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Dear Sirs

Tax Treaty Treatment of Termination Payments

We refer to your invitation for comments on the discussion draft on the tax treaty treatment of termination payments. We understand the aim of the amendments is to mitigate the risk of double taxation and non-taxation of various payments made in connection with the termination of employment, by removing the inconsistent treaty characterisation. We have considered the effectiveness of the proposed changes to the Model Convention Commentary with reference to these stated objectives.

As a framework to our comments we have considered the payments associated with the termination of employment that we commonly see in cross-border cases. Details of these payments and their tax treatment in the UK are provided in the appendix. The different categories of payments have been referenced in the body of our letter.

Analysis of Proposed Changes

The proposed changes have been considered in the order that they appear within the discussion document.

1. **Remuneration for previous work (Case A in the appendix)** – The proposed changes to the Commentary are adequate to clarify that remuneration received in respect of employment should be taxed in the country where the duties that generated the entitlement to the remuneration were carried out. This is an equitable outcome and we approve of the updates.
2. **Payment for unused holiday or sick leave (Case B in the appendix)** – Accrued payments being taxed in reference to the location of the last 12 months of employment unless the facts demonstrate otherwise offers an appropriate compromise between offering prescriptive guidance and flexibility to prevent undesirable outcomes.

3. **Payments in lieu of notice of notice (PILON) (Cases C, D and E)** – This section looks to clarify the treatment of legal or contractual payments individuals receive in place of their working notice, and actually covers a variety of payments with different tax treatment. The Commentary is intended to clarify which State has the right to tax the income where the recipient’s location changes during the period of payments, and looks at the treatment of payments under Case E.

When considering Case E, this section could helpfully provide further clarity around where someone should be taxed if they are repatriated to their home country before being terminated. As they are working in their home country when terminated it could be argued that this indicates that this is where they would have served the notice period so the notice payments should be taxable in their home country. Alternatively, it could be argued that the payment related to their duties prior to repatriation as this is where they would have actually carried out any subsequent duties and consequently the payment should be taxable in the host country.

The proposed addition to the commentary states:

“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”

As globally mobile employees may have worked in more than one State it would be helpful if further guidance could be given. For example stating that unless there were facts and circumstances suggesting otherwise the payment would be apportioned based on the last 12 months of employment.

The proposed changes to the Commentary do not appear to cover the situation where an individual receives a PILON at the same time as their contract is terminated (Cases C and D). A payment under Case C is a payment in respect of the exercise of a discretionary clause within the contract of employment, so a resulting payment would derive from the contract and, therefore, fall within Article 15. It would not however have any relation to the *future* duties (as the contract is terminated) and therefore the test under Case C should in our opinion be backwards-looking rather than forward-looking.

A payment under Case D would be where the employee is entitled to receive notice and this right is breached by the employer and a payment is made. The nature of the payment from a UK perspective is one of damages for breach of contract and, as it does not derive from the contract, it should not be considered under Article 15. The case of *Resolute Management Services Ltd v HMRC* confirmed the position that, if payment is made in the UK that is not taxable as employment income and is instead taxable under section 401 ITEPA 2003. The payment should, therefore, not fall within the scope of Article 15 but instead be considered under Article 21.

From a UK perspective a payment would be taxed on the basis of its substance as opposed to its form. We think this is of importance when considering termination payments where there are many similar but crucially differentiated payments and believe more generally that there would be merit to stating in the Commentary that the principle of substance over form applies for the purpose of termination payments.

4. **Severance payment** – The term “severance payment” is not straightforward as it is often used as a portmanteau term covering payments made up of a number of constituent elements from the cases above. This section looks at how payments made on termination, which derive from the contract or collective agreement, should be taxed. These are covered by Case A in the appendix. The commentary suggests that:

“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.”

Comment should be added regarding the period that should be considered to determine where the employment was exercised. Is it the last day of employment, the last year or another period? Additionally where an employment is with a group should it be the group employment or just the employment with the last member of the group of companies?

