

**Tax treatment of severance payments  
made in a cross-border context –**

**Swiss perspective**

by

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## **I. Introduction**

### **1. Objective of the paper**

It is now clear to most of us that, following the financial crisis and its predictable consequences on the reduction of workforces, the issue of redundancy payments is gaining more importance than ever. Considering the fact that amounts at stake can be important, the question of how such severance payments will be taxed is crucial before any deal is made between employer and employee.

Of course, employees' international mobility nowadays being a common standard, its consequences on the tax treatment of redundancy payments have to be scrutinized, in order to avoid double taxation or double non taxation. Further, knowing that an increasing amount of employees close to retirement age are also being made redundant, it is necessary to analyze what, if any, impact this may have on the tax treatment of their sometimes substantial severance payments.

Questions such as:

- how and under what provisions of the OECD Model Convention such payments should be qualified;
- which state has the taxing rights on a severance payment in case of migration from one country to another, before or after the payment;

- whether there should be an allocation between different States in case of an international career within the same company or group of companies;

are of utmost importance for the persons involved, knowing that some States have a preferential tax treatment of severance payments, while others wish to limit golden handshakes i.a. by tax means.

The OECD's Committee for Fiscal Affairs made no mistake in recognizing the importance of these questions by issuing a discussion draft on the tax treaty treatment of termination payments, leading to additions and amendments to the Commentary on articles 15 and 18 of the OECD Model tax Convention which are now reflected in the 2014 update to the OECD Model Convention.

The next chapter (Part II) will deal with the tax treaty treatment of severance payments given in relation to private employment made in cross-border situations. Their classification under the OECD Model Convention will be analyzed in its articles 15, 16, 18 and 21, article 19 not being addressed in this paper. We will firstly examine whether any guidance could be found in the Commentary up till 2014 and what clarifications have been given by scholars, and secondly what interpretation has been given by national Courts dealing with the question of the qualification and allocation of cross-border severance payments. Consequently, we will highlight the new developments of the 2014 update to Commentary on article 15 OECD Model Convention, and assess its strengths and shortcomings.

The following chapter (Part III) will deal with some selected issues relating to severance payments from a Swiss perspective. In a first subchapter, we will give a brief overview of the tax treatment of severance payments in domestic law, being understood that only the Federal Direct Tax Law (FDTL) will be examined. Consequences in cross-border situations from the Swiss point of view will then be examined.

The scope of the paper will be limited to the examination of the tax treatment of severance payments from an individual income tax point of view under the OECD MC only. Further, social security issues will not be addressed, nor will European case law be examined in this context.

## 2. Definition of severance payment

The definition commonly given to such payments is “money paid in compensation to one whose contractual employment is terminated”<sup>1</sup>.

No definition of severance payments is given in the OECD MC, nor, generally, in existing double tax treaties. Therefore, for the purpose of applying a DTC, States will have to apply art. 3(2) OECD MC and, unless the context otherwise requires, refer to the meaning the term has under its domestic law, the meaning in its tax laws prevailing. One of the difficulties in this approach is that many States just tax severance payments in some way, without defining the term under one of the OECD MC articles. This is likely to lead to qualification conflicts and to cases of double taxation or double non-taxation.<sup>2</sup>

The 2014 Update now gives some definition of a severance payment in para. 2.7 of the Commentary ad art. 15: “(...) severance payment (also referred to as a “redundant payment”) which an employer is required (by law or by contract) to make to an employee whose employment has been terminated. Such a payment is often, but not always, calculated by reference to the period of past employment with the employer”.

It is also often the case that, when a dismissed employee receives a “severance payment”, this payment actually is a real package which may include several types of payments, which all possibly have different tax treatments, like e.g. accrued holiday, gardening leave, damages, an indemnity for long period of employment, a compensation for loss of employment... Identification of the various components may sometimes turn out to be a complex issue.

For the purpose of this paper, the definition of a severance payment will include the following payments made by an employer:

- payment in lieu of a required notice period (PILON), i.e. a compensation for termination of employment in breach of a statutory or contractual obligation to respect a notice period;

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<sup>1</sup> Oxford English Dictionary <http://www.oed.com/view/Entry/176922?redirectedFrom=severance+#eid23473059>

<sup>2</sup> URBÁSEK TOMÁS, Severance payments and golden handshakes under DTC law in LANG MICHAEL, HOHENWARTER DANIELA AND METZLER VANESSA (EDS.), Taxation of employment income in international tax law, Vienna 2009, p. 490 (hereafter URBÁSEK).

- an additional payment based on criteria which need to be agreed on between employer and employee<sup>3</sup> (“other severance payments”);
- a payment made as a “bridge” between the end of employment and ordinary retirement age.<sup>4</sup>

On the other hand, for the purpose of narrowing the scope of this paper, it will e.g. not include damages for unlawful dismissal or relief of distress, payment for unused vacation, or non-competition payments.

## **II. International tax treatment of severance payments**

The questions which arise in this context are the following:

- how is a severance payment to be qualified: income from employment (art. 15 OECD MC) or Directors’ fees (art. 16 OECD MC), income from pensions (art. 18 OECD MC), or other income (art. 21 OECD MC)?
- should the taxation of severance payments paid in a cross-border context be allocated between Residence and Source State, and if so, on what basis?

### **1. OECD Model Convention: 2010-2012 version**

#### **A. Qualification of severance payments**

##### **a) Article 15 OECD MC**

Art. 15(1) OECD MC gives exclusive taxation rights of “salaries, wages and other similar remuneration derived (...) in respect of an employment” to the Residence State, unless employment is exercised in another State. In this case, such income as is derived from such exercise may be taxed in the Source State.

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<sup>3</sup> Such criteria might e.g. be the employee’s previous salary level, his length of employment with the same employer or with the same group, his position achieved, the probability he will find a new position, the remaining period until retirement, etc. See URBÁSEK p. 504

<sup>4</sup> [http://en.wikipedia.org/wiki/Severance\\_package](http://en.wikipedia.org/wiki/Severance_package), October 19, 2014; URBÁSEK p. 488.

It is further to be noted that arts. 16, 18 and 19 OECD MC represent *leges speciales* with respect to art. 15 OECD MC<sup>5</sup>, which does consequently not apply to Directors' fees, pensions and remuneration from government service<sup>6</sup>. To the extent that jurisdictions consider that art. 15 OECD MC constitutes a "closed system" with respect to arts 16 to 20 OECD MC, all "salaries, wages and other similar remuneration derived (...) in respect of an employment" that do not fall under arts. 16 to 20 OECD MC, automatically are covered by art. 15 OECD MC, and not by art. 21 OECD MC<sup>7</sup>.

Since the terms "salaries, wages and other similar remuneration" are not defined in the OECD MC, the interpretation rules given by the OECD MC itself under art 3(2) need to be applied, i.e. the terms will have the meaning they have under the law of the State applying the Convention, unless the context otherwise requires. All that can be concluded from the wording of "other similar remuneration", is that a broad interpretation can be given to the terms "salaries, wages and other similar remuneration"<sup>8</sup>.

The Commentary to art. 15 OECD MC does not give much more guidance, only indicating in its paragraph 2.1 that those terms "include benefits in kind received in respect of an employment", thereby confirming the broad interpretation of these terms<sup>9</sup>.

It seems that the broad interpretation has been used in several Court cases to consider severance pays as falling under the terms "salaries, wages and other similar remuneration", thereby justifying the application of art. 15 to such pays (see below).

However, interpretation by reference to domestic law in itself bears the risk of potential qualification conflicts between Residence and Source State, leading to cases of double taxation or double non-taxation. In principle, double taxation and double non-taxation can be avoided by the application of the rules

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<sup>5</sup> PEETERS BERNARD, Article 15 paragraphe 1 MC OCDE in *Modèle de Convention fiscale OCDE concernant le revenu et la fortune*, DANON ROBERT J.; OBERSON XAVIER; PISTONE PASQUALE; GUTMANN DANIEL (Eds) Basel, 2013, p. 511 (hereafter PEETERS, Article 15 paragraphe 1 MC OCDE).

<sup>6</sup> PÖTGENS FRANK, *Income from International Private Employment: An analysis of Article 15 of the OECD Model*, Doctoral Series, No. 12, Amsterdam, 2006, p. 119 (hereafter PÖTGENS, *Income*).

<sup>7</sup> PEETERS, Article 15 paragraphe 1 MC OCDE, p. 515 ; PÖTGENS, *Income*, p. 119, p. 140.

<sup>8</sup> PEETERS, Article 15 paragraphe 1 MC OCDE, p. 516

<sup>9</sup> *Ibid.*

laid down in the Commentary at para. 32.3 ff ad art 23 A and B, whereby the Residence State will follow the qualification given by the Source State.

“Salaries, wages and other similar remuneration” need to be derived “in respect of an employment”. It can be argued that “in respect of employment” is to be interpreted broadly, thereby also including income when no work is performed<sup>10</sup>. What is clear is that the remuneration must be “caused” by the employment and that there must be a connection between income and employment. The difficulty will more lie in the term “employment” which is again not defined in the OECD MC, and we should again refer to the interpretation rules of art. 3(2) OECD MC thus giving to the term “employment” the meaning it has in respective domestic laws, unless the context otherwise requires<sup>11</sup>.

In this case, it is nevertheless possible to refer to the Commentary which provides for some guidance on the term “employer”, given the fact that an employment relationship by definition requires an employer – employee relationship, though not necessarily the formal employer<sup>12</sup>. It is also clear from the Commentary that art. 15 applies irrespective of the time of payment, i.e. even if payment is made after the relevant work period, as long as there is a clear connection between payment and services provided by the employee<sup>13</sup>. Such guidance seems to be particularly relevant to severance payments.

However, even with this – indirect – guidance in the Commentary, referring to the domestic law meanings of the term “employment” again will give rise to potential qualification conflicts between States. Such conflicts are even more probable with respect to special remuneration, like severance pays, which are sometimes paid when no activity is exercised or is even not allowed (e.g. non-competition payments)<sup>14</sup>.

Summarizing, at this stage and given the broad interpretation to be given to the wording “salaries, wages and other similar remuneration” in art. 15 OECD

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<sup>10</sup> PRASCHL GISELA, Article 15 of the OECD Model Tax Convention on Income from Employment – Income from employment and attribution of the right to tax, in *Source Versus Residence in International Tax Law*, AIGNER HANS-JÖRGEN; LOUKOTA WALTER (Eds), Vienna 2005, p.221. This author contends that this can be derived from the fact that otherwise the term “in exchange for” would have been used, which would suggest a “purely reciprocal character of the payment”.

<sup>11</sup> DANON ROBERT, La notion d’employeur au sens de l’art. 15(2)(b) MC OCDE. Analyse critique du commentaire OCDE et impact sur les CDI suisses, IFF Forum für Steuerrecht 2012, p. 95

<sup>12</sup> Para. 8 ff. ad article 15; PEETERS, Article 15 paragraphe 1 MC OCDE, p. 524

<sup>13</sup> Para. 2.2 ad article 15

<sup>14</sup> Ibid.



MC, and on the basis of the modest guidance given by the Commentary, it appears to us that PILON's are covered by the terms "salaries, wages and other similar remuneration derived (...) in respect of an employment". In this case, there appears to be a clear link between payment and employment<sup>15</sup>. Further, the employee receiving such payment will just be put in the same financial situation as if he had received salary during the period of notice that would have been given<sup>16</sup>. Consequently, because of the closed system of art. 15, as long as such payments made in relation with a private employment are not made to members of a Board of Directors (art. 16 OECD MC), art. 15 would generally apply.

Other severance payments are also "caused" by the employment activity. If they further are calculated, like is often the case, on the basis of past employment history, they can also be considered as "salaries, wages and other similar remuneration". This view has even been supported when a severance was aimed at bridging a period until new employment would be found<sup>17</sup>. As such, these payments would be covered by art. 15 OECD MC. A possible relation with pension payments would nevertheless need to be examined.

As for the payment made as a "bridge" between the end of employment and ordinary retirement age, there appears to be a clear connection with retirement. Therefore, the applicability of art 18 OECD MC first has to be examined.

#### **b) Article 16 OECD MC**

Art. 16 provides for the primary taxation right of « Directors' fees and other similar payments » to the State of which the company is a resident.

The OECD MC again does not define the term "Directors' fees and other similar remuneration", therefore referring to the interpretation rule laid down in art. 3(2) OECD MC.

The Commentary ad art. 16 specifies, like for art. 15, that "the term fees and other similar payments" includes benefits in kind<sup>18</sup>. A broad interpretation of the term seems therefore also allowed, like for art. 15, within the limits though of remuneration paid to a Director *in his capacity as member of the Board*<sup>19</sup>.

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<sup>15</sup> PÖTGENS, Income p. 147

<sup>16</sup> PRASCHL GISELA, Article 15 of the OECD Model Tax Convention on Income from Employment – Income from employment and attribution of the right to tax, p.230

<sup>17</sup> URBÁSEK, p. 494

<sup>18</sup> Para. 1.1 ad art. 16

<sup>19</sup> Para. 2.2 ad art. 16 a contrario

However, leaving the question of qualification of a remuneration received by a Director to domestic law again in itself carries the risk to give rise to qualification conflicts, in particular where members of the Board of Directors also hold executive positions within a company.

Para. 3.1 of the Commentary explicitly mentions that when stock options are granted to members of the Board of Directors of a company, the Source State will have the right to tax the part of the stock option benefit which constitutes Directors' fees. The only limit laid down is that these stock options need to be granted to Directors in their capacity as a member of the Board.

No indication is however given in relation with taxation rights and the timing of the payment. The question whether payments made to Directors after their active time as member of the Board are also covered by art. 16 thus in principle remains open. However, considering the underlying ratio to art 16, i.e. give the taxation rights to the State having to bear the deduction of the payment from the corporate tax base<sup>20</sup>, it is not the time of payment which seems decisive<sup>21</sup>. To the extent severance payments are paid to Directors, application of art. 16 OECD MC is thus not per se excluded because the payment has been paid after termination of the Director's activity<sup>22</sup>.

Consequently, if severance payments are not considered to be falling under art. 21 OECD MC, applying para. 3.1 of the Commentary to other types of payments would mean that any payments, including severance pays, granted to Directors in their capacity of members of the Board can be considered to be falling under art. 16 OECD MC and to follow the same tax treatment as Directors' fees<sup>23</sup>.

The difficulty remains when Directors also hold an executive position: is the severance pay given in connection with their capacity as member of the Board, in which case art. 16 is likely to apply, or in connection with their executive

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<sup>20</sup> The same ratio does not support art. 15, where the physical presence test is determining.

<sup>21</sup> PROKISCH RAINER, Directors' Fees (Article 16 OECD Model Convention), in *Source versus Residence - Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, Lang Michael, Pistone Pasquale, Schuch Josef, Staringer Claus (Eds.), Alphen aan den Rijn 2008, p.206-207.

<sup>22</sup> PISTONE PASQUALE, Article 16 MC OCDE in *Modèle de Convention fiscale OCDE concernant le revenu et la fortune*, DANON, ROBERT J.; OBERSON, XAVIER; PISTONE, PASQUALE; GUTMANN, DANIEL (Eds) Basel 2013, p. 561

<sup>23</sup> URBÁSEK, P. 496; DE JAEGHER CHARLOTTE, *International Taxation of Directors' Fees : Article 16 of the OECD Model or How to Reconcile Disagreement among Neighbours*, *World Tax Journal*, June 2013, p. 249-250.

position, in which case art. 15 will possibly apply. Further, severance payments can indeed be calculated on several grounds, possibly taking into consideration the Director's activity as Board member, but also the executive functions performed. Applying the same logic as described above in relation with stock options would mean giving taxation rights to the resident State of the company on this part of the severance pay which constitutes Directors' fees because it is granted to an executive Director in his capacity as a member of the Board. It is in practice however difficult to determine what part of the severance payment to an executive Director should be considered as Director's fees and what part as ordinary remuneration. It is therefore to be recommended to make clear contractual arrangements that do reflect economic reality.

