



# OECD MODEL TAX CONVENTION: Tax Treaty Treatment of Termination Payments

Discussion Draft:  
25 June to 13 September 2013

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## TAX TREATY TREATMENT OF TERMINATION PAYMENTS

### *Public discussion draft*

Paragraph 4 of the Commentary on Article 18 indicates that “various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following two paragraphs”. Paragraphs 5 and 6 of the same Commentary discuss the extent to which such payments constitute “pensions or other similar remuneration”.

These paragraphs, however, do not address how other provisions, such as Article 15, apply to a variety of payments, such as non-competition payments, that may be made following the termination of an employment. Since the inconsistent treaty characterisation of payments received following the termination of employment creates risks of double taxation and non-taxation, the OECD Committee on Fiscal Affairs, through a subgroup of its Working Party 1 on Tax Conventions and Related Questions, has undertaken work aimed at clarifying how such payments should be treated for tax treaty purposes.

This public discussion draft includes proposals for additions and changes to the Commentary on the OECD Model Tax Convention resulting from the work of that subgroup. These proposals have recently been presented to the Working Party for discussion with a view to their possible inclusion in the OECD Model Tax Convention. Given the fact that the proposals included in this note relate to a variety of payments that may be made to a large number of individuals, the Working Group concluded that its discussion of these proposals would benefit from the views and experience of interested parties and, in particular, of people and organisations (including advisers and representatives from human resources departments) who regularly deal with the tax situation of employees who exercise employment activities in different countries.

The Committee therefore invites interested parties to send their comments on this discussion draft **before 13 September 2013**. These comments will be examined at the September 2013 meeting of the Working Party.

Comments on this discussion draft should be sent electronically (in Word format) by email to [taxtreaties@oecd.org](mailto:taxtreaties@oecd.org) and should be addressed to:

Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD/CTPA

Unless otherwise requested at the time of submission, comments submitted in response to this invitation will be posted on the OECD website.

**This document is a discussion draft released for the purpose of inviting comments from interested parties. It does not necessarily reflect the final views of the OECD and its member countries.**

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## TAX TREATY TREATMENT OF TERMINATION PAYMENTS

### 1. Remuneration for previous work

#### *Description of the payment*

1. Payment of remuneration for work done before the termination of employment will often be made after the employment has been terminated. Such remuneration could cover a salary for the last days of work but also a bonus for a previous year, commissions for sales made before termination, etc.

#### *Proposal*

2. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.3 In some cases, it may be difficult to determine which part of salaries, wages and other similar remuneration paid to an individual are derived from the exercise of employment in a given State. Paragraphs 12.6 to 12.13 below address this issue with respect to the granting of stock-options to an employee who exercises his employment in different States. The issue may also arise in the case of payments made after the termination of employment. Regardless of the terminology used to describe these payments, it is essential to identify the real consideration for each such payment on the basis of the facts and circumstances of each case in order to determine whether the payment constitutes “salaries, wages or other similar remuneration” and the extent to which the payment, or part thereof, may be considered to derive from the exercise of employment in a given State. The following paragraphs discuss these questions with respect to different types of payments that are often made following the termination of employment.*

*2.4 Any remuneration paid after the termination of employment for work done before the employment was terminated (e.g. a salary or bonus for the last period of work or commissions for sales made during that period) will be considered to be derived from the State in which the relevant employment activities were exercised.*

#### *Analysis*

3. The Group agreed that Article 15 would apply to this form of remuneration, which would be sourced where the employee carried on the relevant work during the period covered by the remuneration.

### 2. Payment for unused holidays or sick leave

#### *Description of the payment*

4. After termination of employment, an employee may receive compensation for holidays and/or sick leave to which he was entitled, but did not use, during his period of employment.