If the payment has been calculated based on a specific period of employment that should be the default period to be used.

5. **Payments of damage for unlawful dismissal (Case F)** – The proposed Commentary differentiates between the situation where an individual receives a payment in respect of contract terms and the situation where an individual is receiving punitive damages. The intention is that payments that are received as compensation for not receiving amounts that are contractually or legally due should be taxed in the same way as if the recipient had received the contractually or legally due amounts; whereas payments for punitive damage should not be taxed as employment income but as other income (Article 21).

The proposed treatment of compensation for not receiving contractually due amounts is a departure from the current UK interpretation that such payments would be subject to Article 21 because the payments are not paid for performing employment duties but for breach of contract. Given this appears to be significant change we think it would be important to consider not only whether this is an equitable outcome but whether it is workable and practical.

By allowing compensation payments to be treated as employment income, the commentary will contradict the UK taxation of such payments which is based on the derivation of the payment. This means there is the potential for gaps in taxation where the UK does not tax under domestic legislation and another country cannot tax under the terms of the treaty.

6. **Non-competition payment (Case I)** – The intention of the Commentary changes are that non-competition payments are taxed in the State the recipient is resident in. As the payments are not earnings for performing duties we agree with this approach. The changes prevent abuse by stating that non-commercial payments should effectively be treated as remuneration for previous duties and taxed accordingly.
7. **Payment related to pension rights** – The purposes of this section is to confirm that lump sums paid in lieu of a pension should fall within the scope of Article 18 unless the payment is specifically the refund of contributions. The proposed Commentary is adequate for its purpose.
8. **Deferred remuneration** – The intention of this section is to confirm that deferred compensation should be taxed in the State in which the entitlement accrued. We believe that this is the best approach and that the section is adequate at achieving this aim. The key issues with this area are likely to be the practical issues of apportioning deferred compensation and ensuring the correct taxes are paid in the respective States.
9. **Payment under an incentive compensation arrangement (case K)** – The current complicated position is helped very little by the proposed additions. The main concern remains one of the practicalities of reporting and paying the tax due on the income in the correct jurisdictions.
10. **Fringe benefits for the period after employment (Case L)** – The intention of the changes to this section are to confirm that fringe benefits are taxable in the country where the employee was last employed. The section appears to be appropriate to achieve this gain. However, practical issues may arise from this approach.

For example, if an individual moves from Country A to B after termination and is entitled to life insurance for numerous years after termination it may be challenging to ensure that the correct tax is paid in Country A - specifically if the employer has no cash remuneration to withhold tax from and the individual has severed all ties with that location.

11. **Compensation for loss of earnings on or after termination following injury or disability (Case M)** – The key point this section makes is that compensation payments of this nature could be treated in various ways under tax treaties depending on the nature of the payment. It also looks to set out how the different types of payments should be treated. We believe that it is adequate to fulfil its aims.
12. **Compensation for loss of future earnings (Case N)** – The intention of this section is to confirm that any payments for loss of future commission should be taxed as employment income in reference to the State where the duties that gave rise to the payments occurred. This approach is equitable and that the section is effective at achieving its aim.
13. **Partial retirement payments (Case C)**- The intention of the changes are to confirm that any payments made to an individual whilst they are no longer required to work but have not had their contract terminated should be taxable as employment income in the country they

would have worked. We believe that this approach is equitable and that the section is effective at achieving its aim.

Areas not covered by the changes

The proposed changes to the Commentary do not deal with the situation where someone receives an ex gratia payment under Case G in the appendix (i.e. a payment not made in reference to the contract of employment that is made purely at the discretion of the employer).

Under UK law a payment of this nature is fundamentally different to the payments referenced in section 5 as it is not a result of any legal or contractual requirement. At the moment we consider that payments of this nature do not fall under the terms of Article 15 as they are not specifically remuneration from employment so would be subject to the terms of Article 21 and this interpretation would not change under the updated Commentary. Therefore, we would suggest that a separate section is included in reference to payments of this nature to explicitly state that for the purposes of the interpretation of tax treaties they should not be treated as employment income.

