Income from Inactivity under Article 15 of the OECD Model Tax Convention – Part 1

In this two-part article, the author first introduces the topic of the taxation of income from inactivity under Art. 15 of the OECD Model Tax Convention. He then considers, in Part 1, compensation for the cancellation of employment, sickness benefits and disability allowances and income derived from non-competition agreements. In Part 2, stand-by fees, severance payments and sign-on fees are examined. Part 2 of this article will be published in the November 2009 issue of the Bulletin for International Taxation.

1. Introduction

1.1. In general

Income from inactivity may have a significant social and economic impact on the employees involved and offers employers flexibility in remunerating employees. Where employees perform cross-border activities, such income may give rise to double taxation or double non-taxation due to the operation of Art. 15 (income from employment) of tax treaties based on the OECD Model Tax Convention ("the OECD Model"). Art. 15 of the OECD Model contains undefined tax treaty terms. As a result, the contracting states refer to their domestic laws in interpreting these terms. In doing so, the views of the states involved may deviate. The contracting states' views may also differ with regard to allocating income from inactivity to employment exercised in the various states.

For the purposes of this article, the author regards as inactivity all situations in which no immediate or direct action of the employee is required as consideration for the income received from the current or former employer within a certain period of time. In other words, the employee is not providing regular services for various reasons, including, for example, sickness, disability, being on call, a non-competition situation with regard to his former employer, cancellation of an employment, redundancy, etc. The author provides an analysis of the following types of income from inactivity within the framework of Art. 15 of the OECD Model:

- compensation for cancellation of an employment (see Part 1.2);
- sickness benefits and disability allowances (see Part 1.3);
- income derived from non-competition agreements (see Part 1.4);
- stand-by fees (see Part 2.5);
- severance payments (see Part 2.6); and
- sign-on fees (see Part 2.7).

The premise is that the income component falls within the scope of Art. 15 of the OECD Model, i.e. it is regarded as 'salaries, wages and other similar remuneration',


2. For sign-on fees, see F. Poigems, "Income from International Private Employment" (Amsterdam: IBFD, 2006), Doctoral Series, Vol. 12, pp. 198 and 199. This approach is less clear under US domestic law. In Ken Linneman v. 82 T.C. 514 (1984), the US Tax Court analysed the contract as a non-competition agreement, which is considered as a non-competition agreement for personal service income but contested in a Memorandum of the IRS for Associate Area Counsel, which was drafted by W. Edward Williams (Senior Technical Reviewer Branch 1 International), 31 January 2002, No. 200211011. As a result, it could be clearly concluded from the Linneman decision whether or not a sign-on fee can be regarded as personal service income. Compare also J. Lienbergh, International Taxation: US taxation of foreign persons and foreign income (Boston: Little, Brown, 1986), Vol. I, Part 1, Para. 7.3.2.

3. For compensation for the cancellation of an employment, see the decision of the Netherlands Supreme Court, 16 August 2001, RBN 2001/153, the decision of the v.Hertogenbosch Court of Appeal, 11 April 2003, V-C 2003/42/12, and the decision of the German Federal Court, 12 September 2006, discussed by W. Wasemann, "Vergoeding voor het niet nakomen van een belofte tot toewerking onder het Duits-Zwitsers dubbelbelastingverdrag," Tidschrift voor Voedrecht (2008), No. 336, p. 177 et seq. The IRS has ruled that amounts received by an employee on cancellation of an employment contract are not 'wages' subject to withholding although such payments are gross income to the employee. K. Vogel, H.A. Shultis, R.J. Doerringer and K. van Raad, United States Income Tax Treaties (The Hague/London/Boston: Kluwer Law International: loose-leaf, 1989), Art. 15, p. 23, remark that, as definitions of 'wages' for withholding purposes are not consistent with the definition of compensation for services for substantive tax purposes under § 61 of the Internal Revenue Code (IRC) (Central Illinois Public Service Co. v United States, 435 US 21 (1978)), it appears likely that the United States would regard such payments as 'wages' for substantive tax purposes and, therefore, as governed by Art. 15 of the OECD Model rather than Art. 21. See also FSA 1999/2.

4. For income from a non-competition agreement, see the decisions of the German Federal Court of Appeal, 18 July 1973, RSuRH 73/9, p. 757; 9 November 1977, RSuRH 77/49, p. 115 et seq. and 9 September 1979, RSuRH 80/78, p. 967 et seq.; the decisions of the Brussels Court of Appeal, 14 November 1997, Algemen Tidschrift (1998), Nos. 3-4, p. 122 et seq. and 20 September 2007, Tidschrift voor Voedrecht (2008), No. 341, p. 496 et seq., the Netherlands
The United States (payment for sickness or injuries caused by the job itself and general sick leave or sick days are treated as salary income) and France (whence these benefits are regarded as taxable salary income, but disregarded as salary income if certain conditions are met). In respect of sickness benefits, a distinction should be made between (1) sickness benefits ensuing from the employer’s obligation to pay all or part of the employee’s sickness benefits (as per the social security authorities) whereas the employer’s involvement consists of paying the contributions. In addition to the Netherlands, examples of (1) can be found in Germany (in Germany “sickness income from sickness” in general, must be considered income from employment, as a connection with the employer can be established, see C. Hermann, C. Heuer, A. Raupach, Einkommensteuer und Körperschaftsteuergesetz Kommentar (Cologne: Verlag Dr. Otto Schmidt; Issue 1997–98, 4th ed., Par. 746), and in the United Kingdom (sick pay that is paid to an employee who is temporarily absent from employment is regarded as employment income (Secs. 62 and 221 of the ITEPA)). With regard to sickness, the German Civil Code imposes an obligation on the employer to pay the labour remuneration on days off and in the case of illness (Leibertäglichkeit; Gesetz über die Fortzahlung des Arbeiterlohn bei Krankheit), 24 May 1994, BGB 9 (1994). The decisions of the German Federal Tax Court, 12 October 2003, BiiH 1998, 310, and 31 March 2004, Biiw 2004, No. 43, p. 239 et seq. demonstrate that the wages the employer continues to pay during the employed’s illness are not taxable as employ- ment services within the meaning of Art. 101.1 of the 1973 Germany–Luxembourg tax treaty. Netherlands tax law regards sickness benefits as income from employment. From 1 March 1996, Art. 7.629 paragraphs 1 and 2 of the OECD Model, first part of the first sentence). This first rule applies if the employee exercises his employment in his residence state or in a third state. The third rule also assigns the exclusive taxation right to the employee’s residence state provided that the three conditions of Art. 15(2) of the OECD Model are all satisfied. To be considered income from employment, as a connection with the employer can be established, see C. Hermann, C. Heuer, A. Raupach, Einkommensteuer und Körperschaftsteuergesetz Kommentar (Cologne: Verlag Dr. Otto Schmidt; Issue 1997–98, 4th ed., Par. 746), and in the United Kingdom (sick pay that is paid to an employee who is temporarily absent from employment is regarded as employment income (Secs. 62 and 221 of the ITEPA)). With regard to sickness, the German Civil Code imposes an obligation on the employer to pay the labour remuneration on days off and in the case of illness (Leibertäglichkeit; Gesetz über die Fortzahlung des Arbeiterlohn bei Krankheit), 24 May 1994, BGB 9 (1994). The decisions of the German Federal Tax Court, 12 October 2003, BiiH 1998, 310, and 31 March 2004, Biiw 2004, No. 43, p. 239 et seq. demonstrate that the wages the employer continues to pay during the employed’s illness are not taxable as employment services within the meaning of Art. 101.1 of the 1973 Germany–Luxembourg tax treaty. Netherlands tax law regards sickness benefits as income from employment. From 1 March 1996, Art. 7.629 paragraphs 1 and 2 of the OECD Model, first part of the first sentence). This first rule applies if the employee exercises his employment in his residence state or in a third state. The third rule also assigns the exclusive taxation right to the employee’s residence state provided that the three conditions of Art. 15(2) of the OECD Model are all satisfied.
This third rule, however, takes as the point of attachment situations in which the employee resides in one contracting state (residence state) while working in the other contracting state (work state).