## *Proposal*

5. The Group recommends that the tax treaty treatment of this type of payment should be clarified by adding the following to the Commentary on Article 15:

*2.5 A payment made with respect to unused holidays / sick days that accrued during the last year of employment is part of the remuneration for the period of work that generated the holiday or sick leave entitlement. An employee may also be entitled, at the end of employment, to the payment for holidays and sick days related to a number of previous years that were unused during these years. Absent facts and circumstances showing otherwise, a payment received after termination of employment as compensation for holidays and sick days related to previous years that were unused during these years should be considered to have been a benefit for which the employee was entitled for the last year of employment. One situation where a different conclusion would be justified would be where it would be established, on the basis of the taxpayer's employment records, that these holidays and sick days clearly relate to specific periods of past employment and that the payment constitutes remuneration for these periods of employment. States should take account, however, of the fact that the former employee may have been previously taxed on these holidays and sick days at the time of their accrual. Assume, for instance, that under a State's domestic tax law, holidays and sick days granted with respect to periods of work performed on the territory of that State are treated as a benefit taxable during the fiscal year during which the relevant work was performed and are taxed accordingly. In such a case, the State of residence of the former employee at the time of the subsequent payment with respect to the holidays / sick days would need to provide relief of double taxation for such tax and any State in which the former employee may have worked during his last year of employment should similarly consider that any payment for previous years' unused holiday / sick days that were already taxed on an accrual basis did not relate to employment activities exercised during the last year.*

## *Analysis*

6. The Group generally agreed that such a payment should be treated the same way as remuneration for holidays / sick days taken during the employment: the remuneration paid with respect to the holidays or sick leave is part of the remuneration for the period of work that generated the holiday or sick leave entitlement and, as such, should be covered by Article 15 and sourced where work was performed during that period.

7. The practical difficulty that arises in this case, as in the case of some of the following payments, is where the holidays or sick days have accrued over many years and the employment has been performed in a number of States.

8. The Group agreed that this issue required a solution that could reconcile the principle of taxation in the State where the work that generated the holiday or sick leave entitlement was performed and the need for a workable approach. It therefore decided to endorse an approach according to which, absent facts and circumstances showing otherwise, only the remuneration for holidays / sick days related to the last year of employment should be allocated, on a prorated basis, to where the employment activities were performed during that year. Holidays and sick days related to previous years that were unused during these years and were not taxed when they accrued (see next paragraph) should be considered to be an entitlement carried over from year to year to the last year of employment and, therefore, to be remuneration for employment activities exercised during that last year. One case where the facts and circumstances would justify a different solution would be where it would be established, on the basis of the taxpayer's employment records, that these holidays and sick days clearly relate to specific periods of past employment

and that the payment constitutes remuneration for these periods of employment. Under the proposed approach, therefore, there is a rebuttable presumption according to which the starting point is to attribute the payment for unused holidays and sick days to the last year of employment, but leave the possibility of demonstrating that the unused holidays or sick leave relate to previous years of employment.

9. The above approach, however, needs to take account of the fact that a State where employment was exercised during a previous year may have taxed the benefit of unused holidays and sick days at the time of their accrual. In such a case, the State of residence of the employee at the time of the payment for the unused holidays / sick days needs to provide relief of double taxation for such tax; the State(s) of source for the last year of employment should similarly consider that any payment for previous years' unused holiday / sick days that were already taxed on an accrual basis did not relate to employment activities exercised during the last year.

### **3. Payment in lieu of notice of termination**

#### ***Description of the payment***

10. In many countries, employers can terminate an employment without cause subject to giving advance notice to the employee. If the employee continues to work during the period between the moment he/she receives the notice and the termination date, it is clear that the remuneration for that period is covered by Article 15. In many cases, however, the employer will prefer that the employee who receives the notice stop working immediately rather than work during the period covered by the notice. In such a case, the remuneration is paid for that period in the form of a payment "in lieu" of notice.

#### ***Proposal***

11. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

***2.6 In some cases, the employer is required (by law or by contract) to provide an employee with a period of notice before terminating employment. If the employee is told not to work during the notice period and is simply paid the remuneration for that period, such remuneration is clearly received by virtue of the employment and therefore constitutes remuneration "derived therefrom" for the purposes of paragraph 1. The remuneration received in such a case should be considered to be derived from the State where it is reasonable to assume that the employee would have worked during the period of notice, which will most often be the State where the employment activities were performed at the time of the termination.***

#### ***Analysis***

12. This payment is made in the situation where an employer is required to provide an employee with a period of notice before termination but the employer does not ask the employee to work during the notice period for which remuneration is paid.

