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Self Assessment Tax Returns

1. Some people will no longer be sent tax returns.

In April 2004 we published new guidelines for those who should complete tax returns. You can find these on our website (www.inlandrevenue.gov.uk/sa/guidelines.htm) and in Booklet SA/BK8 *Self Assessment Your Guide*. The new guidelines ensure that people with straightforward tax affairs, whose tax liability can be met through PAYE deductions, will not normally be asked to complete tax returns in the future. The following is an overview of the new guidelines and procedures.

The new guidelines generally benefit:

- Employees paying tax at the higher rate. (Previously employees paying higher rate tax had to complete a tax return irrespective of the complexity of their tax affairs. Higher rate liability alone is no longer a reason for employees to be sent a tax return.)

- Employees paying basic rate tax who claim professional fees and expenses below £2,500 per annum. (Previously employees claiming more than £500 had to complete a tax return.)

- Employees with investment income below £10,000 per annum. (Previously employees with investment income above £8,500 had to complete a tax return.)

- Pensioners and people on low incomes with simple affairs.

Employees

There is now an automatic process for identifying those employees to whom we no longer need to send returns in the future. When a completed tax return is received and entered onto our Self Assessment computer system, the system checks the entries on the return against the new guidelines. Where a return is no longer needed, the following will happen:

- The taxpayer will be sent an 'exit' letter (SA251) and notes informing them that they no longer have to complete a return. The notes explain how the taxpayer's affairs will be handled within the PAYE system and what needs to be done if their circumstances change. Authorised agents will be sent copies of the letter.

- A signal will be set on the taxpayer's record to prevent returns being issued in the future.

- Depending on the taxpayer's circumstances, adjustments are made in the following year's coding record to ensure that any additional tax is paid through PAYE. Any adjustment would be notified to the taxpayer in a coding notice before that year begins (copied to their agent).
- Where appropriate, the system will note the taxpayer's record to issue a one page form, the Tax Review form (P810), the following April. This will be sent where the taxpayer, for example, makes claims to expenses or Gift Aid payments, or has items of income on which additional tax must be paid, such as untaxed interest etc.
- On receipt of the completed Tax Review form, the previous year's liability will be reviewed and any overpayment repaid. Any additional liability will normally be included in the following year's coding record. The Tax Review form will also be used to update the coding record for income and allowances for the current year.
- After the first Tax Review form the taxpayer will receive further forms, on a 3 yearly cycle or, where the individual's affairs are more involved, annually. The taxpayer (or their agent if they have one) should contact the tax office at any time if their affairs change and the coding record is no longer correct.

Low income and pensioner cases

In these cases when a completed tax return is received, the system automatically identifies those customers who potentially no longer need to complete returns. We then carry out a manual review to ensure that the taxpayer's affairs are sufficiently simple and stable not to require tax returns for completion.

Some of these customers will need to be sent the Tax Review form in place of the return, and others may be set up as tax repayment cases so the taxpayer will receive a form R40 to complete for the following year.

In all these cases the taxpayer and their agent (if they have one) will receive an 'exit' letter and notes, as described earlier.

Returning to Self Assessment tax returns

The purpose of the new guidelines is to reduce the compliance burden on taxpayers where possible. The process is based on the information a taxpayer gives in a tax return. But their circumstances may have changed since they completed their last tax return or they may simply prefer, for various reasons, to continue to receive and complete tax returns. Where the taxpayer (or agent) contacts us our records will be noted to ensure that the taxpayer receives returns in future. The taxpayer (or agent) can also request that we set a signal on the system to ensure they are not automatically removed again in the future.

People who return to Self Assessment will receive an 'entry' letter (SA250) (copied to their agent if they have one) explaining that they will be sent tax returns to complete in the future.

Obligations

If we tell someone we will not be sending tax returns in the future, it remains the **taxpayer's responsibility** to let us know if there have been any changes to their financial circumstances, since the information given in their last tax return, that will affect the amount of tax they should pay. **Taxpayers have six months, following the end of the tax year, to tell us about any new income or gains they receive**. And if they start to work for themselves (that is, they become self-employed or join in a partnership), they must tell us within 3 months of their start date. We can charge interest and penalties if we find out by some other means or are told late.

In any case where a return has been issued it must be completed unless it was issued in error (see the final paragraph below, for example).

