A move in the right direction?

Employment Tax

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Robert Jennings and Rob Pearce consider the forthcoming changes to the UK taxation of share awards for internationally mobile employees

Key Points

What is the issue?

FA 2014 introduced new legislation to change the UK taxation of share income for internationally mobile employees; these rules take effect from 6 April 2015. HMRC also published a consultation to change the NIC treatment. Draft legislation has been published and is intended to also take effect from April 2015.

What does it mean for me?

The new tax rules may significantly change the UK income tax and NIC treatment of employment related securities for mobile employees. These rules apply to all chargeable events occurring after April 2015, irrespective of the date of grant. All internationally mobile employees with share income – and their employers –

will need to consider the impact of the changes.

What can I take away?

The UK income tax rules will become less complex and there is a short window in which individuals can take action to mitigate the tax consequences arising from the changes. The NIC rules will look to align NIC with income tax as far as possible. However, the draft rules do not necessarily achieve this so, as drafted, there is likely to be significant complexity for employers, with NIC costs for employers likely to increase as a whole

The taxation of employment related securities (ERS) has always been complicated and when an internationally mobile employee (IME) is in receipt of ERS income, these complications are multiplied, which creates significant compliance challenges for employers.

Currently, the income tax treatment of ERS for an IME depends upon a number of factors, including:

- the type of ERS instrument – for example, whether it is a share option, conditional share award (restricted stock unit (RSU) or performance share plan (PSP)), or a forfeitable or restricted share;
- whether the award is settled in cash or shares;
- whether the IME is inbound to or outbound from the UK; and
- the country to which an outbound IME has moved.

Additional complexity arises when considering the NIC treatment of the awards, as this will often differ from the income tax position.

Income tax

FA 2014 contained a number of significant amendments to the UK legislation governing ERS. The majority of the income tax changes enacted are in line with the recommendations made by the Office of Tax Simplification (OTS).

FA 2014 seeks to simplify the income tax treatment of all ERS held by IMEs, where there is a UK chargeable event (such as a vesting or exercise) occurring on or after 6 April 2015. This will apply regardless of when the award was granted. While these changes will be welcomed by most employers, a number of issues need to be considered before April 2015.

NIC

In July 2014 the government opened a consultation on proposed changes to the NIC rules for ERS income of IMEs. The broad objective of the consultation was to ‘align’ the NIC treatment with that of income tax. However, as drafted, the proposed legislation does not achieve its objective in the way that employers may have hoped and it raises a number of challenges and questions for employers.

Income tax rules

From 6 April 2015, income tax on ERS will generally be payable by reference to an individual’s UK residence and workdays during the period in which the award is earned, regardless of the type of ERS instrument used.

This has a significant impact for employees who, for example, were granted share options or restricted shares while not resident in the UK.

Under the current rules, these awards will not be subject to income tax in the UK, provided they were not granted in contemplation of UK duties. Where the tax point for these awards occurs on or after 6 April 2015, however, the tax treatment will be different from what would currently be the case, as illustrated in Example 1.

Example 1 illustrates how an employee might have an increased UK tax liability under the new rules.

Example 1

A non-UK resident IME was granted a share option while outside the UK and the grant was not made in contemplation of UK duties. The IME subsequently moves to the UK during the earnings period (typically the grant-to-vest period) and becomes UK tax resident, spending all of his or her time working in the UK. The IME then exercises the option in the UK while UK resident.

Under the current rules, no UK income tax would arise at exercise (although a tax liability may arise in the country where the IME was at grant). However, where the exercise occurs after 6 April 2015, UK income tax will arise at exercise based on, broadly, the days in which the IME was working or resident in the UK over the earnings period.

However, other employees might benefit from this change in legislation; in particular, individuals who were granted an option while UK resident and who have moved, or will move, during the earnings period to a country with which the UK does not hold a double tax treaty, as illustrated in Example 2.

Example 2

A UK resident IME was granted a share option while working in the UK. The IME subsequently moves to the United Arab Emirates (UAE) during the earnings period. The IME then exercises the option in the UAE after ceasing to be UK tax resident.

Under the current rules, UK income tax would arise at exercise on the full gain as the IME was UK resident at grant of the option. However, under the new rules, UK income tax will arise at exercise but only on the proportion of the gain that was earned in the UK.

The new legislation being introduced could therefore affect a number IMEs who have ‘touched’ the UK during the vesting period of an award. While the impact on employees who have been awarded conditional awards or restricted stock units may be less significant, early action should be taken to assess the impact of the proposed changes. In particular:

- Employers should ensure they understand how the new rules will impact their UK withholding and reporting requirements.
- Employers should also consider what advice or guidance they provide their employees. For example, IMEs with vested share options may benefit from exercising either before or after 6 April 2015.

NIC rules

While the changes to the income tax treatment have been legislated as part of FA 2014, the changes to the NIC treatment have yet to be finalised. The consultation on the changes to the NIC treatment closed in October 2014 and a response from HMRC is due shortly.

However, HMRC intends the changes to the NIC treatment to take effect from the same time as the changes to the tax treatment and to apply to any ERS chargeable events occurring on or after
6 April 2015.

