

BIAC Comments on the OECD Discussion Draft on the Tax Treaty Treatment of Various Payments Following the Termination of an Employment

September 13, 2013

Dear Pascal,

BIAC appreciates the opportunity to provide comments on the 25 June, 2013 OECD Discussion Draft addressing the *OECD Model Tax Convention: Tax Treaty of Termination payments* (the 'Discussion Draft'). Clear guidance for multinational corporations and their employees that precludes both double tax and double non taxation on payments related to employment termination is important.

BIAC has reviewed the Discussion Draft, and is pleased to provide the following comments on the proposed revisions to the Model Tax Convention Commentary.

General comments:

BIAC's Members are concerned that although the Discussion Draft addresses the question of where compensation should be taxed, it does not address a number of practical challenges. For example, there can be difficulties when administering withholding or payroll taxes for former employees and for payments made after an employment contract has been terminated. This could particularly be the case where a termination takes place in a country of temporary employment, which may not be the home State for either the employee or the employer.

We also note that domestic legislation in many countries places the obligation on the employer to collect taxes from the individual employee receiving any termination payments. This could present challenges in light of the guidance contained in the Discussion Draft since it clearly provides for outcomes that involve tax withholding in a country in which the employee may not be payrolled or even currently located.

In this regard, business is concerned that a lack of clear guidance or definitions will not assist in reducing double taxation and will potentially discourage the flexibility of employment that will contribute to promoting cross border trade and investment. We also consider that guidance ought to facilitate the resolution of disputes and do as much as possible to outline what should be expected of employers in respect of allocation of income for withholding/payroll purposes in addition to determining taxing rights.

We request that the OECD takes such administrative difficulties into account when revising the Discussion Draft, and to consult with business on an on-going basis to understand the practical implications for such revised guidance. BIAC members would be happy to meet with the OECD or member governments to discuss these issues in greater depth.

Specific comments

Two of paragraphs¹ in the Commentary to the Discussion Draft ('the Commentary') refer to a need to determine the State where "...it is reasonable to assume that the employee would have worked". Basing the tax treatment on assumptions rather than specific facts and circumstances increases the risk of disagreements and the difficulty of dealing with and resolving complex cases (for example, in situations involving frequently mobile employees). It may be preferable to state a presumption in favour of the country where the employee was working at the point of termination, as with severance payments.

Also, in dealing with compensation payments, the Discussion Draft generally refers to '*facts and circumstances*' and the need to determine the legal basis for the compensation rights. As such, scenarios exist under which the Commentary may not provide sufficient guidance to clarify the uncertainty.

Paragraphs 14-16: Severance Payments:

The proposal for severance payments is to allocate them to the State where the employment was exercised when terminated and when the obligation to pay arose. The Discussion Draft also suggests that allocating these payments to previous years of employment would also be possible if appropriate. Additional guidance is required to determine which of the two approaches is appropriate and, if the latter, how many past years of employment should be taken into account. Since it will also be relevant which employer pays the severance payment, we believe that this should be clarified in the Discussion Draft.

BIAC proposes the following amendments to **paragraph 2.7** (suggested text in bold and underlined and proposed deletions in bold and struck through):

*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 the existence of a clear legal or other agreement that determines that the payment is related to another employment or contractual right** ~~**in the 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.*

¹ Paragraph 2.6 (payment in lieu of notice of termination) and 2.16 (partial retirement payments).

The guidance might also clarify that this approach should be followed however brief the term of the employment in the State where the employment was terminated, relative to the total period of employment of the individual by the employer or group of employers.

Paragraphs 17-19: Damages

The guidance possibly suffers a gap between contractual termination payments and redundancy payments and other similar payments (which are clearly covered under severance payments) on the one hand, and specified damages on the other. The missing piece may be substantial payments in respect of an unspecified purpose or unspecified potential damages claim. Such payments might best be included through an expansion of the definition of severance payments and the same logic for taxing rights followed.

