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TERMINATION PAYMENTS AND INTERNATIONALLY MOBILE EMPLOYEES

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Speed Read: The taxation of termination payments paid to internationally mobile employees is not subject to the usual residence rules. Employers should ensure that they correctly identify not just the UK tax treatment of the termination package, but also the foreign tax treatment. Employers must also consider the impact of any double taxation treaty on the final tax position. In that regard, the OECD have issued a discussion draft in relation to termination payments which proposes amendments to the commentary on the OECD model tax treaty.

Identifying the correct tax treatment of a termination payment can be fiddly, even in a purely UK context. However, where an employee has spent time working in the UK and working outside the UK for an employer, there is another layer of complexity. The first step, as always, is to analyse what the termination payment is actually for, since only then can an employer/employee determine, so far as the UK is concerned, which part of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") applies to the termination payment. If the termination payment falls within Chapter 3 (Payments and Benefits on Termination of Employment Etc) of Part 6 of ITEPA, it is then necessary to apply Chapter 3's particular "residence" rule – the foreign service exception (or reduction). Finally, the employer/employee should consider the impact of any double taxation treaty that may be relevant. All references to legislation that follow are references to ITEPA, unless stated otherwise.

What is the termination payment for?

A termination payment is usually an aggregate of several payments made for different reasons. Many readers will be familiar with the fact that Chapter 3 of Part 6 does not apply to all types of payment that are commonly described as (or form a part of) a termination payment, and a detailed discussion of the UK tax treatment of termination payments in a purely UK context is beyond the scope of this article. In summary, though, the key point is found in s401(3) – "This Chapter does not apply to any payment or other benefit chargeable to income tax apart from this Chapter". Thus, Chapter 3 of Part 6 will not apply to, for example, a contractual payment in lieu of notice (chargeable under s62), a payment for a restrictive covenant (chargeable under s225) or a payment which constitutes a relevant benefit under an employer-financed retirement benefit scheme (chargeable under s393). Chapter 3 of Part 6 will apply to, for example, statutory and non-statutory redundancy payments, damages for breach of contract, and compensation for unfair dismissal.

Residence

Within Chapter 3 of Part 6, s403 is the taxing section – any payment (or payments in aggregate) within Chapter 3 of Part 6 that exceed £30,000 will be chargeable to UK tax, subject to certain exceptions. So far as

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internationally mobile employees are concerned, this basic rule applies whatever the residence status (under domestic law) of the employee when the employments ends (or when the payment is made, if different). Any employment income under Chapter 3 of Part 6 will be specific employment income for the purposes of Part 2 and the rules related to residence in Chapters 4 and 5 of Part 2 only apply to general earnings, and not specific employment income (see s6(3)). At first glance this seems to give s403 a very broad (and cross-border) scope. However, it is tempered by the foreign service exception and reduction, and (where relevant) by the impact of double taxation treaties.

Foreign service

If the employment in respect of which the termination payment is made includes foreign service, the former employee may enjoy a total exception from, or a reduction in, a charge under s403. Determining what is, and what is not, foreign service is complicated. Under s413, in broad terms (and ignoring the special rules applicable to seafarers):

(a) For service in or after the tax year 2013-14, foreign service is service: (i) outside of the UK, (ii) when the employee was either non-UK resident (as determined using the statutory residence test), or could claim the remittance basis in respect of the earnings arising from such service.

(b) For service in or after the tax year 2003-04 until the tax year 2012-13, foreign service is any service other than service when the employee was resident and ordinarily resident in the UK and for which the employee could not claim the remittance basis in respect of the earnings arising from such service.

(c) Similar rules to those in (b) above applied for tax years prior to 2003-04.

There are some key points to note with respect to the definition of foreign service. Firstly, it strictly relates to service in a single employment. However, by quasi-concession, HMRC will treat employments with different group companies as a single employment for the purposes of calculating periods of foreign service provided that the termination payment relates to the service with those group companies as a whole (as opposed to it relating to, for example, compensation for breach of contract by the last employing company) - see EIM 13975.

