



Dato' Nitin Nadkarni
Partner
Tax, SST & Customs
T: +603 6208 5866
E: nn@lh-ag.com



Jason Tan Jia Xin
Partner
Tax, SST & Customs
T: +603 6208 5873
E: tjx@lh-ag.com

16 APRIL 2020

Tax Implications During Uncertain Times: Compensation Payments

As the Movement Control Order (**MCO**) has again been extended as announced on 10 April 2020, businesses may find it difficult to meet their contractual obligations in the coming weeks, and may even be compelled to take drastic measures to stay afloat. Unfortunately, this may result in a performance default or breach of contract, or worse, termination of existing business and employment agreements. Taxpayers should be aware that payment of compensation or damages for breach of contractual obligations or termination of contracts will have tax implications in respect of the tax deductibility of such payment and the taxability of the sum in the hands of the recipient.

Capital or revenue distinction

Whether or not compensation paid is deductible or compensation received is taxable will generally depend on the character of the payment, i.e. whether it is capital or revenue in nature. This determination requires an examination of the underlying purpose behind the compensation.

Although compensation may have been calculated by reference to loss of profits (income that would have been taxable), this is immaterial to the character of the compensation itself. What must be considered is what the compensation was paid for, and not how the amount of compensation was calculated.¹

Deductibility of compensation payments

In most cases, payment of damages or compensation to discharge a liability arising from a taxpayer's business has been held to be deductible. However, capital expenditure has been statutorily provided to be not deductible.²

When an expenditure is made, not only once and for all, but with

¹ *The Glenboig Union Fireclay Co, Ltd v The Commissioners of Inland Revenue* 12 TC 427
² Income Tax Act 1967, s 39(1)



Katryne Chia Phei Shan
Associate
Tax, SST & Customs
T: +603 6208 5975
E: kc@lh-aq.com



Steward Lee Wai Foong
Tax, SST & Customs
T: +603 6208 5882
E: slw@lh-aq.com

a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, such expenditure is generally characterised as capital, and not revenue.³ Hence, scenarios where compensation is paid to discharge a capital liability, such as for the cancellation of a contract for the purchase of a capital asset or right, will be deemed as capital in nature and not deductible.

In *Lawson*,⁴ the subsidiary of the taxpayer was in deep financial waters and its collapse would have a consequential effect on the taxpayer's business. As part of the condition to allow the taxpayer's subsidiary to be transferred to the Bank of England and to rescue the taxpayer's subsidiary, the taxpayer injected £50 million into its subsidiary. This injection of £50 million was held to be deductible as it was made to remove the threat posed by the insolvency of the taxpayer's subsidiary to the taxpayer's business, thus preserving the trade; it was not a payment for the disposal of a capital asset.

Other instances where compensation payments were held to be revenue expenditure and deductible include:

- Payment made to get rid of an onerous contract or an employee whose continuance in service is undesirable in the company's interest;⁵
- Payment made to terminate a disadvantageous agency contract;⁶ and
- Payment for the retirement of a director to avoid publicity injurious to the company's reputation.⁷

Examples of payments held to be capital expenditure and not deductible are as follows:

- Payment for the cancellation of a contract to supply a ship which was to be used in the business as the ship was to be a capital asset of the business;⁸
- Sum paid to a retiring director to obtain a covenant that he would not compete with the company's business, thus improving the goodwill of the company;⁹ and
- Price paid to procure a reduction in rent payable under a lease with a remaining term of 40 years, which produces an enduring benefit to the company through the improvement of the lease.¹⁰

³ *British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 205
⁴ *Lawson (Inspector of Taxes) v Johnson Matthey plc* [1992] 2 ALL ER 647
⁵ *Director General of Inland Revenue v Kulim Rubber Plantations Ltd* [1981] 1 MLJ 214
⁶ *Anglo-Persian Oil Co Ltd v Dale (Inspector of Taxes)* [1931] All ER Rep 725
⁷ *Mitchell (Inspector of Taxes) v B W Noble Ltd* [1927] All ER Rep 717
⁸ *The "Countess Warwick" Steamship Co v Ogg (HM Inspector of Taxes)* 8 TC 652
⁹ *Associated Portland Cement Manufacturers Ltd v IRC* [1946] 1 All ER 68
¹⁰ *Tucker (Inspector of Taxes) v Granada Motorway Services Ltd* [1979] 2 All ER 801

In respect of retrenchment benefits paid due to redundancy, these payments would be deductible if it is shown that the sum was expended to save the company from extinction.¹¹

In summary, the deductibility of compensation payments would require a scrutiny of the facts to see whether an enduring benefit is brought about. However, it is generally accepted that payments made to deter the collapse of and to preserve a taxpayer's business will be deductible.

