OECD – Model Convention Update on Termination Payments
by KPMG LLP’s Washington National Tax practice, Washington, D.C. (KPMG LLP in the United States is a KPMG International member firm)

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The Organization for Economic Cooperation and Development (OECD) has issued an update to the Model Tax Convention that includes new commentary on the cross-border tax treatment of termination payments in an attempt to clarify how these payments should be taxed, including which country has the taxing right. While there are currently extensive comments under Article 15 of the OECD Model Convention, these comments only relate to pensions or similar payments. Previously, the commentary was silent regarding the range of termination payments. The new commentary is meant to correct the prior lack of guidance.

Why This Matters
For many years, there has been little international agreement on what constitutes severance or termination payments. As a result, the proper tax treatment of severance in a cross-border context has been murky – sometimes cross-border workers have been double-taxed and sometimes these payments have not been taxed at all. Home and host countries oftentimes have conflicting approaches regarding the assignment of taxing rights, even where a treaty is in place. The OECD’s new commentary on Article 15 should help clarify for employers, employees, tax practitioners, tax authorities, and treaty negotiators, the ambiguity that has characterized the tax treatment of and taxing rights over termination payments in a cross-border context.

(About the same time as the announcement for the update to Model Tax Convention came out, the OECD’s Centre for Tax Policy and Administration released Working Paper No. 20, Personal Tax Treatment of Company Cars and Commuting Expenses. The 50-page paper describes the personal tax treatment of the benefits associated with personal use of a company car and of commuting expenses in 27 OECD countries and one partner country. We highlight this briefly on page 3.)

Treaty Treatment of Termination Payments, Article 15
The OECD announced on July 16, 2014, the 2014 update to the OECD Model Tax Convention. The update, which will be incorporated in a revised version of the Model Tax Convention that will be published in the next few months, includes commentary on how to tax termination payments in a cross-border situation. The announcement followed approval of the update by the OECD Council and prior approval by the Committee on Fiscal Affairs on June 26.

An important area – in an international assignment context – which the update addresses is the tax treaty treatment of termination payments, under Article 15, with a view to helping correct the issues of double taxation or non-taxation, prevalent in the previous application of the Model Convention in this area.
Background

On June 25, 2013, the OECD released a Discussion Draft which included proposed commentary on the treatment of tax treaty termination payments received by employees who exercise employment activities in different countries. The discussion draft was intended to critically examine and understand how and by what state these payments are taxed and offer proposals that would help achieve consistency and clarity, especially when treating such payments under a treaty situation. (For prior coverage, see Flash International Executive Alert 2013-110, 6 August 2013.) While up to that point extensive comments existed under Article 18, the comments generally only related to pensions or payments of a similar kind. However, the commentary regarding the range of termination payments, housed under Article 15, was silent. The new commentary on termination payments was formulated to correct the aforementioned lack of guidance.

Many interested parties and organizations were invited to submit comments communicating their practices, interpretations, and opinions regarding the issues. These comments and responses were then examined by Working Party I in their September 2013 and February 2014 meetings. The Working Party formulated and proposed a final version of commentary with the aim of bringing clarity and consistency to the treatment of a wide-range of termination payments in a cross-border context where tax treaty provisions applied, including compensation from accumulated holiday and sick days, damages awards granted for improper termination or breach of employee contract, and non-competition payments.

The Working Committee’s proposed suggestions were adopted by the OECD and included within the official Commentary under Articles 15 and 18 of the OECD Model Tax Convention. The commentary is the OECD’s attempt to correct the issues of double taxation or non-taxation, prevalent in the previous application of the Articles.

New Aspects of Commentary for Termination Payments under Article 15

Below is a brief and partial summary of the updated commentary regarding Article 15.

- The Working Party agreed that salaries, wages, or other similar remuneration, such as bonuses for the last period of work or commissions for sales made during that period, should be considered sourced where the employee carried on the relevant work which gave rise to the remuneration.
- In order to escape double taxation, payments with respect to unused holidays/sick days look to the state’s domestic tax law for the former employee to assess if he/she was taxed on an accrual basis. If they were not so taxed, then they are considered a benefit received in the final period of employment.
  - Rebuttable presumption that payments for unused holidays or sick days is attributed to the last period of employment, with the possibility to demonstrate that some of the holidays or sick days were attributed to previous years of employment.
- Non-competition payments usually will be taxable only in the state where the recipient resides during the period covered by the payment, since these types of payments do not usually derive from employment activities performed before the termination of employment.
**KPMG Note**

The new commentary offers a framework for defining termination payments and determining how they should be treated in accordance with the source of the underlying obligation. In other words, where the obligation arises in a specific period or based on specific work performed before termination, generally the termination-related payment should be sourced to the corresponding state when the obligation arose.

The new commentary to Article 15 discusses how such termination payments are to be treated for tax purposes by countries party to a treaty. This should provide useful guidance for treaty negotiators and tax practitioners/authorities, and ultimately help clarify matters for employees and their employers.

**Next Steps**

The OECD Council approved the proposed commentary as part of the 2014 Update, on July 15, 2014. The Update will be incorporated into the Commentary in the OECD Model Tax Convention with a revised version to be printed in the upcoming months.

**Personal Tax Treatment of Company Cars and Commuting Expenses**

On July 11, 2014, the OECD’s Centre for Tax Policy and Administration released Working Paper No. 20, *Personal Tax Treatment of Company Cars and Commuting Expenses*. The 50-page paper describes the personal tax treatment of (1) the benefits associated with personal use of a company car and (2) commuting expenses, in 27 OECD countries and one partner country, South Africa. The paper examines the fiscal costs and the environmental impact of the tax treatment of company cars and commuting.

The paper looks at the employer provision of company cars and the different ways the countries included in the study value and tax the benefit arising to employees who use the car for personal as well as business purposes. Interestingly, some countries, such as Hungary and Mexico, do not tax personal use of a company car although taxation may apply at the employer level, and may be based on the value of the car, the cylinder capacity of the car, etc.

**KPMG Note**

The provision of a company car – and to a lesser extent, preferential treatment of commuting expenses – can be an important boost to an individual’s compensation. The Working Paper is not an official view of the OECD and there is no indication, at this time, that the OECD is preparing any additional changes to the OECD Model Convention, which was just updated. However because of the potentially large gains, fiscally and environmentally, that could accrue by modulating/reforming the largely preferential taxation of company cars and commuting expenses, the suggested changes may be proposed for adoption in the future.

**Next Steps**

Anyone wishing to comment on the Working Paper has been invited to do so. Comments should be sent to the Centre for Tax Policy and Administration, OECD, 2 rue Andre-Pascal, 75775 Paris Cedex 16, France, or e-mailed to <ctp.contact@oecd.org>.
Footnotes:


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