OECD MODEL TAX CONVENTION: COMMENTS ON DISCUSSION DRAFT TAX TREATY TREATMENT OF TERMINATION PAYMENTS

SECTION 3: PAYMENT IN LIEU OF NOTICE OF TERMINATION

Paragraph 11

According to UK caselaw, a payment in lieu of notice ("PILON") provided for in the employment contract is not remuneration for the duties which the employee would have performed during the notice period if notice had been given. Rather, it is the security which the employee requires, as an inducement to enter into the employment contract, that his salary will continue for a period after the termination. The employee does not require this security "because he wants to continue working while he finds alternative employment; it is because he wants to continue being paid while he finds alternative employment" (*EMI Group Electronics Ltd v Coldicott* [1999] STC 803).

According to UK caselaw, a contractual PILON constitutes "remuneration in respect of an employment" for double tax treaty purposes (*Squirrel v HMRC* [2005] STC (SCD) 717). This is consistent with the finding in *EMI Group Electronics Ltd* that a contractual PILON is "continued salary". However, according to *EMI Group Electronics Ltd*, it is not remuneration which for double tax treaty purposes "derives from the exercise of the employment" in the contracting state in which the employee would have performed the duties of the employment if notice had been given.

A simple example shows that this is the right answer. Suppose that a UK-resident employee has worked for many years in the UK. In the summer of 2012 the UK employer agrees with the employee that he will be transferred on 1 January 2013 to the employer's French branch. However, on 31 December 2012, the employer terminates the employee's employment forthwith and pays him a 3 month PILON, as provided in his contract of employment. It would be most odd (and, indeed, wholly counterfactual) if the UK/France double tax treaty applied on the basis that the contractual PILON was "remuneration deriving from the exercise of the employment" in France. The fact that France might not tax the contractual PILON does not detract from, indeed rather reinforces, the illogicality of regarding the payment as having a French source.

Accordingly, a contractual PILON derives from the employment for double tax treaty purposes but does not derive from the *exercise* of the employment during the notice period (because the employment is not exercised at all during that period). It is one of those payments that arise from time to time under employment contracts which are remuneration for *being* an employee but not for *performing* any particular duties in any particular contracting state. Strictly, therefore, a contractual PILON payment should be taxed only in the residence state. However, contrary to the proposal in para 11 of the Discussion Draft, it would, in our view, be more rational and consistent with the principles underlying article 15 if, absent facts and circumstances indicating otherwise, a contractual PILON was considered to be remuneration derived from the exercise of the employment (i) at the time of the termination of employment (ie when the right to receive the PILON arises), and (ii) in the contracting state in which the employment was exercised at that time. This will give the right answer, in particular, in a case where an employee is due to be transferred by his employer to a different contracting state but, just before his transfer, the employee's employment is terminated without notice.

SECTION 5: PAYMENT OF DAMAGES FOR UNLAWFUL DISMISSAL

Paragraph 18

According to UK caselaw, a payment of damages for unlawful dismissal which reflects lost earnings and is, therefore, calculated in the same way as a contractual PILON constitutes "remuneration in respect of an employment" for double tax treaty purposes (*Squirrel v HMRC* [2005] STC (SCD) 717). However, as in the case of a contractual PILON, it is not remuneration which for double tax treaty purposes "derives from the exercise of the employment" in the contracting state in which the employee would have performed the duties of the employment if notice had been given. The payment is compensation for breach of the employee's legal rights and cannot conceivably be regarded as remuneration for duties which the employee could have, but did not, perform.

Accordingly, to the extent that it reflects lost earnings, a payment of damages for unlawful dismissal derives from the employment for double tax treaty purposes but does not derive from the *exercise* of the employment during the period for which notice should have been, but was not, given (because the employment is not exercised at all during that period) or, indeed, from the *exercise* of any duties at all. Strictly, therefore, such damages should be taxed only in the residence state. However, contrary to the proposal in para 18 of the Discussion Draft, it would, in our view, be more rational and consistent with the principles underlying article 15 if, absent facts and circumstances indicating otherwise, a payment of damages for unlawful dismissal reflecting lost earnings was considered to be remuneration derived from the exercise of the employment (i) at the time of the termination of employment (ie when the right to receive the damages arises), and (ii) in the contracting state in which the employment was exercised at that time. This will give the right answer, in particular, in a case where an employee is due to be transferred by his employer to a different contracting state but, just before his transfer, the employee's employment is unlawfully terminated.

