Privy Council Appeal No. 1 of 1974

Gerard Parkes Heywood – – – – – *Appellant*

v.

The Comptroller-General of Inland Revenue – – – *Respondent*

FROM

THE FEDERAL COURT OF MALAYSIA

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 15TH OCTOBER 1974

Present at the Hearing:

LORD DIPLOCK

VISCOUNT DILHORNE

LORD WHEATLEY

LORD KILBRANDON

LORD SALMON

[*Delivered by* VISCOUNT DILHORNE]

On the 31st July 1968 his employers sent to the appellant a letter which said:—

> "It is with regret that we find it necessary as part of the reorganisation of estates to give you three months' notice of the termination of your employment which notice commences on 1st August. You are due for three months' leave on the 26th October when you will have completed a two-year tour. If you wish you may proceed on that date or before if it is convenient, or you may serve your notice to the 31st October . . . . .
>
> .....
>
> As compensation for loss of employment you have been accorded a sum of $32,000 ex gratia."

The question to be determined in this appeal is whether that sum of $32,000 is liable to income tax under the Income Tax Act 1967 of Malaysia. Four assessments were made on the appellant in respect of it. He appealed to the Special Commissioners who held that the $32,000 was not compensation for loss of employment but a gratuity assessable to income tax under sections 4(*b*) and 13(1)(*a*) of the Income Tax Act and so dismissed his appeal. The appellant appealed unsuccessfully to the High Court and to the Federal Court of Malaysia and now appeals to the Privy Council with the leave of the Federal Court.

The relevant parts of the Income Tax Act are as follows:—

> "Section 4. Subject to this Act, the income upon which tax is chargeable under this Act is income in respect of:—

. . . . . .

(*b*) gains or profits from an employment;

. . . . . .

Section 13(1). Gross income of an employee in respect of gains or profits from an employment includes—

(*a*) any wages, salary, remuneration, leave pay, fee, commission, bonus, gratuity, perquisite or allowance . . . . . in respect of having or exercising the employment;

. . . . . .

(*e*) any amount received by the employee, whether before or after his employment ceases, by way of compensation for loss of the employment . . . . . ."

Schedule 6

EXEMPTIONS FROM TAX

PART 1

INCOME WHICH IS EXEMPT

. . . . . .

15. A payment . . . . . made by an employer to an employee of his as compensation for loss of employment . . . .

. . . . . .

(*b*) in the case of a payment made in connection with a period of employment with the same employer or with companies in the same group, in respect of so much of the payment as does not exceed an amount ascertained by multiplying the sum of two thousand dollars by the number of completed years of service with that employer or those companies."

So under this Act both sums paid as gratuities in respect of having or exercising the employment and sums paid as compensation for loss of employment are chargeable to tax but sums paid as compensation for loss of employment are then exempted from tax if they do not exceed the prescribed limit. The appellant had served his employers, so the Special Commissioners found, for 17½ years so the amount paid to him did not exceed the prescribed limit and if paid to him as compensation for loss of employment is exempted from liability to income tax. If, however, it was paid in respect of having or exercising his employment, it is taxable.

The appellant was first employed as a planter under an agreement in writing dated the 24th April 1951. Under Clause 1 of that agreement he was engaged " for a tour of duty of four years (determinable as hereinafter provided) ". Clause 8 provided that his employment might be terminated by his employers at any time during his tour of duty by three months' notice or three months' salary in lieu of notice. Clause 12 provided that when he had served the full term of four years tour of duty, the appellant should be entitled to leave of absence in Europe on full pay for eight months and Clause 13 provided that if at the expiration of any leave of absence the appellant should return to the service of his employers he should " be deemed to have re-engaged himself . . . for a further term of four years and upon and subject to the same terms and conditions as herein provided and this Agreement shall continue in force and take effect accordingly subject only to such variation as to the salary payable during the further term as shall be agreed."

So although the agreement provided for the appellant's employment for four years to be followed by eight months' leave of absence on full pay, it contemplated that he might return to his employers' service after that and made some provision for what was to happen in that event.

