LHAG Insights

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Tax Treatment of Retrenchment Benefits

With the extension of Phase 1 of the National Recovery Plan and implementation of the Enhanced Movement Control Order (EMCO) in several states, many employers are now constrained to undergo a retrenchment exercise to sustain their business operations. A retrenchment exercise would usually involve payment of retrenchment benefits to the affected employees in accordance with the employment contract or employment law. Given this, it seems timely to revisit the tax treatment of retrenchment benefits under the Income Tax Act 1967 (**ITA**). This alert will assess the tax implication on the business (as the payor) and the employee (as the recipient).

Employer's standpoint

From the employer's standpoint, the consideration is whether the retrenchment benefits are deductible as business expense under s 33(1) of the ITA.

In *Ampat Tin Dredging*,[1] the High Court held that retrenchment benefits paid before a winding up were not deductible under s 33(1) of the ITA, as the payment could not be regarded as exclusively incurred in the production of income. The decision was premised on the court's finding that the true object of the retrenchment benefits was not for the survival of the business, but for the extinction or the expected extinction of the business. A similar decision was reached in *International Foods*,[2] where the High Court found that the taxpayer was already gearing itself towards voluntary liquidation well before the retrenchment exercise took place.

However, the High Court in *Ampat Tin Dredging* acknowledged that retrenchment benefits paid are deductible if the taxpayer could prove that the payment was expended for the purpose of saving the company from extinction. This is in line with foreign authorities where the courts have held that retrenchment benefits

1 *Ampat Tin Dredging Ltd v Director General of Inland Revenue* [1982] CLJ Rep 402 (HC)
2 *Ketua Pengarah Hasil Dalam Negeri v International Foods Sdn Bhd* [2000] 1 LNS 153 (HC)

are deductible as business expense if their purpose is to improve the efficiency of the business. For instance, the retrenchment benefits will be deductible if it is intended to remove redundancy in the company or to avoid adverse consequences to the business.

Ultimately, payment of retrenchment benefits is not definitively excluded from deduction under s 33(1) of the ITA. The question is whether the retrenchment benefits are incurred to improve the efficacy of the business or save a business from extinction. This is a question to be decided based on the factual circumstances of each case (e.g. the timing of payment, the terms of employment contract and the conditions that trigger the payment). If the answer is in the affirmative, the retrenchment benefits should be deductible under s 33(1).

Employee's standpoint

From the employee's standpoint, the consideration is the taxability of the retrenchment benefits under s 13(1) of the ITA. Generally, retrenchment benefits received as compensation for loss of employment are taxable under s 13(1)(e) of the ITA. The assessment will be subject to the exemptions under paragraph 15(1) of Schedule 6 of the ITA:

(a) A full exemption is granted to compensation made on account of loss of employment due to ill-health (see paragraph 15(1)(a) of Schedule 6 of the ITA); and

(b) A partial exemption is granted to compensation made on account of loss of employment due to other reasons, such as premature termination. The amount exempted is dependent on the years of service and date of termination (see paragraph 15(1)(b) of Schedule 6 of the ITA).

However, if the retrenchment benefits are in effect a gratuity payment for past services, these will not be eligible for the exemptions under paragraph 15(1) of Schedule 6 of the ITA, as they will be assessed as perquisite under s 13(1)(a) of the ITA.

Whether retrenchment benefits should be treated as a gratuity payment under s 13(1)(a) or compensation for loss of employment under s 13(1)(e) depends on the factual circumstances (e.g. the terms of the employment contract, company's policy and past practices, and method of calculating the retrenchment benefits).

According to the Inland Revenue Board,[3] salary in lieu of notice, and other payments made to employees who have become redundant for reasons beyond their control may be regarded as compensation for loss of employment. Reference may also be

[3] Public Ruling No 1/2012

made to *GPH*,[4] where the Privy Council held that payments made pursuant to a compensation scheme should not be treated as gratuity.

The question is always the real character or nature of the payment, and not what the parties call it. As held by the Special Commissioners of Income Tax (SCIT) in *THH*,[5] payment for premature termination should generally be viewed as compensation for loss of employment to be assessed under s 13(1)(e) of the ITA. The SCIT also held that the position remains notwithstanding the fact that the payment was labelled as "gratuity" in the employment contract.

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4 *GPH v Comptroller-General of Inland Revenue* (1950-1985) MSTC 22
5 *THH v Ketua Pengarah Hasil Dalam Negeri* (2009) MSTC 3,821