The question of delimitation of between art. 16 and 18 OECD MC is not likely to arise in case of severance payments paid to retiring Directors<sup>24</sup>. One of the reasons is that "non-executive directors, as a rule, will not have the right to receive a pension after their active time"<sup>25</sup>. This means that, if the question of the qualification of a severance pay as pension arises, the issue will be to determine whether the pay is to be considered as remuneration for an executive position (art. 15 OECD MC) or as pension (art. 18 OECD MC), not whether it is a Director's fee (art. 16 OECD MC) or a pension.

### **c) Article 18 OECD MC**

According to art. 18, "pensions and other similar remuneration in consideration of past (private) employment shall be taxable only" in the Residence State. Art. 18 already in its own terms refers to "past (private) employment; a demarcation from art. 15 is therefore obviously required, and particularly relevant in the context of severance payments paid at or close to retirement age.

It is worth noting that it is only in relation with art. 18 that the Commentary mentions "payments (...) made to an employee following cessation of employment". Whether or not such payments fall under the Article will be determined by the *nature* of the payments, having regard to the *facts and circumstances in which they are made*<sup>26</sup>. In our opinion, it can be inferred from the

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<sup>24</sup> Unlike the delimitation between art. 15 and 18 OECD MC in case of severance pays to employees close to retirement age.

<sup>25</sup> PROKISCH RAINER, *Directors' Fees* (Article 16 OECD Model Convention), p. 207

<sup>26</sup> Para. 4 ad art. 18.

terms that the nature of the payment should be of a “pension-like” nature, in the meaning of meeting financial needs linked to old-age, disability or death<sup>27</sup>.

Further guidance is given in the following paragraphs. Para. 5 confirms a broad interpretation has to be given to the words “other similar remuneration”, which may include “a lump-sum payment *in lieu of* periodic pension payments that is made *on or after cessation* of employment”.

The question might here be raised whether a lump-sum payment made by an employer at cessation of employment, which is intended to increase pension rights of the employee by covering an existing pension gap, would fall under this definition. A clear argument in favour of this view would be that in para. 6, the Commentary itself provides that a demarcation between art. 15 and 18 is a question of fact, and that “For example, if it is shown that the consideration for the payment is the (...) compensation of a reduced pension, then the payment may be characterised as other similar remuneration falling under the Article”.

On the other hand, “the *source* of the payment is an important factor; payments made from a pension scheme would normally be covered by the Article”. Therefore, the wording does in our opinion not per se exclude payments made by other entities than a pension scheme, like e.g. an employer<sup>28</sup>, but nevertheless clearly puts limits to the application of art. 18 to such payments.

“Other factors which could *assist*” – and are thus only indicators helping for the qualification of payments under art 18 – “include: whether a payment is made on or after the cessation of employment giving rise to the payment, whether the recipient continues working, whether the recipient reached the normal age of retirement (...), the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits”<sup>2930</sup>. It is evident that those criteria

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<sup>27</sup> See PROKISCH RAINER, Art. 15 – Einkünfte aus unselbständiger Arbeit, in Doppelbesteuerungsabkommen – Kommentar, VOGEL KLAUS, LEHNER MORIS (Eds.), Munich, 2003, para. 9, arguing that art. 15 OECD MC can be demarcated from art. 18 OECD MC by looking at the reason for the payment, payments made under art. 18 OECD MC having a provident character

<sup>28</sup> This has been confirmed in numerous Court decisions ; see below.

<sup>29</sup> Para. 6 ad art. 18.

<sup>30</sup> See also PISTONE PASQUALE, Article 18 MC OCDE in Modèle de Convention fiscale OCDE concernant le revenu et la fortune, DANON, ROBERT J.; OBERSON, XAVIER; PISTONE, PASQUALE; GUTMANN, DANIEL (Eds) Basel 2013, p. 622

could also assist to determine whether severance payments could qualify as pensions<sup>31</sup>.

According to Prof. Pötgens, the main characteristics of a pension within the meaning of art. 18 OECD MC are a care requirement, a reasonableness requirement and the requirement to terminate the employment during which the pension was accrued<sup>32</sup>. Therefore, “if a severance payment does not meet the above criteria, it falls under Art. 15”<sup>33</sup>, and *a contrario*, if it meets the above criteria, it falls under Art. 18<sup>34</sup>. However, the Commentary itself does not specifically underline this care requirement<sup>35</sup>.

There however still seems to be some disagreement on the question whether all employment has to be terminated, or whether only the employment to which the severance payment is connected can be terminated, thereby allowing the employee to take up a new employment<sup>36</sup>.

Summarizing, in our opinion, a severance payment other than a PILON might be qualified as pension under the Commentary if

- it is paid in lieu of a pension
- it has a “pension-like” nature within the meaning given above, and is not only a compensation for loss of employment;
- it is paid to elderly or disabled employees.

The questions whether the employee continues working or not, whether he has actually reached retirement age or not, or what the status of other recipients is<sup>37</sup>, should not be decisive, but only “assist” in the qualification.

As for the payment made as a “bridge” between the end of employment and ordinary retirement age, there seems to be a clear connection with retirement<sup>38</sup>. The question whether such payment should be a compensation for a reduced pension is however not clearly answered by the Commentary. In our opinion,

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<sup>31</sup> PÖTGENS, Income p. 193

<sup>32</sup> Ibid. and cited case law

<sup>33</sup> Ibid. p. 189

<sup>34</sup> Ibid. p. 198

<sup>35</sup> Ibid. p. 193

<sup>36</sup> Ibid. p. 188

<sup>37</sup> If this criterium was decisive, severance payments made in the case of reorganization lay-offs would never qualify as pensions, since all categories of employees – young and older – might be affected by the lay-off.

<sup>38</sup> See also PROKISCH RAINER, Severance Payments, ET, May/June 1998, p. 178

it should not be necessary, and might well come *in addition to* usual full pension payments.

Conversely, a severance intended to be a transitional payment until a new employment has been found, would fall under art. 15 OECD MC<sup>39</sup>.

#### **d) Article 21 OECD MC**

All items of income not dealt with in other articles are taxable in the Residence State only. Accordingly, if a severance pay is not qualified as an income from employment, Directors' fees, or a pension, it will be "other income" and fall under this article.

The Commentary itself does not make any reference to a severance payment as "other income".

Scholars do not agree whether art. 21 might apply to severance payments. Positions are as follows:

On the one hand, if we consider that art. 15 and following constitute a functional closed system, and that art. 15 is an "other income provision" for all income from employment<sup>40</sup>, and if we consider that a severance pay is "income from employment", then art. 21 should not apply.

This position has e.g. been followed by the Dutch Supreme Court and by the German Federal Tax Court<sup>41</sup>.

On the other hand, Prof. Prokisch e.g. considers that even if severance payments are often taxed domestically as income from employment, art. 15 OECD MC is more restrictive, since it only applies to payments directly connected with employment performed. Therefore, when the severance does not represent deferred compensation or when it does not have a pension character, such direct connection between the services performed and the compensation received is lacking<sup>42</sup>. Indeed, a mere causal connection between a severance payment and past employment is not sufficient to qualify such pay as income from employment. "Rather, severance payments are aimed at compensating

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<sup>39</sup> PÖTGENS, Income p. 190

<sup>40</sup> PÖTGENS, Income, p. 137 ff.

<sup>41</sup> See case law quoted at PÖTGENS, Income, p. 142 ff.

<sup>42</sup> PROKISCH RAINER, Art. 15 – Einkünfte aus unselbständiger Arbeit, para. 17

for a social hardship (...). Such payments are not compensation for lost income either”<sup>43</sup>. Therefore, they should be considered as “other income” falling under art. 21 OECD MC.

In our eyes however, as mentioned earlier, there seems to be a clear connection between employment and severance payment, causing the application of art. 15 OECD MC, or in certain cases between pension and severance pay, entailing the application of art. 18 OECD MC. The application of art. 21 might then only be contemplated if the payment is to be considered as income from inactivity, like a breach of contract, i.e. if it is not a compensation for past activity. Income from inactivity within this meaning does however not fall within the definition of severance payment given for the purpose of this paper, and art. 21 should hence not apply<sup>44</sup>.

### **B. Allocation of taxing rights**

The question of the allocation of taxing rights between Residence and Source State only arises in the context of art. 15 OECD MC. Indeed, art. 16, 18 and 21 OECD MC give primary resp. exclusive taxing rights to resp. the Residence State of the company of which the recipient of the pay is a member of the Board, and to the Residence State of the recipient for both art. 18 and 21. Consequently, if a severance pay is qualified as Director’s fee, pension or other income, the allocation of taxing rights will be evident.

Under art. 15 OECD MC, the Residence State has the exclusive taxing rights on income from of employment, unless employment is exercised in the other State. In such case, taxing rights on remuneration *derived from the exercise* in the Work State are in principle attributed to the Work State, unless the conditions of art. 15(2) apply. The major difficulty in the instances examined in this paper is that often, no activity is *exercised* anymore. Can a severance payment then be considered to be *derived from the exercise* of an employment?

It is generally understood that “employment (...) exercised in the other Contracting State” refers to days of physical presence in the Work State when performing the work for which the income is paid<sup>45</sup>. The Commentary does not give any indication as to how a salary should be allocated between the two

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<sup>43</sup> PROKISCH RAINER, Severance Payments, p. 180

<sup>44</sup> See URBÁSEK p. 503

<sup>45</sup> Commentary para.1 ad art 15 OECD MC

Contracting States, but it is generally admitted that a *pro rata temporis* allocation on the basis of time worked in both States appears to be the most logic allocation<sup>46</sup>.

If one considers that art. 15 OECD MC is applicable to a severance payment, and that there is thus a causal link between employment and income, it has been written that “it would be inconsistent to argue against an allocation of the remuneration”<sup>47</sup>. Accordingly, on the one hand, the taxing rights on the part of the severance pay remunerating work performed abroad should be allocated to the Work State<sup>48</sup>, irrespective of when and where the payment occurs<sup>49</sup>, “the focus (being) (...) on whether the remuneration *accrues* (emphasis added) to the employee in respect of the period he spent abroad”<sup>50</sup>. This principle would also be applicable if, like is usually the case, the severance is paid without any work being performed anymore. Consequently, an employee moving to a new Residence State at the end of his employment relationship, but receiving the severance after his move, would remain taxable on his severance payment in the Work State. This allocation might be applied to severance payments calculated on the basis of the past time of employment.

In such case, a time based apportionment of the severance will generally occur. Other allocation methods might however be required, e.g. if the severance is calculated on the basis of the last salary, and the compensation and activity structures differ between Work State(s) and Residence State<sup>51</sup>.

This principle seems workable in simple cases, e.g. if there is only one Work State, but can lead to many practical difficulties in the case of an employee having worked in more than two countries for the same employer or group. Should the severance be apportioned *pro rata temporis*? What would be the reference period to be considered: the whole employment period with the same employer or even with the same group, or only a shorter reference period

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<sup>46</sup> PEETERS, Article 15 paragraphe 1 MC OCDE, p. 527

<sup>47</sup> PROKISCH RAINER, Severance Payments, p. 179; PROKISCH RAINER, Art. 15 – Einkünfte aus unselbständiger Arbeit, para. 17, where the alleged inconsistency of the BFH is criticised, which can only be precluded by the application of art. 21 OECD MC to severance payments. See also REICH MARKUS, Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis, in Festschrift Walter Ryser, Bern 2005, p. 200

<sup>48</sup> See also URBÁSEK p. 505

<sup>49</sup> Commentary para. 2.2 ad art. 15 OECD MC

<sup>50</sup> PROKISCH RAINER, op. cit. p. 180

<sup>51</sup> PÖTGENS FRANK, The Allocation of Severance Payments under Article 15 of the OECD Model, in A tax globalist. Essays in honour of Maarten J. Ellis, VAN ARENDONK HENK, ENGELEN FRANK ET AL. (Eds) Amsterdam 2005, p. 118



prior the employee's dismissal? How would the employee meet all his tax obligations in all of his former Work States?

On the other hand, if the severance payment is not a consideration for work performed abroad, or is not *derived from the exercise* of an employment, i.e. "focus of the payments is (...) the employment relationship as such and not a distinctive employment activity within the employment relationship"<sup>52</sup>, we fall back on the first general rule of art. 15(1) OECD MC, and the Residence State has exclusive taxation rights.

A third possibility is to consider that the severance, in particular the element of the payment compensating loss of income, has to be allocated to future employment. The place of exercise of employment would then be where the employment would have been exercised if the employment relationship had not been terminated prematurely, provided this can be determined. The place of exercise of employment thus has to be determined fictitiously<sup>53</sup>. If the fictitious place of exercise can not be defined, the Residence State keeps the exclusive taxing rights on the severance pursuant to art. 15(1) 1<sup>st</sup> part of the 1<sup>st</sup> sentence OECD MC<sup>54</sup>.

The difficulty will therefore be to determine what part of the severance is remunerating which activity, if any<sup>55</sup>. Is it compensating past performances, is it intended to bridge a period until a new position is found<sup>56</sup>, is it compensating the loss of employment, or work which should have been performed in the future?

Answers will often be a question of fact, and several solutions have been put forward in international case law, as explained below.

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<sup>52</sup> PRASCHL GISELA, Article 15 of the OECD Model Tax Convention on Income from Employment – Income from employment and attribution of the right to tax, p.245.

<sup>53</sup> PÖTGENS FRANK, Income p. 442

<sup>54</sup> PÖTGENS FRANK, The Allocation of Severance Payments under Article 15 of the OECD Model, p. 112

<sup>55</sup> See for similar difficulties in relation with stock options : PÖTGENS FRANK, Cross-border Taxation of Employee Stock Options: How to Improve the OECD Commentary – Part 2, ET, October 2007, p. 467

<sup>56</sup> PÖTGENS FRANK, Income from cross-border employment, Executive Master of Advance Studies in International Taxation, Neuchatel (2012-04-10), <http://dare.ubvu.vu.nl/handle/1871/33349>, October 20, 2014, slide 10

## 2. Selected international case law and practice

As a matter of fact, in many countries, severance pays are considered as falling under art. 15 OECD MC, by reference to their own domestic law. Usually, when severance payments are given a domestic law definition, Courts have considered them to be salary falling under art. 15 OECD MC, unless they fall under art. 18 OECD MC<sup>57</sup>.

### A. Germany

The Federal Tax Court (Bundesfinanzhof) has ruled on several occasions that severance payments are income from employment in the meaning of art 15 OECD MC, and are not to be considered as “other income”<sup>58</sup>.

However, unless a specific DTC provides otherwise, they do not represent an additional payment for past services, and can thus not be allocated to a specific past activity performed in Germany or abroad. Instead, they are to be considered as a financial compensation for a loss of employment. A mere causal link between a payment and an activity is not considered as sufficient to allocate taxing rights to the Work State<sup>59</sup>. Accordingly, those payments, which are not considered as “derived from” an activity, are only taxable in the Residence State of the employee at the time of payment, on the basis of art. 15(1) 1<sup>st</sup> part of the 1<sup>st</sup> sentence OECD MC<sup>60</sup>. This was again confirmed recently<sup>62</sup>. This position is also followed by the Ministry of Finance<sup>63</sup>.