On the expiry of his leave following on the completion of this tour of duty, the appellant was re-engaged for a three year tour commencing on the 26th February 1956. On completion of that tour, he was entitled to six months' leave of absence which began on the 21st February 1959. He was then re-engaged for a further three years commencing on the 21st August 1959 after which he was entitled to and received six months' leave which began on the 28th September 1962.

Before he went on this leave, he entered into a fresh agreement in writing with his employers dated the 27th March 1962. Under that agreement he agreed to serve his employers for a period which was specified in Clause 2 as follows:—

> "The period of service . . . shall continue for a period of three years or such other period as shall be agreed . . . from the date of last returning to Malaya for service under the terms of the previously existing Agreement . . . and thereafter (unless the same shall have been previously determined as hereinafter provided by either party) shall be deemed to be an engagement from year to year determinable at any time by three months' notice on either side and subject to the terms and conditions herein contained."

The Special Commissioners found as a fact that the appellant's employment under this contract began on the 27th March 1963.

Clause 8 of the agreement provided that on the completion of three years' service and on the completion of each subsequent three years should the appellant continue in the service of his employers, the appellant should be entitled to six months' leave of absence on full pay. Clause 13 provided that the appellant or his employers might terminate the agreement at any time by three months' notice in writing or a sum equivalent to three months' salary in lieu of notice. It went on to provide that if the appellant terminated the agreement before "the completion of three years' service or, as the case may be, a shorter period of service hereunder or the completion of any subsequent term of three (or less) years", the appellant should not be entitled to any leave of absence or any leave pay.

The Special Commissioners found as a fact that by this written agreement the appellant was engaged for a term of three years. They made no reference to that part of Clause 2 quoted above which clearly states that after serving the three years he was to be deemed to be serving on an engagement from year to year. The construction to be placed on a written agreement is not a question of fact and the full terms of the agreement show that this finding was inaccurate and incomplete.

The retirement age of employees such as the appellant was fifty-five and under this agreement unless his employment was terminated by notice or salary in lieu of notice, the appellant had a clear expectation of employment until he reached that age.

On the 20th August 1962, after the completion of this written agreement and before the appellant commenced his leave on the 28th September 1962, his employers wrote to him saying that they were prepared to re-engage him "for a further tour of three years at a commencing basic salary of $950, the other terms and conditions of such tour would be as laid down in your Service Agreement dated the 27th March 1962". This offer was accepted by the appellant.

Before he went on leave following this tour of duty the appellant received a letter dated the 14th April 1966, offering him re-engagement "for a further tour of two years followed by three months leave". The letter said that his commencing basic salary would be $1,500 per month "and the other terms and conditions of your employment will be as laid down in your Service Agreement dated the 27th March 1962 and subsequent variations thereof".

Construing this letter with that agreement, the appellant was engaged for a further tour of two years and thereafter unless his employment was terminated in accordance with the agreement, to be deemed to be engaged from year to year.

On the 26th October 1968 his two year tour of duty came to an end, five days before the three months' notice he had been given took effect.

Neither the terms of the agreement of the 24th April 1951 nor those of that of the 27th March 1962 gave the appellant any entitlement to receive any payment on the termination of his employment. His employers had however drawn up a scheme for compensating their employees for loss of employment in consequence of amalgamations. The details of the scheme were exhibited to the Case Stated and were as follows:—

" Age	*Allow % month Salary/O for each year of service*	*Service reckoned from 21 years*	*Compensation in months salary/O Allow*	
28 ...	10%	7	0·7	Minimum
29 ...	20%	8	1·6	say
30 ...	30%	9	2·7	3 months
31 ...	40%	10	4·0	
32 ...	50%	11	5·5	
33 ...	60%	12	7·2	
34 ...	70%	13	9·1	
35 ...	80%	14	11·2	
36 ...	90%	15	13·5	
37–45 ...	100%	16–24	16–24	
46 ...	90%	25	22·5	
47 ...	80%	26	20·8	
48 ...	70%	27	18·9	
49 ...	60%	28	16·8	
50 ...	50%	29	14·5	
51 ...	40%	30	12·0	
52 ...	30%	31	9·3	
53 ...	20%	32	6·4	
54 ...	10%	33	3·3	
55 ...	Nil	34	Nil "	