In the UK it is relatively common for individuals to forgo their entitlement for contractual termination payments and receive employer contributions to their pension scheme instead. We feel this scenario should be covered by the Commentary (Case J in the appendix). We would suggest that the Commentary specifies that any such payments to a pension scheme are considered under Article 18 as opposed to Article 15.

Other comments

Broadly the proposed changes to the Commentary appear to achieve the aim of reducing the scope for double taxation by making it clear which country has the primary right to taxation. However, it does not, and cannot, deal with the differences between treatments of termination payments under domestic legislation. As a result, cases of non taxation will continue (and should continue) where the country allocated the taxing rights specifically exempts certain payments under domestic legislation, and the proposed amendments to the Commentary will not completely remove the risk of non-taxation.

KPMG values the opportunity to be part of this discussion and we share the aims of equitable tax treatment in relation to these complex cross-border transactions. If you would like to discuss any of the points raised in our letter please contact either Steve Wade (+44 20 7311 2220) or Neal Smith (+44 20 7311 3882).

Yours faithfully

Steve Wade
Director, KPMG LLP

Appendix

- A. Contractual remuneration for previous work** – Payments in respect of prior duties under the contract of employment – taxed as employment income in the UK.
- B. Payments for unused holiday pay/sick leave** – Payments in respect of unused contractual entitlement - taxed as employment income in the UK.
- C. Payments whilst on “Gardening Leave”** – Salary and other amounts (e.g. continuing benefits or pension contributions) paid to an individual while they are serving their notice period but not required to attend work - taxed as employment income in the UK.
- D. Contractual payments in lieu of notice** – Payments made to an individual under the terms of their contract for their contract being terminated without serving notice – taxed as employment income in the UK.
- E. Non-contractual payments in lieu of notice** – Payments made to the individual to compensate for them for their contract being breached and not receiving their entitled notice period – on the basis this payment relates to a breach of contract (rather than the exercising of a discretionary term within the employment contract), it is not taxed as employment income but instead taxed under section 401 ITEPA 2003.
- F. Payments for breach of contract** – Payments made when an individual’s contract is breached (e.g. wrongful dismissal) – income is taxed under section 401 ITEPA 2003.
- G. “Ex-gratia” payments** – Payment made to an individual not in reference to their employment contact (e.g. a payment made to ensure lasting goodwill of the employee to their ex employer) - income is taxed under section 401 ITEPA 2003.
- H. Statutory redundancy pay** – Payments which are legally required to be paid to an individual when an employee’s role is made redundant, the extent of the payment is dependent of the period of service prior to redundancy – income taxed under section 401 ITEPA 2003 subject to a limited exemption from tax under section 309 ITEPA 2003.
- I. Payments in respect of restrictive covenants** – Payments made to an individual in exchange for a new agreement to restrict their activity after their termination (examples would include not setting up a competing business for a period of time) – Payments of this nature are taxed as employment income under section 225 ITEPA 2003.
- J. Employer payments to a pension scheme on termination** – Payments made by the employer to a qualifying pension scheme. This is often made in exchange for the employer forgoing rights to other termination payments – Generally exempt from taxation.

- K. Equity compensation** – Awards of equity (or options to acquire equity) in relation to the period employment - taxed as employment income in the UK.
- L. Continuing entitlement to receive earnings or benefits** – Ongoing benefits following termination such as continuing life assurance, medical cover, etc – benefits and payments are taxed as employment income in the period that the employment ceases.
- M. Compensation for loss of earnings on or after termination following injury or disability** – Normally exempt from tax in the UK but dependent of the exact nature of the payment.
- N. Compensation for loss of future earnings** – Commonly referred to as a Payment in Lieu of Remuneration (or PILOR), this is taxed in the UK as employment income.