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<sup>57</sup> PÖTGENS, Income, p. 186-187

<sup>58</sup> See BFH, decisions of 18.07.1973, I R 5269, BStBl 1973 II p. 757; of 24.02.1988, I R 143 84, BStBl 1988 II p. 819; of 10.07.1996, I R 83/95, BStBl 1997 II p. 341

<sup>59</sup> PERDELWITZ ANDREAS, Treaty between France and Germany –German Federal Financial Court qualifies severance payment as income from employment, IBFD Report, August 7, 2014

<sup>60</sup> BFH, decision of 24.02.1988, BStBl 1988 II p. 819, BFH, decision of 10.07.1996, I R 83/95, BStBl 1997 II p. 341 commented by PROKISCH RAINER, Severance payments; BFH, decision of 02.09.2009, I R 111/08, <http://www2.bfhurteile.de/IR11108.htm>, November 16, 2014

<sup>61</sup> Prof. Pötgens explains that the Court distinguishes “between two different kinds of causality in art 15(1) of the OECD Model. These decisions require for the classification of a severance payment under Art. 15 (the first rule) another type of causality with employment than under the second rule of that provision, i.e. allocation of the severance payment to an employment exercised in the Work State”. PÖTGENS, Income p. 360

<sup>62</sup> BFH, decision of 24.07.2013, I R 8/13, made public on 06.08.2014

<sup>63</sup> BMF SCHREIBEN VOM 14.09.2006, Steuerliche Behandlung des Arbeitslohns nach den Doppelbesteuerungsabkommen IV B 6 – S 1300 – 367/06, para. 6.3 [http://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF\\_Schreiben/Internationales\\_Steuerrecht/Allgemeine\\_Informationen/2006-09-14-Steuerliche-Behandlung-Arbeitslohn-](http://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF_Schreiben/Internationales_Steuerrecht/Allgemeine_Informationen/2006-09-14-Steuerliche-Behandlung-Arbeitslohn-)

It is to be noted however that in this last mentioned decision of the BFH<sup>64</sup>, the BFH finally came to a different conclusion, based on the wording of the German-French DTC, which was different from the OECD MC wording of art. 15. The taxpayer, a German resident had received a severance from a French company after having been employed in France. German tax authorities wanted to include this payment in the German tax base, as “other income”. The BFH however ruled in favour of the taxpayer. Severance payments indeed qualify as income from employment under domestic law, and not as other income as alleged by the tax administration, but *in casu*, the payment could only be taxed in France per art. 13(1) of the German-French DTC. This provision explicitly refers to the payer of the severance and to the place where the activity was performed out of which the income originates<sup>65</sup>. In this case, a mere causal link between an employment relationship and a payment by an employer is therefore considered as sufficient to allocate taxing rights to the Work State<sup>66</sup>, so that all income attributable to the activity is taxable by the Work State.

On the other hand, if severance payments are paid as compensation for a long lasting past work relationship, they are to be considered as “derived from employment”, and are thus taxable in the Work State<sup>67</sup>.

Severance payments can also be considered as pensions within the meaning of art. 18 OECD MC, if they have a provident feature. In order to delimit a payment under art. 15 OECD MC from a payment under art. 18 OECD MC, it is not the time of payment which is decisive, but rather the reason for the payment<sup>68</sup>.

Since the allocation as applied by German Courts can easily lead to double non taxation of this income – i.e. if the Residence State allocates the severance to Germany where the employment was previously exercised, the German Ministry of Finance concluded several mutual agreements with other States

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[DBA.pdf?\\_blob=publicationFile&v=9](#), November 16, 2014; ENTWURF BMF SCHREIBEN VOM 08.11.2013, Steuerliche Behandlung des Arbeitslohns nach den Doppelbesteuerungsabkommen, <https://www.muenchen.ihk.de/de/recht/Anhaenge/entwurf-des-bmf-schreibens-stand-8.-november-2013-.pdf>, November 17, 2014

<sup>64</sup> BFH, decision of 24.07.2013, I R 8/13

<sup>65</sup> Author’s translation of « aus der die Einkünfte herrühren »;

<sup>66</sup> BFH, decision of 24.07.2013, I R 8/13, para. 17; PERDELWITZ ANDREAS, op. cit.

<sup>67</sup> KUDERT STEHPAN AND BLUME ANJA, Besteuerung von Abfindungen an ausländische Arbeitnehmer, Praxis Internationale Steuerberatung 9/2014, p. 248, <http://www.iww.de/pistb/musterfaelle/der-praktische-fall-bestuerung-von-abfindungen-an-auslaendische-arbeitnehmer-f78835>, October 20, 2014

<sup>68</sup> BFH, decision of 19.09.1975, BStBl 1976 II p. 65 mentioned in BMF SCHREIBEN para. 124.

with respect to the taxation of these payments<sup>69</sup>. On the basis of these mutual agreements, the allocation of taxing rights first depends on the nature of the payment. If it has a provident aspect, it is taxable as a pension in the Residence State; if it is a subsequent payment or another compensation sourced in the past employment relationship, or generally if it is a compensation for early termination of employment, it is taxable in the (former) Work State<sup>70</sup>. If the employee has also worked in his Residence State before termination of employment, the taxing rights with respect to payments made as compensation for an early termination of employment are allocated on a *pro rata temporis* basis, in accordance with the allocated taxing rights on regular employment income. Some mutual agreements besides provide for a residual right to tax in favour of the Residence State in order to prevent double non-taxation<sup>71</sup>.

Such mutual agreements, even when transposed in German law by a regulation based on law<sup>72</sup>, have nevertheless been challenged by German Courts, because, they contravene the hierarchy of norms. Consequently, such agreements are not binding for Courts<sup>73</sup>. Since this case is still pending before the BFH, it is presently not clear to whom the taxing rights are to be allocated<sup>74</sup>.

## B. The Netherlands

The Dutch Supreme Court (Hoge Raad) has also confirmed on several occasions that severance payments qualify as employment income within the meaning of art. 15 OECD MC, by reference to Dutch domestic law<sup>75</sup>.

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<sup>69</sup> Agreements were concluded with Belgium, the Netherlands, Luxemburg, Austria, Switzerland and the UK.

<sup>70</sup> Entwurf BMF Schreiben, para. 5.5.4.2

<sup>71</sup> E.g. Switzerland: BMF SCHREIBEN VOM 25.03.2010, BStBl 2010 I, p. 268

<sup>72</sup> See for Switzerland Verordnung zur Umsetzung von Konsultationsvereinbarungen zwischen der Bundesrepublik Deutschland und der Schweizerischen Eidgenossenschaft (Deutsch-Schweizerische Konsultationsvereinbarungsverordnung – KonsVerCHEV), para. 24, <http://www.gesetze-im-internet.de/bundesrecht/konsverchev/gesamt.pdf>, October 20, 2014

<sup>73</sup> BFH, decision of 02.09.2009, I R 111/08; HESSISCHES FINANZGERICHT, Urteil vom 8. Oktober 2013 – 10 K 2176/11, <http://www.lareda.hessenrecht.hessen.de/jportal/portal/t/s15/page/bslaredaprod.psml?&doc.id=STRE201375299%3Ajuris-r01&showdoc-case=1&doc.part=L>, October 20, 2014

<sup>74</sup> BFH, Anhängiges Verfahren, I R 79/13; KÖLBL SUSANNE UND ROSS-KRISCH NADJA, Abfindungen bei Aufhebungsverträgen im internationalen Kontext. Steuerliche Behandlung im In- und Ausland, IWB 19/2014, 2014, p. 718

<sup>75</sup> HOGE RAAD, decision of 26.08.1981, Nr. 20.413, BNB 1981, p 307. See also PEETERS, Article 15 paragraphe 1 MC OCDE, p. 517 and references given

In 2004, it issued two decisions in relation to the taxation of redundancy payments in an international context, which are still to be considered as leading cases<sup>76</sup>. The outcomes can be summarized as follows<sup>77</sup>:

- If a payment is aimed at compensating non-material damages or costs, it does not have a sufficient link with an employment; the payment can therefore not be considered as taxable salary under domestic law, and no allocation issues arise;
- If a severance is aimed at compensating particular work, taxing rights are in principle allocated to the Work State under art. 15 (1) OECD MC, unless art. 15(2) OECD MC applies. This principle applies whether or not there is any actual recharging to the local permanent establishment of the employer (see below)<sup>78</sup>. It is to be noted that the fact that the severance has been calculated e.g. by reference to the number of past years or employment is not sufficient to consider that the severance directly compensates particular work<sup>79</sup>. An example of such allocation has been when the employee had exercised different functions within a group of companies<sup>80</sup>;
- If a severance is aimed at providing a living until retirement, or an improvement of pension rights, the payment qualifies as a pension within the meaning of art. 18 OECD MC. In this context, objective criteria have to be examined, like e.g. the age at which the severance is granted, and whether it is reasonable to believe at the time of the payment that the recipient will be able to gain new income from employment. Subjective elements like the intentions of the recipient are

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<sup>76</sup> HOGE RAAD, decision of 11.06.2004, nr. 37.714, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2004:AF7812>, November 27, 2014; HOGE RAAD, Uitspraak van 11.06.2004, nr. 38.112, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2004:AF7816>, November 27, 2014

<sup>77</sup> HOGE RAAD, Conclusie Procureur-Generaal bij de Hoge Raad der Nederlanden Mr. C.W.M. Van Ballegooijen, nr. 11/00165, <http://www.uitspraken.nl/uitspraak/parket-bij-de-hoge-raad/bestuursrecht/belastingrecht//ecli-nl-phr-2011-br6388>, November 27, 2014

<sup>78</sup> Ibid, para. 6.10

<sup>79</sup> HOGE RAAD, decision of 11.06.2004, nr. 37.714, para. 3.3

<sup>80</sup> PÖTGENS FRANK, Income from Inactivity under Article 15 of the OECD Model Tax Convention – Part 2, Bulletin for International Taxation, November 2009, p. 500, footnote 100 citing Court of Appeal decision in BNB 2005/57

not decisive in this qualification, nor what has been agreed between parties<sup>81</sup>;

- If a severance does not fall within one of these categories, e.g. if it is a compensation for loss of income in the future, it must be considered that it is generally connected with employment, and that taxing rights have in principle to be divided based on the employment history;
- In order to avoid practical issues in the allocation of taxing rights, and in order to give some content to the required link between compensation and activity, the Supreme Court has given “directives” which will apply unless special circumstances require a different allocation. According to these “directives”, the taxing rights on the severance payment will be divided between the Work States in the same proportion as ordinary remuneration has been allocated on the basis of art. 15(1) and (2) OECD MC during employment history. Employment history is based on a reference period which goes from January 1 of the year of dismissal until the dismissal, and includes the four preceding calendar years;
- In order to meet the requirement of a sufficient level of connection with past employment in the Work State, the severance must be borne by an employer resident of the Work State, or by a permanent establishment or a fixed base which the employer has in the Work State. The term “borne by” means a *de facto* recharging to companies or permanent establishments of the group, and not only an allocation on the basis of general allocation keys<sup>82 83</sup>. The rationale behind this reasoning is that if there is no actual recharging to a local entity, local tax authorities will not even be aware of the severance and hence will not tax it. Accordingly, there can not be any issue of double taxation. In a

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<sup>81</sup> HOGÉ RAAD, decision of 03.05.2000, nr. 34.361, para. 3.6 and ff, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2000:AA5676>, December 7, 2014; PÖTGENS, Income, p. 189

<sup>82</sup> HOGÉ RAAD, decision of 23.06.2006, nr.42544, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2006:AX9140> December 1, 2014; HOGÉ RAAD, arrest van 11.04.2008, nr.43093, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2008:BC9185>, December 1, 2014

<sup>83</sup> By contrast, ordinary salary does not have to be actually recharged, but can be allocated on the basis of general allocation keys to a permanent establishment or fixed base in order to be “borne by” within the meaning of art. 15(2)(c) OECD MC. HOGÉ RAAD, decision of 23.11.2007, nr.42743, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2007:AY8549>, December 1, 2014

specific case, this view has been seen as being in accordance with one of the objectives of the applicable DTC, i.e. the prevention of fiscal evasion<sup>84</sup>. If the connection requirement is not met because the severance is not borne by an employer, a permanent establishment or a fixed base in the other Contracting State, the general rule of art 15(1) 1<sup>st</sup> sentence applies, i.e. the Residence State has exclusive taxing rights<sup>85</sup>.

This view has been criticised since these conditions are mentioned in art. 15(2) (b) and (c) OECD MC, and not in art. 15(1) OECD MC; and that such a “borne by” requirement should thus not come into play to establish a connection with past employment in the Work State<sup>86</sup>. We can only agree with this view.

In our opinion, the “Directives” given by the Supreme Court have the merit of giving clear and detailed guidance on the tax treatment of severance payments; they also consider possible different remuneration structures between Work States which may require a different allocation method than the *pro rata temporis* method<sup>87</sup>. It is nevertheless unfortunate, to say the least, that it is not based on negotiated treaty provisions nor on legislation. Determining this reference period might also lead to arbitrary results<sup>88</sup>.

The Supreme Court also interestingly confirmed that employment by various companies within the same group could indeed be considered as one single employment relationship<sup>89</sup>.

Like mentioned above for Germany, it is to be noted that the legal effect of the mutual agreement concluded with Germany is presently also being challenged by Dutch Courts, limiting the application of its subject-to-tax clause<sup>90</sup>.

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<sup>84</sup> Ibid. par 6.11 concerning the Netherlands – Vietnam DTC

<sup>85</sup> HOGE RAAD, decision of 11.04.2008, nr. 43.093, para. 4.6, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2008:BC9185>, December 1, 2014

<sup>86</sup> PÖTGENS FRANK, The Allocation of Severance Payments under Article 15 of the OECD Model, p. 121; Further references cited in PÖTGENS FRANK, Income from Inactivity under Article 15 of the OECD Model Tax Convention – Part 2, footnote 102, p. 500

<sup>87</sup> Ibid. p. 501

<sup>88</sup> See examples given in PÖTGENS, Income, p. 450-451

<sup>89</sup> HOGE RAAD, decision of 19.11.2004, nr. 39.695 para. 3.3, <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:HR:2004:AR5983>, November 27, 2014

<sup>90</sup> RAMAEKERS VALÉRIE, Is de houdbaarheid besluit ontslagvergoedingen Nederland – Duitsland verstreken?, <http://www.futd.nl/nieuwsbrief/over-de-grens/laatste-nummer/is-de-houdbaarheid-besluit-ontslagvergoedingen-nederland-duitsland-verstreken/>, March 2014, November 27, 2014, mentioning case AWB – 13 - 1782 of January 24, 2014

### C. Belgium

The Court of Appeal of Brussels decided that severance payments can be considered as “other similar remuneration” within the meaning of art. 15 OECD MC, which thus applies<sup>91</sup>. In this case, the allocation key for the taxing rights on the severance payment proposed by the taxpayer, and accepted by both the tax administration and the Court, was based on the allocation of the taxing rights on income from employment between Belgium and the other Work State in the year preceding the end of employment. This element was considered as reasonable by the Court to assume that all activities performed in execution of the employment contract, and which were deemed to be the source of the severance payment, were performed in the same proportion in the different Work States<sup>92</sup>. This decision has been found to be pragmatic, but also discretionary: why consider one year only whereas the allocation on the basis of previous years of employment might have been different<sup>93</sup>?

The Ministry of Finance also issued a circular letter concerning the application of art. 15 OECD MC<sup>94</sup>. It confirms previous case law according to which the terms “salaries, wages and other similar remuneration” is not defined in the OECD MC and hence has to be interpreted by reference to domestic law. Art. 31 CIR expressly provides that compensation received by reason or at the end of employment, or at the breach of an employment contract, is considered to be income of employee<sup>95</sup>, which is hence covered by art. 15 OECD MC<sup>96</sup>.

