Chartered Institute of Taxation
Excellence in Taxation

Tax Treaty Treatment of Termination Payments
Response by the Chartered Institute of Taxation

Introduction

The Chartered Institute of Taxation (CIOT) refer to the public discussion draft published by the OECD on the tax treaty treatment of termination payments under the OECD Model Convention published on 25 June 2013.

As a general point, this discussion draft suggests some changes and additions to the Commentary on the OECD Model Tax Convention. The implication from the discussion draft is that there is no intention to make any change to the Model OECD Tax Convention to reflect the changes and additions proposed. We suggest that the Working Party should consider whether changes to the Model OECD Tax Convention are required as there is a fair bit to read in to the existing standard wording to get to the results suggested in the discussion document.

Also, we would like to understand why the proposal to amend the Commentary is made at all. There is no explanation of this in the discussion draft and there is also no indication of any difficulties of interpretation that have arisen in this area in practice. The growing size of the Commentary and frequent amendment gives rise to its own problems. These are, particularly, which version of the Commentary to apply and whether the Commentary is consistent with the interpretation given by the courts of member countries. Simply expanding the Commentary where there is no identified difficulty in interpretation merely adds bulk without improving clarity. Although many of the suggested changes are uncontroversial, we would suggest that they are also not needed.

That said, if changes are to be made, it would also be useful for the Commentary to make plain that it is talking about the whole range of terminations from falling out, to redundancy (ie there is no longer a role/job) to ex gratia payments. In fact, we suggest that there should be a separate section dealing with ex gratia payments. This might say simply that an ex gratia payment should be treated as other income within Article 21.

The remainder of this response uses the same numbered headings as in the discussion draft.

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Specific Comments

1 Remuneration for previous work

1.1 We agree that the proposals to clarify the tax treaty treatment of this type of payment seem fair and we approve it.

2 Payment for unused holiday and sick leave

2.1 While, as a practical matter, it may seem sensible to presume that the payment arises in respect of the last 12 months prior to termination as a starting point, we do not think that this should be included in the Commentary as a matter of interpretation. This should always simply be a question of fact. Although the proposals allow for the presumption to be rebutted on the basis of the facts and circumstances, including the presumption at all is a good example of needlessly adding to the Commentary.

3 Payment in lieu of notice of termination (PILON)

3.1 Linking the right to tax to where an individual would have worked is a recipe for uncertainty. Although it may be obvious in simple cases, in more complex situations this will simply give rise to speculation and assumptions. Simple cases such as where there is a fixed term secondment are easily addressed on the facts. Where an individual is simply spending time in the source country on an ad hoc basis it may be difficult to say and the practical solution would be for the residence state only to have the taxing right.

3.2 Again, we do not think that any presumption should be included as a matter of interpretation. These are attempts to inject new policies through the policy and do not clarify the meaning of the Article.

3.3 In any event, the proposal here is insufficient. It only considers where a payment in lieu of notice is made AND the employment continues until the end of the notice period but the employee does not work. It does not consider where the employee is dismissed, is paid a PILON and the employment contract is terminated with that payment. It also does not consider the case where an expat is seconded to country A (host country) to work but is recalled to country B (home country) where he is terminated. He may thus be resident at the time of the payment in both countries.

4 Severance payment

4.1 Once again we disagree with the inclusion of any presumption in the Commentary for the reasons mentioned above.

4.2 The Commentary does not address the question of which country the individual worked in up to the time of severance. If this means immediately before, then, for example, a payment by reference to many years would not properly be reflected. Thus we suggest that this again is simply a question of fact. It would be more helpful for the Commentary to clarify that this should not be judged simply by where the employee is at the time of termination. That would be capricious. It should be by reference to the whole of the employment relationship and taking into account the law governing the employment. The proposed changes do not fully explore the

temporal questions as to which is the residence state and when this is to be determined. This is common to a number of specific issues and may resolve a number of them.

4.3 Difficulties in practice are more likely to arise as a result of contracting states categorising the payments differently. It is not obvious that such payments are similar to salary or wages simply because the amount is often calculated by length of service. The proposed wording assumes this is the case but offers no analysis or justification. This could be resolved by applying the categorisation under the law of the state that governs the employment relationship. This of course has its own difficulties in some cases, for example, where statutory severance regimes apply notwithstanding the contractual regime. However, it underlies the need to look at this case-by-case rather than the broad brush adopted in the proposals.

4.4 We suggest that the Commentary should explicitly say that where the payment is referable to many years service, then there should be exemption in the country of source at the point of termination (ie where the employment was exercised up to termination) to the extent that the payment was not in respect of employment exercised in the state where the employment was terminated. For example if an individual worked in China for 15 years, then went to France for 12 months where the employment was terminated, the severance payment may effectively be connected wholly or in part to China. In such circumstances France should either not be entitled to tax or only to tax a commensurate fraction. Although consideration of the 'facts and circumstances' should permit this, it would be helpful to see an example of this to reinforce it.

4.5 In addition, it would be helpful for the Commentary to say explicitly that this situation is to be distinguished from Section 5 (Payments of damages for unlawful dismissal) which is about payment of damages for breach of the employment contract.

