Cross-border

Jonathan Schwarz on the proposed changes laid out in the recent OECD discussion draft to Article 15

KEY POINTS

- In June the OECD released a discussion draft examining termination of payments for tax treaty purposes
- OECD wants to change Article 15, giving the taxing right to the state where employment is exercised
- Article interpretation favours exclusive residence state taxation, leading to over-complexity for most cases

Tax treaties are designed primarily to prevent double taxation. They do so by allocating the right to tax items of income or gain either to the country of residence of the taxpayer or to the country of source of the income or gain. In relation to employment income most treaties that follow the OECD or United Nations model double taxation conventions, Article 15, give the country of residence of the employee the exclusive right to tax income from employment. By way of exception, the country where the employment is exercised (if different from the country of residence) is also entitled to tax the income. Where both countries tax the income, the residence state must give credit for tax paid in the source state or exempt the income derived from the source state.

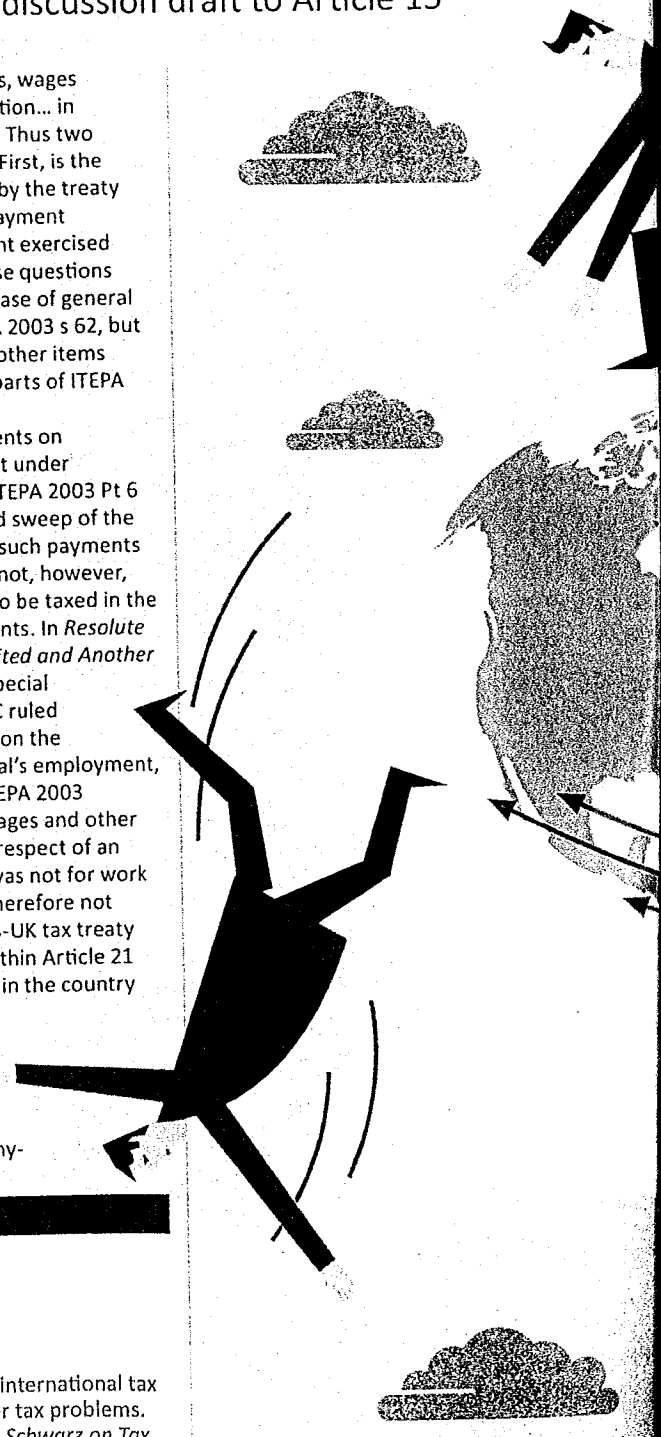
UK domestic law at its simplest complies with these international norms: UK residents are liable to tax on earnings from employment regardless of where the work is exercised (ITEPA 2003 s 15). Non-residents are liable to tax on earnings from employment where the duties are performed in the UK (ITEPA 2003 s 27). UK residents are entitled to credit for any foreign income tax they pay in respect of duties performed abroad (TIOPA 2010 s 18). If only tax were that simple!