With respect to the allocation of taxing rights, the Ministry of Finance differentiates between severance payments in lieu of notice, and severance payments not made in lieu of notice<sup>97</sup>.

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<sup>91</sup> COUR D'APPEL DE BRUXELLES, 19.12.1997, JDF 1999, Nr 03/04 cited together with earlier case law by PEETERS, Article 15 paragraphe 1 MC OCDE, p. 516-517

<sup>92</sup> HÜRNER STEPHEN, La taxation de l'indemnité de dédit sous l'angle du statut fiscal spécial accordé par la circulaire administrative du 8 août 1983 et de la convention belgo-française, 15.02.2007, <http://www.tax-advisers.be/infra/pdf/dedit.pdf>, December 10, 2014 ; PÖTGENS, Income p. 452

<sup>93</sup> PEETERS BERNARD, Article 15 of the OECD Model Convention on « Income from Employment” and its Undefined Terms, ET February/March 2004, p. 74

<sup>94</sup> CIRCULAIRE N° AAF 2005/0652 (AAF 08/2005) 25.05.2005, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=76141ff2-439a-4d3d-8bfc-bf470a8f3dfc#findHighlighted>, December 10, 2014

<sup>95</sup> Author's translation ; CIR 92, art. 31, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=fc0e6997-7d5c-47be-ab6d-a5cc8744a7f2#findHighlighted>, December 10, 2014

<sup>96</sup> Circulaire n° AAF 2005/0652 (AAF 08/2005) 25.05.2005, para. 3.3

<sup>97</sup> Ibid. para. 3.5



In the former case, the severance is deemed to be directly related to the *employment exercised at the moment the employment contract is terminated*, and is therefore taxable in the State where the employment is exercised at that moment, i.e. the Work State where the employee should have worked during the notice period. If employment was exercised in several States at that moment, an allocation has to be made between those Work States. The time of payment is irrelevant, since the right to receive said compensation is acquired at the moment an end is made to the employment contract. Accordingly, the allocation of taxing rights has to be determined at this particular point in time.

Conversely, severance payments not made in lieu of notice are not necessarily only related to the activity exercised at the moment the contract is ended. This can be the case if the work contract was concluded in a foreign jurisdiction where a notice period is not mandatory, or if a payment is made in addition to a PILON. Therefore, such payments are in principle connected to the *overall activities* exercised in the framework of the employment contract. If the employee has worked in several countries during his employment contract, taxing rights will be split between the States which have had the right to tax regular income.

The possible allocation between different Work States will be pro rated on the basis of the number of days of physical presence in each of these Work States during which employment was exercised<sup>98</sup>.

It is further added that, if the severance is aimed at providing support until retirement age, or when it is supplementing a pension or another similar remuneration, the payment qualifies as a pension within the meaning of art. 18 OECD MC.

#### **D. The United Kingdom**

The Special Commissioner Dr. Avery Jones CBE decided in 2005 in *Squirrel vs HMRC*<sup>99</sup> that, since the term “salaires, wages and other similar remuneration” was not defined in the applicable 1975 UK-US DTC, use had to be made of the interpretation rule of art. 3(2) to determine whether severance payments fell under art 15 of the DTC. Since the severance payment in question, a PILON, was taxed in the UK in a similar way to remuneration from employment,

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<sup>98</sup> Ibid. para. 5.3

<sup>99</sup> CASE SPC 493 Peter John Squirrel v. Her Majesty's Revenue and Customs, 23.06.2005, IBFD

art. 15 of the DTC would apply. This case is however seen as being atypical by HMRC, and it is not certain that the same conclusion would be reached for non contractual payments related to the termination of employment<sup>100</sup>. Further, it has also been argued that this decision might not have been upheld in appeal, since a PILON actually is a compensation for a breach of contract rather than remuneration for past or future work<sup>101</sup>.

Since the employment had been exercised in the UK, “so much as is derived from such exercise, which is the whole, may be taxed in the UK”<sup>102</sup>. If employment had been exercised in a different State than the Residence State, “such remuneration as is derived therefrom may be taxed in (the Work State)”<sup>103</sup>. Conditions of art. 15(2) of the applicable DTC were then examined, in order to determine whether the Residence State could be given the exclusive taxing rights on the severance. For this purpose, the Special Commissioner referred to the period of 183 days *in the tax year concerned*, (emphasis added) and to the fact that the employer was not a resident of the employee’s Resident State.

We infer from this allegation, that taxing rights would be allocated to the Work State if, *in the tax year concerned*, the employee was present in the Work State for a period of more than 183 days – the “employment history” hence being limited to *the tax year concerned* -, or if the remuneration was paid by an employer resident of the Work State or borne by a permanent establishment of the employer in the Work State.

In a case concerning the 2001 UK-US DTC, the *Resolute* case<sup>104</sup>, the Special Commissioner Malcolm Gammie CBE QC however considered that, unlike in the *Squirrel* case, an *ex gratia* payment nonetheless considered to be a termination payment for domestic purposes, could not be said to fall within the

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<sup>100</sup> PÖTGENS, Income, p.190; EDWARDS JEREMY AND FOSTER LAURA, Taxation of Termination Payments, Tax Journal, Issue 829, 15, March 20, 2006, p. 16

<sup>101</sup> HILL JAMES, Termination payments and internationally mobile employees, [http://www.may-erbrown.com/files/News/74977fc0-22ab-4fff-a2fc-8aabc31f896/Presentation/NewsAttachment/6de56b1c-1938-4796-98f3-8bc95b70f6f4/art\\_hill\\_nov1813\\_termination-payments.pdf](http://www.may-erbrown.com/files/News/74977fc0-22ab-4fff-a2fc-8aabc31f896/Presentation/NewsAttachment/6de56b1c-1938-4796-98f3-8bc95b70f6f4/art_hill_nov1813_termination-payments.pdf), October 20, 2014

<sup>102</sup> CASE SPC 493 Peter John Squirrell v. Her Majesty’s Revenue and Customs, 23.06.2005, par 13, IBFD

<sup>103</sup> Ibid.

<sup>104</sup> CASE SPC 710 Resolute Management Services Ltd Mrs Kathleen Ann Haderlein v Revenue & Customs, 27.08.2008, <http://www.bailii.org/uk/cases/UKSPC/2008/SPC00710.html>, December 12, 2014

ordinary meaning of the terms “salaries, wages and other similar remuneration”. *In casu*, the payment had been made “for doing the right thing” i.e. resigning. Since there was no *quid pro quo*, the payment lacked “the necessary nexus with services rendered that usually characterizes payments as salary, wages and other remuneration”<sup>105</sup>. The fact that this payment happened to be taxed domestically as income from employment was not sufficient to consider this payment to be “similar” to salary and to fall under art. 15 OECD MC. Since the payment was not considered as employment income, it fell under the “other income” provision (art. 21 OECD MC), and was taxable in the State where the taxpayer was resident at the time of payment. The fact that the *ex gratia* payment was not a *quid pro quo* differentiated this payment from the PILON examined in the abovementioned Squirrell case, where the PILON was considered to have sufficient nexus with the services<sup>106</sup>.

It is however not certain that this case can be considered as setting a real precedent, since – the amounts at stake most likely not justifying an appeal - the HMRC did not appeal this decision, therefore probably considering it as essentially based on infrequent facts<sup>107</sup>.

### **E. US-Italy 1999 Income Tax Treaty**

It is noteworthy that the US – Italy 1999 DTC explicitly provides for the allocation of severance payments in its art. 18(3). It states the following: “Notwithstanding the provisions of paragraph 1<sup>108</sup>, if a resident of a Contracting State becomes a resident of the other Contracting State, lump-sum payments or severance payments (indemnities) received after such change of residence that are paid with respect to employment exercised in the first-mentioned State while a resident thereof, shall be taxable only in that first-mentioned State. For

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<sup>105</sup> Ibid. para. 38

<sup>106</sup> CLEAVE BRIAN CB QC, UK Special Commissioners Decide the *Resolute* Case Concerning the Taxation of an Ex Gratia Termination Payment as Employment Income, Bulletin for International Taxation, January 2011, p. 21-25

<sup>107</sup> Ibid. p 25

<sup>108</sup> Para 1 relates to the allocation of taxing rights on “pensions and other similar remuneration beneficially derived by a resident of a Contracting State in consideration of past employment”

purposes of this paragraph, the term “severance payments (indemnities)” includes any payment made in consequence of the termination of any office or employment of a person.”<sup>109</sup>

According to the IRS Technical Explanation on this Convention, “this paragraph is intended to prevent potential abuses of paragraph 1. For example, Italian law requires Italian employers to make certain lump-sum retirement payments to employees upon their retirement. Absent paragraph 3, an employee resident in Italy who anticipates receiving such a payment might establish residence in the United States in order to obtain more favorable U.S. tax treatment under paragraph 1. Similarly, paragraph 3 prevents a U.S. resident who anticipates receiving a lump-sum distribution from a U.S. pension plan with respect to employment in the United States from establishing residence in Italy in order to obtain more favorable Italian tax treatment under paragraph 1”<sup>110</sup>. The scope of this provision is thus relatively restricted, since it is only limited to situations of change of residence after employment and before payment. E.g. the issue of an allocation of a severance payment in a case of change of change of residence during employment is left unresolved<sup>111</sup>.

It is further to be noted that this provision falls under art. 18 DTC titled “pensions, etc”, which might indicate that this qualification might apply. Alimonies and child support payments however also fall under this article, whereas they usually would not be considered as “pensions” in a “provident” meaning.

## F. Conclusions

Based on the abovementioned case law and practices, we can conclude the following on the tax treatment of severance payments:

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<sup>109</sup> Convention between the Government of the United States of America and the Government of the Italian Republic for the avoidance of Double Taxation with respect to taxes on Income and the Prevention of Fraud or Fiscal, <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/italy.pdf>, December 11, 2014

<sup>110</sup> Department of the Treasury Technical Explanation of the Convention between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teitaly.pdf>, December 11, 2014, ad art. 18 (3)

<sup>111</sup> See also PÖTGENS, Income p. 453

1. Most States would consider severance payments to fall under art 15 OECD MC. Art. 21 OECD MC would more seldom apply (see *Resolute Case* in the UK however considered as an exception).
2. They can however be considered as pensions if they have a provident aspect, in particular if they are intended to provide a financial support until retirement, or to complement pension rights (See Germany, the Netherlands and Belgium). Age and the difficulty to find a new employment can be considered as an indication hereof.
3. More divergent views appear on the possible allocation of the taxing rights:
  - The severance does not have a direct link with the exercise of employment, and thus has to be attributed to the Residence State (Germany);
  - The severance does have a link with the exercise of employment and taxing rights should be attributed to the Work State (Germany if it is compensating a long-lasting relation, the Netherlands, Belgium, the UK in the *Squirrell case*);
  - If taxing rights are attributed to the Work State, but employment was exercised in more than one Work State, even more different views appear, notably on the “length of the employment history” to be taken into consideration.
4. Such divergent views on the allocation of taxing rights on employment income are likely to lead to situations of double taxation or double non-taxation. Those situations can not be solved by way of rules given by the Commentary on conflicts of qualification<sup>112</sup>, since it might well be argued that there is no qualification conflict, both States qualifying the income as income from employment.
5. Consequently, the allocation of taxing rights would preferably be determined by DTC’s or other bilateral (or multilateral) agreements<sup>113</sup>. Without such inter-State agreement, double taxation and double non-taxation could only be avoided by a mutual agreement procedure or a

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<sup>112</sup> Comm. para. 32.3 ff. ad art. 23 A and B OECD MC

<sup>113</sup> Provided of course those mutual agreements are validly transposed in internal law, and are consequently applied by domestic Courts (see the cases of Germany and the Netherlands)

provision similar to art. 23A(4) OECD MC in the case of exemption countries<sup>114</sup>.

Without any such inter-State agreement, we believe that severance payments which can be seen as directly related and directly compensating particular work, should clearly be allocated to the Work State where this specific activity was carried out. However, this is likely to happen in a very limited number of cases only.

So, more generally seen, we believe that PILON's, which are payments replacing a notice period, should in principle be allocated to the State where it is likely this notice period would have been worked. This fictitious determination may however appear to present some practical difficulties. Therefore, an allocation to the place where employment was exercised at the moment the contract was terminated would be preferred.

As for a real severance payment, it appears to us that its aim actually is to offer some financial support until a new employment is found, or to compensate loss of employment. However, it is generally calculated by reference to the length of employment, to the salary, to the last position, etc, and clearly also rewards the employee's loyalty. It has therefore accrued during the period of employment and should in our opinion thus be allocated on a *pro rata temporis* basis to the Work States. However, in order to remain a workable solution, we believe a limit has to be set on the reference period to be taken into account.

### 3. OECD Model Convention: 2014 Update

The OECD Committee on Fiscal Affairs has been recognizing those qualification and allocation issues lately, and has issued a public discussion draft in June 2013<sup>115</sup>, which led to amendments of the Commentary on art. 15 OECD MC in the 2014 Update to the OECD Model Tax Convention<sup>116</sup>.

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<sup>114</sup> PÖTGENS, Income p. 452-454

<sup>115</sup> OECD MODEL TAX CONVENTION: Tax treaty Treatment of Termination Payments. Discussion Draft: 25 June to 13 September 2013, <http://www.oecd.org/ctp/treaties/Discussion%20draft%20Termination%20Payments.pdf>, September 9, 2014

<sup>116</sup> 2014 UPDATE TO THE OECD MODEL TAX CONVENTION, approved by the OECD Council on July 15, 2014, <http://www.oecd.org/ctp/treaties/2014-update-model-tax-convention.pdf>, September 9, 2014

## **A. Discussion Draft: tax treaty treatment of termination payments**

The CFA acknowledges that the Commentary until 2014 only gives limited guidance on the tax treatment of payments made following termination of employment in cross-border situations, recognizing that the only way such payments are examined in the pre-2014 Commentary, is to determine whether such payments constitute “pensions or other similar remuneration” in the meaning of art. 18 OECD MC, without any examination of such payments under art. 15 OECD MC. Since a different treaty characterization of these payments may lead to situations of double taxation or double non-taxation, these issues needed to be addressed by the OECD<sup>117</sup>.

It is generally stressed that “regardless of the terminology used to describe these payments, it is essential to identify the *real consideration* for each such payment on the basis of the facts and circumstances” of each payment to conclude whether they fall under art. 15 OECD MC or not<sup>118</sup>.

Various forms of payments made after cessation of employment are examined in the Discussion Draft, like remuneration for previous work, payment for unused holidays, sick leave, payments related to pension rights, or severance payments. Given the definition of the severance payment for the purpose of this paper, we will limit our analysis of the Discussion Draft to payments in lieu of notice of termination and severance payments, and to other termination payments when relevant for severance payments.

### **a) Payments in lieu of notice of termination (PILON)**

Such a payment is given by an employer who, based on legal or contractual regulations, should, before terminating an employment relationship, respect a notice period during which the employee should work, but rather prefers the employee to stop working immediately and therefore gives him a payment “in lieu of notice”<sup>119</sup>.

The Discussion Draft confirms in a new para. 2.6 ad art. 15 OECD MC that:

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<sup>117</sup> OECD MODEL TAX CONVENTION: Discussion draft on the tax treaty treatment of termination payments, June 25, 2013, <http://www.oecd.org/tax/treaties/terminationpayments.htm>, September 9, 2014 (hereafter DISCUSSION DRAFT)

<sup>118</sup> DISCUSSION DRAFT, para. 2

<sup>119</sup> Ibid. chapter 3

- The remuneration paid for the notice period during which the employee is not required to work constitutes income received by virtue of employment within the meaning of art. 15 OECD MC;
- Such remuneration is “derived therefrom” within the meaning of art. 15(1) OECD MC and consequently has to be allocated to the Work State;
- The Work State is 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”. It is further commented that the place where the employee would have worked often will be the Residence State of the employee, or the Work State “where the employee has been present for more than 183 days or where he has been working for a local employer or for the permanent establishment of a foreign employer”<sup>120</sup>.

