



INLAND REVENUE BOARD MALAYSIA

**COMPENSATION FOR LOSS
OF EMPLOYMENT**

PUBLIC RULING NO. 1/2012

Translation from the original Bahasa Malaysia text

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CONTENTS	Page
1. Introduction	1
2. Interpretation	1
3. Lump Sum Payment On Termination Of Employment	1
4. Compensation For Loss Of Employment	2
5. Payment Of Compensation For Loss Of Employment	3
6. Determination Of Elements Of Compensation And Gratuity	3
7. Tax Treatment Of Compensation For Loss Of Employment	4
8. Separation Scheme	9
9. Period Of Employment With The Same Employer	11
10. Termination Of Employment Of A Service And Non-Service Director Of A Controlled Company	13
11. Effective Date	14

DIRECTOR GENERAL'S PUBLIC RULING

A Public Ruling as provided for under section 138A of the Income Tax Act 1967 is issued for the purpose of providing guidance for the public and officers of the Inland Revenue Board Malaysia. It sets out the interpretation of the Director General of Inland Revenue in respect of the particular tax law, and the policy and procedure that are to be applied.

A Public Ruling may be withdrawn, either wholly or in part, by notice of withdrawal or by publication of a new ruling which is inconsistent with it.

**Director General of Inland Revenue,
Inland Revenue Board Malaysia.**

1. This Ruling explains the characterisation of lump sum payments received by employees upon the termination of their employment as compensation for loss of employment and the tax treatment of compensation for loss of employment.
2. The relevant provisions of the Income Tax Act 1967 (ITA 1967) for this Ruling are sections 7, 13, subsection 83(3) and paragraph 15 of Schedule 6.
3. The words used in this Ruling have the following meaning:
 - 3.1 "Employer" in relation to an employment, means –
 - (a) the master, where the relationship of master and servant subsists;
 - (b) where the relationship does not subsist, the person who pays or is responsible for paying any remuneration to the employee who has the employment, notwithstanding that that person and the employee may be the same person acting in different capacities.
 - 3.2 "Employee" in relation to an employment, means –
 - (a) the servant, where the relationship of servant and master subsists;
 - (b) where the relationship does not subsist, the holder of the appointment or office which constitutes the employment.
 - 3.3 "Service director", in relation to a company, means a director who is employed in the service of the company in a managerial or technical capacity, and is not, either on his own or with any associate or associates, the beneficial owner of (or able directly or through the medium of other companies or by any other indirect means to control) more than 5% of the ordinary share capital of the company.
 - 3.4 "Employment" means –
 - (a) employment in which the relationship of master and servant subsists;
 - (b) any appointment or office, whether public or not and whether or not that relationship subsists, for which remuneration is payable.
 - 3.5 "Controlled company" means a company having not more than fifty members and controlled, in the manner described by section 139 of the ITA 1967, by not more than five persons.
4. **Lump Sum Payment On Termination Of Employment**
 - 4.1 An employee's employment may cease due to a variety of reasons such as retirement, resignation, premature termination of the contract of service or by mutual agreement.

- 4.2 When an employment ceases, the employer may make a lump sum payment in accordance with the terms and conditions of the contract of service. The lump sum payment may be described by the employer as compensation for loss of employment, ex-gratia, contractual payment, retrenchment payments, gratuity, etc.
- 4.3 The circumstances and nature of the payment must be reviewed to determine the real character of the payment. The amount paid on the termination of an employment may consist of the following two elements:
- (a) it is attributable to the loss of employment such as redundancy (compensation); and
 - (b) it is attributable to the past services of the employee (gratuity).

The purpose of the lump sum payment has to be established in order to determine the tax treatment of the payment received by the employee.

- 4.4 Employees can seek redress for wrongful dismissal or termination breaches of the employment contract by the employer by making a complaint or claim to the Department of Industrial Relations Malaysia, Industrial Court, Civil Courts or Labour Court. Where the court finds that the dismissal was without cause or excuse, the two main remedies that are determined by the court are reinstatement of the dismissed employee and/or monetary compensation for the wrongfully dismissed employee. As such, the monetary award by the court to the employee has to be analysed in order to ascertain the tax treatment on the recipient.