13. The Group agreed that the payment should be considered to be compensation for work in the State where it is reasonable to assume that the employee would have worked during the period of notice. In most cases, this will be the same State as the State of residence of the employee; in most other cases, the primary taxing rights will be given to a State where the employee has been present for more than 183 days or where he has been working for a local employer or for the permanent establishment of a foreign employer, which would make it possible for the employer to determine where tax should be paid (*i.e.* in the case of the termination of employment at a time when the employee is working in another State for a short

period of time, Article 15(2) will generally prevent taxation by that State and the State of residence of the employee will have exclusive taxation rights over the payment).

#### **4. Severance payment**

##### *Description of the payment*

14. Employers may be required by law, by contract or by the terms of a collective agreement to make a “severance” payment to an employee whose employment is terminated. That payment will often, but not always, be calculated by reference to the period of past employment with the employer (e.g. a payment equal to the monthly salary multiplied by the number of years of past services).

##### *Proposal*

15. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.7 A different situation is that of a severance payment (also referred to as a “redundancy payment”) which an employer is required (by law or by contract) to make to an employee whose employment has been terminated. Such a payment is unrelated to any obligation to give advance notice of the termination and is often, but not always, calculated by reference to the period of past employment with the employer. Absent facts and circumstances indicating otherwise, such a severance payment should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to make the payment arose); as such it constitutes remuneration derived from that employment for the purposes of the last sentence of paragraph 1.*

##### *Analysis*

16. The Group concluded that, absent facts and circumstances that would indicate otherwise, a severance payment should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated and when, therefore, the obligation to make the payment arose. This solution would not preclude allocating the payment to previous years of employment where the facts and circumstances would make that possible and appropriate.

#### **5. Payment of damages for unlawful dismissal**

##### *Description of the payment*

17. An employee whose employment was terminated may have legal grounds to claim that the employment was terminated in violation of the contract of employment, the law or a collective agreement (e.g. because the employment was terminated without reasonable cause and without proper notice). There may also be legal grounds under tort law depending on the circumstances of the termination. The employee may receive a judicial award or settlement as damages for breach of the relevant contractual or legal obligations.

##### *Proposal*

18. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

**2.8** *An individual whose employment is terminated may have legal grounds to claim that the employment was terminated in violation of the contract of employment, the law or a collective agreement; there may also be other legal grounds for claiming damages depending on the circumstances of the termination. This individual may receive a judicial award or settlement as damages for breach of the relevant contractual or legal obligations. The tax treaty treatment will depend on what the damage award seeks to compensate. For instance, damages granted because an insufficient period of notice was given or because a severance payment required by law or contract was not made should be treated like the remuneration that these damages replace. Punitive damages or damages awarded on grounds such as discriminatory treatment or injury to one's reputation should, however, be treated differently; these payments would typically fall under Article 21 although they could also constitute a capital gain covered by Article 13 under the definition of capital gains in some States.*

### **Analysis**

19. The above proposal recognises that a distinction needs to be made on the basis of what the damage award seeks to compensate. Damages granted because an insufficient period of notice was given or because a severance payment required by law or contract was not made should be treated like the remuneration that these damages replace. Punitive damages or damages awarded on grounds such as discriminatory treatment or injury to one's reputation should, however, be treated differently; these payments would typically fall under Article 21 although they could also constitute a capital gain covered by Article 13 under the definition of capital gains in some States.

## **6. Non-competition payment**

### **Description of the payment**

20. Under the provisions of an employment contract or of a legal settlement following the termination of an employment, a previous employee may receive a payment in consideration for an obligation not to work for a competitor of his ex-employer. This obligation is almost always time-limited and often geographically-limited.