Needless to say, this outline of various forms of income from inactivity is questionable, as some of these forms are (sometimes fictitiously) regarded as income from active employment in some jurisdictions. It may also be argued that a certain activity may be identified with regard to these activities, which is already embedded in their characterization as "salaries, wages and other similar remuneration" within the meaning of Art. 15 of the OECD Model. As noted previously, the domestic laws of the states applying the applicable tax treaty play an important part in characterizing the income. The domestic laws of many countries presume that an underlying activity is involved; otherwise, the income would be regarded as capital income. Nonetheless, the author believes it is justifiable to regard these income components as one category, but to examine them separately given the specific issues that surround them.

1.2. Main issues

In addition to the question of whether or not the various forms of income from inactivity fall under Art. 15 of the OECD Model, i.e. constitute "salaries, wages and other similar remuneration", the following issues arise:

- does the inactivity constitute the exercise of an employment;
- where is the employment exercised (the geographical element); and
- to which "activity" should the income be allocated ("derived from")?

These main issues are summarized in Diagram 1, which outlines the various timing and causality matters that play a part in respect of income from inactivity.

It should be noted that a clear distinction cannot always be drawn between the main issues. Diagram 1 demonstrates that there is an interaction between the exercise of the employment in the work state and the allocation of the inactivity income, which interaction is difficult to segregate into different categories. Such segregation is also visible when considering the various causality and their interaction with regard to income from inactivity, i.e.,

- functional causality, i.e. the causality that arises when determining whether or not the income from inactivity can be regarded as "salaries, wages and other similar remuneration" within the meaning of Art. 15 of the OECD Model;

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4. Being on call or prepared to perform certain activities when a particular future event occurs, for instance, can under certain circumstances be considered as performing activities according to the domestic laws of some jurisdictions. See Part 2.5 and Reimer, supra note 2, pp. 126-128.
5. Compare Reimer, supra note 2, pp. 54-57.
6. In the same sense see Reimer, supra note 2, pp. 248-252. It is useful to note that Reimer primarily focuses on income derived from a non-compensation agreement.
1.3. Exercise of employment

Having concluded that the income at issue falls under Art. 15 of the OECD Model, it should be determined whether or not the inactivity, as such, constitutes the exercise of an employment. In this respect, Reimer's analysis should be noted. Reimer differentiates between various types of behaviour (Verhalten), i.e. on the one hand, "action" (Handlung) and, on the other, "inaction" (Nicht-Handlung). "Action" can consist of "doing" (Tun) or "omitting" (Unterlassen). From this perspective, "omitting" can be regarded as a species of the genus "action", i.e. "qualified passivity" (qualifizierte Passivität), whereas "inaction" is regarded as "mere passivity" (schlichte Passivität). Reimer provides the following summary (Diagram 2):

As a result an omission is "passive" (inaction) if a person refrains from what would otherwise constitute a passive investment, whereas the omission may be called "active" if the person refrains from performing a certain activity. Diagram 2 is useful in determining whether or not the inactivity, as such, constitutes the exercise of an employment for the purposes of Art. 15 of the OECD Model. If the author understands Reimer's analysis correctly, an example of "omission" is a non-competition agreement, as such an agreement may impose an obligation on the employee not to use his skills and knowledge during a certain period of time (and possibly restricted to a defined region). Accordingly, Reimer views such an omission, where the former employee agrees not to use his skills or knowledge or to use them in a restrictive way, as an alternative form of action that should be treated accordingly. Consequently, these types of omissions could constitute the exercise of an employment for the purposes of Art. 15 of the OECD Model, but the domestic law of the states applying a tax treaty may also play a part. These may interpret a non-competition agreement differently (see 4).

"Mere passivity", in general, would not occur where the income falls under Art. 15 of the OECD Model, as this classification presupposes some sort of activity. As a result, the focus is on whether the inactivity, as such, can be regarded as the exercise of an employment in the work state or whether an employment exercised in the work state forms, or is deemed to form, the basis of that income. Compensation for the cancellation of an employment, for instance, is not granted to the former employee, because he is asked to omit a certain activity, for example, not to compete with his former employer. In Diagram 2 'cancellation of an employment' would be considered 'mere passivity' rather than 'qualified passivity'. This type of inactivity is not normally regarded as the exercise of an employment within the meaning of Art. 15 of the OECD Model. Rather, it has the character of compensating an employee for the cancellation of a promised employment. If the inactivity, as such, does not constitute the exercise of an employment, the first rule of Art. 15 of the OECD Model applies, unless it can established that the interaction with the allocation of the inactivity income in question results in determining a fictitious place of exercise of the employment (where the employment would have been exercised had the employment continued) or certain services that were provided in the past ought to have been decisive in this respect (this view is taken by the tax courts of certain jurisdictions in respect of severance payments; see Part 2, 6).

