to the sought after the second edition of Law and Practice of Singapore Income Tax and the 2004, 2008 and 2012 editions of Halsbury's Laws of Singapore.

*This technical event commentary is written by SIATP's Assistant Manager, Michelle Yap.*