Most treaties provide an additional exemption from taxation in the source country for employees who spend fewer than 183 days in any 12-month period in that country. This exemption is conditional on either the remuneration not being paid by or on behalf of a resident of the source country or not being borne by a permanent establishment there.

Article 15 covers 'salaries, wages and other similar remuneration... in respect of an employment'. Thus two questions frequently arise. First, is the payment of a kind covered by the treaty article and second, is the payment connected with employment exercised in the source country? These questions are not too difficult in the case of general earnings taxed under ITEPA 2003 s 62, but may be challenging where other items taxable under the various parts of ITEPA are engaged.

The treatment of payments on termination of employment under domestic law, centred on ITEPA 2003 Pt 6 Ch 3, is complex. The broad sweep of the legislation is to treat most such payments as taxable. Tax treaties do not, however, permit all such payments to be taxed in the hands of treaty non-residents. In *Resolute Management Services Limited and Another v HMRC* [2008] SpC 710, Special Commissioner Gammie QC ruled that an *ex gratia* payment on the termination of an individual's employment, although taxable under ITEPA 2003 s 401, was not 'salaries, wages and other similar remuneration... in respect of an employment' because it was not for work done. The payment was therefore not within Article 15 of the US-UK tax treaty but was 'other income' within Article 21 and, as such, taxable only in the country of residence.

On 8 November 2011, Germany and the UK signed a memorandum of understanding on the application of the Germany-



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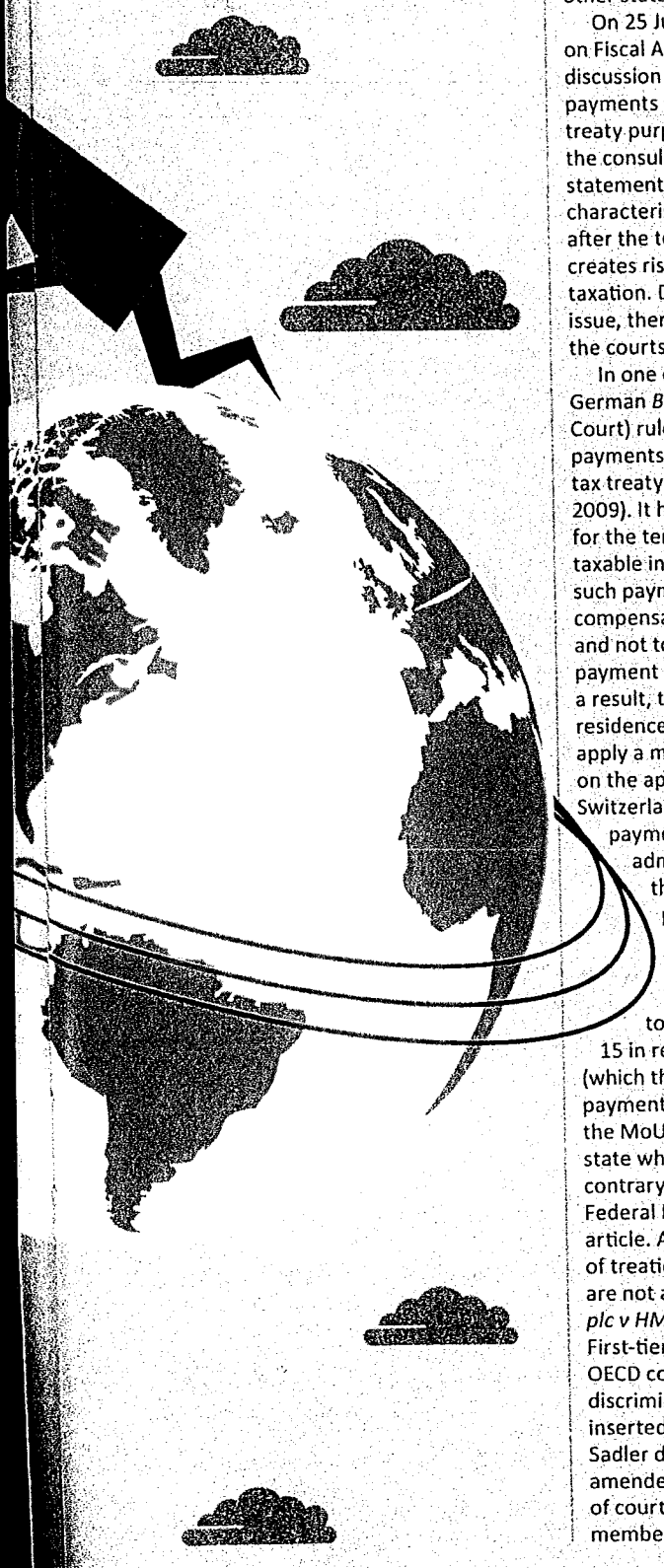
Profile Jonathan's practice as a barrister focuses on international tax disputes as counsel and as an expert and advice on solving cross-border tax problems. He is also a South African advocate and a Canadian barrister. His books *Schwarz on Tax Treaties* 3rd edition and *Booth and Schwarz: Residence, Domicile and UK Taxation* 17th edition, have just been published. He is a visiting Professor at the Dickson Poon School of Law, King's College London.