SECTION 6: NON-COMPETITION PAYMENTS

Paragraph 21

According to UK caselaw, a payment in consideration of a non-compete covenant constitutes "remuneration in respect of an employment" for double tax treaty purposes (cf *Squirrel v HMRC* [2005] STC (SCD) 717). However, it is a payment for giving up a valuable legal right and cannot conceivably be regarded as remuneration for either for the duties of the employment which the employee actually performs or remuneration for the duties which the employee could have, but did not, perform during the non-compete period (*Beak v Robson* 25 TC 33). It is not, therefore, remuneration which for double tax treaty purposes "derives from the exercise of the employment".

Strictly, therefore, a non-compete payment should be taxed only in the residence state. However, in view of the approach which we support in relation to contractual PILONs and damages for unlawful dismissal (neither of which constitute remuneration for performing any particular duties in any particular contracting state), it would, in our view, be consistent with the principles underlying article 15 if, absent facts and circumstances indicating otherwise, a non-compete payment was considered to be remuneration derived from the exercise of the employment (i) at the time when the non-compete covenant was entered into (ie when the right to receive the payment arises and regardless of when the employment terminates and when the payment is actually made), and (ii) in the contracting state in which the employment was exercised at that time. If the covenant is entered into shortly before employment starts or shortly after it ends, it should be regarded as entered into just after the employment starts or, as the case may be, just before it ends.

SECTION 7: PAYMENTS RELATED TO PENSION RIGHTS

Paragraph 25

In our view, contrary to the proposal in para 25 of the Discussion Draft, a reimbursement of pension contributions after temporary employment should be regarded, absent facts and circumstances indicating otherwise, as derived from the exercise of the employment (i) in the years in which the contributions were made, and (ii) in the contracting state or states in which the employment was exercised in those years.

Take, for example, an employee who is employed in the UK for two years, is transferred to France for one year and contributes £1,000 each year to his employer's pension scheme. He resigns at the end of the third year and his pension contributions are returned to him. We believe that his receipt of £3,000 at the beginning of the fourth year should be regarded as deriving, as to two thirds, from the exercise of his employment in the UK and, as to one third, from the exercise of his employment in France.

SECTION 11: TERMINATION FOLLOWING INJURY OR DISABILITY

Paragraph 37

We agree with the proposal in para 37 of the Discussion Draft that, if a contracting state taxes as employment income post-termination contractual payments in respect of sickness or injury, the

payments should be regarded, absent facts and circumstances indicating otherwise, as derived from the exercise of the employment (i) at the time when it was terminated (and when, therefore, the obligation to make the payments arose), and (ii) in the contracting state in which the employment was exercised at that time. We feel this is consistent with our above recommendations in relation to contractual PILONs and damages for unlawful dismissal.

SECTION 13: PARTIAL RETIREMENT PAYMENTS

Paragraph 44

We believe, contrary to the proposal in para 25 of the Discussion Draft, that payments of salary for a period during which the employee is not required to work but his employment subsists (eg partial retirement or gardening leave) should be dealt with according to our recommendation in relation to contractual PILONs. (We assume that the employee is not "on call" or liable to be consulted during the period.)

It is wrong in principle to regard remuneration as deriving from the performance of duties which the employee could have, but did not, perform. A simple example similar to the one we used in relation to contractual PILONs shows that regarding the remuneration as deriving from non-existent duties does not give the right answer. Suppose that a UK-resident employee has worked for many years in the UK. In the summer of 2012 the UK employer agrees with the employee that he will be transferred on 1 January 2013 to the employer's French branch. However, in late December 2012, the employee applies for, and is granted, immediate partial retirement on terms that his salary will continue to be paid for 6 months. It would be most odd (and, indeed, wholly counterfactual) if the UK/France double tax treaty applied on the basis that the PILON was "remuneration deriving from the exercise of the employment" in France.

10 September 2013