5. Compensation For Loss Of Employment

Pursuant to paragraph 13(1)(e) of the ITA 1967, compensation for loss of employment is specifically included in the gross income from an employment. Compensation for loss of employment would include:

- (a) salary or wages in lieu of notice;
- (b) compensation for breach of a contract of service;
- (c) payments to obtain release from a contingent liability (employer's obligation) under a contract of service;
- (d) ex-gratia or contractual payments such as redundancy payments, severance pay, etc. made to employees who have become redundant for reasons beyond their control;

- (e) a payment in consideration of a covenant, arrangement or similar agreement restricting the activities of an employee in respect of engaging in an employment of a similar kind after termination of his employment.

6. Payment Of Compensation For Loss Of Employment

Payment of compensation for loss of employment may be made:

- (a) at the discretion of the employer where the employment is terminated prematurely. The most common situation where employees receive settlements in the form of compensation for loss of employment upon cessation of an employment is when they are made redundant and are prematurely terminated. This situation occurs due to a reduction or ceasing of a particular kind of work or possibly a complete closure of a business or department. It can also be due to a takeover, merger or reorganisation of a business that involves restructuring its workforce until different jobs are required and some posts are no longer needed, or
- (b) under a court order in proceedings for wrongful dismissal or otherwise for breach of contract of employment or by way of a settlement between the parties to such proceedings or a settlement of a claim in respect of which such proceedings could have been taken, or
- (c) by way of compensation for the extinguishment of any right, the infringement of which will be actionable.

7. Determination Of Elements Of Compensation And Gratuity

- (a) For the purposes of income tax exemption, the characteristics and nature of termination payments prevail over form and labelling of such payments.
- (b) The method of making an apportionment between gratuity and compensation depends on the circumstances of each case. In general, consideration is given to the employer's normal practice in granting gratuities to employees leaving his service and the rate or amount of gratuities normally granted.

Example 1

Distinction between compensation for loss of employment and gratuity

Fizo, aged 46, has worked as a technician in a manufacturing company for the past 16 years. Fizo's post became redundant in 2011 when the manufacturing company decided to outsource the work done by Fizo's department. Upon termination of his employment, the company paid Fizo a lump sum of RM200,000 which included RM100,000 as compensation for loss of

employment and RM100,000 as gratuity. The quantum of gratuity payment was in accordance with the company's existing policy and practice.

The lump sum payment received by Fizo consists of an element of compensation for loss of employment and gratuity (as calculated in accordance with the company's existing policy and normal practice.)

- (c) If the lump sum payment is received due to premature termination of an employment which has the prospect of continuing up to the retirement age, such sum should be treated as compensation for loss of employment.

Example 2

Premature termination prior to 1.7.2008

Anthony, aged 39, has been working with a plantation company since 1.3.1997. The company was taken over by another plantation company and Anthony was retrenched on 31.5.2008 due to redundancy. He was paid retrenchment benefits amounting to RM110,000.

Anthony was prematurely terminated from an employment which had the real prospect of continuing up to retirement age. The retrenchment benefits of RM110,000 is considered as compensation for loss of employment.

- (d) Where a contract of employment is for a specific number of years and the employment ends at the specified time or the retirement age, any lump sum paid to the employee should not be treated as compensation for loss of employment since the employment has ceased because the full term of the contract has expired or the cessation of the employment is at the retirement age. Such payments would generally be considered as gratuity.

8. Tax Treatment Of Compensation For Loss Of Employment

A payment (other than a payment by a controlled company to a director of the company who is not a full-time service director) made by an employer to an employee of his as compensation for loss of employment or in consideration of any covenant entered into by the employee restricting his right to take up other employment of the same or a similar kind is given full or partial exemption on the following basis pursuant to paragraph 15 of Schedule 6 of the ITA 1967:

- (a) if the Director General of Inland Revenue (DGIR) is satisfied that the payment is made on account of loss of employment due to ill health, the compensation is fully exempted; or
- (b) in the case of a payment made in connection with a period of employment with the same employer or with companies in a group, with effect from 1.7.2008 an exemption of RM10,000 is given for each completed year of

service if the employment is with the same employer or with companies in the same group. Prior to 1.7.2008, the amount of exemption was:

- (i) RM6,000 for the years of assessment 2003 to 2008
- (ii) RM4,000 for the years of assessment 1987 to 2002
- (iii) RM2,000 for the year of assessment 1986 and prior years

for each completed year of service with the same employer or with companies within the same group.