5 Payments of damages for unlawful dismissal

5.1 The proposal in the discussion document is to distinguish between payments made for breaches of contract where insufficient notice is given – non-contractual PILONs – and payments as punitive/discriminatory damages. The former would be Article 15 and the latter Article 21, Article 13 etc. This seems to be a sensible approach. However, it does depend on a split being available.

5.2 The real difficulties are where contracting states classify the payments differently. Allocation between different kinds is always problematic. This is a good example of why the proposals in the Discussion Draft overall are disappointing because they miss the wood for the trees. While focusing in detail on particular kinds of payment, the drafters appear to have lost sight of the fact that a purpose of treaties is to facilitate the free movement of goods, investment and workers. In the case of cross-border workers, simplicity is of the essence. This would suggest interpretation of the Articles that favours exclusive residence state taxation. Such an approach itself would provide administrative simplicity for employees, employers and tax administrations. As with all tax treaties, that requires an element of revenue sacrifice by all countries when they are source countries. While there will be some very well-paid individuals who receive substantial termination payments, in the vast majority of cases the modest amounts involved will not justify the complexity and record-keeping required to demonstrate where a particular ingredient of a payment is taxable. If the OECD is to be helpful, a simple pragmatic approach would be best.

5.3 If damages (other than non-contractual PILONS) are 'other income' under Article 21, it may be taxed in the country of residence. This could throw up inequities if both contracting states tax that payment, one on source and the other on residence unless a clear elaboration of the temporal issues identifies when residence is to be determined. For example, if an individual has worked for 20 years, has reached a senior position while working in two (or more) different countries, and is then unfairly terminated, the damages may reflect that the payment is by reference to the whole contract. There may be more than one residence state in such circumstances if it is to be determined. As a practical matter, if residence is only tested at the time of termination, a simple result will follow although in cases such as the above example, states would need to accept that they could not tax such payments even if an individual had been resident there for some time.

6 Non-competition payment

6.1 The proposals here highlight the fact that in the UK, non-competition payments are only treated as remuneration only as a result of domestic statute law. This gives rise to complications in a cross-border setting. The proposal is that the payment should be treated as Article 15 income for the period that the non competition payment is for. In other words if a taxpayer cannot compete for two years, then the payment is primarily taxable in the country in which he resides for the next two years. We agree that if the payment is for not competing post termination, it should not be taxable in the other state as not competing is not the exercise of employment. Cases where the payment is in fact for past employment do not from part of this analysis as they are not non-compete payments but additional salary and the commentary should make this clear.

6.2 A further point is that the ex-employer has to evaluate the worth of the non-competition payment. This may not be straightforward if it is not separately identified.

6.3 A better solution might be not to treat the payment as additional remuneration. This is because In principle it is not similar to salary or other remuneration and, therefore, should strictly fall within Article 21. The fact that some states deem these payments to be employment income under domestic statute when others do not illustrates that where there are differing tax policies that may result in double-non taxation, this is merely by reason of the co-existence of separate tax systems and should not be automatically viewed as improper use of a treaty. Abusive cases can simply be dealt with by rules relating to abuse.

7 Payment related to pension rights

7.1 Broadly we agree with the analysis.

7.2 It would be helpful if the Commentary also covered severance payments which the departing employee elects to be waived in lieu of an employer contribution into their pension plan. The Commentary should confirm that the payment should then be taxed as an employer pension contribution (which is what it then is).

8 Deferred remuneration

8.1 Broadly we agree with the analysis. This is a complex area because deferred remuneration plans may last many years.

8.2 An important point to be considered is the way in which the relevant fiscal authorities around the world should interact. The earnings in a deferred remuneration plan may build up over many years. If these earnings are in reality earnings of the year when the work was performed, and the country of source has allowed a deferral of tax – but not an exemption – then there needs to be a mechanism for ensuring the country of source is notified of the payment.

8.3 Much will hinge on withholding taxes deducted by the employer because if an employee has been in country X for 5 years but has a deferred award from country Y 7 years earlier which vests, then in practice will, or should, that employee submit a tax return to submit to country Y.

8.4 In addition, some plans 'invest' in deposits, shares etc giving rise to further problems as to who taxes the investment return as opposed to the underlying earnings.

8.5 We suggest that the position should simply be determined by the facts and circumstances in each case.

9 Payment under an incentive compensation arrangements

9.1 These payments raise similarly difficult questions to those discussed under paragraph 8 above.

10 Fringe benefits for the period after employment

10.1 The principles set out here seem logical from a UK perspective. However, we are unclear why this should not always be a question of facts and circumstances rather than this being an override to an unnecessary presumption.

10.2 In practice, however, the treatment of these may be difficult to enforce. How would the country where the employment was exercised know about/enforce its taxing rights?

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

11.1 Broadly we agree with the proposals. However we suggest that the Working Party considers the guidance in recent HMRC publications. In our view the style of this recent guidance is more helpful than the changes to the Commentary that are proposed. By giving examples and saying how they will be treated, most of the possible distinctions would be covered. For example, if there is a payment for personal injury caused by the employer's negligence, then that should be excluded from Article 15 – and indeed all tax.

12 Compensation for loss of future commissions

12.1 We agree with the analysis.

13 Partial retirement payments

13.1 We agree with the analysis.

The Chartered Institute of Taxation

The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

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The Chartered Institute of Taxation
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