payments



UK tax treaty to termination payments. Germany has signed similar MoUs with other states.

On 25 June 2013, the OECD Committee on Fiscal Affairs released a public discussion draft on how termination payments should be treated for tax treaty purposes. No reason is given for the consultation apart from the generic statement that inconsistent treaty characterisation of payments received after the termination of employment creates risks of double taxation and non-taxation. Despite the complexity of the issue, there have been few cases before the courts on the subject.

In one of the few reported cases, the German *Bundesfinanzhof* (Federal Financial Court) ruled on the taxation of severance payments under the Germany-Switzerland tax treaty (IR 111/08 of 2 September 2009). It held that severance payments for the termination of employment are taxable in the state of residence only as such payments are to be considered a compensation for the loss of employment and not to be qualified as an additional payment for previously exercised. As a result, they were only taxable in the residence country. The court refused to apply a memorandum of understanding on the application of the Germany-Switzerland tax treaty to termination payments concluded by the two tax administrations, to the effect that the taxation right for severance payments is generally allocated to the state where the employment was exercised.

The OECD proposes changes to the commentary on Article 15 in relation to severance payments (which they also describe as 'redundancy payments') adhering to the approach in the MoUs of giving the taxing right to the state where employment is exercised, and contrary to the decision of the German Federal Financial Court interpreting that article. Attempts to change the meaning of treaties through amended commentary are not always successful. In *FCE Bank plc v HMRC* [2010] UKFTT 136 (TC), the First-tier Tribunal refused to follow the OECD commentary to Article 24 (Non-discrimination) of the OECD Model Treaty inserted in 2008. Judges Avery Jones and Sadler disapproved arguments in the amended commentary particularly in light of court decisions to the contrary in OECD member countries.

Changes to the commentary are proposed on 12 other aspects. Some are less controversial, such as associating remuneration for previous work and payment for unused holidays or sick leave and deferred remuneration with the state in which the employment is exercised. A problem arises in the context of circumstances where individuals are paid for not working: in ordinary language, employment is not exercised by a person who does not work. This suggests that payments *in lieu* of notice of termination and non-compete payments would be taxable in the residence state only. However, it is proposed that PILONs be taxed in the country where the individual would have worked if they had worked out their notice. On the other hand, genuine non-compete payments are clearly recognised as not remuneration for employment and outside Article 15.

Other topics examined include payment of damages for unlawful dismissal, payment related to pension rights, payment under an incentive compensation arrangement, fringe benefits for the period after employment, compensation for loss of earnings on or after termination following injury or disability, compensation for loss of future commissions and partial retirement payments. *Ex gratia* payments are not considered. The discussion draft recognises explicitly that the treatment of various kinds of payment will depend on the legal and factual context in which a particular payment is made. This acknowledgement, while entirely appropriate, calls into question the necessity for such a lengthy expansion of the commentary when a case-by-case examination will often be required.

The proposals are disappointing because they miss the wood for the trees. While focusing in detail on particular kinds of payment, the drafters 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 article 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 majority of cases modest amounts involved will not justify the complexity and record-keeping required to demonstrate where a particular ingredient of a payment is taxable.