



Salaries Tax

Determining whether or not payments on termination of employment are subject to salaries tax is no straightforward matter

Tax Lawyer suspects that many readers would automatically assume that a lump sum payment made on termination of employment for 'settlement of all past, present and future claims (arising from the employment)' would be tax-free in the hands of the former employee.

In *Mairs v Haughey* [1993] STC 569, Lord Woolf considered whether an *ex gratia* payment, received by an employee in lieu of his contingent right to receive a non-statutory redundancy payment, was an emolument from employment.

His Lordship indicated at p 577, that where a payment was made for two separate identifiable considerations, the Inland Revenue Commissioner was entitled to apportion the payments and to assess that portion subject to tax.

In D24/97 12 IRBRD 195; (1998) HKRC §80-519 the Inland Revenue Board of Review (the Board) considered whether a sum payable under the taxpayer's employment contract on termination of employment (but at a lesser amount based on a compromise with the employer), was assessable to salaries tax. At pp 202-203 the Board stated: 'The dispute as to the amount cannot change the nature of the payment. If the original entitlement under the contract is taxable, it does not become non-taxable because the parties reached a settlement on the amount payable.'

In *Carter v Wadman* (1946) 28 TC 41 Lord Greene MR, drew a distinction between:

- a payment made as damages for the repudiation of a service agreement under which the claims were not in any way settled or discharged but altogether withdrawn, and
- a payment made partly for the cancellation of a service agreement

and partly in settlement of all past, present and future claims.

In this case it was held that a lump sum paid to the taxpayer to terminate his service agreement and expressed to be 'in full settlement of all past, present and future claims' was assessable to the extent to which it represented a profit from employment. Lord Greene said at pp 52-53:

In the present case the £2,000 does not purport to be paid as damages. It is, no doubt, in part the price of the cancellation of the agreement, but it is also ... paid partly in settlement of past and then present claims. One of those claims was the claim to a fourth part of the profits of the business down to 2 December, 1942. The Appellant's right to this claim was, in our opinion, clearly a profit arising from an employment of profit within Schedule E ... [We] respectfully agree with their Lordships [in *Tilley v Wales* (1943) 25 TC 136] that in principle there must be apportionment ...

Courts in Australia have been more reticent about taxing such payments. The leading authority there is *McLaurin v FCT* (1961) 104 CLR 381. In this case, the High Court of Australia dealt with the question of whether a lump sum was chargeable. The lump sum was calculated by reference to specific items of damage, the details of which were not supplied to the taxpayer. Although the court denied that an apportionment was proper on the facts of the case, it nonetheless stated at p 391:

... a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates and an income or non-income nature attributed to portions of it accordingly [authority cited]. But while it may

be appropriate to follow such a course where the payment or receipt is in settlement of distinct claims of which some at least are liquidated: cf *Carter v Wadman*; or are otherwise ascertainable by calculation: cf *Tilley v Wales*; it cannot be appropriate where the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single, undivided amount of damages.

Accordingly, where an employee's liquidated claims against the employer (on termination of the employment) are not withdrawn but settled by a payment, that payment is taxable to the extent to which it represents income from employment.

Following the reasoning in *Mairs v Haughey*, the payment can derive its character from the nature of the various sums it replaces. Thus, items such as salary in arrears, leave pay and bonuses claimed by an employee upon termination, all fall within the definition of income from employment. If the termination payment includes these income items, it should *prima facie* be chargeable to salaries tax. Conversely, if the payment includes non-income items, such as payment in lieu of notice, this is not assessable as income from employment and not chargeable.

Where an amount paid as compensation for settlement of claims arising from termination of employment is less than the amount claimed but each of the claims is for a liquidated amount of damages, UK (and to a much lesser extent, Australian) courts have been prepared to apportion the compensation paid on a *pro rata* basis and to tax the proportional income amount.

This will only be the case, however, where the proportion - which each claim bears to the total amount of compensation paid - can be readily ascertained and thus apportioned on a reasonable basis.

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