1.4. Place of exercise of employment

It is crucial in this respect to determine the place where the "inactivity" is exercised or, alternatively, where other activities are exercised that form the basis for the relevant income (the timing aspect). As noted in 1.2, an overlap with the other main issues cannot be avoided. The following places of the exercise of employment can be distinguished, i.e. the place where:

(1) the former employee is physically present whilst being inactive;
(2) the employment would have been exercised if the employment had continued, when the contract was breached or when the employee was called on to provide his services; and
(3) the employment was exercised in the past.

It could be argued that, in line with the Commentary on the OECD Model and the interpretation based on Art. 3(2), the employment is exercised where the employment would have continued.

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8. Reimer, supra note 2, p. 15.
12. Compare Reimer, supra note 9, p. 111.
employee is physically present whilst being inactive, provided that the inaction constitutes or is regarded as the exercise of an employment. According to this point of view, the allocation of the income would not lead to additional difficulties. An objection that could be raised to this approach is that it may give rise to certain situations of abuse, as individuals may move their tax residence to low-tax jurisdictions. Nonetheless, the risk of abusive use does not alter the principle of the physical presence that can also be followed in these cases.

The other two approaches have, however, also been adopted with regard to income from inaction. Specifically, the approach in (2) is applied, inter alia, to income derived from a non-competition agreement and to Netherlands sickness benefits. The approach in (3) is adopted regarding severance payments.

When various places can be distinguished where the employment was fictitiously exercised (i.e. several of the elements referred to in (1) to (3) apply), account can also be taken of the way in which the income was allocated, as this allocation focuses particularly on the causality between this income and the exercise of the employment. This is important in ultimately determining the locus of the exercise of the employment in question (see 1.5.).

1.5. Allocation of income

The question as to how the income received as consideration for the inactivity is to be allocated should be considered separately. Accordingly, it is not sufficient to establish whether or not the inactivity constitutes the exercise of an employment and where this occurs. An assessment should be made of the place to which the income must be allocated (geographic causality), as it is conceivable that several places where the employment has been exercised can be identified, located in various jurisdictions. The allocation issue may also shed light on the question of whether or not and where an employment is exercised. The following demonstrates that several allocations are possible within the framework of income from inactivity, which may depend on the facts pursuant to the domestic law of the states applying the relevant tax treaty:

- **Direct allocation**: the income may be allocated directly to the exercise of an employment that may be constituted by the inactivity as such, which is deemed to occur where the individual in question is physically present.

- **Replacement of income approach**: the income replaces the regular salary that would have been received if the employee had been active – for example, a severance payment that is intended to compensate for the loss of future employment income. Certain sickness benefits replacing regular salary income during the period of sickness, income derived from a non-competition agreement intending to replace all or part of the employment income that the former employee could have gained had he not been restricted in the usage of his knowledge and skills. As a result, the income is allocated in these situations to the place where the employment would have been exercised had the employment continued.

- **Accrual approach**: the entitlement to the income relating to inactivity accrued during the period that the individual in question provided his services – for example, the entitlement to all or part of a severance payment could be considered to have accrued in the years in which the former employee provided his services on behalf of the employer (or a group of companies to which this employer belonged), where the number of years of service is one of the factors determining the amount of this part of the severance payment.

1.6. Analytical approaches

The various approaches are detailed in Part 1, 2, 3, and 4, and in Part 2, 5, 6, and 7, according to the type of income from inactivity. The author notes the advantages and disadvantages of the possible views with regard to the item of income, using court decisions in various jurisdictions, and indicates which view he prefers, taking into consideration the principles underlying the second rule of Art. 15 of the OECD Model.

2. Compensation for Cancelled Employment

2.1. Preliminary remarks

Based on the outline in the introduction (see 1.2.), the following considerations may arise regarding compensation for the cancellation of an employment in light of the second rule of Art. 15 of the OECD Model:

- **Exercise**: compensation for the cancellation of an employment does not give rise to the exercise of an employment, as the employee is compensated

14. See Potens, Income from International Private Employment, supra note 1, pp. 302-313 for an overview of the domestic law of some selected countries and the case law developed in those countries. Compare Reinier, supra note 2, p. 416.

15. Although Reinier, supra note 2, pp. 415-416 and 425, disagrees with this view, he admits that no theoretical counter-arguments can be formulated against the application of this principle to income from inactivity.

16. Reinier endorses this conclusion with regard to non-competition agreements, as they constitute an ‘alternative’ form of action that should be treated in the same way as the regular performance of services with regard to determining the place of exercise. In this respect compare Reinier, supra note 2, pp. 416-419. Reinier, supra note 2, p. 419, admits that difficulties may arise when the non-competition agreement is not geographically limited. Reinier’s objection to the approach that takes the physical presence of the individual whilst being inactive as the point of attachment is that it may encourage these individuals to move their tax residence to low-tax jurisdictions. This objection (giving rise to abuse) is to a certain extent, applies to the view he wishes to follow in respect of the place of exercise with regard to non-competition agreements. The latter may also be subject to abuse, as the hypothetical place of exercise is, inter alia, based on the intentions of the parties involved, which may also be controlled and influenced to some extent (Reinier, supra note 2, p. 425 remarks that none of the possible solutions is compelling). In another context (Reinier, supra note 9, p. 117), he proposes a ‘substance over form’ approach that looks at the economic substance rather than the private law form. A country is to be regarded as an (additional) place of residence only if it was included in the geographic scope of the negative obligation under private law and if the inclusion was driven by reasonable economic interests.

17. Compare also Reinier, supra note 2, pp. 279 and 280.
because the employer was not able or willing to keep his promise to offer the employee another suitable position.

- **Allocation**: it could be argued that the compensation in question should be allocated under the replacement approach. In this case, in lieu of a suitable position, the employer paid an amount to compensate the former employee for the loss of future employment income he suffered as a result of the promised employment relationship being cancelled.