Secondly, for tax years 2012-13 and earlier the definition of foreign service is generous – it includes UK duties by a UK resident, provided he/she was not ordinarily resident at the time (see, for example, A Gomez Rubio v HMRC TC2047). The definition is much tighter for the tax year 2013-14 onwards, as the UK duties of a UK resident can no longer qualify as foreign service (even if they meet the conditions of s26A). This was a change which was highlighted in the explanatory notes to the Finance Act 2013. It also seems that the UK duties of a non-UK resident no longer qualify as foreign service (a change which wasn't so highlighted).

Once the length of foreign service has been ascertained, it is necessary to apply s413(1) (for total exemption) or s414 (for a reduction). For total exemption under s413(1) to be available, the foreign service must comprise any one of the following:

(a) three-quarters or more of the whole period of service ending with the date of the termination or change in question, or

(b) if the period of service ending with that date exceeded 10 years, the whole of the last 10 years, or

(c) if the period of service ending with that date exceeded 20 years, one-half or more of that period, including any 10 of the last 20 years.

If the s413(1) tests are not met, partial exemption under s414 may be available. It is calculated as follows:

(Total termination payment - £30,000) x (Length of foreign service ÷ Length of total service)

An important point for employers is that partial foreign service relief (under s414) is strictly claimed by employees and therefore when operating PAYE, no account should be taken of partial relief. However, in practice, HMRC may agree to permit the employer to operate PAYE taking account of the partial relief where the employer has requested the same in advance.

The impact of tax treaties

Where a termination payment within s401 is paid to an internationally mobile employee (and is not wholly exempt as a result of foreign service or for other reasons), the application of any relevant double taxation treaty can be critical. The UK's double taxation treaties do not deal specifically with termination payments. Thus, the treatment of such payments will usually depend on whether they are classed as:

- "Salaries, wages and other similar remuneration", in which case they fall under the employment article (article 15 in the OECD Model) and are taxed in the state in which the former employee is resident, unless the employment is exercised in the other contracting state, in which case remuneration derived from that employment may be taxed in that other state;
- "Pensions and other similar remuneration", in which case they fall under the pensions article (article 18 in the OECD Model) and are taxed in the state in which the former employee is resident; or
- "Other Income", in which case they fall under the residual income article (article 21 in the OECD Model) and are taxed in the state in which the former employee is resident.

In Resolute Management Services Limited v HMRC [2008] STC (SCD) 1202, a company had made a substantial ex gratia payment to one of its ex-employees. She was a US citizen, but she had worked for the company in the UK for many years. The payment was made approximately two months after the employee had left the company (from which she had resigned) and returned to the US, albeit that the decision to make the payment had been taken before she left. The Special Commissioner found that there was no evidence that the payment related to or was conditional on past or future employment, and that it was a genuine ex gratia payment. On this basis, he also found that the payment could not be considered to be "salaries, wages and other similar remuneration" for the purposes of article 14 of the UK/US double taxation treaty, but would fall within the other income article (article 22) of the UK/US double taxation treaty. As such, it was not subject to any UK tax, since the employee had become a US resident (again) by the time of the payment.

This can be contrasted with Squirrel v Revenue and Customs Comrs [2005] STC (SCD) 717. In that case, an individual received a payment in lieu of notice ("PILON") whilst he was a UK resident under UK domestic law, and a US resident under US domestic law. The Special Commissioner found that the PILON (paid on 1 April 2000) was taxable under s148 ICTA 1988 (the forerunner to s401). Whilst it is not clear from the decision, we assume that the PILON was not explicitly stated in the employment contract, since if it was, it would have been fully taxable under the old Schedule E (following the long established principle in EMI Group Electronics Ltd v Coldicott [1999] STC 803). Notwithstanding this, the Special Commissioner held that such a payment was "salaries, wages and other similar remuneration" for the purposes of article 15 of the 1975 UK/US double taxation treaty, on the basis that it was equivalent to remuneration. It is questionable whether this would have been upheld on appeal, given that an argument can

be made that a PILON in such circumstances is in fact a payment for breach of contract, and does not relate to (nor is it conditional upon) any past or future work (though see below as regards the OECD's views). The net result was that the payment was taxable in the UK (under s148 ICTA), irrespective of whether the individual was UK resident or US resident for the purposes of the UK/US double tax treaty (such question being deliberately left undecided by the Special Commissioner).