(Refer to paragraph 10 of this Ruling for a further explanation on Period Of Employment With The Same Employer)

Example 3

Premature termination due to ill-health

Sonia, aged 50, was advised to leave her employment on 1.3.2009, after 11 completed years of service with the same employer, due to her failing health and declining performance at work. Her employer paid her RM22,000 as compensation for loss of employment.

The full amount will be exempt from tax in the year of assessment 2009 if the DGIR is satisfied that the compensation received was due to the loss of employment as a result of ill-health.

Note: The health condition of the employee has to be certified in writing by a Medical Board. Documentation that verifies the medical condition of the employee has to be forwarded to DGIR.

Example 4

Premature termination prior to 1.7.2008

The facts are the same as in Example 2.

Anthony had worked with the company for 11 years and 3 months. He worked for 11 complete years of service. As he was retrenched on 31.5.2008, he was eligible for an exemption of RM6,000 for each completed year of service. The computation of the exemption of retrenchment benefits and income chargeable to tax is as follows:

Year of Assessment 2008

<i>Retrenchment benefit</i>	<i>RM110,000</i>
<i>Less: Exemption - 11 years @ RM6,000 p.a.</i>	<i><u>RM 66,000</u></i>
<i>Income chargeable to tax</i>	<i><u>RM 44,000</u></i>

Example 5

Premature termination with effect from 1.7.2008

The facts are the same as in Example 4 except that Anthony was retrenched on 31.12.2009.

Anthony had worked with the company for 12 years and 10 months. He worked for 12 complete years of service. As he was retrenched on 31.12.2009, he was eligible for an exemption of RM10,000 for each completed year of service. The computation of the exemption and income chargeable to tax is as follows:

Year of Assessment 2009

<i>Retrenchment benefit</i>	<i>RM110,000</i>
<i>Less: Exemption - 12 years @ RM10,000 p.a.</i>	<u><i>RM120,000</i></u>
<i>Income chargeable to tax</i>	<u><u><i>NIL</i></u></u>

Example 6

Premature termination and out of court settlement

Larry, a researcher with a multinational company in Malaysia, commenced employment with the company on 1.3.1990. His contract of service was terminated on 1.3.2003 as the company decided to close the research and development division in Malaysia. Larry objected to the company's decision and instituted legal proceedings against the company on 1.6.2003. After the court case dragged on for a few years, both Larry and his former employer agreed to an amicable out of court settlement through a Deed of Settlement dated 1.3.2008. The following payments were agreed upon by both parties on condition that Larry would not be reinstated to his former position:

Loss of basic pay/allowance from 1.3.2003 to 1.3.2006	RM700,000
Reimbursement of medical expenses	RM100,000
Severe distress and hardship	RM700,000
Legal costs	RM500,000

- (a) *Larry commenced his employment on 1.3.1990 and was terminated on 1.3.2003. He was offered back pay for the period from 1.3.2003 to 1.3.2006 without being reinstated to his former position in the company. His service is deemed to have been terminated on 1.3.2006 and payment is deemed to have been made upon the signing of the Deed of Settlement on 1.3.2008.*

- (b) *Based on the facts of the case, tax treatment on the payments will be as follows:*
- (i) *back pay of RM700,000 is taxable in the year of assessment the agreement is concluded;*
 - (ii) *reimbursement of medical expenses is not taxable;*
 - (iii) *payment of RM700,000 for severe distress and hardship is considered a capital receipt and is not taxable; and*
 - (iv) *legal fees is not an allowable expense and the payment is also not subject to tax.*

- (c) *The computation of the exemption and income chargeable to tax is as follows:*

Larry's period of service from 1.3.1990 to 1.3.2006 was for 16 years.