- **Fictitious place of exercise**: the interaction with the allocation leads to a fictitious place of exercise. This allocation establishes a causal link with (the loss of) future income. As a result, the allocation can only be made when the place of exercise is fictitiously determined, i.e. where the employment would have been exercised had it been continued.

- As stated in 1.3, one other possibility is that the first rule is applied, as the former employee has never provided nor will provide any services as consideration for this compensation. This would not lead to additional allocation difficulties and to the need to fictitiously determine a place of exercise, as the first rule applies, provided that the employee is physically present in the residence state during his inactivity. These different views are elaborated on in 2.2 and 2.3.

### 2.2. Case law

**Decision of the Netherlands Supreme Court of 10 August 2001, BNB 2001/353**

In its decision of 10 August 2001, **BNB 2001/353**, the Netherlands Supreme Court ruled on compensation attributed to a resident of France for the cancellation of promised employment that would have been exercised in the Netherlands.18 The Supreme Court allocated the compensation based on the "replacement approach". The Court then applied the fiction that the employment was not cancelled, but was, instead, carried on, despite the individual in question not being physically present in the Netherlands to exercise the terminated employment. It held that suitable employment would likely have been exercised in the Netherlands, which was enough for the second rule of Art. 15(1) of the 1973 France–Netherlands tax treaty to be applied. This meant that the payment was taxable in the Netherlands.19 The Supreme Court took the view that the place in which the employment was exercised must be deduced from the employment contract or from the expectations (voorstelling) of the parties.

**BNB 2001/353** has been criticized, as it ignores the strict requirement that the employment is deemed to be exercised in the other state only if the employee is physically present to provide services there.20 If the employment does not take place, it may be difficult to claim that services or duties have been performed, which is important, irrespective of the interpretation of the term "exercise".

The services in this case were also not provided in the Netherlands. In addition, the taxpayer argued that, for those reasons, the second rule did not apply.21

**Decision of the German Federal Tax Court of 12 September 2006**22

The arguments included in the criticism regarding **BNB 2001/353** were adopted by the German Federal Tax Court in its decision of 12 September 2006. The Court held that compensation for the cancellation of a promised employment that was granted by a German resident GmbH to a resident of Switzerland did not fall under the second rule of Art. 15(1) of the 1971 Germany–Switzerland tax treaty, but, rather, under the first rule of that provision assigning the taxation right to the residence state (Switzerland). It argued that the second rule of Art. 15(1) giving the authority to tax the compensation in question to the work state did not apply, as the compensation was not in consideration for employment services that were actually provided. These types of income do not fall under the second rule, but, rather, under the first rule of Art. 15(1) of the tax treaty in question that was patterned on Art. 15 of the OECD Model (compare in Part 2.6.2.1. the view of the German Federal Tax Court regarding the characterization of severance payments under German tax treaties).

### 2.3. Evaluation

In certain cases, it may be difficult or impossible to determine where the employment would have been exercised if it had not been cancelled. An objection to **BNB 2001/353** is that the parties involved could have given some direction as to this place by including it in the employment contract, for instance, if they were aware beforehand that the employment would end in the near future. In this respect, the facts of the decision of the s-Hertogenbosch Court of Appeal of 11 April 2003, **V-N 2003/42.12** should be considered. In that case, the UK company to which the plaintiff was assigned made him redundant and this company had to compensate or bear (at least partly) the losses that its action caused. The BV (a private limited liability company) that assigned the plaintiff promised to give him a suitable job, knowing that it did not have a position available that was suitable for his talents, knowledge and experience (this position would have had to been in the financial area, which

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18. For a short description of BNB 2001/353, see R. Bettens, "Lump sum paid by Netherlands resident company in lieu of suitable position not taxable in the Netherlands: Europese Taxatie 31 (2003), p. 425. The decision of the s-Hertogenbosch Court of Appeal of 11 April 2003, V-N 2003/42.12 is in line with BNB 2001/353. This involved the treatment of compensation for the cancellation of an employment under the 1953 Netherlands–Switzerland tax treaty. For a discussion of this case, see Bettens, p. 424 et seq.

19. The Supreme Court found that the exception in Art. 15(2) of the 1973 France–Netherlands tax treaty did not apply, without indicating which of the three conditions was not met.


22. See W. Wantman, supra note 1, pp. 177 et seq.
was based in Switzerland within the group of companies at issue). Consequently, the s-Hertogenbosch Court of Appeal held that the authority to tax this compensation could not be assigned to the Netherlands, considering the factual impossibility that the cancelled employment could be exercised in the Netherlands. The approach that was adopted in BNB 2001/353 could, on a practical level, be applied with difficulty. Further, such application would depend on an interpretation of the facts, which would not necessarily have to be followed in another jurisdiction. One of these practical impediments could be determining the 183-day threshold for the purposes of Art. 15(2)(a) of the OECD Model. The fiction that the employment is deemed to have been exercised where it would have been exercised had it been continued, could make Art. 15(2)(a) meaningless. This also results in additional issues. What is the period of time that is taken into account to determine where the employment would hypothetically have been exercised? Will the work state change (and has the residence state concluded a tax treaty with this new work state)? Will he return to his residence state? Will his status as an employee change into that of a director, etc.? As noted in 1.4, the other approach adopted by the German Federal Tax Court in its decision of 12 September 2006, under which the residence state would be entitled to tax the compensation at issue, may result in situations in which the former employee may try to move his residence to a low-tax jurisdiction. The possibilities of abuse under both views could be removed by including a subject-to-tax clause in a particular tax treaty or in the Commentary on the OECD Model.

Even though both approaches may be asserted, the author believes that the practical difficulties surrounding the view set out in BNB 2001/353 and the fact that the employee did not perform an activity in consideration for the compensation or omit an activity should result in the application of the first rule rather than the second rule. As a result, the author endorses the decision of the German Federal Tax Court of 12 September 2006.