2. Short Tax Return

For the past two years we have piloted a new shorter tax return. The language on both the 4-page form and the guide, which accompanies it, has been simplified. The new form is being issued nationally this year for the first time and we estimate that around 1.5 million taxpayers should receive it.

The short tax return (STR) contains a selection of questions from the main return aimed at maximising the number of people eligible to use it. Because it contains limited questions, only those whose tax affairs are straightforward can use the form. These include some employees, pensioners and the self-employed with turnovers below £15,000. In addition, they may have straightforward investment income, or a modest amount of income from property. People receiving trust income and company directors, for example, are not able to use the form.

People who qualify for the STR will be sent the form, along with the accompanying guidance (Your guide to the Short Tax Return) to help them complete it. As there is no facility to self-calculate on the STR no separate Tax Calculation guide is sent. There is, for those who want an idea of their liability, a 2 page indicative calculation at the end of the guide.

The STR is unlike the main tax return in that it does not have any supplementary pages, with one exception, capital gains. This year we are piloting a new shorter capital gains supplement for those using the STR who have capital gains.

In addition to completing the two-page supplement, taxpayers will be required to send in their capital gains computations. We will monitor the pilot throughout the year to see what issues surface.

There are some important rules governing the use of the STR:

- Because the STR is limited, we will only send it to people who, based on the information from their previous return, fall within its ambit. Taxpayers cannot self select a STR and it will not be available from the Orderline, local offices or the website. In the event of the loss or destruction of the original form you should contact the issuing Inland Revenue office who will send a duplicate.

- Those receiving the form must decide, using the guide, whether they are, in fact, eligible to use it. People's circumstances change from one year to the next – new sources of income arise which may fall outside the scope of the short return and prevent its use.

- People sent the form may choose not to use it if they prefer to send in a main return, either on paper or electronically. There is no electronic version of the STR or any substitute STR form. However, the on-line version of the main return effectively tailors the return to each taxpayer and provides other benefits such as an automatic calculation and immediate confirmation of receipt.

- The STR is not issued to people who filed their previous return after 31 January.

- A STR issued to one person must not be used by another. Apart from the fact that they may not be eligible to use the form, the STR carries a bar code, which identifies the person to whom it is addressed.

The STR has been designed to be captured automatically, improving speed and accuracy of processing. To ensure STRs are processed successfully:

- All forms must be sent to our processing facility in Netherton. Reply envelopes are provided with the return.

- The forms must be correctly completed following the guidance on the front page of the form. Arithmetical errors or missing information, for example, will slow down the process.

- The actual STR form must be completed. A photocopy will not be acceptable.

- Any attachment to the form will slow down the process. Ideally the form should be sent back without any attachments. The only exception is the capital gains supplement and computations, where appropriate. Where additional information is essential it should be set out in a letter enclosed (not pinned or stapled) with the return.

Finally

Both of the procedures described above (no longer sending tax returns and the STR) rely on the information from the completed tax return for one year being entered onto our computer system before the selection for the following year's return is made. The selection run is carried out in February. Paper returns filed later on in the filing period (from 1 October to 31 January) are not guaranteed to have been entered onto our system in time to influence the following year's selection. In that event customers who are eligible for an 'exit' letter or a STR will continue to receive a main return. If a customer believes their return may have been submitted too late to qualify they should contact their tax office who may be able to help. However, those who file their returns after 31 January will not benefit from either the STR or an exit letter.

Both these measures have been successfully piloted. Research carried out shows them to have generated very high satisfaction ratings with taxpayers taking part in the pilots.

Sending Employer's Annual Returns for 2004-05

This article mostly concerns filing Employer's Annual Returns online. However, it does have important information about sending complete and part Returns on paper.

Online filing from April

With more than 500,000 employers, agents and payroll bureaux registered to use our online services, we are pulling out all the stops to make sure that online filing of Employer's Annual Returns (P14 and P35 information) runs smoothly for employers and agents.

Most employers file online between 10am and 4pm. They might get a slightly speedier service if they can try to send Returns outside those peak hours. And it will help to avoid the peak filing days, usually 18 and 19 May.

Anyone can get help with online filing by calling our Online Services Helpdesk on 0845 60 55 999:

- weekdays between 8am – 10pm

- weekends and Bank Holidays 10am – 6pm.

Your P35

Employers must not send us a paper P35 if they send their P35 online, even if they get one through the post. If we do get both, and the paper Return is accepted before the online Return, we will treat the Return as being made by paper. This means that large employers (250 or more employees) who must file online will incur the online filing penalty and small employers (fewer than 50 employees) will not get the tax-free incentive.

