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Dear Sir

Tax Treaty Treatment of Termination Payments

Thank you for the opportunity to comment on the proposed additions to the OECD Commentary on Article 15(2) of the Model Treaty, to clarify the treatment of various payments on termination of employment.

We agree that it is helpful for the OECD to tackle this matter in the way proposed in the Discussion Draft issued on 25 June. We consider that the approach adopted is generally sensible and right. However, the further proposed elaboration for the Commentary seems to be incomplete in places or risks creating a conflict of sourcing for internationally mobile staff who receive termination payments while on secondment or afterwards. In particular, we think it is important to distinguish cases where:

- The employment ends completely while the employee is abroad (perhaps through a breach by the employer) but payments continue afterwards, and
- Employment duties cease while the employee is abroad but the employment itself continues for a period after he resumes residence in his home state.

We think it unlikely that the home country, the residence state, will refrain from taxing employment income received while the employment continues. The Commentary should recognise this.

Our detailed comments are set out in the Appendix to this letter. If you have any questions about matters raised in this letter please contact Philip Paur (ppaur@deloitte.co.uk – +44 20 7007 1666) or the undersigned.

Yours faithfully

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Appendix

Payment in lieu of notice (PILON)

The treatment of PILONs is more involved that the discussion draft allows. There are two sorts of PILON: payments made as recurrent salary during a period of terminal leave from the employment (garden leave), and payments made by the employer as compensation for breach of the employee's notice entitlement under the employment contract. With the former, the employment ends at the end of the notice period. In the latter case, the employment generally ends immediately on the breach.

The discussion draft does not distinguish the two and implies that in either case payment is considered to be derived from the state where it is reasonable to assume that the employee would have worked during his notice period. This is fair enough where the employment continues during the notice period and the employee remains in the state where he was working when the active employment ceased. However, such a rule is not appropriate in other cases.

Take, for instance, the position of an employee who would have moved to a different state during the notice period, but does not do so because the employment ends before he is due to do so. It does not seem appropriate that the state where he was due to work should have any taxing right simply because if the employment had continued he would have worked there. This would be contrary to the general rule in paragraph 1 of the Commentary that income is taxable in the state where the employment is actually exercised.

It is quite common for the active employment of an internationally mobile employee to be terminated at the end of a secondment, because there is no position for him to return to in his home country. The employee usually returns to live in his home country, but may instead seek further employment in the host country or a third country. If the employment continues during the garden leave period, during which the employee is once more resident in his home country, it is difficult to see why the former host state, where the employee was resident when the active employment ceased, should retain taxing rights over the pay for that period. It should not make any difference whether the employee was due to work back in the home country during the garden leave period, had the active employment continued. The same applies where he instead goes to work and becomes treaty resident in a third country.

By contrast, if the employment is severed while the employee is still resident in the host country, any payment in lieu of notice made as compensation for the breach of contract should be sourced to the host country. The fact that the employee would have worked in another country had the employment continued should not entitle that country to taxing rights, whether or not the employee actually goes to or becomes resident in that country during what would have been the severance period.

Severance (redundancy) payment

The proposal to treat such payments as derived from the state where the employment was exercised when the employment was terminated may well conflict with the sourcing rule for such payments adopted by many counties. The report acknowledges that such payments are often calculated by reference to the period of past employment. Countries such as the UK, US and France go further and treat the severance payment as income for the multi-year period taken into account for calculation purposes. If the approach recommended by the discussion draft is adopted, a sourcing conflict is likely, as illustrated by this example:

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Mr X is a resident of the UK who is employed by A Ltd for six years. He is then seconded by A Ltd to Germany, where he works for the sister company, B Ltd. After four years, while still living and working in Germany, he is made redundant, whereupon he immediately returns to the UK and resumes UK residence. He receives from A Ltd a redundancy payment of £50,000 calculated by reference to his 10 year period of service with the group, and his salary at the date of termination.

After applying a statutory £30,000 exemption, the UK would view 60% of the £20,000 net (£12,000) as UK source. However, the discussion draft would treat the whole of the £50,000 payment as German source. There is a sourcing conflict: Germany apparently has taxing rights on the whole of the payment, and the UK on part. It would help if the Commentary addressed this problem.