### **Proposal**

21. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

**2.9** *Under the provisions of an employment contract or of a settlement following the termination of an employment, a previous employee may receive a payment in consideration for an obligation not to work for a competitor of his ex-employer. This obligation is almost always time-limited and often geographically-limited. Whilst such a payment is directly related to the employment and is therefore "remuneration ... derived in respect of an employment", it would not, in most circumstances, constitute remuneration derived from employment activities performed before the termination of the employment. For that reason, it will usually be taxable only in the State where the recipient resides during the period covered by the payment. Where, however, such a payment made after the termination of employment is in substance remuneration for activities performed during the employment (which might be the case where, for example, the obligation not to compete has little or no value for the ex-employer), the payment should be treated in the same way as remuneration received for the work performed during the relevant period of employment. Also, where an employment contract includes the obligation for an employee not to work for a competitor of his ex-employer after his employment but that obligation does not give*

*rise to one or more separate payments after the termination of the employment, no part of the remuneration received during the employment should be treated differently from the rest of that remuneration solely because it could be allocated to such an obligation.*

### *Analysis*

22. Non-competition payments made after the termination of employment will normally be covered by Article 15 because they constitute “remuneration ... in respect of an employment”. In most cases, however, they cannot be considered to be derived from employment activities performed before the termination of the employment because they relate to an obligation that applies after the employment has been terminated. For that reason, they will usually be taxable only in the State where the recipient resides during the period covered by the payment. There are cases, however, where non-competition payments made after the termination of employment are in substance remuneration for activities performed during the employment and should be treated as such. This could be the case, for example, of a payment made to an ex-employee where it was clear, at the time when the employer agreed to make such a payment, that the non-competition obligation of that ex-employee had little or no value for the employer.

23. The above proposal treats in the same way non-competition payments provided for in the contract of employment and those negotiated after the termination of the employment. It makes a distinction, however, between situations where one or more separate payments for an obligation not to compete are made after the employment and situations where the obligation not to compete after employment is one of the contractual obligations of an employee for which that employee is remunerated during the period of employment. In the latter case, it would be inappropriate to treat differently from the rest of the remuneration any part of the remuneration that could be allocated to that specific obligation.

## **7. Payment related to pension rights**

### *Description of the payment*

24. Various payments may be made after the termination of an employment with respect to pension contributions or pension entitlements of the former employee.

### *Proposal*

25. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.10 As explained in paragraphs 4 to 6 of the Commentary on Article 18, various payments may be made after the termination of an employment with respect to pension contributions or pension entitlements of the former employee. According to paragraph 6 of that Commentary, “[w]hether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact”. The paragraph gives the example of a “[r]eimbursement of pension contributions (e.g. after temporary employment)” as a payment that would not be covered by Article 18. To the extent that such a reimbursement of contributions would constitute additional remuneration for previous employment that results from the termination of the employment, it would be covered by Article 15 and should be viewed as deriving from the State where the employment was exercised when the employment was terminated.*

## *Analysis*

26. The Group considered that such payments should be treated in accordance with the principles put forward in paragraphs 4 to 6 of the Commentary on Article 18. As explained in these paragraphs, a lump-sum payment in lieu of periodic pension payment that is made on or after cessation of employment may, depending on the circumstances, fall within Article 18 but that would not be the case for the reimbursement of pension contributions (e.g. after temporary employment), which would presumably fall under Article 15. Paragraph 6 indicates that “[w]hether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact” and provides some examples and relevant factors.

## **8. Deferred remuneration**

### *Description of the payment*

27. Payments may be made after the termination of employment pursuant to various deferred remuneration arrangements.

### *Proposal*

28. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.11 Payments may be made after the termination of employment pursuant to various deferred remuneration arrangements. Such a payment should be treated as remuneration covered by Article 15 and, to the extent that it can be associated to a specific period of past employment in a given State, it should be considered to be derived from the employment activities exercised in that State. Since many States would not allow the deferral of tax on employment remuneration even if the payment of that remuneration is deferred, it will be important for States that will tax deferred remuneration payments received after the termination of employment to ensure that double taxation is relieved.*

## *Analysis*

29. The Group concluded that such payments should be treated as income covered by Article 15 and, to the extent that a payment could be associated to a specific period of past employment in a given State, it should be considered to be derived from the employment activities exercised in that State.

## **9. Payment under an incentive compensation arrangement**

### *Description of the payment*

30. Various payments may be made after the termination of an employment on account of incentive compensation in general and stock-options in particular.