3. Sickness Benefits and Disability Allowances

3.1. In general

Difficulties arise by applying the second rule of Art. 15 of the OECD Model in respect of sickness benefits and disability allowances attributed to a resident of State R, but not to employment exercised in State W. Netherlands case law distinguishes between sickness benefits and the statutory disability benefits scheme. The first category falls under Art. 15 of the OECD Model and is regarded as continued payment for the employment that was originally performed (this characterization is recognized under Netherlands civil and tax law), whilst payments under the statutory disability benefits scheme are classified either under the "other income" article or under a specific social security provision in a tax treaty. The focus is on a jurisdiction taxing sickness and disability allowances.

3.2. Preliminary remarks

These are as follows:

- **Exercise:** Illness as such cannot be regarded as the exercise of an employment, although some states do, as the employer is statutorily obliged to continue paying all or part of his salary during his illness;
- **Allocation:** The replacement approach should apply as, given these assumptions, the sickness benefits are intended to replace the regular salary payments in the period that the employee was unable to perform his regular duties due to illness; and
- **Fictitious Place of Exercise:** The place where the employment would have been exercised had the employee not been ill.

3.3. Case law

**Netherlands case law**

The Amsterdam Court of Appeal in its decision of 21 March 1986, V-N 1987, p. 299 seq., the s-Hertogenbosch Court of Appeal in its decision of 19 January 2006, V-N 2006/34.12 and the Netherlands Supreme Court in its decision of 24 April 1957, BNB 1957/189 do not regard the place where the individual actually stays during the period of inactivity, i.e. sickness, as the location where he exercises his employment. In other words, the second rule of Art. 15 of the OECD Model is applied instead of the first rule (this would probably also have been the case if BNB 1957/189 had related to a tax treaty instead of the non-resident tax liability of the Netherlands). The courts appear to follow the premises referred to in 3.2. Consequently, they consider where the employment would normally have been exercised if the employee had not been sick. In all three cases, this was the Netherlands, which is in line with the decisions noted in 2.2. regarding compensation allocated in respect of cancelled employment.

This deviation from the principle of physical presence in these cases of inactivity may be questioned, and it could also be argued that the first rule applies. This would result in the taxation right being allocated to the resi-
The OECD Model applied whilst the employee was inactive and the benefits were allocated by the employer to the employee. The Amsterdam Court of Appeal held that the sickness benefit was to be allocated to the place where the employment would normally have been exercised (replacement approach in combination with fictitious place of exercise), whilst the State Secretary disregarded such an allocation in respect of the supplementary payments made by the former employer over and above the statutory disability benefits (no replacement approach, but accepting the establishment of a fictitious place of exercise).

The author would prefer a clear line. The employment is deemed to be exercised where the employee is physically present, which should also apply if he is temporarily or permanently unfit to perform his regular duties, for whatever reason. If the contracting states wish to apply other criteria to allocate the taxation rights regarding these payments and allowances, they would need to specify them in their tax treaty. This could be done by including a specific social security provision in a tax treaty, under which either one or both categories would be taxable in the former work state (see 3.5.).

3.4. Relationship to Belgium and Germany

The Netherlands case law approach is not followed in some neighbouring countries. In Germany, the physical presence of the employee during his illness is the principle followed. The German Federal Tax Court, in its decision of 17 October 2003, BfH/11/304/04, 161 and by reference to Wassermeyer states that being ill is treated as the exercise of an employment and the salary continues to be paid by the employer. If the employee is physically present in the work state whilst sick, he is deemed to exercise his employment in that state. Consequently, as Germany regards the physical presence of the employee during his illness as the determining factor, this could result in double taxation or double non-taxation in relation to the Netherlands. 34

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29 Previously, i.e. from 1 March 1996 until 1 January 2004, this period lasted one year.
30 Such a classification may be different if this supplementary payment was covered by a specific social security provision or a pension provision in a particular tax treaty: provided that the latter contained a definition of pension that included payments made as compensation for injuries received.
31 A difference between the illness benefits and the supplementary payment over and above the statutory disability benefits is that the former has a temporary character (extends for a maximum of two years), whilst the latter is of a more permanent nature (it can extend from two years after the employee becomes ill until he retires). Apparently, this supported the presumption that the relationship between the supplementary payment and the employment is more remote than in respect of illness benefits, which results in taxation in the work state for the illness benefits and in the residence state for the supplementary payment.
33 Wassermeyer, supra note 32, Para. 148.
Belgian case law does not always follow Netherlands case law either. In the decision of the Antwerp Court of Appeal of 26 September 1994, the Court referred to the non-performance of activities relating to these forms of benefits as one of the grounds for not applying Art. 15 of the former 1970 Belgium–Netherlands tax treaty to illness benefits that were allocated to a resident of Belgium who normally exercised his employment in the Netherlands. The Court of Appeal classified these illness benefits under Art. 22 ("other income") of the previous 1970 Belgium–Netherlands tax treaty. Although this decision of the Court of Appeal has been criticized, it demonstrates that the exercise of the employment can be interpreted differently. The Court of Appeal referred explicitly to the employment not being exercised during the period of illness.

3.5. 2001 Belgium–Netherlands tax treaty

Art. 18(6) of the 2001 Belgium–Netherlands tax treaty provides a partial solution for the problem outlined in respect of the employer's obligation to pay 70% of the employee's salary, or at least the statutory minimum salary, for the first 52 weeks of illness, which was based on Art. 7:629 of the Netherlands Civil Code as it read prior to 1 January 2004. From 1 January 2004 this period may last 104 weeks.

Art. 18(6) of the relevant tax treaty provides a solution for the exercise of the employment by including a deeming provision, which codifies the Netherlands case law outlined above. Specifically, Art. 18(6) of the 2001 Belgium–Netherlands tax treaty allocates the taxation right to the source state in the first year of the employee's illness, despite his being unable to exercise the employment either fully or partially. After this year, the taxation right is allocated to the source state, i.e. the state where the employee would normally exercise his employment if he were to continue to exercise the employment fully or partially.

