Employment-related securities: International hybrid working

Employment Tax International Tax

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We consider the treatment of restricted securities for individuals who undertake hybrid working overseas.

Key Points

What is the issue?

International hybrid working can give rise to employment tax charges on an employee’s equity participation outside of the individual’s home country.

What does it mean to me?

Where a group has set up a management equity plan, particular care should be taken to ensure that there are no unintended tax consequences of individuals choosing to work remotely overseas.

What can I take away?

Due consideration should be given to the rules in Part 7 of the Income Tax (Earnings & Pensions) Act 2003, where overseas workers participating in a management equity plan intend to spend time working in the UK.

For many people, some degree of hybrid working is now firmly here to stay. Technology to support this new approach has advanced at a rapid pace over the last few years. Many aspects of the job can arguably be carried out just as effectively virtually as they can in person, at least for short periods of time or in relation to carrying out certain tasks.

Naturally this has led employees to question why their work must be carried out from their home base. Provided there is a suitable internet connection, and good coffee, what should stop individuals from working remotely wherever in the world they may find themselves, balancing their work around their lives. Naturally, this depends on having the right to work, which is a separate matter. This desire to work flexibly is becoming so common that many employers now have policies in place governing overseas 'homeworking' by employees.

Tax residency

The general starting point for many tax authorities is to levy taxes based on an individual's tax residency status. However, when it comes to employment taxes, where an individual carries out their duties is equally important. Employment tax issues could arise where employees spend time working outside their home country.

The risk of such issues inadvertently occurring is increased where decisions are made by employees themselves over their homeworking location without proper consultation with their employers, who are better placed to assess the tax risks of these arrangements.

If an employee is exposed to employment taxes outside of their home jurisdiction, not only could this impact the taxation of their salary and other compensation, but an often overlooked point is that it could affect the taxation of an individual's participation in a company management equity plan. Not all jurisdictions treat an investment in a management equity plan in the same way, depending on the terms, and therefore unexpected complexities can quickly arise.

Restricted securities

The rules in respect of the taxation of restricted securities under the Income Tax (Earnings and Pension) Act 2003 Part 7 Chapter 2 is a particularly complex area and a detailed discussion of this piece of legislation is beyond the scope of this article.

However, broadly, where an employee acquires shares with restrictions attached and where the individual does not make a timely election under s 431, specific employment income is deemed to arise under s 426 when certain chargeable events occur. One such event would be the lifting of restrictions on the securities, which will depend upon the securities' terms and vesting schedule. In a private company, it is not uncommon for the securities to fully vest only upon a disposal event of the business to a third party.

The process to make a valid election is set out in detail in s 431, including: the requirement for the election to be made within 14 days of the securities being acquired; and the requirement that the individual has UK taxable earnings in the tax year in which the securities are acquired. The election provides that the individual is taxed by reference to the unrestricted market value and that subsequent growth is subject to capital gains tax.

Non-residents working in the UK

The provisions determining the treatment of restricted securities for internationally mobile employees are found in s 41F. Broadly, these state that income deriving from restricted securities that is not treated as 'foreign' is subject to income tax in the UK. Foreign would include, for example, income relating to duties performed wholly outside of the UK. Therefore, income relating to duties performed in the UK will, on the face of it, be taxable in the UK.

This is a rather simplistic analysis, and it will be important to consider the nature of the duties being performed in the UK, as well as the impact of any double taxation agreement between the UK and the employee's home country. However, on the assumption that relieving provisions do not apply, what constitutes income deriving from duties performed outside the UK versus inside the UK is determined by ss 41H and 41L. These state that the income in question must be apportioned and that apportionment should be done on a just and reasonable basis.

Incidental duties

The legislation has long recognised the international nature of both today's businesses and their workers, and there is specific legislation addressing the tax implications where employees spend time working outside of their home location. Historically, this legislation will have been applied in arriving at a logical outcome where employees made short non-substantive business trips to the UK on behalf of their overseas employer. In these instances, it seems just that taxing rights should remain with the worker's overseas employer.

In more recent years, this legislation may serve to relieve taxation of overseas workers' remote homeworking in the UK but the position will be heavily dependent on the facts. Given the high degree of flexibility afforded to workers today over their hybrid working pattern, the outcome and final position could be somewhat grey.