### *Proposal*

31. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.12 Various payments may be made after the termination of an employment on account of incentive compensation in general and stock-options in particular. Whilst the treaty treatment of*

*each such payment will depend on its own characteristics, the principles put forward in paragraphs 12 to 12.15 of the Commentary, which deal specifically with stock-options, will assist in dealing with other forms of incentive compensation.*

### *Analysis*

32. The Group concluded that such payments should be treated in accordance with the principles put forward in paragraphs 12 to 12.15 of the Commentary on Article 15, which are applicable to stock-options.

## **10. Fringe benefits for the period after employment**

### *Description of the payment*

33. An employee may be entitled to medical or life insurance coverage for a certain period after termination of his/her employment. He/she may also be entitled to other benefits, such as the services of an employment consultant or agency.

### *Proposal*

34. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.13 An employee may be entitled to medical or life insurance coverage for a certain period after termination of his/her employment. He/she may also be entitled to other benefits, such as the services of an employment consultant or agency. Absent facts and circumstances indicating otherwise, such benefits should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to pay these benefits arose).*

### *Analysis*

35. Like a severance payment, these benefits are paid after employment pursuant to an obligation that arose from the employment. The above proposal therefore suggests that absent facts and circumstances indicating otherwise, such benefits should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to pay these benefits arose).

## **11. Compensation for loss of earnings on or after termination following injury or disability**

### *Description of the payment*

36. Another type of payment that could be made on or after termination of an employment is a compensation payment for loss of future earnings following injury or disability suffered during the course of employment.

### *Proposal*

37. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.14 Another type of payment that could be made on or after termination of an employment is a compensation payment for loss of future earnings following injury or disability suffered during*

*the course of employment. The tax treaty treatment of such a payment would depend on the legal context in which it was made. For instance, payments under a social security system such as a worker's compensation fund could fall under Articles 18, 19 or 21 (see paragraph 24 of the Commentary on Article 18). A payment that would constitute a pension payment would be covered by Article 18. A payment made because the employee has legal grounds for claiming damages from his employer with respect to a work-related sickness or injury would typically fall under Article 21 (although it could also constitute a capital gain covered by Article 13 under the definition of capital gains in some States). A payment made by the employer pursuant to the terms of the employment contract even though the sickness or injury is not work-related or the employer is not responsible for that sickness or injury should be dealt with in the same way as a severance payment: absent facts and circumstances indicating otherwise, such a payment should be considered to be remuneration covered by Article 15 which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to make the payment arose). A short-term disability payment made in the course of employment, however, should be treated in the same way as the payment of sick days during the course of employment; such a payment would be covered by Article 15 (Article 17 in the case of entertainers and sportsmen) and taxable in the State in which the employee normally exercised the employment before becoming sick or being injured.*

#### *Analysis*

38. The Group concluded that the tax treaty treatment of such a payment would primarily depend on the legal context in which it was made. For instance, payments under a social security system such as a worker's compensation fund could fall under Articles 18, 19 or 21 (see paragraph 24 of the Commentary on Article 18). A payment could also be made because the employee has legal grounds for claiming damages from his employer with respect to a work-related sickness or injury. Such a payment would typically fall under Article 21 although it could also constitute a capital gain covered by Article 13 under the definition of capital gains in some States.

39. A payment could also be made by the employer even though the sickness or injury is not work-related or the employer is not responsible for that sickness or injury. For instance, the employment contract or collective agreement (*e.g.* in the case of members of a sports team) could provide for a compensation payment if sickness or injury prevents the employee from continuing to work. Such a payment should be dealt with in the same way as a severance payment, which means that absent facts and circumstances indicating otherwise, such a payment should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to make the payment arose). A short-term disability payment made in the course of employment, however, should be treated in the same way as the payment of sick days during the course of employment; such a payment would be covered by Article 15 (Article 17 in the case of entertainers and sportsmen) and taxable in the State in which the employee normally exercised the employment before becoming sick or being injured.

#### **12. Compensation for loss of future commissions**

##### *Description of the payment*

40. Following termination of employment, a salesperson may receive a payment in relation to the loss of future commissions.