Taxability of compensation receipts

Compensation received in respect of the contract in the ordinary course of business will be revenue in nature. For example, damages for breach of contract paid to replace profits which the taxpayer would or might have made under the contract are a revenue receipt. In contrast, payments arising from contracts that go towards the profit-making structure of the taxpayer's business or a capital asset will have a capital character. Hence, compensation that is received in respect of fixed assets, for the termination of a profit-making apparatus and source of income, or for the surrender of rights, are typically capital in nature and not taxable.

Payments held to be revenue receipts and taxable include compensation received:

- by shipowners for loss of profits arising from the shipbuilders' delay in executing ship repairs;¹²
- by an engineering company for loss of profits arising from the failure of the government to sell to the company certain material as agreed under a contract;¹³
- by shipbuilders in respect of the cancellation of contracts for the building of two steamships;¹⁴ and
- for the termination of one of several of the taxpayer's agency agreements.¹⁵

Payments held to be capital receipts and not taxable include:

- Liquidated damages received pursuant to the terms of the contract for the failure of the supplier to supply plant and machinery on time;¹⁶
- Compensation for termination of profit-pooling agreements;¹⁷ and
- Compensation for the termination of an exclusive distribution

¹¹ *ATD Ltd v Director General of Inland Revenue* (1950-1985) MSTC 429

¹² *Burmah Steam Ship Company, Limited v The Commissioners of Inland Revenue* (1) (1929-1932) 16 TC 67

¹³ *Sommerfelds Ltd v Freeman (Inspector of Taxes)* [1967] 2 All ER 143

¹⁴ *Short Bros Ltd v Commissioners of Inland Revenue* (1930) 12 TC 955

¹⁵ *Kelsall Parsons & Co Ltd v IRC* [1938] SC 238

¹⁶ *Commissioners of Income Tax v Saurashtra Cement Ltd* (2010) 233 CTR (SC) 209

¹⁷ *Van den Berghs Ltd v Clark* [1935] 19 TC 390

agreement where the taxpayer was the sole and exclusive distributor of goods bearing a certain brand and the taxpayer did not have any other sources of income.¹⁸

Employment income for individuals

Compensation received by employees for the loss of employment has been statutorily provided to be part of employment income and taxable in the hands of the employee.¹⁹ However, an exemption of RM10,000 is provided for each year of completed service with the company or companies in the same group.²⁰

Conclusion

In light of the current economy brought about by the COVID-19 pandemic and the MCO, companies would be required to reassess their contractual obligations and business structure and make difficult decisions to ensure their viability. Given that the termination of different agreements will entail different tax implications, it is important for these to be factored into the decision-making process. While case law has set out some tests and principles that could be useful aids in determining the nature of a compensation payment, taxpayers should be mindful that the revenue and capital distinction is a question of fact and will differ on the circumstances of a case. If taxpayers intend to claim deduction for these payments, it is paramount to show that the payments are crucial to preserve the company's business.

Katryne Chia Phei Shan (kc@lh-ag.com) and
Steward Lee Wai Foong (slw@lh-ag.com)

If you have any queries, please contact the authors or Tax, SST & Customs partners, **Dato' Nitin Nadkarni** and **Jason Tan Jia Xin**, at tax@lh-ag.com

Lee Hishammuddin Allen & Gledhill

Level 6, Menara 1 Dutamas
Solaris Dutamas
No. 1, Jalan Dutamas 1
50480 Kuala Lumpur
Malaysia

T +603 6208 5888
F +603 6201 0122/0136
E enquiry@lh-ag.com
W www.lh-ag.com

Published by the Tax, SST & Customs Practice

© Lee Hishammuddin Allen & Gledhill. All rights reserved. The views and opinions attributable to the authors or editor of this publication are not to be imputed to the firm, Lee Hishammuddin Allen & Gledhill. The contents of this publication are intended for purposes of general information and academic discussion only. It should not be construed as legal advice or legal opinion on any fact or circumstance.

[Feedback](#)

[Unsubscribe](#)

¹⁸ *MSE Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2015) MSTC ¶10-049
¹⁹ ITA, s 13(1)(e) and *SV v Ketua Pengarah Hasil Dalam Negeri* (1997) MSTC 2911
²⁰ ITA, Schedule 6, para 15