#### **b) Severance payments**

No definition is given of such a payment, the Draft only stating in a new para. 2.7 to the Commentary ad art. 15 OECD MC that “a different situation [from the abovementioned PILON] is that of a severance payment (also referred to as a “redundancy payment”) which an employer is required (by law or by contract) to make to an employee whose employment has been terminated”<sup>121</sup>. Such a payment has the following characteristics:

- it is “unrelated to any obligation to give advance notice of the termination”;
- it “is often, but not always, calculated by reference to the period of past employment with the employer”<sup>122</sup>.

A new paragraph 2.7 of the Commentary ad art. 15 OECD MC confirms that:

- a severance payment is remuneration within the meaning of art. 15 OECD MC;
- a severance payment is “derived from”, within the meaning of art. 15(1) last sentence, the State where employment was exercised at the

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<sup>120</sup> Ibid. para. 13

<sup>121</sup> Ibid. para. 15

<sup>122</sup> Ibid.



time of termination of employment; taxing rights on the severance payment are hence allocated to this Work State;

- the presumption that the severance payment is derived from the State where employment was exercised at termination, is rebuttable. Therefore, is not precluded, the allocation of the payment to “previous years of employment” and hence the allocation of taxing rights to States where employment has been exercised in previous years<sup>123</sup>.

May also constitute some form of severance payment, and hence has to be treated accordingly, a “compensation for future commissions that the salesperson would likely have earned if she had continued to work for the same employer”<sup>124</sup>.

### **c) Damages**

It is to be noted that the Discussion Draft proposes to make the tax treatment of damages paid dependent on what the damage seeks to compensate. “Damages granted because an insufficient period of notice was given or because a severance payment required by law or contract was not made should be treated like the remuneration that these damages replace”<sup>125</sup>.

Accordingly, if the PILON is considered inadequate because the period of notice considered was insufficient, the related damage payment would be considered as remuneration within the meaning of art. 15 OECD MC, and should be allocated to the Work 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”<sup>126</sup>.

Likewise, if a legally or contractually required severance was not made, the related damage payment would be considered as remuneration within the meaning of art. 15 OECD MC, and should in principle be allocated to the State where employment was exercised at the time of termination of employment, unless facts and circumstances indicate otherwise<sup>127</sup>.

Other damages on the other hand, fall under art. 21 OECD MC.

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<sup>123</sup> Ibid. para. 16

<sup>124</sup> Ibid. para. 41 with a proposed new para. 2.15 of the Commentary ad art. 15 OECD MC

<sup>125</sup> Ibid para. 18 with a proposed new para. 2.8 of the Commentary ad art. 15 OECD MC

<sup>126</sup> Ibid. para. 11

<sup>127</sup> Ibid. para. 15

#### **d) Partial retirement payments**

This is the title under which a new para. 2.16 ad art. 15 OECD MC is proposed. “As part of a transitional arrangement leading to the termination of employment, an employee may receive a full or a reduced salary for that period during which the employee is not required to work”<sup>128</sup>. Apparently, both stand-by fees and payments for gardening leave are viewed by this paragraph<sup>129</sup>, but, despite the heading, not only true partial retirement payments.

- Remuneration “paid by the employer for a period during which the employee is not required to work even though the employment has not been terminated”, falls under art. 15 OECD MC;
- It is “derived from the State where it is reasonable to assume that the employee would have worked during that period”, i.e. usually the State where activities were performed before “cessation of work”<sup>130</sup>;
- In particular, payments made for the period during which the employee cannot be required to work should be treated like payments in lieu of notice of termination”<sup>131</sup>.

### **B. OECD MC Commentary as of 2014**

Additions to the OECD MC Commentary in relation with termination payments have been included in the 2014 Update to the OECD MC and related Commentary, approved by the CFA on June 26, 2014, and by the OECD Council on July 15, 2014<sup>132</sup>.

Before that, the Discussion Draft had been released for public comments, after which some changes were made to the Discussion Draft. Those changes are examined below.

#### **a) Payments in lieu of notice of termination (PILON)**

The new paragraph 2.6 ad art. 15 OECD MC confirms the type of payment described in the Discussion Draft and endorses the following:

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<sup>128</sup> Ibid. para. 44

<sup>129</sup> Ibid. para. 45

<sup>130</sup> Ibid. para. 44

<sup>131</sup> Ibid. para. 45

<sup>132</sup> 2014 UPDATE TO THE OECD MODEL TAX CONVENTION, approved by the OECD Council on July 15, 2014, <http://www.oecd.org/tax/treaties/2014-update-model-tax-convention.pdf> September 9, 2014

- Remuneration for the period of notice during which the employee is told not to work is income from employment within the meaning of art. 15 OECD MC;
- Such remuneration is “derived therefrom” within the meaning of art. 15(1) OECD MC and consequently has to be allocated to the Work State;
- The Work State is the State “where it is reasonable to assume that the employee would have worked during the period of notice.” The determination of this place “should be based on all facts and circumstances. “In most cases it will be the last location where the employee worked for a *substantial period of time* (emphasis added) before the employment was terminated; also, it would be clearly inappropriate to take account of a prospective employment period in a State where the employee might have been expected to work but did not, in fact, perform his employment for a *substantial period of time*.”

#### Comments

1. This new paragraph 2.6 ad art. 15 OECD MC basically takes over the Discussion Draft’s proposal, however giving a different perspective to the “State where it is reasonable to assume that the employee would have worked during the period of notice”. Whereas the Discussion Draft bluntly asserted that it would “most often be the State where the employment activities were performed at the time of the termination”, the amended Commentary provides a more nuanced structure, however also leaving more room for interpretation.
2. Several questions arise in relation to PILON’s:
  - a) The Commentary describes the payments examined as follows: “if the employee is told not to work during the notice period and is simply paid the remuneration for that period (...)”. In our opinion, this means that the work contract has not yet been terminated, and that the employee receives income for a period still being covered by his work contract, but during which he simply is not required to work.

In our opinion, and despite the title of “payment in lieu of notice of termination” under which this paragraph fell in the Discussion Draft,

such payment is rather a gardening leave<sup>133134</sup>. Accordingly, it is quite normal that a gardening leave is considered as income from employment, since it is “ordinary” salary, the work contract not being terminated.

A PILON on the other hand involves that the payment is made after termination of the contract. It is in our eyes also to be considered as remuneration, because of the causality link with employment. However, the difference should have been made more obvious in the Commentary, and the treatment clearly differentiated, whereas the difference plainly has not even been considered<sup>135</sup>. Further, the characteristics of the payment are more akin to a severance payment. Should not the allocation of taxing rights of a PILON rather have followed the allocation determined in para. 2.7 of the Commentary for severance payments?

- b) The Commentary applies a “replacement of income approach” leading to the determination of a “fictitious place of exercise”<sup>136</sup>. Determining a fictitious place of exercise by definition adds a supplementary difficulty to the already difficult question of place of exercise of a non-activity, since it is by essence based on speculation<sup>137</sup>.

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<sup>133</sup> “In particular it is necessary to distinguish between a PILON and a gardening leave situation. In the latter an employee will typically be given proper notice of termination of employment but told not to attend work during the notice period. As proper notice is given, payment for the period to the termination date cannot properly be described as made **in lieu of** notice. The payment is simply the salary due for the period of notice and so taxable under Section 62 ITEPA 2003 (see [EIM00670](#)), whether or not it is paid as a lump sum. In this case, the employment continues to the termination date whether the employee works or not.” HMRC – EMPLOYMENT INCOME MANUAL; EIM12975 - Termination payments and benefits: payments in lieu of notice (PILONs) and gardening leave: general; <http://www.hmrc.gov.uk/manuals/eimanual/eim12975.htm>; December 21, 2014

<sup>134</sup> See also TUMPEL MICHAEL AND JAHN ROBERT, Termination of Employment – The OECD-Model-Convention and its proposed Update 2014, 21<sup>st</sup> Viennese Symposium on International Tax Law, slide 9; [http://www.wu.ac.at/dibt/taxlaw/events.main/nat.events/maisymposium2014\\_tumpel\\_jahn.pdf](http://www.wu.ac.at/dibt/taxlaw/events.main/nat.events/maisymposium2014_tumpel_jahn.pdf), October 15, 2014

<sup>135</sup> CHARTERED INSTITUTE OF TAXATION, Tax Treaty Treatment of Termination Payments – Response, October 23, 2013, para. 3.3 <http://www.oecd.org/tax/treaties/CIOT%20-%20130920%20OECD%20Termination%20Payments%20-%20CIOT%20comments.pdf>, September 9, 2014

<sup>136</sup> PÖTGENS, Income p. 845

<sup>137</sup> TUMPEL MICHAEL AND JAHN ROBERT, Termination of Employment – The OECD-Model-Convention and its proposed Update 2014, slide 9; HILL JAMES, Termination payments and internationally mobile employees

A major difficulty seems to arise for internationally operating employees. E.g. what would be the fictitious place of exercise of an employee resident in State R, working in State S and having his related salary taxed in State S because the exception of art. 15(2) OECD MC does not apply, but also occasionally working in State R or in third States? His ordinary salary for days worked in State R and in third States is in principle taxable in State R, on the basis of art. 15(1) OECD MC. How is it possible to determine where “it is reasonable to assume that the employee would have worked during the period of notice” if his employment involved extensive travelling? A *pro rata temporis* allocation between States R and S does not seem very practicable in such cases and is likely to lead to disagreement between both States. Would we then fall back on art. 15(1) OECD MC in case of doubt on the deemed place of exercise of employment? We believe this would be the most reasonable option; a clarification on the question would however have been welcome.

- c) What is a “substantial period of time”?
- d) In the Discussion Draft, reference was made to the 183 days rule and to the local employer or permanent establishment (art. 15(2) OECD MC) when the employee is working in a State for a short period of time. The new Commentary only provides that it would be “inappropriate to take account of a prospective employment period in a State where the employee (...) did not, in fact, perform his employment for a substantial period of time”. The fictitious place of exercise accordingly has to be “supported” by past employment.

In our opinion, a clear reference to art. 15(2) should however preferably have been made rather than a reference to “a substantial period of time”.

Further, quid if the employee did not perform “for a substantial period of time” his employment in the State where he would have worked during the period of notice – e.g. because of extensive travelling before termination of employment, whereas his employer or a permanent establishment of his employer bearing his remuneration is actually located in that State? On the basis of the Commentary alone, this would not allocate any taxing rights to the State where the employer is located. We nevertheless believe that, if it is considered that remuneration is “derived from” the exercise of employment within the

meaning of art. 15(1) OECD MC, the text of art. 15(2) OECD MC should prevail over the Commentary.

- e) How is the 183 days period mentioned in art. 15(2)(a) OECD MC calculated: with or without the notice period? Could the State where it is assumed the employee would have worked during the notice period, exactly on the basis of this assumption, include the period of notice to calculate the period of 183 days of presence on its territory, even when the employee actually spends this period in the other State? Since it is generally accepted that only days of physical presence are considered, it is assumed that this principle would also apply here, and that only the actual days of physical presence would be taken into consideration<sup>138</sup>. Conversely, if the employee stays in the State where he was assumed to work during the period of notice, even without working –e.g. to look for other work or business opportunities, those days of physical presence should be considered for the computation of the 183 days. Some express indication in the Commentary would however have added clarity on the subject.

#### **b) Severance payments**

The new paragraph 2.7 ad art. 15 OECD MC confirms the type of payment described in the Discussion Draft<sup>139</sup> and endorses the following:

- Such payment is income from employment within the meaning of art. 15 OECD MC;
- Such remuneration is “derived therefrom” within the meaning of art. 15(1) OECD MC;
- The payment is considered as remuneration for the last 12 months of employment; it should therefore be allocated on a pro-rated basis to where employment was exercised during those last 12 months. This last part is a major difference compared to the Discussion Draft, which only considered the State where employment was exercised upon termination;

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<sup>138</sup> DAL COL PHILIPPE, La «*clause du monteur*» selon l'article 15 (2) du Modèle de convention fiscale concernant le revenu et la fortune de l'OCDE, RDAF, 2014/04, p. 281

<sup>139</sup> Except for the fact that the following part of the sentence has been deleted: “(such a payment) is unrelated to any obligation to give advance notice of termination”. In our eyes, this however does not have any impact on the material description of the payment.

- The presumption that the severance payment is derived from the State where employment was exercised during the last 12 months of employment, is rebuttable.

#### Comments

1. As seen before, most States already considered severance payments as income from employment, but also had different allocation methods, leading to possible cases of double taxation or double non-taxation. Therefore, in our eyes, the Updated Commentary at least has the merits not only to unequivocally qualify this income, but also to give a clear indication on how the remuneration should be allocated between Contracting States. If the Commentary is followed by States and by their Courts, this should avoid cases of double taxation and double non-taxation which had been known in the past. Of course, it remains to be seen if and how the Commentary will be applied.
2. Further, by stating that a severance “is often, but not always, calculated by reference to the period of past employment with the employer”, the Commentary in our view also clarifies that this allocation applies generally, whether the severance is calculated by reference to the past or not. In our opinion, the recommended allocation should then also apply to severance payments seen as a compensation for a loss of employment or a bridge to a future employment. One may disagree with this unilateral interpretation given by the Commentary, but it has the virtue of avoiding divergent allocations by Contracting States.
3. A reference period of 12 months seems reasonable in our eyes. Actually, if the most “correct” reference period would have been the whole employment relationship, since income has accrued during the whole period of employment, this does really not seem to be practicable nowadays<sup>140</sup>. Conversely, allocating taxing rights to the State where the employment was exercised upon termination would appear to be too casual. Therefore, an intermediate reference period seems to be preferable, the difficulty then being to determine the length of this period.

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<sup>140</sup> The same issue with respect to pensions paid to individuals having worked in several States had been identified in the OECD Cross-Border Pensions Discussion Draft, and had resulted in the proposal to allocate taxing rights on pensions to the Residence State only

4. Moreover, with a rebuttable presumption on the 12 months period remuneration, it is still possible to evidence that the payment remunerates a different or a specific period of employment, e.g. if a severance has been calculated by reference to specific past years of services spent in other countries.
5. Unlike the interpretation given by Dutch Courts, no reference is made to the entity paying or bearing the cost of the severance. This has to be welcomed, since the condition applied by Dutch Courts is not mentioned in art. 15(1) OECD MC.
6. Nonetheless, the question of the possible qualification of a severance as a pension payment is not specifically raised in the Updated Commentary, the new para. 2.10 of the Commentary ad art. 15 OECD MC simply referring to the existing Commentary ad art. 18 OECD MC.
7. Finally, it is not specified whether the employment period encompasses employment with the same Group of companies, or only with one of the companies of the Group<sup>141</sup>.

### c) Damages

The new paragraph 2.8 ad art. 15 OECD MC takes over the wording of the Discussion Draft<sup>142</sup>.

#### Comments

1. Applying equal treatment to equivalent payments is a worthy objective<sup>143</sup>. However, our understanding is that judicial damages should come *in addition to* the PILON or the severance pay which was legally or contractually due. Should the damage then follow the same tax treatment?