### *Proposal*

41. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.15 After termination of employment, a salesperson may receive a payment in relation to the loss of future commissions. The tax treaty treatment of such a payment will depend on the legal context in which the payment is made. Depending on the circumstances, this payment could constitute deferred remuneration to which the salesperson was entitled in relation to previous sales or could be made pursuant to a provision of the employment contract according to which the salesperson has a right to commissions on any future sales to a client that the salesperson brought to the employer; in both cases, the payment should be dealt with as remuneration for the employment services exercised when the sales that gave rise to these payments were made. A payment that would constitute a compensation for future commissions that the salesperson would likely have earned if she had continued to work for the same employer may also constitute a compensation for unlawful dismissal or a form of severance payment; where that is the case, the payment should be dealt with accordingly.*

### *Analysis*

42. The Group concluded that the treaty treatment of such a payment would depend on the legal context in which it is made. Depending on the circumstances, this payment could constitute deferred remuneration to which the salesperson was entitled in relation to previous sales, which would mean that the payment should be dealt with as remuneration for the employment services exercised when the sales were made. The same treatment would seem appropriate if the payment was made pursuant to a provision of the employment contract according to which the salesperson has a right to commissions on any future sales to a client that the salesperson brought to the employer. A payment that would constitute a compensation for future commissions that the salesperson would likely have earned if she had continued to work for the same employer may also constitute a compensation for unlawful dismissal or a form of severance payment; where that is the case, the payment should be dealt with accordingly.

## **13. Partial retirement payments**

### *Description of the payment*

43. As part of transitional arrangement leading to the termination of employment, an employee may receive a reduced salary for a period during which that employee is not expected to work.

### *Proposal*

44. The Group recommends that the tax treaty treatment of this type of payment should be clarified through the following addition to the Commentary on Article 15:

*2.16 As part of a transitional arrangement leading to the termination of employment, an employee may receive a full or reduced salary for a period during which that employee will not work. Where the salary is paid by the employer for a period during which the employee is not required to work even though the employment has not been terminated, the salary is still received by virtue of the employment and therefore constitutes remuneration “derived therefrom” for the purposes of paragraph 1. The remuneration received in such a case should be considered to be derived from the State where it is reasonable to assume that the employee would have worked during that period, which will most often be the State where the employment activities were performed before the cessation of work.*

### *Analysis*

45. The Group concluded that it would be important to determine the exact circumstances in which such a payment is made before reaching a conclusion as to how it should be dealt with for treaty purposes. In some cases, the payment could be made on the condition that the employee remains available to work if that employee's services are required; that payment, which would be equivalent to a stand-by remuneration should be treated as remuneration for the period when the employee provides reduced services and allocated to the State where he is physically present during that period (typically the State of residence). Payments made for a period during which the employee cannot be required to work should be treated like payments in lieu of notice of termination (see section 3 above).

## ANNEX

### PROPOSED CHANGES TO THE COMMENTARY

The following is a consolidated version of the various proposals for changes to the Commentary of the OECD Model Tax Convention proposed in this discussion draft (additions to the existing text of the Commentary appear in ***bold italics*** and deletions appear in ~~strike through~~).

*Add the following paragraphs to the Commentary on Article 15:*

***2.3 In some cases, it may be difficult to determine which part of salaries, wages and other similar remuneration paid to an individual are derived from the exercise of employment in a given State. Paragraphs 12.6 to 12.13 below address this issue with respect to the granting of stock options to an employee who exercises his employment in different States. The issue may also arise in the case of payments made after the termination of employment. Regardless of the terminology used to describe these payments, it is essential to identify the real consideration for each such payment on the basis of the facts and circumstances of each case in order to determine whether the payment constitutes “salaries, wages or other similar remuneration” and the extent to which the payment, or part thereof, may be considered to derive from the exercise of employment in a given State. The following paragraphs discuss these questions with respect to different types of payments that are often made following the termination of employment.***

***2.4 Any remuneration paid after the termination of employment for work done before the employment was terminated (e.g. a salary or bonus for the last period of work or commissions for sales made during that period) will be considered to be derived from the State in which the relevant employment activities were exercised.***