Special online filing arrangements for 2005

It has proved necessary for the testing of our new computer systems for Employer's Annual Returns to stretch into May.

Our new computer for sending information from your Employer's Annual Returns to our other systems will go 'live' towards the end of May, later than the original planned switch-on date of 6 April. The later date will allow us to carry out more rigorous testing of our new processes. But we have taken every step to ensure that we are 'open for business' for 2004-05 online filing on 6 April.

From 6 April we will:

- apply initial quality checks on Returns sent over the Internet at the Government Gateway;
- where these initial checks are passed, send an on-screen message saying that we have accepted the Return (Internet filers who have provided an email address and Electronic Data Interchange filers (EDI) will get an email);
- store successful Returns until the new computer is up and running;
- later, pass Returns to the new computer.

If the Return fails the initial checks at the Government Gateway, it is vital that it is corrected quickly and re-submitted by the 19 May filing deadline. So we urge employers and agents to allow plenty of time to file, and not leave it until the last minute and risk getting a penalty for not meeting the deadline.

Filing within seven days of 19 May

Extra Statutory Concession B46 allows employers up to seven more business days after the Employer's Annual Return filing deadline of 19 May to get their Return to us before we charge a late filing penalty. This Concession is intended to address the situation where a Return is delayed by something beyond the employer's control, such as postal delays, but it also applies to online Returns as well as those sent on paper or by magnetic media. Although online transmissions are much faster than post, they are not always instantaneous. Sometimes, computer problems or problems with Internet connections can cause delays in online filing. So, if we receive the Return by 26 May 2005, we will not charge a late filing penalty.

What will happen in May and later this year?

Our new computer will apply further quality checks on P14s sent via the Internet, and then on the whole Return, including the P35. But a Return will not be rejected if it fails any of those further checks, as long as we have a full Return with no parts missing.

Where a Return fails the further checks, we will look into the reason for the failure. We will correct the Return with the help of the sender (probably by telephone). We will not charge a late filing penalty if the original Return was sent online by 19 May.

We will start these further checks towards the end of May. This means that we may be contacting employers and/or agents later than expected to put right errors in Returns filed in April or May. So employers will need to make sure that they have easy access to their 2004-05 end of year records from which the Return was made.

P14s sent by EDI will be validated immediately on receipt and Returns that include errors will be rejected for correction. Checks to see that the P14s and the P35 totals are correct will be done later, after the end of May.

The non-online filing penalty will apply where the complete original Return (P35 and all the P14 parts) is not sent online.

Re-submitting incorrect Returns

Very exceptionally, we may need to ask the sender to correct a Return and re-submit it. Where this happens we will attach the original submission date to the Return and provided the original Return was received on time we will not seek to charge a late filing penalty. If the employer is unable to re-submit the replacement online because of limitations in their software, we will not seek to charge the non-online filing penalty and would be willing to pay the incentive to a small employer, as long as all of their original Return was sent online.

Sending Returns in parts

Some employers will find that their business circumstances require them to send their Return in separate parts. We must have all the parts of a Return before we can make an incentive payment or prevent penalties.

If employers or agents file in parts (for example, send P14s in batches), the further quality checks will be applied to each P14 part separately and then to the whole Return (P14s and P35). Whoever sends in each part will get the same acceptance message saying: 'The EOY Return has been

processed and passed full validation', even if there may be more parts to follow. It is important that the acceptance message is not misinterpreted as a successful submission of the whole Return. So whoever is sending the P35 Return part must make sure that every part has been or will be sent in. We recommend that agents tell their clients how many parts they intend to send and when they have been sent. We also recommend that the P35 is sent last.

Internet and EDI filers can replace a part as long as the replacement has the same Unique Identifier as the part that it replaces. A replacement must be done before the P35 has had the acceptance message.

Any changes or additions instigated by the employer after all parts of a Return, including the P35, have been accepted must be made as an amendment.

Sending supplementary or amended information

The law requires employers to send a full and complete Return by 19 May. While we recognise that some employers need to make changes to their Return or send supplementary information, there is no provision in law for a second (supplementary) or amended Return. Where the employer recognises that a full Return was not made we need:

- amended P14 and P35 details showing only the value of the changes;
- a letter to their Inland Revenue office setting out the reason the Return was not full and complete in the first place.