As with income tax, the current NIC rules relating to ERS income for IMEs are complex. The NIC position can depend on a number of factors, such as:

- whether an income tax charge arises;
- whether the IME moves to an 'agreement' country, an EEA country or Switzerland, or a 'non-agreement' country;
- whether the IME holds a Certificate of Coverage or A1 to remain in a specific social security regime; and
- whether the IME moves location as an assignee or permanent transfer.

Most readers will recognise that the NIC position does not always follow the income tax position. In particular, NIC is generally due on ERS income on an all-or-nothing basis – ie NIC is not generally apportioned. Under the proposed new rules, however, liability to NIC on ERS will be based on the amount of time during the earnings period for which the IME is UK insured. Similar to the new income tax rules, this is regardless of the IME's residence position at grant or vesting/exercise of the ERS. Therefore, the proposed new rules may result in both UK inbound and outbound IMEs, who would not currently be liable to NIC on their ERS, becoming liable to NIC on a proportional basis, as illustrated in Example 3.

Example 3

Currently, inbound IMEs who were granted share options before arrival in the UK (and where the grant was not made in respect of UK duties) do not incur a NIC liability as there is no charge to income tax.

Under the proposed new rules, a NIC charge would arise for inbound employees for any part of the grant-to-vest period when the individual is UK insured.

Example 3 appears to show that the NIC rules are being aligned to the income tax rules. This was the broad intention of the proposal; however, the key difference is the basis on which the apportionment will be made.

Under the tax rules, any apportionment will be based, broadly, on UK residence/workdays; however, under the proposed NIC rules, any apportionment will be based on periods for which the employee is UK insured. While UK insurability and tax residence could be the same, this will not always be the case. For example:

- where the IME has moved from the UK to a 'non-agreement' country as a secondee, the IME remains subject to social security in the UK for an additional 52 weeks (the '52-week rule'); and
- where the IME is subject to a Certificate of Coverage/A1 arrangement, they remain within their home social security system regardless of a change in tax residency.

See both scenarios set out in Example 4 for further details.

Example 4

1. A UK outbound IME is assigned to Singapore

A share option is granted while the individual is UK resident and vests on the third anniversary of the date of grant. The IME is assigned to Singapore one year after the grant of the option. The IME then exercises the option immediately on vesting.

UK income tax would be due on the apportioned gain based, broadly, on UK residence (that is, one-third of the gain). NIC would also be due on the apportioned gain based, however, on the period for which the IME was UK insured. In the current case, he or she is UK insured for year one (when in the UK) and year two (due to the 52-week rule). As such, NIC will be due on two-thirds of the gain.

(Under the current rules, there would be no NIC as the employee is outside the scope of NIC at the tax point. This is therefore a significant change.)

2. A US outbound IME is assigned to the UK but remains under US social security by a Certificate of Coverage for two years before being localised to the U

A share option is granted at the end of year one of the UK assignment and exercised immediately on vesting on the third anniversary of the date of grant.

UK income tax would be due on the full gain at exercise. However, NIC would be due only on the proportion of the gain at exercise that related to the period for which the IME was UK insured, being two-thirds of the gain, as the individual was insured for only two of the three years (in the first year they were covered by a Certificate of Coverage and therefore not UK insured).

If the proposed rules are to be implemented as they are, NIC and income tax liabilities on the ERS would be calculated based on two different apportioned amounts and RTI reporting may require differing adjustments in the NIC and income tax fields. Although NIC costs will be reduced under some scenarios, we expect NIC costs for UK employers generally to increase.

In addition, the proposed changes increase the risk of a double charge to social security arising on the same ERS income. Where an IME moves between the UK and an EC or social security agreement country there cannot be a double charge. It is unclear how the competent authorities will deal with these provisions so there may need to be frantic negotiations to determine how double charges will be avoided. Where an IME moves to a ‘non-agreement’ country, such double charges may be unavoidable.

Conclusion

The income tax changes are significant and are likely to affect many employees currently holding share awards. While the changes can be seen as a positive step towards simplifying the income tax treatment of ERS, the current proposals for NIC do not appear to provide the same simplicity. It will be interesting to see HMRC’s response to the NIC consultation, and whether any amendments are made to the draft legislation and the guidance they subsequently provide. Employers may then need to act quickly to ensure that they can comply with any new rules from 6 April 2015.

Action Points

1. Watch for further announcements regarding the NIC changes.
2. Consider how the income tax and proposed NIC changes will impact your share plans.
3. Identify employees who will be impacted, and if appropriate, communicate with them about the proposed changes (being careful not to provide ‘investment advice’).

4. Analyse where the company’s costs may increase, either due to:
    1. ?awards held by a tax equalised employee becoming taxable in the UK; and/or
    2. new/increased NIC charges. (If necessary ensure that appropriate provisions are made for the increased costs.)
5. ?Consider the impact of the changes on future assignment costs and whether a change in assignment policy is needed.
6. Ensure payroll teams are notified and can manage their withholding and reporting obligations.