The appellant at the time of the termination of his employment was 41 and the amount of $32,000 paid to him was in accordance with this scheme. Though calculated by reference to age and years of service, it will be seen that the scheme did not provide for a constantly increasing percentage of his salary to be paid to him the longer he was employed, as might be expected if the payment was to be deferred remuneration for his services, but that after reaching the age of 45, for a reduced percentage to be paid each year. Instead of getting no percentage of his salary at the age of 55, if the scheme was one for providing deferred remuneration for his services during his working life, one would have expected it to provide for the maximum payment to an employee who had worked so long for his employers. This scheme made, in their Lordships' opinion, provision for payment of compensation for loss of future employment and their Lordships are unable to accept the Special Commissioners' conclusion that the payment made to the appellant was a gratuity for past services.

Suffian F. J., who delivered the judgment of the Federal Court, referred to the judgment of Rowlatt J. in *Chibbett v. Joseph Robinson & Sons* (1924) 9 T.C.48 and in particular to Rowlatt J.'s statement that it seemed to him that

> " compensation for loss of an employment which need not continue, but which was likely to continue, is not an annual profit within the scope of the Income Tax at all."

The Federal Court rejected this and cited from the judgment of Romer L. J. in *Henry v. Foster* (1931) 16 T.C. 605 at 634 the passage where he said that compensation for loss of office, as he understood it, meant

> " a payment to the holder of an office as compensation for being deprived of profits to which as between himself and his employer he would, but for an act of deprivation by his employer . . . , have been entitled."

In the view of the Federal Court, the test to be applied was whether the appellant had been deprived of profits to which he was entitled and as he had not been " deprived of anything to which he was entitled ", that Court held that the money paid to him was not compensation for loss of employment.

In their Lordships' view this conclusion was erroneous though the Federal Court was right in holding that the appellant had not been deprived of anything to which he was entitled. If under his contract of service the payment was one to which he was entitled, that would support the contention that it was one related to his service and was part of his remuneration for his services. It is unfortunate that Romer L. J. used the words " have been entitled ". If instead he had said " have earned ", the error into which the Federal Court fell would have been avoided. In their Lordships' opinion Romer L. J. was in his judgment contrasting payment made to a man for services he had rendered with compensation for loss of earnings he would have received if his employment had not been terminated.

In *Hunter v. Dewhurst* (1932) 16 T.C. 615 Lord Macmillan at p. 653 criticised one passage in Rowlatt J.'s judgment in *Chibbett v. Joseph Robinson & Sons* (*supra*) thinking that it was too widely expressed, as remuneration for services may take the form of a payment at the end of the employment, and a payment does not necessarily cease to be remuneration for services because it is payable when the services come to an end. He did not criticise the passage from Rowlatt J.'s judgment cited above. In *Comptroller-General of Inland Revenue v. Knight* (PC) [1973] A.C. 428 the decision in *Chibbett v. Joseph Robinson* was approved; and their Lordships in this case see no reason to dissent from or to question the proposition that for a payment to be compensation for loss of employment, there must be a real prospect of future employment. If that does not exist, then the payment cannot be compensation for the loss of earnings for the prospect of future earnings is not there.

In this case there was a real prospect of employment until the appellant reached the age of 55, as the facts stated above show, though that service might be terminated in accordance with the contract of service before the appellant reached that age. There was no entitlement to any such payment and the scheme, in accordance with which the payment was calculated, itself shows that the scheme was not designed for anything other than the calculation of the amounts to be paid as compensation for the loss of future earnings.

The Federal Court went on to hold that the payment made to the appellant was a gratuity in respect of having or exercising employment and so within s. 13(1)(*a*) of the Income Tax Act. In their view there was clear evidence that the payment though not of a contractual nature was made in reference to and by virtue of his employment " especially when it is remembered that the quantum was related to the total period of his service ".