Payment of damages for unlawful dismissal

Quite often payments made under an agreement whereby both sides compromise potential or actual claims against the other will be calculated by reference to a period of past service or a contractual period of notice, or both, and will embrace potential claims for unfair dismissal etc. If an analysis is required to determine the correct sourcing approach (e.g. for the notice period, or for the last year in which the employment is held), it could be quite difficult to attribute amounts to each. It would be helpful if the Commentary made clear that where the payment is predominantly a PILON e.g. compensation for the premature termination of a fixed period contract, the whole of it should be treated as such. Similarly, where it is predominantly compensation for loss of office, or a payment in lieu of redundancy, the whole of the payment should be so treated.

Non-competition payment

Again, there is a practical difficulty in measuring the true value to be attributed to the non-compete payment, which may be quite different to the amount of the payment stipulated in the severance contract. It would be helpful if the Commentary made clear that a non-compete payment made on termination of employment which merely reinforces the existing confidentiality obligations in the employee's contract of employment is treated in the same way as any severance payment paid in conjunction with it. Where the termination arrangements stipulate non-compete obligations for the employee akin to those that were in force during his period of active employment, but no separate payment is made, there should not be any requirement to carve one out notionally from other remuneration paid on termination.

Where discrete non-compete payments are made after the employment has ceased, they may well be taxable in the state where the member resides if that is where he formerly exercised the employment. However, if he becomes resident in another state after the employment ceased, one where he had not exercised the employment, it appears doubtful that such payments would be treated as chargeable income in that state. In that case, the state where the employment was last exercised would expect to have the primary taxing right. If the residence state at the time of payment taxes the payment, e.g. as a capital payment, it should allow double tax relief for income tax charged in the state where the employment was last exercised.

Payments related to pension rights

We agree that a reimbursement of pension contributions made during a period of temporary employment should on the face of it be treated as additional remuneration falling under Article 15. However, further clarity is required as to what constitutes a reimbursement of contributions. For instance, if a foreign employee seconded to work for a period in an Asian country is entitled to withdraw his compulsory

provident fund contributions on departure, that would clearly be a withdrawal of contributions. However, if, in accordance with scheme rules, a resident employee withdraws recently made lump sum contributions from an overseas pension scheme, perhaps while he is still below the residence state's normal retirement age, that should not be viewed as a withdrawal of contributions by the residence state just because its own rules would not permit it.

Deferred remuneration

Again, we agree that the state where the remuneration was earned should retain taxing rights. However, deferred remuneration payments may also be pension lump sums or payments. Where they have this dual character, the Commentary should explain clearly whether Article 15 or Article 18 applies.

Payment under an incentive compensation arrangement

We agree with the proposal to adopt the stock option sourcing approach for other types of incentive payment.

Fringe benefits for the period after employment

It seems to us that the sourcing of fringe benefits should follow that for PILONs, where these apply. In other words, where the employment ends with a payment in compensation for breach of notice the fringe benefits should be taxed as further remuneration for the final period in which the employment was held. By contrast, where fringe benefits are provided only during a period of garden leave while the employment continues, the state in which the employee is resident during that period should have the primary taxing right. If the benefits are provided throughout and beyond the garden leave period it may be appropriate to source them in part to the state where the employee was working when the active employment ceased. The Commentary should provide guidance on this.

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

We broadly agree with the proposed addition to the Commentary at paragraph 37. Again, though, as for severance payments, where the employer pays compensation we would distinguish between compensation paid when the termination of the active employment coincides with the ending of the employment altogether, and compensation paid during a period of absence from the employment, for that period. Compensation paid in these circumstances should be treated as arising in the state where the employee is resident at the time, even if he does not work there.

Compensation for loss of future commissions/ Partial retirement payments

We assume that "partial retirement payments" refers to "Teilzeit" arrangements (such as found in Germany) whereby employees may continue to be paid for non-working periods as they approach retirement. If so, we are in agreement with the proposed additional Commentary but have no further observations to offer.