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<sup>141</sup> KPMG LLP, Tax Treaty Treatment of Termination Payments, para. 4, September 17, 2013, [http://www.oecd.org/tax/treaties/KPMG%20\(UK\)%20--%20L-OECD-Termination%20Payments%20final.pdf](http://www.oecd.org/tax/treaties/KPMG%20(UK)%20--%20L-OECD-Termination%20Payments%20final.pdf), September 9, 2014

<sup>142</sup> Except for the last sentence relating to capital gains, irrelevant for PILON's and severance payments

<sup>143</sup> See also TUMPEL MICHAEL AND JAHN ROBERT, Termination of Employment – The OECD-Model-Convention and its proposed Update 2014, slide 13 and PRASCHL GISELA, Article 15 of the OECD Model Tax Convention on Income from Employment – Income from employment and attribution of the right to tax, p.230



2. The difficulty might also be to identify the different components of a damage and what they each compensate.

#### **d) Partial retirement payments**

No changes have been made compared to the Discussion Draft.

#### Comments

Since the tax treaty treatment is equivalent as for PILON's examined in the new para. 2.6 of the Commentary ad art. 15 OECD MC, the same comments can basically be repeated here.

1. Income viewed by this new paragraph are both stand-by fees and payments for gardening leave. Like mentioned above, since the work contract is not yet terminated, and since the employee receives income for a period still being covered by his work contract, but during which he simply is not required to work, it does indeed seem quite logical to consider those payments as income from employment.
2. The Commentary again uses the "fictitious place of exercise", like for PILON's. As seen before, this may lead to practical difficulties.
3. The same questions arise with respect to the calculation of the 183 days period mentioned in art. 15(2)(a) OECD MC.

### **C. Global evaluation**

Finally, it can be confirmed that the 2014 Updated Commentary ad art. 15 OECD MC well identifies the issues related to termination payments made in a cross-border context:

- are those payments to be qualified as "salaries, wages or other similar remuneration" covered by art. 15 OECD MC, or do they fall under another article of the OECD MC?
- if such payments do fall under art. 15 OECD MC, to what extent are those payments, or part thereof, to be considered as "derived from the exercise of an employment in a given State"<sup>144</sup>?

The initiative taken by the CFA to treat those issues is thus most welcome.

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<sup>144</sup> 2014 UPDATE, Commentary para. 2.3 ad art. 15 OECD MC

The answer to the first question is however partially disappointing, because the Updated Commentary misses the point to make a clear differentiation between art. 15 and 18 OECD MC. The question: “when is a severance payment to be considered as a pension payment?” remains basically unanswered, depending on “facts and circumstances”.

The answer to the second question has mainly been given by recognizing the “predominant character conferred to the nexus between termination payments and the Source State rather than giving precedence to the Residency State”<sup>145</sup>.

As seen above, several uncertainties nevertheless remain, and it remains to be seen how States will settle these uncertainties.

With the identification of the real consideration of each termination payment, a welcome substance-over-form approach has been taken by the OECD<sup>146</sup>. Of course, this always involves some degree of uncertainty as to the final qualification to be given to these payments.

Further, was the Commentary really the best place to try to resolve these questions? Even if the Commentary itself promotes an ambulatory interpretation of tax conventions in the light of amended Commentary provisions<sup>147</sup>, we know this position is often challenged. Will States and their Courts really apply the Updated Commentary, especially in those States where the Updated Commentary conflicts with existing case law (e.g. Germany or the Netherlands)? Ununiform application of the Commentary may even lead to more legal uncertainty, with some States applying the Updated Commentary and others not.

It has also been argued, and, in our eyes not without foundation, that “in case of cross-border workers, simplicity is of the essence. This would suggest interpretation of the Articles 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 coun-

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<sup>145</sup> ERNST & YOUNG, Public Discussion Draft on the tax treatment of termination payments – changes to the commentaries to article 15 of the OECD model tax convention Income from employment. EY response by Jean-Nicolas Lambert, chapter 4, [http://www.oecd.org/tax/treaties/EY%20\(Belgium\)%20\(revised\)%20--%20OECD%20Comments%20terminationL.pdf](http://www.oecd.org/tax/treaties/EY%20(Belgium)%20(revised)%20--%20OECD%20Comments%20terminationL.pdf), September 9, 2014

<sup>146</sup> 2014 UPDATE, Commentary para. 2.3 ad art. 15 OECD MC

<sup>147</sup> Commentary, Introduction OECD Model 2012, para. 35

tries. While there will be some very well-paid individuals who receive substantial termination payments, in the vast majority of cases the modest amounts involved will not justify the complexity and record-keeping required to demonstrate where a particular ingredient of a payment is taxable. If the OECD is to be helpful, a simple pragmatic approach would be best<sup>148</sup>. Even if dogmatically, we do not agree with this position, especially if a severance is calculated taking into account the period of past employment, we nevertheless have to admit that such a pragmatic approach clearly has merits and would present great advantages. This was also a solution favoured by Prof. Pötgens, possibly with an anti-abuse provision like in the US-Italy DTC or a subject-to-tax clause, i.a. in order to avoid abusive schemes<sup>149</sup>.

### **III Tax treatment of severance payments in Switzerland**

#### **1. Domestic law**

No legal obligation exists to pay an indemnity in case of termination of employment; a notice period needs however to be respected<sup>150</sup>. An exception arises in the following context: “Where an employment relationship with an employee of at least 50 years of age comes to an end after twenty years or more of service, the employer must pay the employee a severance allowance”<sup>151</sup>. Other payments will therefore be sourced in an agreement, or are to be considered as penalties<sup>152</sup>. As mentioned before, those penalties, non-competition payments or damages are excluded from the scope of this paper; salary paid for the period of notice is ordinary salary; therefore, we will focus on the payments sourced in agreement.

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<sup>148</sup> CHARTERED INSTITUTE OF TAXATION, Tax Treaty Treatment of Termination Payments – Response, October 23, 2013, para. 5.2

<sup>149</sup> PÖTGENS, Income p. 454

<sup>150</sup> Art. 335c CO : from one to three months, depending on the length of employment, and absent different contractual, standard or collective employment agreement

<sup>151</sup> Art. 339b CO. Those payments may be reduced by benefits from an occupational benefits scheme funded by the employer –art 339d CO. Therefore, this exception has lost much of its importance since the Federal Act of 25 June 1982 on Occupational Old Age, Survivors' and Invalidity Pension Provision.

<sup>152</sup> Art. 336a CO: unlawful termination of employment relationship

## A. Realization of income

It is the moment at which an item of income is “realized” which constitutes a taxable event<sup>153</sup>, and which will also be relevant for the moment of taxation of this item of income. An item of income is realized when an individual receives the income, or when he has a firm claim on its payment, which he may dispose of<sup>154</sup>. Conditional for the realization of an income is that the taxpayer must have certainty on the existence and on the amount of his claim, it being sufficient that the amount of the claim can be determined on the basis of objective criteria<sup>155</sup>. Concretely, this means that an item of income can be realized, and therefore become taxable, before its payment. Absent different agreement, a severance payment is due on termination of the employment relationship<sup>156</sup>, and will thus in principle be realized at termination of employment, even if payment occurs at a later date<sup>157</sup>.

The difference in timing between realization and payment may have some importance in a cross-border context, since the Residence State might be different at the time of payment as the Residence State at the time of realization of income. E.g. a taxpayer may be subject to an unlimited tax liability in Switzerland at the time of *realization* of income from a severance payment, but will not be so anymore at the time of *payment*, and will be liable to tax in another jurisdiction.

## B. Qualification of severance payments

It is remarkable that the question of qualification of severance payments in domestic law has received very little attention, most probably because the way such payments are taxed is clear –they are fully taxable together with other income - , and makes their qualification less relevant<sup>158</sup>.

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<sup>153</sup> OBERSON XAVIER, *Droit fiscal suisse*, Basel, 2012, p.99

<sup>154</sup> NOËL YVES, *Commentaire ad art. 16, para. 30 and cited case law of Federal Tribunal in YERSIN DANIELLE; NOËLYVES (Eds.) Commentaire romand Impôt fédéral direct. Commentaire de la loi sur l'impôt fédéral direct*, Basel, 2008

<sup>155</sup> *Urteil des Bundesgericht 2C\_319/2012*, 17.10.2012, para. 2.3.1, <http://www.bger.ch/fr/index/jurisdiction/jurisdiction-inherit-template/jurisdiction-recht/jurisdiction-recht-urteile2000.htm>, December 30, 2014

<sup>156</sup> Art. 339c para. 4 CO

<sup>157</sup> REICH MARKUS, *Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis*, p. 195; ARRÊT DU TRIBUNAL CANTONAL VAUDOIS, FI.2008.0126, 11.09.2009, RF, 2010/3, p. 193-198

<sup>158</sup> See also about „other income“ REICH MARKUS, *Steuerrecht*, Zurich, 2012, p. 332

On the one hand, art. 17(1) FDTL, under the heading “Income from dependent gainful activity” provides that all income from employment is fully taxable, and gives an illustrative list; the concept of income from employment thus has to be interpreted broadly<sup>159</sup>. Severance payments are not part of the list, but they need to be mentioned on the annual salary statement issued by the employer<sup>160</sup>, and, when source taxation is applicable, are subject to source tax in principle only withheld on income from employment or income replacing income from employment<sup>161</sup>. Further, severance payments are part of the “determining salary” for social security purposes and are subject to social security withholdings like ordinary salary<sup>162</sup>. This all tends to show severance payments are considered as income from employment.

On the other hand, under the heading « Other income », at art. 23 FDTL, we find that all income acquired in replacement of income from gainful activity is taxable<sup>163</sup>, and that all payments received at termination of activity or for the non-exercise of an activity are fully taxable as well<sup>164</sup><sup>165</sup>. Those provisions seem to encompass severance payments<sup>166</sup>.

Qualification, and even application of art. 23(a) vs 23(c) FDTL, thus remains ambiguous<sup>167</sup>.

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<sup>159</sup> REICH MARKUS, *Steuerrecht*, Zurich, 2012, p. 270

<sup>160</sup> Guide d'établissement du certificat de salaire et de l'attestation de rentes, para. 27-28, <http://www.estv.admin.ch/bundessteuer/dienstleistungen/00666/00852/index.html?lang=fr>, January 1, 2015

<sup>161</sup> Art. 83-84 FDTL and art.91 FDTL ; Art. 3(2)(a) OIS

<sup>162</sup> Art. 7q RAVS

<sup>163</sup> Art. 23(a) FDTL

<sup>164</sup> Art. 23(c) FDTL

<sup>165</sup> It has been argued that income covered by art 23(a) and (c) FDTL could have been covered by art. 17 FDTL, which would then treat income from employment during exercise and at termination, as well as replacement income. See NOËL YVES, *Commentaire ad art. 23*, para. 2

<sup>166</sup> NOËL YVES, *Commentaire ad art. 23*, para. 24

<sup>167</sup> NOËL YVES, *Commentaire ad art. 23*, para. 23

## C. Tax treatment of severance payments

### a) Unlimited tax liability

#### Ordinary taxation procedure

If a taxpayer is unlimited liable to tax because of his personal attachment<sup>168</sup>, the scope of his liability in principle covers his worldwide income, irrespective of the source of income<sup>169</sup>.

Under art. 23(a) and (c), severance payments are fully taxable, together with all other income, at the ordinary tax rates. The ordinary assessment occurs after filing an annual tax return. Two exceptions to the principle of taxation at ordinary rates apply:

- ✓ First exception : tax treatment of pension capital

If a severance payment paid by an employer can be considered to be equivalent to a lump-sum payment by a pension fund (art. 17(2) FDTL), taxation occurs separately from the taxpayer's other income, at a preferential tax rate, like for capital payments made by a pension fund (art. 38 FDTL).

The FTA has issued a circular to define in which cases a severance payment has a provident feature or is to be considered as an income acquired in compensation<sup>170</sup>. Severance payments have a provident feature if they are exclusively and irrevocably aimed at reducing the financial consequences deriving from risks linked to old-age, invalidity or death. This means that they need to be similar to pension payments and aim at maintaining the ordinary standard of living of the recipient in case of occurrence of an insured event. Such appreciation must be carried out at the moment of the payment, and not *a posteriori*. Following conditions have to be met cumulatively:

- The taxpayer leaves the company at an age of at least 55;
- Principal employment is permanently discontinued;

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<sup>168</sup> For the applicable conditions, see art. 3 FDTL

<sup>169</sup> Art. 6(1) FDTL

<sup>170</sup> CIRCULAIRE ADMINISTRATION FEDERALE DES CONTRIBUTIONS NO 1, Les indemnités de départ et les versements de capitaux de l'employeur, 03.10.2002, chapter 1, <http://www.estv.admin.ch/bundessteuer/dokumentation/00242/00380/?lang=fr>, December 30, 2014

- A future pension gap occurs because of the early exiting of the company and its pension fund<sup>171</sup>.

The same criteria apply to severance payments paid by an employer abroad to recipients unlimited tax liable in Switzerland<sup>172</sup>.

In order to benefit from the favourable tax rate applicable to capital payments by pension funds, severance payments done by employers must thus have a predominant provident purpose<sup>173</sup>.

It appears that, domestically, a severance payment taxed *like* a pension payment because having the same features and aims as a pension, can also be qualified as *being* a pension payment<sup>174</sup>; it should even have been addressed under the income from pensions provision (art. 22 FDTL)<sup>175</sup>.

- ✓ Second exception : non provident pension payment replacing periodical payments

If a severance payment replaces periodical payments which do not have a provident character, the payment will be fully taxable with all other income, but the applicable tax rate will be calculated as if an annual payment had been made instead of a lump-sum (art. 37 FDTL). This second exception applies in a relatively limited number of cases.

Following several judgments of the Federal Tribunal, the CSI has issued a recommendation with respect to the application of art. 37 FDTL to severance payments<sup>176</sup>. Conditions are globally as restrictive as for the application of art. 38 FDTL, except for the requirement of the future pension gap, and the related

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<sup>171</sup> Those criteria have been specified – and softened - by the Federal Tribunal: the age of 55 is not an unconditional minimum age in case e.g. of reorganization of an enterprise; abandonment of activity must not be seen as a stringent condition, but must rather be considered in the light of perspectives to find an equivalent position at the time of payment ARRÊT DU TRIBUNAL FÉDÉRAL 2C\_538/2009, 19.08.2010, para. 6.1 and 6.3, <http://www.bger.ch/fr/index/jurisdiction/jurisdiction-inherit-template/jurisdiction-recht/jurisdiction-recht-urteile2000.htm>, January 1, 2015

<sup>172</sup> CONFERENCE SUISSE DES IMPOTS, PRÉVOYANCE ET IMPÔTS. CAS D'APPLICATION DE PRÉVOYANCE PROFESSIONNELLE ET DE PRÉVOYANCE INDIVIDUELLE, loose-leaf, Case A.9.1.4

<sup>173</sup> Ibid. para. 4.5

<sup>174</sup> REICH MARKUS, Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis, p. 204

<sup>175</sup> KNÜSEL BRUNO, Kommentar ad art. 17 in ZWEIFEL MARTIN; ATHANAS PETER (Eds), Kommentar zum schweizerischen Steuerrecht. Bundesgesetz über die direkte Bundessteuer (DBG), Basel, 2008, p. 176-177

<sup>176</sup> CONFERENCE SUISSE DES IMPOTS, RECOMMANDATION RELATIVE A L'APPLICATION DU TAUX PERIODISE AUX INDEMNITES DE DEPART VERSEES PAR L'EMPLOYEUR, Prévoyance et Impôts

pension feature. Absent this pension feature, there is no discussion whether a severance payment taxable under art. 37 FDTL would qualify as pension.