Paragraphs 20-23: Non-Competition Payments

The Discussion Draft states that non-compete payments should be sourced to where the employee was ‘*during the period covered by the payment*’. The Discussion Draft justifies this treatment by stating that non-competition payments are for future employment (or an obligation not to work as the case may be) and therefore should be future sourced.

While the logic outlined in the Discussion Draft may seem reasonable, the result could be problematic for two reasons:

1. It will not be possible for the previous employer to predict the location of the employee during the non-competition period for purposes of compliance obligations; and
2. Lump sum payments are often made covering several components (for example, non-competition, non-disparage, non-solicit, waiver of any claims, agreement to arbitration) which are difficult to determine.

It would be necessary for a former employer to calculate an appropriate allocation of such a payment between the various components (which may not be possible to do with specificity) and then to determine where each of the components should be assigned to and taxed. This could lead to a significant administration burden and opportunities for abuse.

BIAC suggests that clear ‘bright line’ guidance should be introduced so that all payments are sourced where the employee was at termination, which would be in line with the tax treatment of severance payments (and as we have suggested for payments in lieu of notice of termination for example), i.e. based on the location of employment at termination, being as logical a presumption as any for the location in which the employee might otherwise compete, and thereby providing certainty for the employer also.

BIAC proposes the following amendments to **paragraph 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 every** circumstances, constitute remuneration derived from employment activities performed before the termination of the employment. For that reason, it **might will usually in***

one view 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. However, in another view, typically the location in which the employee is not to compete may include and be centred on the location in which the employment was terminated. Based on this rationale and with the added benefit of the certainty that it brings, the payment should be treated as being remuneration derived from the State where the employment was exercised when the employment was terminated and taxed in that State.~~

Paragraphs 27-29: Deferred compensation payments:

The issue of deferred compensation also remains a potential area of double taxation. We note that the Commentary (2.11) states that "it will be important for States...to ensure that double taxation is relieved", but there is no procedural guidance provided in the Discussion Draft to address different States taxing the same payment twice. BIAC would welcome further guidance in this area.

Also, proposed paragraph 2.11 does not provide adequate clarity for situations where deferred compensation payments cannot be associated to a specific period of past employment. To address this, and to eliminate the risk of double taxation, all payments of deferred compensation received after the termination of an employment that cannot be associated to specific periods of past employment should be treated as being remuneration arising from the terminated employment and subject to taxation in the State where the employment was exercised immediately prior to termination.

BIAC proposes the following amendments to **paragraph 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. Where it is not possible to allocate deferred compensation to specific periods of past employment in a given State, such payments made after termination of employment should be treated as being remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated. 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.

Paragraphs 30-32: Payment under incentive compensation arrangements:

BIAC notes that ‘compensation payments are not defined in the Discussion Draft, but that the commentary recommends the same treatment as stock options. This may be problematic, as the commentary on Article 15 relating to stock options (12-12.15) allows States to tax at any time between grant and exercise, or subsequent sale. As such, this would permit different States to treat incentive compensation as being potentially taxable if the employment for which the incentive compensation is being paid was exercised in that State for some period. Currently there is no effective mechanism to allocate taxing rights only to one State. As incentive compensation does not have all of the characteristics of stock options and there is no clear alignment between the generally accepted events which create liability to tax for stock options (grant, vest, exercise and sale) and the date giving rise to tax liability for other forms of incentive compensation, we suggest that clear guidance should be given that gives more certainty over the date on which the incentive compensation will be treated as taxable remuneration.

BIAC proposes the following amendments to **paragraph 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. **For the purposes of applying paragraphs 12 to 12.15 of the Commentary to incentive compensation that does not take the form of stock options, the incentive compensation should be treated as if the right to the compensation was a stock option right that vested and was exercised on the date that the compensation is paid.***

We very much appreciate your taking these comments into account in your further revision of the Discussion Draft. If it would be useful, BIAC representatives would be pleased to meet with representatives of the OECD or member governments to assist in furthering the attempt to clarify the treatment of termination payments.

Sincerely,



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Chair, BIAC Tax Committee

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