***2.5 A payment made with respect to unused holidays / sick days that accrued during the last year of employment is part of the remuneration for the period of work that generated the holiday or sick leave entitlement. An employee may also be entitled, at the end of employment, to the payment for holidays and sick days related to a number of previous years that were unused during these years. Absent facts and circumstances showing otherwise, a payment received after termination of employment as compensation for holidays and sick days related to previous years that were unused during these years should be considered to have been a benefit for which the employee was entitled for the last year of employment. One situation where a different conclusion would be justified would be where it would be established, on the basis of the taxpayer’s employment records, that these holidays and sick days clearly relate to specific periods of past***

*employment and that the payment constitutes remuneration for these periods of employment. States should take account, however, of the fact that the former employee may have been previously taxed on these holidays and sick days at the time of their accrual. Assume, for instance, that under a State's domestic tax law, holidays and sick days granted with respect to periods of work performed on the territory of that State are treated as a benefit taxable during the fiscal year during which the relevant work was performed and are taxed accordingly. In such a case, the State of residence of the former employee at the time of the subsequent payment with respect to the holidays / sick days would need to provide relief of double taxation for such tax and any State in which the former employee may have worked during his last year of employment should similarly consider that any payment for previous years' unused holiday / sick days that were already taxed on an accrual basis did not relate to employment activities exercised during the last year.*

*2.6 In some cases, the employer is required (by law or by contract) to provide an employee with a period of notice before terminating employment. If the employee is told not to work during the notice period and is simply paid the remuneration for that period, such remuneration is clearly received by virtue of the employment and therefore constitutes remuneration "derived therefrom" for the purposes of paragraph 1. The remuneration received in such a case should be considered to be derived from the State where it is reasonable to assume that the employee would have worked during the period of notice, which will most often be the State where the employment activities were performed at the time of the termination.*

*2.7 A different situation is that of a severance payment (also referred to as a "redundancy payment") which an employer is required (by law or by contract) to make to an employee whose employment has been terminated. Such a payment is unrelated to any obligation to give advance notice of the termination and is often, but not always, calculated by reference to the period of past employment with the employer. Absent facts and circumstances indicating otherwise, such a severance payment should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to make the payment arose); as such it constitutes remuneration derived from that employment for the purposes of the last sentence of paragraph 1.*

*2.8 An individual whose employment is terminated may have legal grounds to claim that the employment was terminated in violation of the contract of employment, the law or a collective agreement; there may also be other legal grounds for claiming damages depending on the circumstances of the termination. This individual may receive a judicial award or settlement as damages for breach of the relevant contractual or legal obligations. The tax treaty treatment will depend on what the damage award seeks to compensate. For instance, damages granted because an insufficient period of notice was given or because a severance payment required by law or contract was not made should be treated like the remuneration that these damages replace. Punitive damages or damages awarded on grounds such as discriminatory treatment or injury to one's reputation should, however, be treated differently; these payments would typically fall under Article 21 although they could also constitute a capital gain covered by Article 13 under the definition of capital gains in some States.*

*2.9 Under the provisions of an employment contract or of a settlement following the termination of an employment, a previous employee may receive a payment in consideration for an obligation not to work for a competitor of his ex-employer. This obligation is almost always time-limited and often geographically-limited. Whilst such a payment is directly related to the employment and is therefore "remuneration ... derived in respect of an employment", it would not, in most circumstances, constitute remuneration derived from employment activities performed*

*before the termination of the employment. For that reason, it will usually be taxable only in the State where the recipient resides during the period covered by the payment. Where, however, such a payment made after the termination of employment is in substance remuneration for activities performed during the employment (which might be the case where, for example, the obligation not to compete has little or no value for the ex-employer), the payment should be treated in the same way as remuneration received for the work performed during the relevant period of employment. Also, where an employment contract includes the obligation for an employee not to work for a competitor of his ex-employer after his employment but that obligation does not give rise to one or more separate payments after the termination of the employment, no part of the remuneration received during the employment should be treated differently from the rest of that remuneration solely because it could be allocated to such an obligation.*