Year of assessment 2008

<i>Compensation for loss of employment</i>	<i>RM700,000</i>
<i>Less: Exemption – 16 years @ RM6,000 p.a.</i>	<i><u>RM 96,000</u></i>
<i>Income chargeable to tax</i>	<i><u>RM604,000</u></i>

Example 7

Premature termination – Constructive dismissal

Aaron commenced employment with a bank in Malaysia on 2.1.1990. He was subsequently promoted to a branch manager on 1.6.1995. In 2005, the bank was involved in a merger exercise with another bank. As a result of this merger, Aaron was informed on 30.6.2005 of his redesignation from the post of a branch manager to a customer service manager effective 1.7.2005. Aaron refused the redesignation claiming that it was a demotion and walked out on 30.6.2005.

On 2.7.2005 Aaron wrote to the bank and claimed that he had been constructively dismissed from the bank due to a serious breach of the employment contract. On 31.10.2009, both parties mutually agreed to a settlement of RM800,000 as compensation for loss of employment based on the previous voluntary separation schemes offered by the bank.

Note: Constructive dismissal is an act of an employee terminating the contract of his service with the employer, or resigning due to the conduct or behaviour of the employer. In other words, constructive dismissal is an act of walking out by the employee.

The compensation for loss of employment is deemed received on the date the agreed settlement was concluded and signed. The amount exempted for each completed year of service by virtue of paragraph 15(1)(b) of Schedule 6 of the ITA 1967 is determined based on the date the agreed settlement was concluded and signed (31.10.2009). As such, Aaron qualifies for an exemption of RM10,000 for each completed year of service from 2.1.1990 to 30.6.2005 (15 years).

The computation of the exemption and income chargeable to tax is as follows:

Aaron's period of service from 2.1.1990 to 30.6.2005 was for 15 years.

Year of Assessment 2009

<i>Compensation for loss of employment</i>	<i>RM800,000</i>
<i>Less: Exemption - 15 years @ RM10,000 p.a.</i>	<i><u>RM150,000</u></i>
<i>Income chargeable to tax</i>	<i><u>RM650,000</u></i>

Example 8

Premature termination – Court award

Johan commenced employment with an engineering company on 2.1.1996. His service was terminated prematurely on 2.1.1999. Johan filed a suit at the Industrial Court for unjust dismissal. The Industrial court had awarded Johan a compensation of RM100,000 on 30.11.2009.

The compensation is deemed to have been received on 30.11.2009, the date of the court order. The amount exempted for each completed year of service by virtue of paragraph 15(1)(b) of Schedule 6 of the ITA 1967 is determined based on the date of the court order (30.11.2009). As such, Johan qualifies for an exemption of RM10,000 for each completed year of service from 2.1.1996 to 2.1.1999 (3 years).

The computation of the exemption and income chargeable to tax is as follows:

Johan's period of service from 2.1.1996 to 2.1.1999 was for 3 years.

Year of Assessment 2009

<i>Compensation for loss of employment</i>	<i>RM100,000</i>
<i>Less: Exemption - 3 years @ RM10,000 p.a.</i>	<i><u>RM 30,000</u></i>
<i>Income chargeable to tax</i>	<i><u>RM 70,000</u></i>

Example 9

Compensation due to change of compulsory retirement age

Fikri joined an oil & gas company in Malaysia on 4.8.1983. The compulsory retirement age of the company was 61 years but in 2005 the terms and conditions of service were changed under a new scheme where the compulsory retirement age was reduced to 55 years. As a compensation for the reduced retirement age, the company made payments according to a specified formula for the last 72 months which is payable over 10 yearly instalments until employees attain the age of 55 years. Fikri was 51 years of age when he accepted the offer in 2005. On 15.1.2009, Fikri retired upon reaching the age of 55 years. Fikri had received a total compensation of RM1,200,000.