In *Stedeford v. Beloe* [1932] A.C. 388 where the governing body of a school granted an annual pension to a headmaster on his retirement and there was no scheme in existence under which the headmaster could have qualified for a pension, Viscount Dunedin in the course of his speech said that the pension was not

> " given to him in respect of his office as headmaster. It is only given to him because he is no longer headmaster."

and

> ". . . . . in these circumstances I am of opinion that here the payment is purely voluntary and cannot be subjected to income tax."

The fact that a payment is purely voluntary does not mean that it is exempt from tax under the Income Tax Act 1967 of Malaysia for gratuities are expressly included in s. 13(1)(*a*) of that Act if in respect of " having or exercising the employment ".

A few weeks before Gill F. J. delivered his judgment in this case the Privy Council delivered judgment in *Comptroller-General of Inland Revenue v. Knight* (*supra*). That judgment cannot have come to the notice of Gill F. J. for if it had, it is inconceivable that he would not have referred to it. It was, however, brought to the attention of the Federal Court.

In that case the taxpayer was employed under an agreement terminable, as was the agreement in this case, by three months' notice. The taxpayer was declared redundant without being given three months' notice, and given redundancy pay at the rate of one month's salary for every year of office; so, to apply the words used by the Federal Court in this case, " the quantum was related to the total period of his service ". The taxpayer contended that the redundancy pay was given in consideration of the abrogation of his contract of employment and so was not taxable. The Revenue contended that the pay was taxable under s. 10(1)(*a*) of the Income Tax Ordinance No. 48 of 1947 of Malaysia. The wording of that provision was slightly different to that of s. 13(1)(*a*) of the Income Tax Act in that it defined gains or profits from any employment as meaning, *inter alia,* a gratuity paid " in respect of the employment " whereas the section of the Act uses the words " in respect of having or exercising the employment ". Lord Wilberforce in the course of delivering the judgment of the Board said the question under s. 10(1)(*a*) of the Ordinance was whether the money was paid in respect of the employment

and

> " If the fact is that it was paid in respect of the loss of the employment, it does not come within the taxing words.".

It was held that the pay was not taxable.

In this case the payment made to the appellant cannot be regarded as one in respect of his exercising his employment for it was one in respect of the cessation of his employment; nor is it to be regarded as one in respect of his having the employment. Those words would be apt to include deferred remuneration.

While it is true that in calculating the amount of the payment to the appellant, regard was had to his age and length of service, that does not decide the question whether or not it was in respect of his having the employment. In *Comptroller-General v. Knight* (*supra*), as has been pointed out, the amount of the redundancy pay was related to the length of service but that was not decisive of that case. Paragraph 15 of Schedule 6 to the Act itself requires regard to be had to the length of service for determining the maximum amount of compensation for loss of employment exempt from tax.

Upjohn J. (as he then was) pointed out in *Hochstrasser v. Mayes* [1960] A.C. 376 that

> "the authorities show that to be a profit arising from the employment the payment must be made in reference to the services 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."

This was cited with approval by Viscount Simonds in his speech in that case. He said:—

> "In this passage the single word 'past' may be open to question, but apart from that it appears to me to be entirely accurate."

A payment made as compensation for loss of employment cannot be made in respect of employment or in respect of having or exercising the employment. The two things are mutually exclusive.

In their Lordships' opinion the facts of this case clearly establish that the payment in question was compensation for loss of employment and the respondent has wholly failed to show that it was in respect of having or exercising the employment.

Their Lordships will accordingly advise The Yang Dipertuan Agung that the appeal should be allowed and the four assessments made on the appellant discharged. The respondent must pay the appellant's costs of this appeal and in the courts below.

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In the Privy Council

GERARD PARKES HEYWOOD

v.

THE COMPTROLLER-GENERAL OF INLAND REVENUE

DELIVERED BY
VISCOUNT DILHORNE

Printed by HER MAJESTY'S STATIONERY OFFICE
1974