Art. 18(6) of the 2001 Belgium–Netherlands tax treaty also applies to statutory disability allowances, provided that the employee is partially disabled. If the employee is fully disabled, this allowance is covered by the general rules of Art. 18(1)(b) and (2) of the tax treaty. It is not clear whether payments supplementing statutory disability allowances, i.e. where the employee is partially disabled, which are made by the employer are classified under Art. 18(6) of the 2001 Belgium–Netherlands tax treaty. The text of the provision requires the payment to be made in execution of the social legislation of the contracting state concerned. It is not entirely clear what the expression 'social legislation' means and whether or not it should be limited to statutory social security regulations that would exclude the supplementary payments made by the employer. Although the continued salary payments during the first year of the employee's illness do not stem from the social legislation, based on a strict interpretation of this expression (but from the Civil Law Code), they nevertheless fall under Art. 18(6) of the tax treaty, at least according to the view expressed in the joint explanatory memorandum drafted by the Belgian and Netherlands tax authorities. This may support the classification of payments supplementing statutory disability allowances under that provision, provided the other conditions are met.

3.6. Evaluation

It can be concluded that difficulties may arise in respect of sickness benefits. If the employer is required to continue paying all or part of the employee's salary during a certain period of illness, the question arises as to where the employment is exercised during the illness and where these sickness benefits must be allocated. These issues could be resolved by including these benefits in a social security provision, which was the solution adopted in the 2001 Belgium–Netherlands tax treaty. Nevertheless, this solution could be criticized, as the obligation to pay all or part of the employee's salary during a period of illness is, at least under the laws of the Netherlands and Germany, not imposed on the employer under social security legislation (based on a strict or literal interpretation of this expression), but is derived, instead, from civil law. It would appear to be more logical from this perspective to include a specific provision in Art. 15 of the relevant tax treaty or in the protocol accompanying the tax treaty, which could include a specific division of taxation rights as Art. 18(6) of the 2001 Belgium–Netherlands tax treaty.

Alternatively, a statement could be included at the end of Para. 1 of the Commentary on Art. 15 of the OECD Model. The author would, however, opt for the inclusion of a specific provision in a tax treaty, as it is not possible to draw general conclusions with regard to the domestic tax treatment of illness benefits because this influences the treatment under a tax treaty. This can be illustrated by comparing case law developed in various jurisdictions. According to the decisions of the Netherlands tax courts, for instance, sickness benefits must be allocated, pursuant to the replacement approach, to the place where the employment would have been exercised had the employee not become ill, whereas the German

35. B. Poerts, "Interpreteerproblemen i.v.m. ziekte-uitkeringen", Fiscale Internationaal (1995), No. 135, p. 7 discusses this decision. See also A. Elinghe, "Inkomsten uit niet zelfstandige arbeid (Belgische beigangen)." Werkibel voor fiscale Recht (1995), No. 616, pp. 1498-1499

36. The Court of Appeal made a similar legal consideration in classifying a Netherlands AAW (General Disability Insurance Act (Algemene Arbeidsongeschiktheitswet) allowance (the AAW was abolished on 1 January 1998) in its decision of 16 January 2001 discussed by M. Vrauen, "Ziekte-uitkeringen vallen onder het reisterlaak", Fiscale Internationaal (2001), No. 207, pp. 3-4 and in characterizing a Netherlands WAO (Occupational Disability Insurance Act (Wet op de arbeidsongeschiktheidsverzekering) allowance in its decision of 10 February 2004. Internationale Fiscale Activiteiten (2004), No. 5, pp. 3-6.

37. From 1 January 2006, the WAO was replaced by the VLA (the Law on Work and Income According to Working Ability (Wet Werk en inkomen naar Arbeidsvermogen)

38. Point 22 of the protocol to the 2001 Belgium–Netherlands tax treaty does not clarify this issue either. It only states that 'social legislation' means a 'system concerning social security'.

436 | BULLETIN FOR INTERNATIONAL TAXATION OCTOBER 2009 © BFD
Federal Court looks to the employee's physical presence whilst being ill.

4. Non-Competition Agreements

4.1. In general

If an employee who resides in State R derives income from a non-competition agreement with his former employer resident in State W, difficulties may arise in determining which state has the right to tax this income. In this context, the following preliminary remarks can be made regarding a non-competition agreement.

- **Exercise**: the obligation that the agreement imposes on the employee to omit certain activities during a defined period of time (and possibly restricted to a certain region) can be regarded as the exercise of an employment. This does not necessarily have to be followed in all jurisdictions.

- **Allocation**: (1) direct allocation or (2) the replacement of income approach. The income derived from the non-competition agreement is intended to replace the regular employment income that the employee would have earned had he not been required to omit the activities and the usage of his experience and skills.

- **Place of exercise**: (1) the place where the employee is physically present to honour his commitments or (2) the place where the employment would have been exercised had the employee not had to omit certain activities.

The foregoing could result in two main applications (see 4.2 and 4.3) of the second rule of Art. 15(1) of the OECD Model to income derived from non-competition agreements (a third approach could follow from the Netherlands domestic law interpretation of income derived from a non-competition agreement and should be restricted to that jurisdiction; see 4.4).

4.2. First approach: taxation where the employment would have been exercised

This approach was adopted by the German Federal Tax Court. The Court ruled that the place where the employment is exercised is deemed to be the place where the competitive activities would presumably have been exercised if the individual had performed the omitted activity. The Federal Tax Court held that an exception exists to this principle if there is no direct connection between the agreed abstention from competition and the territory of the relevant contracting state. In other words, if failure to honour the agreement could occur anywhere in the world, the place where the person was physically present must, in the absence of other specific criteria, be taken to be the place where he honoured the commitment. In its ruling of 9 November 1977, BSBl 1978 II, p. 195 et seq., the Federal Tax Court appeared to distinguish the nature of the abstention, i.e. whether it was the main feature of the contract or whether it was merely ancillary to a former employment relating to active personal services. In the latter case, according to the Federal Tax Court, the place of abstention from activity should be deemed to be the place where the personal services were previously performed.

The Brussels Court of Appeal, in its decision of 20 September 2007, appears to endorse the German Federal Tax Court's view. Even though its legal considerations are not entirely unequivocal in this respect, it appears that the Court, in allocating the taxing right, intended to rely on the place where the employment would have been exercised when the former employee did not honour his commitments under the agreement, i.e. the former work state. The Court attached relevance to the fact that the non-competition agreement was limited to the French territory, which enabled it to establish the state where the employment would have been exercised when performing the omitted activity. It is unclear whether or not the Court would have reached a different conclusion had the employment been exercised in different states.