Fikri was taxed on the full compensation received due to the following reasons:

- (a) *the compensation was made under the amended terms of service and not due to the termination of his employment. The offer of the new scheme was accepted by Fikri on his own free will; and*
- (b) *the compensation received was due to services performed by him as an employee of the oil & gas company and not due to the termination of his employment.*

9. Separation Scheme

With effect from the year of assessment 2007, any payment received by an employee from an employer for an early termination of an employment contract under a separation scheme will be granted an exemption from income tax pursuant to subparagraph 15(3) of Schedule 6 of the ITA 1967. Subparagraph 15(3) is applicable provided that such a scheme from which payment had been made does not expressly or impliedly provide for the employee to be reemployed under any other scheme of employment by the same or any other employer. In other words, if the separation scheme offers the employees reemployment with the same employer or any other employer, the payment under the scheme does not qualify for an exemption.

Example 10

Voluntary Separation Scheme - Period of employment is less than a year

Saravanan commenced employment as a managing director with the Malaysian branch of an American company on 1.4.2008. Following the company's decision to undergo a corporate restructuring, the position of managing director of the company became redundant to the company's business requirement. Saravanan opted for the

Voluntary Separation Scheme offered and the final employment date was 1.2.2009. The compensation for loss of employment paid amounted to RM200,000.

Saravanan's period of employment was for 10 months. As he did not complete a year's service, he did not qualify for any exemption under paragraph 15(1)(b) of Schedule 6 of the ITA 1967.

Example 11

Voluntary Separation Scheme - Period of employment is more than a year

The facts are the same as in Example 10 except that Saravanan commenced employment on 1.4.2003.

Saravanan's period of employment from 1.4.2003 to 1.2.2009 was 5 years 10 months.

The computation of the exemption allowed and income chargeable to tax is as follows:

Year of Assessment 2009

<i>Compensation for loss of employment</i>	<i>RM200,000</i>
<i>Less: Exemption of 5 years @ RM10,000 p.a.</i>	<i><u>RM 50,000</u></i>
<i>Income chargeable to tax</i>	<i><u>RM150,000</u></i>

Example 12

Voluntary Separation Scheme - Reemployment is expressly stated

Ezat worked as a factory supervisor in a frozen cake and pastry production company since 1.3.1998. On 1.8.2008, Ezat opted for early termination of his employment contract under a voluntary separation scheme whereby it was expressly stated in the terms of the scheme that all employees of the company would be employed by a related company involved in meat processing. Ezat was paid RM50,000 as compensation for loss of employment.

Although Ezat had been paid compensation for loss of employment, he was not eligible for any exemption because the separation scheme expressly stated that all employees would be employed by another company.

Example 13

Voluntary Separation Scheme - Reemployment is implied

Sandra worked as a factory production worker in an electronics company since 1.3.2000. The company offered all its employees a separation scheme as the companies in the same group had undergone a reorganisation. The company made

arrangements to get all the employees employed by a subsidiary company. Sandra opted for the separation scheme and received RM8,000 as compensation for loss of employment as it was implied by the employer that her service would continue at another company.

Although Sandra had been paid compensation for loss of employment, she was not eligible for any tax exemption since it was implied that she would be employed at a subsidiary company through the arrangements made by the employer.

10. Period Of Employment With The Same Employer

When an employee receives payment in the form of compensation for loss of employment it is necessary to determine whether the payment is in connection with a period of employment with the same employer or with companies in a group. This is for the purpose of computing the tax exemption pursuant to paragraph 15 of Schedule 6 of the ITA 1967. Among the circumstances that should be examined are as follows:

- (a) A period of employment with the same employer includes a period of employment in a business where the employer has changed but the management and control of the business remains substantially with the same person or persons.

Example 14

Employer - Sole proprietor becomes principal shareholder in a company

Alias was a sole proprietor of Alias Enterprise since 2002 and in 2008 the business was taken over by Tegas Sdn Bhd, a company in which he is a principal shareholder. Jaafar, an employee of Alias Enterprise since 2002 continued his employment under the existing terms and conditions of the employment contract even though the business was taken over by Tegas Sdn Bhd. On 30.11.2011, Jaafar's service was terminated and he was paid compensation for loss of employment.

The entity of the employer has changed from a sole proprietorship to a company. Jaafar's continuous employment in Alias Enterprise and Tegas Sdn Bhd will be considered to be a period of employment with the same employer. Jaafar's employment period from the year 2002 is considered continuous till November 2011.