### Source tax

Under art. 83 ff FDTL, foreign workers may be subject to source tax on their income from employment under certain circumstances. Rates take into consideration usual professional expenses and the taxpayer's family situation. In addition to this, unless the source taxpayer is entitled to file a subsequent tax return<sup>177</sup>, he may request a correction of source tax withheld to claim a limited number of additional individual deductions<sup>178</sup>.

As mentioned above, severance payments are also subject to source tax as income acquired in compensation for income from employment<sup>179</sup>. Art. 3(2)(a) OIS provides that capital payments replacing periodical payments are taxable at the rate which would have been applicable had an annual payment occurred. The same tax treatment as foreseen in art. 37 FDTL is therefore applicable. However, asking for the application of the favourable tax rates of art. 38 FDTL is not mentioned in these limited number of cases. The question arises how a source tax payer might then be able to claim these rates which would have been applicable to him had he been assessed under the ordinary procedure. In our opinion, because of the principle of equality of treatment, this possibility should clearly remain open to source tax payers who are not allowed to file a subsequent tax return.

### **b) Limited tax liability**

Under art 5 FDTL, individuals who are not unlimited liable to tax are nevertheless subject to a limited tax liability in Switzerland if they have an economic attachment, e.g. if they exercise a gainful activity in Switzerland<sup>180</sup>. This provision applies whatever the moment of payment, i.e. also after a taxpayer's departure from Switzerland, as long as income relates to employment exercised in Switzerland<sup>181</sup>, and may therefore also be relevant for severance payments paid after departure of the country.

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<sup>177</sup> Art 90(2) FDTL

<sup>178</sup> Art. 2(1)(e) OIS

<sup>179</sup> Art. 84(2) FDTL

<sup>180</sup> Art. 5(a) FDTL

<sup>181</sup> ARRÊT DU TRIBUNAL FÉDÉRAL, 15.02.2001, RDAF 2002 II, p. 19-25



Income from employment is subject to source tax<sup>182</sup> at rates taking into consideration usual professional expenses and the taxpayer's family situation. Severance payments paid to persons having exercised an employment in Switzerland will therefore be subject to source tax to be withheld by the employer.

Persons without personal attachment in Switzerland are also subject to a limited tax liability if they receive income from Swiss pension institutions of private law<sup>183</sup><sup>184</sup>, which is also subject to source tax. Source tax rates on capital payments are determined by reference to art. 38(2) FDTL, i.e. basically same tax rates are applicable as for resident persons receiving a pension capital<sup>185</sup>.

In the case of realization of the severance payment having pension features while the taxpayer is unlimited tax liable in Switzerland, and its payment occurring after departure from Switzerland, there might be a conflict between the ordinary tax procedure, under which art. 38 FDTL would be applicable, and the source tax procedure. It seems that in such case, art. 38 FDTL might not be applied, but that the severance payment should possibly be subject to source tax<sup>186</sup>.

The question then arises whether severance payments having a pension feature within the meaning of art. 17(2) FDTL earned by individuals not unlimited tax liable in Switzerland after employment in Switzerland, would be taxed at source under art. 91 FDTL at "ordinary" source rates, or under art. 96 FDTL, possibly at a preferential tax rate. Scholars seem to accept that severance payments having a pension feature are assimilated to pension income, both in domestic and international law (see below). Accordingly, these payments should not be subject to source tax under art. 91 FDTL as income from employment. Such severance payments are not subject to source tax under art. 96 FDTL either, since, the wording of art 96(2) FDTL is clear and its application is limited to payments made by a provident institution<sup>187</sup>. No source taxation should therefore in principle occur on the basis of domestic law.

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<sup>182</sup> Art. 91 FDTL

<sup>183</sup> Art. 5(1)(e) FDTL

<sup>184</sup> In the meaning of : deriving from a private work relationship as opposed to a public work relationship. LAFFELY MAILLARD GLADYS, Commentaire ad art. 96, para. 2

<sup>185</sup> Art. 96(2) FDTL; See also the art. 3 of the Appendix to OIS

<sup>186</sup> LAFFELY MAILLARD GLADYS, Commentaire ad art. 38 para. 7

<sup>187</sup> LAFFELY MAILLARD GLADYS, Commentaire ad art. 96, para. 3; RICHNER FELIX, FREI WALTER, KAUFMANN STEFAN, MEUTER HANS ULRICH, Handkommentar zum DBG, Zurich, 2009; p. 917. Contra: REICH MARKUS, Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis, p. 190, who argues that pension income

However, in a case more extensively discussed below, the Federal Tribunal ruled in an *obiter dictum* that payments made before retirement age can not be pensions<sup>188</sup>. Since in our opinion this *obiter dictum* was made in relation with a domestic law qualification, all severance payments would be considered as income from employment and could therefore be subject to source tax under art. 91 FDLT.

The application of DTC's and their possible limitation of Switzerland's taxing rights pursuant Swiss domestic law, of course remains reserved and still has to be examined.

## 2. Tax treaty law

The same issues as examined in the 2<sup>nd</sup> part of this paper arise: how are severance payments qualified, and if they are qualified as income from employment, how are taxing rights allocated? In opposition to other countries examined earlier, those topics have not been extensively dealt with by Swiss national Courts.

International tax treatments of income from employment and from pensions in DTC's concluded by Switzerland basically follow art. 15 and 18 of the OECD MC; all considerations below will therefore only concern provisions similar to art. 15 and 18 OECD MC, and deviating DTC's will not be analysed. Further, the special case of frontier workers will not be examined either in the present paper.

### A. Qualification of severance payments

Swiss scholars tend to qualify severance payments as other income falling under art. 21 OECD MC, because they are not seen as compensation for the exercise of an activity, thereby lacking the immediate connection with the exercise of activity, but as a means to facilitate the employee's professional

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and provident payments made by an *employer* are to be qualified as income from employment (because not able to be taxed at source under art 96 FDTL). We understand that these payments should accordingly be taxed at source under art. 91 FDTL.

<sup>188</sup> ARRET DU TRIBUNAL FEDERAL 2C\_604/2011, 09.05.2012, para. 5.3, <http://www.bger.ch/fr/index/jurisdiction/jurisdiction-inherit-template/jurisdiction-recht/jurisdiction-recht-urteile2000.htm>, November 10, 2014

transition<sup>189</sup>. This is also the position taken by the Geneva cantonal tax administration<sup>190</sup>.

However, it is generally observed that the trend is to qualify severance payments as falling under art. 15 OECD MC<sup>191</sup>. It is, at least generally speaking, also the position taken by the Vaud cantonal tax administration<sup>192</sup>.

The FTA confirms that art 15, 18 or 21 OECD MC can apply, depending on the specific circumstances of the case<sup>193</sup>.

Without formally taking position on this difference of qualification, the Federal Tribunal (TF) nevertheless clearly confirmed that remuneration for the period before the contract is terminated and during which the employee is not required to work anymore but still has duties of loyalty and confidentiality, is to be qualified under art. 15 CH-GR DTC<sup>194</sup>. In this case, these payments are a clear compensation for duties performed by the employee<sup>195</sup>. The Court left open the question whether the same qualification would apply without these duties of loyalty and confidentiality.

There is no agreement either if art. 18 OECD MC might apply to pension-like severance payments. On the one hand, it has been contended that the domestic qualification as pension of severance payments meeting the conditions of art. 17(2) FDTL also extends to international tax law<sup>196</sup>. On the other hand, it has been argued that pension payments and other similar remuneration have an autonomous meaning, and that a domestic qualification of these payments is not sufficient to qualify them also as pensions under tax treaty law. Determining factors are rather the legal reasons of the payment, which must be the provident nature of the payment after termination of employment. Payments

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<sup>189</sup> ARRÊT DU TRIBUNAL FÉDÉRAL 2C\_604/2011, 09.05.2012, para. 4.4; REICH MARKUS, Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis, p. 199; DÜRR SAMUEL, Art. 15 OECD-MA in Kommentar zum Internationalen Steuerrecht, ZWEIFEL MARTIN; BEUSCH MICHAEL; MATTEOTTI RENÉ (Eds) Basel 2015, N. 17

<sup>190</sup> E-Mail from Ligne directe du service de taxation D, 10.11.2014

<sup>191</sup> REICH MARKUS, Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis, p. 200; OBERSON XAVIER, Précis de droit fiscal international, Bern, 2014, p. 191

<sup>192</sup> SANDRI GIAN, Income from employment, directors' fees and pensions, MASIT, December 4, 2013, slides 63-64

<sup>193</sup> E-mail from Federal Department of Finance (Mr. Mezzi), 13.01.2015

<sup>194</sup> The DTC between Switzerland and Greece had the same wording as the OECD MC. ARRÊT DU TRIBUNAL FÉDÉRAL 2C\_604/2011, 09.05.2012, para. 6

<sup>195</sup> Ibid., para. 5.3

<sup>196</sup> LAFFELY MAILLARD GLADYS, Commentaire ad art. 96, para. 3

done before termination of active employment are generally to be seen as income from employment. The recipient should thus usually have reached retirement age. An exception of this principle can be seen for payments aimed at bridging the period until retirement, if it can be assumed that, considering his age, the recipient will not find a new position anymore<sup>197</sup>.

In our opinion, payments viewed by art. 17(2) FDTL even have a more “pension-like” or provident objective than payments only aiming to bridge the period until retirement: they are intended to fill the gap *in pension rights* and not only the gap in salary due to early termination of employment. Therefore, considering this even more provident goal, art. 18 OECD MC should apply to them, even given the non-automatic correspondence between domestic and treaty law meanings. The fact that later on a new employment is taken up again should not be decisive, since one must look at objective chances to find a new position at the time of payment of the severance.

To our knowledge, Swiss Courts never had to unambiguously decide on the qualification of a severance payment meeting the conditions of art. 17(2) FDTL. A relevant case might be a 2007 decision of the Cantonal Tribunal of Basel Land<sup>198</sup>. It had to decide on a severance payment to a recipient domiciled in Switzerland, and who had exercised his activity in the United Kingdom. On the one hand, the taxpayer claimed an exemption of part of the payment for employment exercised abroad on the basis of art. 15(1) of the UK-CH DTC. And on the other hand, the tax payer also claimed the application of art. 17(2) and 38 FDTL because the payment had a pension feature. The Tribunal denied both claims, but noted that claiming both the application of art. 15(1) and 18 of the UK-CH DTC actually was contradictory, since provident payments are excluded from the scope of art. 15 DTC<sup>199</sup>. Therefore, even if denying the pension feature of the severance in this concrete case, the Tribunal implicitly recognized the qualification of severance payments as income from employment, unless they have a provident feature.

The Federal Tribunal in an *obiter dictum* has mentioned that payments made before retirement age can not be pensions<sup>200</sup>, and can therefore not fall under

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<sup>197</sup> REICH MARKUS, Die Besteuerung von Arbeitseinkünften und Vorsorgeleistungen im internationalen Verhältnis p. 204

<sup>198</sup> ENTSCHEID DES STEUERGERICHTS DES KANTONS BASEL-LANDSCHAFT NR.2/2007, 12.01.2007, [http://www.baselland.ch/fileadmin/baselland/files/docs/fkd/steuern/praxis/2007/6\\_2007\\_488-496.pdf](http://www.baselland.ch/fileadmin/baselland/files/docs/fkd/steuern/praxis/2007/6_2007_488-496.pdf), January 4, 2015

<sup>199</sup> Ibid. para. 6

<sup>200</sup> ARRÊT DU TRIBUNAL FÉDÉRAL 2C\_604/2011, 09.05.2012, para. 5.3

art. 18 OECD MC<sup>201</sup>. This would mean that severance payments meeting the conditions of art. 17(2) FDTL would not be qualified as pension payments under treaty law. In our opinion however, this *obiter dictum* was made in relation with a domestic law qualification, which is not automatically the same for a treaty law qualification.

Since the Geneva tax administration considers severance payments as other income, no demarcation issue with art. 18 arises. The Vaud tax administration on the other hand considers that severance payments meeting the conditions of art. 17(2) FDTL are not pension income: they are income from employment but taxed at a privileged tax rate<sup>202</sup>.

In this context, it is worthwhile mentioning that Switzerland concluded several DTC's limiting the application of the article on pension income to periodical pensions and annuities only<sup>203</sup>, thereby *de facto* excluding the application of the relevant provision to capital payments, and therefore also to severance payments.

## **B. Allocation of taxing rights**

As seen before, a severance payment is considered as salary for Swiss social security purposes. In 1998, the Federal Tribunal had to decide on social security contributions to be withheld by a Swiss employer on a severance payment paid to a tax resident in Belgium who should have exercised his activity in Geneva<sup>204</sup>. The payment had been made because the employment contract had been terminated following a company reorganization before activity had actually started. The recipient had thus never been domiciled, nor had he physically exercised any activity in Switzerland. Those two criteria being determining for liability to social security withholding, he therefore contended that no Swiss social security contributions were due on this payment. Even if not domiciled in Switzerland, the Federal Tribunal nevertheless decided that the severance should be subject to Swiss social security, because the connecting

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<sup>201</sup> ZÜGER MARINA; VON AH JULIA, Art. 18 OECD-MA in Kommentar zum Internationalen Steuerrecht, ZWEIFEL MARTIN; BEUSCH MICHAEL; MATTEOTTI RENÉ (Eds) Basel 2015, N. 134

<sup>202</sup> Telephone conversation with Vaud Cantonal Tax Administration (Mr. Tille), 25.11.2014

<sup>203</sup> E.g. DTC with India and Pakistan

<sup>204</sup> ARRÊT DU TRIBUNAL FÉDÉRAL, 23.02.1998, 124 V 100, <http://www.bger.ch/fr/index/juridiction/jurisdiction-inherit-template/jurisdiction-recht/jurisdiction-recht-lei-tentscheide1954.htm>, November 14, 2014

factor in the present case was the place where the recipient *should* have exercised his activity, i.e. Switzerland<sup>205</sup>. It is to be noted that this decision concerned the application of social security law, which may even in purely domestic cases differ from tax law, even for the qualification as salary. This is even more true since social security does not always require a physical presence in Switzerland. However, it is striking how close this interpretation is to the treatment given to PILON's in the 2014 Update, and maybe how visionary this analysis was.

In the abovementioned case decided by Cantonal Tribunal of Basel, the taxpayer, domiciled in Switzerland at the time of payment, had received a severance payment following a company reorganization, calculated on the basis of his salary, age and years of service; of his 29 years of employment, 3 years had been exercised in Switzerland and 26 years in the UK. The taxpayer therefore argued that, on the basis of art. 15(1) 2<sup>nd</sup> sentence CH-UK DTC<sup>206</sup>, Switzerland could only tax 3/29 of the whole severance payment, in analogy to what the Federal Tribunal had decided for bonus payments<sup>207</sup> and income from exercise of options.

The Tribunal however decided that bonus payments and income from stock option exercise were to be seen as deferred remuneration which realization had already occurred during exercise of employment. Taxation of severance payments could only be made in analogy to bonus payments –i.e. on the basis of a prorated tax allocation – provided they had the same function, i.e. they were also deferred remuneration<sup>208</sup>. In the concrete case, there was no indication whatsoever that the severance payment was deferred remuneration for activities exercised in the UK and that the claim on the severance had already arisen during activity in the UK. Generally speaking, a claim on a severance payment to be paid within the framework of a company reorganization lay-off could only arise after and on the basis of having been made redundant, and was seen as a compensation for a future loss of income<sup>209</sup>. There was consequently no link with a place of exercise. Taxing rights on severance payments

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<sup>205</sup> Ibid. para. 3b

<sup>206</sup> With the same wording as art. 15 OECD MC

<sup>207</sup> See ARRÊT DU TRIBUNAL FÉDÉRAL, 15.02.2001, RDAF 2002 II, p. 19-25, mentioned above

<sup>208</sup> ENTSCHEID DES STEUERGERICHTS DES KANTONS BASEL-LANDSCHAFT NR.2/2007, 12.01.2007, para.4c

<sup>209</sup> Ibid.

paid after a company reorganization have then to be allocated to the Residence State on the basis of art. 15(1) CH-UK DTC<sup>210</sup>.