Even though the Internal Revenue Service (IRS) is of the opinion that income derived from a non-competition agreement...
agreement does not fall under Art. 15.44 the view of the German Federal Tax Court is also followed in the United States. In The Korfand Company Inc.45 and Private Letter Ruling 840104.46 the source of a non-competition agreement was deemed to be located in the United States because the place of performance would have been the United States if the recipients had violated their obligations and abstention from competition occurred in the same place.47 The source is, therefore, the place or places where the recipient agrees not to compete.48 As a result, the source is the state where the employment would have been exercised, which is also where taxation should occur, provided that the tax treaty allocates the taxation right to that state.

Although these sources do not explicitly refer to the interaction between the several elements (exercise, allocation and place of exercise), the results stem from this interaction.49 The foregoing also illustrates that this approach may result in a number of practical difficulties if, for instance, it is difficult to determine where the omitted services could have been provided (the comments made on this principle with regard to compensation for the cancellation of an employment and sickness benefits similarly apply).

4.3. Second approach: taxation in the residence state where the employee is physically present to honour his commitments

This view appears to have been followed by the Brussels Court of Appeal.50 In one of its decisions the Court of Appeal was of the opinion that the personal activities giving rise to the income were carried on in the individual's residence state. These personal activities consisted of refraining from competing against the employer and not using, in any way, the knowledge and skills that were obtained during the period of employment activities performed on behalf of that employer. The Court came to this conclusion, as the compensation, which was allocated to the employee in five annual instalments, with each instalment amounting to 25% of his last earned salary, was dependent on strict observance of the non-competition agreement. The income derived from the non-competition agreement differed in this respect from, for instance, a severance payment in that the income from the non-competition agreement would only be obtained if and insofar as the individual refrained from competing against his former employer. The employer was also able to check whether or not the individual correctly and sufficiently observed his obligations under the agreement. In addition, the employer could release the individual from his obligations under the agreement, which would result in the employer not having to pay the remaining instalments. These elements were sufficient for the obligations imposed by the agreement to be regarded as an activity if the individual were to fulfil them.51 The right to tax the income derived from the non-competition agreement was allocated to the individual's residence state, as he was physically present in that state to perform his personal activities, i.e. to refrain from competing against his former employer. As a result, the compensation received for not competing against his former employer could be allocated directly to this activity. In the Circular of 25 May 2005,32 the Belgian tax authorities endorsed this view, i.e. the allocation of the taxation right to the residence state of the recipient of the income.53

It is important to note that the non-competition agreement that was the subject of the Brussels Court of Appeal's decision appeared to have a general scope, i.e. it appeared from the decision that it was not restricted to a certain country or countries.54 This differs from the decision of the Brussels Court of Appeal of 20 September 200755 (see 4.2.), but it is unclear whether or not this difference explains the different outcome that the Court

44. See supra note 1.
45. I.T.C. 1110 (1943).
46. Goldberg, supra note 1, p. 565.
47. See supra note 1.
48.19.5
49. Korfand concerned business activities rather than employment activities. The California Court of Appeal, No. D0140358, Milhous v. Firstar Bank Board adopted a different approach, holding that the income from a covenant not to compete was not attributable to activities or capital (the plaintiffs at issue sold their business) in California.
50. If the non-competition agreement covers only the United States, the compensation is US-source income under the domestic rules. If the agreement covers only a foreign country or countries, the compensation is foreign-source income. If the agreement covers both the United States and one or more foreign countries, the income should be allocated between the United States and the foreign sources on a reasonable basis under § 863(b)(1) of the IRC. See 1D. Kuntz and R.J. Peroni, U.S. International Taxation (New York: Warren, Gorham & Lamont, loose-leaf, 2002), A2, Para. 29, p. A2-177. For a critical analysis of Korfand, see A. Moore, Finding a Nexus for Nonperformance of Services: The Assignment of Primary Taxing Authority under the OECD Model, Emory International Law Review (1997), Vol. 11, pp. 131-133.
51. Engler, supra note 39, p. 122 et seq.
53. It is useful to note that the case law in non-cross-border situations appears to regard not competing against the former employer as an activity, i.e. the exercise of an employment. Compare the decision of the Antwerp Court of Appeal, 25 April 2000, Fiscal Actualities 2000, No. 20, p. 1 et seq. In the Court's view, the non-competition agreement is to be regarded as an 'addendum' to the employment contract. Consequently, performance of the agreement must be regarded as the exercise of a professional activity. Compare also the comments made by L. van de Woyene, in an annotation to the decision of the Belgium Supreme Court of 22 September 2003, Algemeen Vlaamse Tijdschrift (2004), No. 1, p. 54, where the court indicated that compensation derived from a non-competition agreement from a Belgian tax law perspective. A severance payment can be considered remuneration for concrete employment activities, but is, instead, granted because of previously provided services. Remuneration for not competing against the employer is characterized as consideration for the performance of activities that have to be carried out after the termination of the employment contract, i.e. refraining from performing similar activities that could harm the enterprise that the employee has left. The author notes that it is not yet certain whether or not the decision of the Belgium Supreme Court of 22 September 2003, Algemeen Vlaamse Tijdschrift (2004), No. 1, p. 51 et seq. will be followed for tax purposes.
54. No. AFZ 2005/0652.
55. This view is also found in the Resolution of the German tax authorities of 14 September 2006 (BMF IV B 6-S13000-367/06), point 6.4. For a critical analysis of the views of the Belgian tax authorities, see B. Peeters, Artek 15 OEKO-Modellverdienste: inkomen uit niet-rentbepalende arbeid - De nieuwe administratieve circulaire d.d. 23 mei 2005 en de niet gedefinieerde begrippen, Tijdschrift voor Rechtspersoon en Vermogenschap (2006), p. 203 et seq. This criticism is primarily directed towards the reasoning that the tax authorities provided in support of their approach.
56. Since the law of 4 July 1978, a non-competition agreement must be restricted to Belgian territory. The agreement at issue in the decision of the Brussels Court of Appeal was not governed by this law.
57. See supra note 42.