The legislation under s 39 states that provided the duties carried out by a non-resident in the UK are merely incidental to the performance of their duties in their home country, the duties carried out in the UK are deemed to be performed outside of the UK. What constitutes merely incidental duties is not defined in the legislation; however, HMRC Employment Income Manual EIM40204 sets out that it is necessary to consider the nature of the individual's duties both in and out of the UK to form a judgment. Some examples of the types of activities HMRC would expect to fall into the merely incidental bucket include, for example:

- arranging meetings and business travel;
- providing feedback on employee performance and/or business results, if this does not involve the employee concerned in preparation or analysis whilst in the UK and as long as responsibility for these matters is not part of the employee's core duties of employment;
- input to team restructuring and staff matters, provided that the employee does not have a management role; and
- reading generic business emails that do not relate directly to the employee's role/responsibilities.

The list is not exhaustive and what constitutes merely incidental for one individual may not be the same for another.

Application of the double tax treaty

If the duties carried out by an individual cannot be said to be incidental to the employee’s role outside the UK, the other area to consider is the application of the employment income article of the relevant double taxation agreement between the UK and the individual’s country of residence. If the conditions of the agreement are met, any employment income that would otherwise become taxable in the UK under domestic law will remain taxable only in the individual’s home country.

The precise wording of the conditions will depend upon the relevant treaty; however, broadly the three conditions are commonly:

1. The individual’s presence in the UK does not exceed 183 days in a 12 month period (either a rolling 12 month period or the calendar year depending on the treaty).
2. The individual’s remuneration is paid by, or on behalf of, an employer who is not a resident of the UK. Broadly, this means the individual is employed (legally/economically depending on the jurisdictions) by an employer outside of the UK.
3. The individual’s remuneration is not borne by a permanent establishment which the employer has in the UK.

Applying these conditions could be complex, particularly in the context of large international groups where the individual’s economic employer and the cost of their remuneration being borne outside of the UK may be less clear.

Case study: the impact of hybrid working

Justine is employed by Group Y, a Dutch based business. Prior to the pandemic, Justine both lived and worked in the Netherlands. However, given the acceptance of hybrid working, Justine now splits her time between her homes in the Netherlands and the UK. She now typically spends three to four days in the Netherlands in any given week and the remainder of the time in the UK. Whilst in the UK, she works from home.

Group Y believes in making employees owners of the business and therefore four years ago Justine was invited to acquire shares in Group Y. The terms of these shares require her to remain employed by the group or otherwise she will forfeit her shares. As she is employed by a local Dutch business, no specific UK tax advice was taken at the time she acquired her shares.

Group Y’s majority shareholders are currently undertaking a disposal of the group, whereby Justine would also be required to sell her shares.

What this means for management’s equity

As Justine is an employee of Group Y and received shares as result of her employment, the shares will be employment-related securities. The shares will also be restricted securities under s 423(1) on the basis they are forfeitable if she leaves her employment. Justine did not make a s 431 election within 14 days of acquiring her shares and therefore a proportion of the value she realises in respect of the shares as part of the upcoming transaction will be treated as specific employment income under the restricted securities regime.

Justine’s tax residency status would need to be assessed. Assuming that she is non-UK resident, as Justine carries on her regular duties whilst in the UK, her work in the UK would not be considered incidental to her Dutch employment.

Turning to the UK-Netherlands double taxation agreement, and assuming that Justine has spent more than 183 days in the UK in a 12 month period, the conditions in Article 14 (Income from Employment) would not be met. Therefore Justine will be subject to UK income tax on the proportion of her employment income that relates to UK workdays.

This would include her share proceeds relating to UK workdays and deemed to be specific employment income under the restricted securities rules. It is likely that such a charge to UK tax was not on Justine’s radar. In addition, her share proceeds may be subject to capital gains taxes, instead of employment taxes, in the Netherlands, which could further complicate the position with regard to claiming tax credits.

Conclusion

The focus of this article has been on the application of the restricted securities rules in an international context for workers employed by the group. The final position in any of these cross border cases is highly fact dependent and can become complex quickly including where Employer of Record arrangements are in place, which is a separate topic.

It is also worth noting that there are wider potential tax implications for the group and its corporation tax position. It is therefore recommended that there are robust processes and controls in place and careful planning is undertaken to ensure there are no nasty surprises for employee shareholders on realising the value of their equity.