*2.10 As explained in paragraphs 4 to 6 of the Commentary on Article 18, various payments may be made after the termination of an employment with respect to pension contributions or pension entitlements of the former employee. According to paragraph 6 of that Commentary, “[w]hether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact”. The paragraph gives the example of a “[r]eimbursement of pension contributions (e.g. after temporary employment)” as a payment that would not be covered by Article 18. To the extent that such a reimbursement of contributions would constitute additional remuneration for previous employment that results from the termination of the employment, it would be covered by Article 15 and should be viewed as deriving from the State where the employment was exercised when the employment was terminated.*

*2.11 Payments may be made after the termination of employment pursuant to various deferred remuneration arrangements. Such a payment should be treated as remuneration covered by Article 15 and, to the extent that it can be associated to a specific period of past employment in a given State, it should be considered to be derived from the employment activities exercised in that State. Since many States would not allow the deferral of tax on employment remuneration even if the payment of that remuneration is deferred, it will be important for States that will tax deferred remuneration payments received after the termination of employment to ensure that double taxation is relieved.*

*2.12 Various payments may be made after the termination of an employment on account of incentive compensation in general and stock-options in particular. Whilst the treaty treatment of each such payment will depend on its own characteristics, the principles put forward in paragraphs 12 to 12.15 of the Commentary, which deal specifically with stock-options, will assist in dealing with other forms of incentive compensation.*

*2.13 An employee may be entitled to medical or life insurance coverage for a certain period after termination of his/her employment. He/she may also be entitled to other benefits, such as the services of an employment consultant or agency. Absent facts and circumstances indicating otherwise, such benefits should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to pay these benefits arose).*

*2.14 Another type of payment that could be made on or after termination of an employment is a compensation payment for loss of future earnings following injury or disability suffered during the course of employment. The tax treaty treatment of such a payment would depend on the legal context in which it was made. For instance, payments under a social security system such as a worker’s compensation fund could fall under Articles 18, 19 or 21 (see paragraph 24 of the*

*Commentary on Article 18). A payment that would constitute a pension payment would be covered by Article 18. A payment made because the employee has legal grounds for claiming damages from his employer with respect to a work-related sickness or injury would typically fall under Article 21 (although it could also constitute a capital gain covered by Article 13 under the definition of capital gains in some States). A payment made by the employer pursuant to the terms of the employment contract even though the sickness or injury is not work-related or the employer is not responsible for that sickness or injury should be dealt with in the same way as a severance payment: absent facts and circumstances indicating otherwise, such a payment should be considered to be remuneration covered by Article 15 which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to make the payment arose). A short-term disability payment made in the course of employment, however, should be treated in the same way as the payment of sick days during the course of employment; such a payment would be covered by Article 15 (Article 17 in the case of entertainers and sportsmen) and taxable in the State in which the employee normally exercised the employment before becoming sick or being injured.*

*2.15 After termination of employment, a salesperson may receive a payment in relation to the loss of future commissions. The tax treaty treatment of such a payment will depend on the legal context in which the payment is made. Depending on the circumstances, this payment could constitute deferred remuneration to which the salesperson was entitled in relation to previous sales or could be made pursuant to a provision of the employment contract according to which the salesperson has a right to commissions on any future sales to a client that the salesperson brought to the employer; in both cases, the payment should be dealt with as remuneration for the employment services exercised when the sales that gave rise to these payments were made. A payment that would constitute a compensation for future commissions that the salesperson would likely have earned if she had continued to work for the same employer may also constitute a compensation for unlawful dismissal or a form of severance payment; where that is the case, the payment should be dealt with accordingly.*

*2.16 As part of a transitional arrangement leading to the termination of employment, an employee may receive a full or reduced salary for a period during which that employee will not work. Where the salary is paid by the employer for a period during which the employee is not required to work even though the employment has not been terminated, the salary is still received by virtue of the employment and therefore constitutes remuneration “derived therefrom” for the purposes of paragraph 1. The remuneration received in such a case should be considered to be derived from the State where it is reasonable to assume that the employee would have worked during that period, which will most often be the State where the employment activities were performed before the cessation of work.*

*Replace paragraph 4 of the Commentary on Article 18 by the following:*

*4. Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following two paragraphs (see also paragraphs 2.13 to 2.16 of the Commentary on Article 15, which deal with the application of the Convention to a number of these payments).*