438 | BULLETIN FOR INTERNATIONAL TAXATION OCTOBER 2009
reached in that decision. Some Belgian academics believe that the income derived from a non-competition agreement is governed by the general principle that the right to tax this income is allocated to the state or states where the competing activities would have been performed (see also 4.2.) The only exception to this rule is if these activities cannot be specified. In this situation, the state where the individual is present to comply with the agreement should also have the right to tax that income. For this reason, it is not entirely clear whether or not the Brussels Court of Appeal attached any significance to the general scope of the agreement and the impossibility of specifying the activities. The Court’s considerations reveal that it regards refraining from competing against the former employer as an activity, but it is not totally clear whether this activity is deemed to be performed in the residence state as the individual was physically present in that state to comply with his obligations under the agreement or because it was impossible, given the general scope of the covenant, to specify the countries in which the covenant would have effect. The 2007 decision does not clarify this issue either.

4.4. Third approach: the second rule does not apply

The author believes that this could be the result of the way in which the income derived from the non-competition agreement is classified from a Netherlands tax perspective. This type of income is not considered to be regular employment income for Netherlands tax purposes (Art. 3.80 of the Personal Income Tax Act 2001 and Art. 10 of the Wage Withholding Tax Act 1964), but instead falls under the extension of the Netherlands wage concept included in the Netherlands Income Tax Act (Art. 3.82(b)(2) of the 2001 Personal Income Tax Act). According to this provision, income enjoyed in return for ceasing or refraining from activities, such as a non-competition agreement, is regarded as wages. The reason the income derived from a non-competition agreement falls under this extension is that the individual performs no actual employment activities in return for this income. Consequently, the connection with the employment is too remote to characterize income as regular employment income. The State Secretary for Finance adopted similar reasoning regarding supplements paid by the employer over and above statutory disability allowances, in the context of which it was not necessary to establish the location where the employment would have been exercised according to the employment contract or the parties’ expectations, which was the situation in respect of compensation paid for the cancellation of the employment. There is no need to establish a connection with regard to income derived from a non-competition agreement, as there is no specific employment performed in consideration for the relevant income from a Netherlands tax perspective.

A comparable approach was apparently adopted by the Belgian tax authorities regarding a payment derived from a non-competition agreement, provided that the payment is only allocated to the former employee in instalments that depend on the strict observance of the covenant. The tax authorities state that these instalments are paid because of the absence of a later activity within the sector concerned. As a result, the remuneration derived from the non-competition agreement is not primarily paid because of the former activity. Consequently, this remuneration is only taxable in the state where the beneficiary resides at the moment of payment. 15

4.5. Evaluation

The approaches in 4.2. to 4.4. demonstrate the difficulties that may arise in determining whether or not an activity is performed if the employee refrains from competing against his former employer under a non-competition agreement and where that employment is exercised. If refraining from competing against a former employer is not regarded as an activity, the second rule does not apply and the remuneration is taxable in the employee’s residence state (see 4.4.). Needless to say, the ultimate characterization depends on the domestic laws of the state applying the tax treaty.

Nevertheless, taking the difficulties mentioned under the first (4.2.) and second approach (4.3.) into consideration, the author would prefer to regard not competing against a former employer as the exercise of an employment, which is exercised in the place where the employee is physically present to comply with the obligation imposed by the agreement. As it is possible that a state will regard not competing against a former employer as the exercise of an employment that is deemed to occur at the different locations where the employee would have exercised his employment had he not had to omit his
activities or to refrain from competing, the author would prefer to include a statement in a particular tax treaty or in the Commentary on the OECD Model that refraining from competing against the former employer would constitute the exercise of an employment. This exercise would occur where the employee is physically present to comply with the obligations of the agreement. The income derived from this agreement is directly attributed to this exercise.

Abstracting from the domestic law descriptions, the author believes that there are arguments to support this statement. If the employee agrees that he will not compete against his former employer and will not use the skills and experience he acquired during, inter alia, the terminated employment, the employee's value on the labour market will be reduced. Consequently, it may be stated that the performance of the employment may also consist in not conducting certain activities. The individual in question does not perform any activities at his former employer's request by virtue of a non-competition agreement. The former employer does not want the individual to use his knowledge and abilities to benefit the employer's competitors. In fact, the former employer makes 'negative' use of this individual's working capacity. The former employer rewards this 'negative' use, as the employee's inactivity may have a foreseeable adverse effect on his value in the market.

In addition, if refraining from competing against the former employer is not regarded as the exercise of an employment, the tax jurisdiction is allocated to the employee's residence state under the first rule (see 4.4.). An approach according to which the income derived from the non-competition agreement should be taxed in the former work state should, according to the author, be rejected. The income attributed in consideration of the non-competition agreement has no connection with the employment previously exercised in the work state. The legal cause for paying the remuneration is not the former performance of activities, but, rather, the abstinence from competing against the employer. As has also been noted with regard to compensation for the cancellation of an employment and in respect of sickness benefits, the first approach (replacement approach in combination with establishing the place of exercise as the location where the employment would have been exercised had the employee not been obliged to omit his activities pursuant to the agreement) raises practical difficulties (the parties concerned may attempt to give a certain direction to this location and it may be impossible to determine this location) and systematic difficulties (the application of the 183-day rule). This lends support to the approach that the right to tax the remuneration in question should be assigned to the state in which the individual is physically present to observe the obligations imposed by the non-competition agreement. Consequently, the author would recommend including a remark in the Commentary confirming these principles.

63. The author refers to Art. 18(3) of the new 1999 Italy–United States tax treaty as an example of a provision intending to resolve some aspects of the cross-border treatment of income derived from a non-competition agreement. This article states: "Notwithstanding the provisions of paragraph 1, 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 the first-mentioned State. For 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. The last sentence of this provision is not clarified in the Technical Explanation of the tax treaty in question. It appears, however, that this sentence is rooted in Italian law and also comprises income derived from a non-competition agreement." See C.M. Paolilla, "International tax aspects of deferred remunerations (Italian National Report), Cahiers de Droit Fiscal International, Vol. 85B (The Hague, London/Boston, Kluwer Law International, 2000) p. 534.
64. Vogelgesang, supra note 41, Para. 95.
66. Hellwig, supra note 1, p. 86; Von Bornhaupt, supra note 65, p. 11; Inn, supra note 65, p. 204; Proksch, supra note 40, pp. 894-895; and H. Vogel, "Aktuelle Fragen bei der Auslegung von Doppelbesteuerungsabkommen", Der Betriebs-Berater (1978), No. 21, p. 1021.