Two points jump out from these cases. First, the key to the application of a treaty will be to determine what the termination payment really represents (as it is for determining whether s401 applies). Second, the timing of the payment may be critical, partly because of the UK's rather unusual domestic law tax years, and partly because internationally mobile employees may well have left the UK (and ceased residence?) by the time a termination payment is paid.

The OECD discussion draft

Given the difficulties in applying tax treaties to termination payments, it is welcome that on 25 June 2013, the OECD's Committee on Fiscal Affairs issued a discussion draft on this specific issue. The draft identifies a number of different types of payment and makes proposals for additions to the commentary to the OECD Model Treaty for each of them. In brief:

- Remuneration for previous work, and deferred remuneration, should be covered by Article 15 and sourced where the employee carried on the relevant work during the period covered by the remuneration.
- Payment for unused holidays and sick leave should be covered by Article 15 and sourced where the work was performed during the relevant period. To help provide a "workable" solution they proposed that where the period extended over a number of years, the payment for unused holiday and sick leave should relate only to the last year of employment.
- Payment in lieu of notice of termination should be covered by Article 15 and should be considered to be compensation for work in the State where it is reasonable to assume that the employee would have worked during the period of notice.
- Severance payments (which would include redundancy payments) should be covered by Article 15 and should be considered derived from the State where the employment was exercised when the employment was terminated.
- Payment of damages for unlawful dismissal may be covered by Article 15 or 21, depending on what the award seeks to compensate.
- Restrictive covenant payments should normally be covered by Article 15, but in most cases will be taxable only in the State where the recipient resides during the period covered by the restrictive covenant.
- Payments related to pension rights should be covered by Article 18 (although reimbursement of pension contributions would probably fall under Article 15).

Whilst additional guidance on the application of tax treaties to termination payments is welcome, it will be interesting to see whether all of the Committee's proposals are adopted. Reaction to the proposals has not been universally positive, and to some degree the proposals raise as many questions as they answer.

In relation to PILONs, for example, basing taxing rights on the assumption of where the employee would have worked could lead to uncertainty. Furthermore, and key from a UK tax perspective, it is not clear whether the comments on PILONs are designed to cover situations where there is no PILON clause in the contract, and where a failure to provide notice represents a breach of contract (with the PILON effectively representing damages for that breach). In such circumstances, the payment is not "clearly received by virtue of the employment", but rather the payment is

received by virtue of the ending of the employment relationship (and, usually, the accompanying settlement agreement). It is also understood that, at least informally, HMRC have indicated that they view such "non-contractual" PILONs as ordinarily falling within the other income article of treaties (although there is an agreement between the UK and Germany – dated 8 November 2011 – under which the states agree that severance payments "granted in general for the dissolution of the contract of employment" should fall within the employment article of the UK-Germany double tax treaty).

In relation to redundancy payments, it does not follow that they should be categorised as remuneration just because such payments are often calculated by reference to length of service. Furthermore, it is arbitrary to propose that such payments derive solely from the state where the employment was exercised when terminated. In their response, CIOT have suggested that the country where the severance payment arises should exempt any part of the severance payment calculated by reference to length of service in the other country (see the CIOT response dated 20 September 2013, paragraph 4.4).

The proposals related to restrictive covenants are mixed. It seems sensible that payments made during the employment for a restrictive covenant in the employment contract (in the unusual situation where such payments are separated from salary) are taxed in accordance with the employment article. However, the comment that a restrictive covenant payment in general is "directly related to the employment and [is] therefore remuneration derived in respect of an employment" is, frankly, odd. Any such payment made after the employment has terminated is, if made at all, usually made in respect of a restrictive covenant which goes above and beyond what was already in the employment contract. By definition, the restrictive covenant and the payment for it relate to not being in (specified) employment. Thus, to tax them under the employment article and by reference to the place where the employee resides in the period covered by the restrictive covenant (where the recipient may well not be restricted, or may even not be employed at all) is illogical. It would appear that the more straightforward analysis (which will often lead to the same result in practice) is that such payments should be treated as other income.

In any event, it seems that the difficulties of characterisation of termination payments paid to internationally mobile employees are likely to continue.

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