On the basis of this judgment, it can therefore be argued that taxing rights on a severance payment having a link with a Work State, i.e. being a continued payment for an activity exercised in the Work State, should be allocated to the Work State, on a *pro rata* basis, on the basis of 15(1) 2<sup>nd</sup> sentence OECD MC<sup>211</sup>. If there is no relation with a Work State, or if the severance is a compensation for a future loss of income, taxing rights have to be allocated to the Residence State on the basis of art. 15(1) 1st sentence OECD MC. Severance payments done following a social plan are generally a compensation for a future loss of income.

Even if we have excluded from the scope of this paper salary paid for the period of notice, it is worthwhile to analyze the abovementioned 2012 judgment<sup>212</sup>. The Federal Tribunal there ruled that remuneration for the period before termination of the contract during which the employee was not required to work anymore but still had to respect duties of loyalty and confidentiality, was to be qualified as income of employment under art. 15 CH-UK DTC<sup>213</sup>. In the present case, employer and employee had concluded on June 21, 2007 an agreement that the employment relationship would be terminated in August 2010, when the employee would reach retirement age. During this 3 year period, the employee would not be required to work, but had to respect loyalty and confidentiality obligations. He would receive an annual salary and bonus. In July 2007, the employee moved to Greece, where he established a new domicile. The Federal Tribunal ruled that the employment relationship had continued, and that the employee had continued to exercise an employment, even if the employee was not required to work anymore. This employment had continued to be exercised in Switzerland until the employee's departure from Switzerland; after his departure, the employee was not physically present in Switzerland anymore and therefore not exercising any activity in the country. Accordingly, not only his salary for the period until his departure, but also his bonus paid in 2008 but related to the period until the taxpayer's departure

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<sup>210</sup> Ibid. para. 4d

<sup>211</sup> FREI CLEMENS, Severance pay : a comparison of taxation principles in Switzerland and abroad, Tax News Ernst & Young, March 2008, [https://www2.eycom.ch/publications/items/tax\\_news/20080319\\_taxnews/200801\\_EY\\_Tax\\_News\\_e.pdf](https://www2.eycom.ch/publications/items/tax_news/20080319_taxnews/200801_EY_Tax_News_e.pdf), p.6, January 4, 2015

<sup>212</sup> ARRET DU TRIBUNAL FEDERAL 2C\_604/2011, 09.05.2012

<sup>213</sup> ARRET DU TRIBUNAL FEDERAL 2C\_604/2011, 09.05.2012, para. 6

in July 2007, was taxable in Switzerland on the basis of art. 15(1) CH-GR DTC<sup>214</sup>.

This ruling can be compared to the tax treatment of PILON's in the 2014 Update. As mentioned earlier, the PILON envisaged by the OECD is rather a gardening leave, i.e. a period before termination of employment during which the employee is not required to work. The "notice period" in the present case is not a real notice period, and extends for over more than 3 years. But it fully makes sense to consider remuneration for the period before termination of employment as salary. In our eyes, the Federal Tribunal has been more consistent by allocating this salary to the place where employment was physically exercised, rather than to where it would be "reasonable to assume" the employee would have worked, which *in casu* however would have been identical.

Until now, the Federal Tribunal as hence not yet taken a clear position on the allocation of taxing rights with respect to other severance payments.

The Canton of Geneva, qualifying severance payments as "other income" accordingly allocates exclusive taxing rights to the Residence State.

The Canton of Vaud, which generally qualifies them as income from employment in principle will allocate taxing rights between the Residence State and the Work State on a *pro rata temporis* basis if it is proven that (part of) the severance payment is related to an activity in both States<sup>215</sup>. However, from our experience, what the cantonal tax administration considers as "a proof of relation of (part of) the severance payment being related to activities exercised outside of Switzerland" actually means "a proof of being taxed outside of Switzerland". Indeed, as long as no evidence of effective taxation outside of Switzerland is provided, the tax administration will not consider that the severance pay relates to activities exercised outside of Switzerland, and no exemption will be granted, since it is the tax administration's aim to avoid double non-taxation<sup>216</sup>. Further, like the Dutch Courts, another decisive element seems to be which entity is actually carrying the financial burden of the severance in which country. If a Swiss-based entity is paying the severance and is deducting it as a business expense, the Vaud tax authorities will consider this as being a proof that the severance relates to work exercised in Switzer-

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<sup>214</sup> Ibid. para. 5.3 and 6

<sup>215</sup> SANDRI GIAN, slides 63-64

<sup>216</sup> Telephone conversation with Vaud Cantonal Tax Administration (Mr. Sandri), 20.10.2014



land, and will tax the payment in the hands of the employee. Finally, it is argued by the tax authorities that, if a Swiss resident tax payer receives a severance payment after an international career in a group, he did not have a claim on the severance when he left the other countries for Switzerland, since he did not even know at the time that he would receive this payment<sup>217</sup>.

It is however noteworthy that art. 15 OECD MC does not provide for the necessity of a link between the right to tax an employment income and the related deduction as business expense; on the contrary, it is the physical presence which is the decisive criterium. Further, if double non-taxation should in principle be prevented, this issue should first be solved by adequate treaty provisions or with the help of the Commentary. So, if no taxation occurred outside of Switzerland, because of a conflict of qualification – e.g. the former Work State qualifies severance payments as other income taxable in the Residence State assumed to be Switzerland, Switzerland would indeed have the right to tax according to the rules laid down in para. 32.6 and 32.7 of the Commentary ad art. 23 A and B. If however, the other State also qualifies severance payments as income from employment, but allocates taxing rights differently than the Vaud tax administration, this is not a conflict of qualification, but rather a conflict of interpretation (e.g. one State considers the severance payment as having a direct link with the former exercise of activity, and the other does not). Double taxation will then probably in practice be avoided by the cantonal tax administration, which will refrain from taxing if the other State has already taxed the payment<sup>218</sup>. On the other hand, in case of non-taxation in the other country, Switzerland as an exemption country should accept to exempt that part of the income which, in conformity with the interpretation by Vaud, is *pro rata* related to an activity exercised outside of Switzerland, unless the applicable DTC contains a provision similar to art. 23(4) OECD MC or a subject-to-tax clause.

As for severance payments meeting the conditions of art. 17(2) FDTL, the Vaud tax administration considering it to be income from employment, will, in principle, apply the same allocation rules as explained above. Therefore, if such a severance payment is paid to a non-resident taxpayer after employment exercised in Switzerland, it will be considered as taxable in Switzerland and

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<sup>217</sup> See for the same argument ENTSCHEID DES STEUERGERICHTS DES KANTONS BASEL-LANDSCHAFT NR.2/2007, 12.01.2007, para.4c

<sup>218</sup> It will then probably avoid the taxpayer to have to initiate a lengthy and costly mutual agreement procedure

will be subject to source tax under art. 91 FDTL, with the possibility to ask for a correction of source tax rates to apply the pension source tax rates<sup>219</sup>.

It has further been confirmed by the Vaud tax administration – the Geneva tax administration not having taken formal position on this – that it will continue its present practice with regard to severance payments even after the 2014 Update, and that it will simply continue to ask for evidence of taxation abroad in order to accept exemption<sup>220</sup>.

The State Secretariat for International Financial Matters will in principle not accept an allocation of taxing rights under the 2010 OECD MC. However, under the 2014 Update, it recognizes that an international tax allocation might be considered<sup>221</sup>. It is unclear whether this might be a recognition of future application of the 2014 Update in the tax administration's practice.

No case law is available yet on this 2014 Update; however, considering the ambulatory interpretation given by the Federal Tribunal to the Commentary<sup>222</sup>, it is not certain the refusal of Vaud to apply the 2014 Update would stand before Courts.

Finally, also worth mentioning, Switzerland has concluded a mutual agreement with Germany<sup>223</sup> qualifying severance payments as income from employment, unless they have a provident feature. In this case, those payments fall under art. 18 CH-D DTC and taxing rights are allocated to the Residence State. On the other hand, if those payments are deferred remuneration from a previous employment, or if they are paid for early termination of employment, taxing rights are to be allocated to the former Work State, or, if work has been performed in both States, taxing rights have to be allocated between both States on a *pro rata temporis* basis in accordance with the allocated taxing rights on regular employment income. It is further provided that if a resident of one of the States receives a severance payment in relation with a former employment from an employer resident in the other Contracting State after having moved from his former Work State to his new Resident State, and those payments are not taxed in the former Work State, they may nevertheless be

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<sup>219</sup> Telephone conversation with Vaud Cantonal Tax Administration (Mr. Tille), 25.11.2014

<sup>220</sup> Telephone conversation with Vaud Cantonal Tax Administration (Mr. Sandri), 20.10.2014

<sup>221</sup> E-mail from Federal Department of Finance (Mr. Mezzi), 13.01.2015

<sup>222</sup> OBERSON XAVIER, Précis de droit fiscal international, para. 119

<sup>223</sup> BMF SCHREIBEN VOM 25.03.2010, BStBl 2010 I, p. 268

taxed in the Residence State. Unlike Germany, there nevertheless seems to be very little information available on its application by Switzerland.

### 3. Conclusions

Based on the above mentioned case law and practices, we can conclude the following:

1. Qualification of severance payments in domestic law is not unequivocal in Switzerland, being either income from employment or “other income” on the one hand, or possibly pension income on the other hand.
2. Domestically, severance payments being employment income or “other income” are fully taxable together with all other income. Pension-like severance payments are taxed at a preferential rate.
3. This preferential tax treatment of pension-like severance payments can raise several issues in case of source tax withholding. Source tax payers subject to an unlimited liability in Switzerland should e.g. be able to ask for a correction of source tax tariffs in order to claim the application of the preferential tax rate applicable to pension-like severance payments when those payments indeed meet the applicable criteria. In case of limited tax liability and payment of a pension-like severance, the situation is even less clear, and it might even be argued that, if a qualification of pension income can be given to pension-like severance pays, no source tax should be withheld on the basis of domestic law.
4. Qualification of severance payments in treaty law is not clearer. Swiss scholars will rather qualify severance payments as falling under art. 21 OECD MC. The Federal Tribunal never formally qualified these payments as “income from employment” or as “other income”, and there are even different practices in this respect from the cantonal tax administrations. As for the demarcation between art. 15 and 18 OECD MC, it can be argued that the Federal Tribunal ruled that pension payments can not be made before retirement age, and that pension-like severance payments can therefore not fall under art. 18 OECD MC. On the other hand, there seems to be a tendency to qualify severance payments having a pension-like character in the domestic meaning also as income from pensions in the tax treaty law meaning.

5. Finally, there is no clear-cut case law either on the topic of the allocation of taxing rights on severance payments, at least from the Federal Tribunal. On the basis of the ruling of the Basel Cantonal Tribunal, it would appear that if a severance payment has a link with a Work State, i.e. it is a continued payment for an activity exercised in the Work State, taxing rights should be allocated to the Work State. If the severance is a compensation for a future loss of income, taxing rights should be allocated to the Residence State. Tax administrations' practices however remain divergent, and some tax administrations would, in our opinion, rather allocate taxing rights in such a way so as to avoid double non-taxation.

## IV Conclusion

We have seen the importance of the issue of the tax treaty treatment of severance payments in cross-border cases. Both qualification and allocation issues may arise in this context, with the intrinsic risk of double taxation or double non-taxation.

Exceptionnally, it has been decided that severance payments do fall under art. 21 OECD MC, but, because of the causal connection between such income and employment and art. 15's broad scope, most States would consider PILON's and severance payments as being covered by art. 15 OECD MC.

If one considers that art 15 and following constitute a closed functional system, and that art 15 is the "other income" article for income not falling under art. 16 till 20 OECD MC, it has first to be examined whether the severance payment should not fall under these articles. In this context, the main difficulty will be to demarcate income from employment from pension income. Severance payments can indeed be considered as pensions if they have a provident aspect, in particular if they are intended to provide a financial support until retirement, or to complement pension rights. Age and the difficulty to find a new employment can be considered as an indication hereof.

More divergent views appear on the possible allocation of the taxing rights. A first view is that severance payments are not considered to be derived from the exercise of employment in the Work State (e.g. if a severance is seen as a compensation for social hardship), and taxing rights are thus allocated to the Residence State pursuant to the general rule of art. 15(1) 1<sup>st</sup> sentence OECD MC. A second view is that the entitlement to the severance has accrued during

the period of exercise of employment and taxing rights should be attributed to the Work State. This will usually be done on a time based apportionment, the difficulty then being to determine the reference period to be considered. A third possibility is to consider that the severance has to be allocated to future employment, the place of exercise of employment being determined fictitiously. Such allocation conflicts will most likely not be solved by the Commentary's rules on conflicts of qualification since it might well be argued that there is no qualification conflict. It has therefore been advocated that the allocation of taxing rights should be determined by DTC's or other bilateral (or multilateral) agreements.

Additions to the OECD MC Commentary in relation with termination payments included in the 2014 Update to the OECD MC and related Commentary are therefore most welcome. Several termination payments have been discussed in the new paragraphs of the Commentary. In particular, it has been confirmed that PILON's and severance payments both are to be seen as income from employment covered by art. 15 OECD MC. PILON's in principle are seen as "derived from the State where it is reasonable to assume that the employee would have worked during the period of notice". Severance payments are, absent facts and circumstances indicating otherwise, considered as remunerating the last 12 months of employment, and should be "allocated on a pro-rated basis to where employment was exercised during this period".

This Update is in our opinion especially an important guideline for Switzerland, where there is no clear-cut case law on the qualification of severance payments or on their allocation.

Many uncertainties nevertheless remain, in particular, with respect to the determination of the fictitious place of exercise, but the Updated Commentary has the merit of attempting to bring some uniformity in an area where there did not exist much uniformity and agreement. The question however remains to see if and how the Commentary will be applied by national Courts.

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#### **IV. Table of abbreviations**

Art.	Article
ASA	Archives de droit fiscal suisse
BMF	Bundesministerium der Finanzen
BNB	Beslissingen in Belastingzaken
BFH	Bundesfinanzhof
BStBl	Bundessteuerblatt
CFA	OECD Committee on Fiscal Affairs
CIR	Code des Impôts sur les Revenus 1992
CO	Code des Obligations (Swiss Code of Obligations)
Commentary	Commentary to the OECD Model Convention on Income and Capital
CSI	Conférence Suisse des Impôts
DTC	Double tax convention
ET	European Taxation
FDTL	Federal Direct Tax Law
FTA	Federal Tax Administration
HMRC	Her Majesty's Revenue and Customs
IBFD	International Bureau of Fiscal Documentation
IFF	Institut für Finanzwissenschaft, Finanzrecht und Law and Economics
IRS	Internal Revenue Service
IStR	Internationales Steuerrecht
IWB	Internationale Wirtschaftsbriefe
JDF	Journal de Droit Fiscal
Nr.	Number

NTFR	Nederlands Tijdschrift voor Fiscaal Recht
OECD	Organisation for Economic Cooperation and Development
OECD MC	OECD Model Convention on Income and Capital – Version 2010-2012
OIS	Ordonnance sur l'imposition à la source
2014 Update	2014 Update to the OECD Model Tax Convention
Para.	Paragraph
PILON	Payment in Lieu of Notice
RAVS	Règlement sur l'assurance-vieillesse et survivants
RF	Revue Fiscale
RDAF	Revue de Droit Administratif et de Droit Fiscal
TF	Tribunal Fédéral