For the purpose of computing the tax exemption on the compensation for loss of employment, the period of tax exemption commences from 2.1.2002 to 30.11.2011.

Example 15

Employer – Sole proprietor becomes a substantial partner in a partnership

Mohan was a sole proprietor of Mohan Transport Enterprise. He decided to form a partnership with Dave, his brother but Mohan remained substantially in control of the new partnership business, Mohan & Dave Transport Co. All the employees working for Mohan Transport Enterprise continued their employment with the new partnership under the existing terms and conditions of the employment contract.

Any period of time spent by an employee in the business with the individual and subsequently in the partnership will be taken to be a period of time spent with the same employer.

- (b) If an employment is with companies in the same group, any period of employment with the various employers within the same group of companies is taken to be a period of employment with the same employer. Pursuant to subsection 2(4) of the ITA 1967, companies are in the same group if:
- (i) two or more companies are related within the meaning of section 6 of the Companies Act 1965;
 - (ii) a company is so related to another company which is itself so related to a third company;
 - (iii) the same persons hold more than fifty per cent of the shares in each of two or more companies; or
 - (iv) each of two or more companies is so related to at least one of two or more companies to which paragraph (iii) above applies.

Example 16

Employer – Companies in the same group of companies

Dexter, an accountant with a furniture manufacturer, Designer Furniture Sdn Bhd, started working with the company on 1.1.1996 and his employment was terminated prematurely on 31.12.2008. He was paid compensation for loss of employment amounting to RM120,000. Prior to his employment with Designer Furniture Sdn Bhd, Dexter was employed by a fellow subsidiary, Designer Teakwood Furniture Sdn Bhd from 1.1.1993 to 31.12.1995.

Although each company managed different businesses, both Designer Furniture Sdn Bhd and Designer Teakwood Furniture Sdn Bhd are subsidiaries of a common holding company. Therefore both companies are in the same group within the meaning of subsection 2(4) of the ITA 1967. Any period of employment with any of the companies within the same group

of companies is treated as employment with the same employer. Therefore Dexter's period of employment within the same group of companies is from 1.1.1993 to 31.12.2008, which is 16 completed years of service.

The computation of exemption and income chargeable to tax is as follows:

Year of Assessment 2008

<i>Compensation for loss of employment</i>	<i>RM120,000</i>
<i>Less: Exemption - 16 years @ RM10,000 p.a. (restricted to RM120,000)</i>	<u><i>RM120,000</i></u>
<i>Income chargeable to tax</i>	<u><i>NIL</i></u>

11. Termination Of Employment Of A Service And Non-Service Director Of A Controlled Company

Example 17

Dismissal of a service director of a controlled company

Seng Fatt Sdn Bhd is a transport business controlled by the Seng family. The shares of the company are held by Seng Fatt and his three sons all of whom are executive directors of the company. On 1.3.2009, Jack, the finance director of the company was dismissed from service after having worked for 5 completed years with the company. He was paid a compensation for loss of employment of RM200,000.

Seng Fatt Sdn Bhd is a controlled company as all its shares are held by the Seng family and the management is controlled by Seng Fatt and his three sons. Since Jack is the finance director and has no shareholding in the company, he is considered a service director. Jack qualifies for an exemption on the compensation received by him from Seng Fatt Sdn Bhd.

The computation of exemption and income chargeable to tax is as follows:

Year of Assessment 2009

<i>Compensation for loss of employment</i>	<i>RM200,000</i>
<i>Less: Exemption - 5 years @ RM10,000 p.a.</i>	<u><i>RM 50,000</i></u>
<i>Income chargeable to tax</i>	<u><i>RM150,000</i></u>

Example 18

Termination of employment of a non-service director of a controlled company

The facts are the same as in Example 17 except that one of Seng Fatt's sons, Kim Seng who has a shareholding of 15% in the company had his employment terminated on 31.3.2009. He received RM300,000 as compensation for loss of employment.



Kim Seng did not qualify for an exemption since he was a director of a controlled company and was not a service director.

12. Effective Date

This ruling is effective for the year of assessment 2012 and subsequent years of assessment.

**Director General of Inland Revenue,
Inland Revenue Board Malaysia.**