In line with Inland Revenue practice over many years, we will look at amended information and, where appropriate, consider a penalty under Section 98A(4) Taxes Management Act 1970.

We recommend that amendments are not sent until the end of May when the new computer system is up and running. Our systems will however be capable of accepting amended details from the outset.

Amended information does not have to be sent in the same way as the original Return. Amendments can be made on paper or by using the Inland Revenue's free Online Return and Forms - PAYE service.

Using both Internet and Electronic Data Interchange

EDI users who want to send their P35 over the Internet must register to use PAYE Online for Employers - Internet then choose to de-select the option to get P6s, P6Bs, P9s, Student Loans and tax credits forms sent to their Internet secure mailbox. Otherwise these will be sent to their secure mailbox and EDI output will stop.

To change the setting when activating, EDI users need to select 'want to change' under the 'Statutory notices over the Internet' section. Details of all the above notices will be shown as automatically selected 'Yes'. EDI users need to change the answer to 'No' for each of the notices they do not wish to get over the Internet. Preferences can be changed later by selecting 'change your statutory notice' option from the PAYE service page.

Small employers and the £250 online filing incentive payment

We will not be able to write to small employers to confirm that we are crediting £250 to their account until their Return has gone through all of our quality checks. This may mean that we do not write to them until later. Employers cannot claim the £250 back from us as a cheque repayment until they get that letter.

An acceptance message will say that we have the Return, but our staff cannot check any figures until the new computer system is ready. This will limit the answers we can give small employers about their incentive payment.

But small employers do not have to wait for that letter to get their incentive payment. The on-screen message that we will send saying that we have accepted an online Return is the assurance that the employer has qualified. Anytime after getting that message, small employers can deduct (self-serve) £250 for filing online from their next payment for 2005-06 due to us, without having to wait for us to credit it to their payment record. **Small employers sending their Return in parts must wait until every part of their Return has been accepted before deducting the incentive from a 2005-06 payment.**

It would be helpful if employers could send us a 'nil' payslip for any complete month(s) or quarters covered by the tax-free payment to avoid unnecessary payment reminders. We must have written authority from an employer before we send the employer's tax-free incentive payment to a third party, such as a payroll agent. The payment is only tax-free to the employer. Later, when we have all the parts of a Return and process the Return information to our various systems, we will credit the £250 to the employer's payment record and send written confirmation that we have done this. Only at that stage, if the employer has not already self-served (and has no tax and National Insurance arrears), can he or she ask us to send the incentive payment as a cheque repayment.

Incentive payments are only available to employers that send every part of their Return online.

Changes to incentive regulations

Changes to the incentive regulations (Statutory Instrument SI2005/826) were announced on 18 March. These changes are intended to deny incentive payments to a tiny minority of employers who, we believe intend to abuse the incentive process. The changes also clarify how the incentives will be applied or paid.

The changes introduce an anti-avoidance provision in order to refuse an incentive (or recover it where already paid) where the employing entity appears to have been set up, or to have paid PAYE income, wholly or mainly to gain the tax-free incentive payment. This provision will have no impact on our processing routines and is not intended to prevent the genuine small employer from benefiting from the incentive payment.

The provision is widely drawn to ensure that those abusing the incentive provisions cannot readily circumvent the new provision by making small changes to their artificial arrangements. We do not intend to use the provision to deny incentive payments to businesses that appear to have incorporated mainly to take advantage of wider tax breaks.

From 19 March, we will challenge the relevant employers with a view to not paying or withdrawing an incentive which has already been paid, where we have reason to believe that that the incentives provisions are being unfairly exploited. The employer will have the right of appeal to the Commissioners.

Please see revised text of paragraphs 1-4 that were revised on 19 April 2007.

The anti-avoidance provision will apply to 2004-05 incentives for employers that make the first 2004-05 payment, which requires the creation of a P11 deductions working sheet (or equivalent IT record), after 18 March 2005.

For 2005-06 and subsequent years, the provision will apply to all employers.

The amendments to the regulations also clarify how the incentives will be applied or paid. With effect from April 2005, when any request for a cheque repayment of the incentive is made we will first set the £250 against any outstanding arrears of tax, National Insurance, student loan deductions and related penalties and interest. We will send a cheque for the balance. Cheque repayments of the incentive can only be considered after the employer has received written confirmation that the incentive has been credited to their payment record. These changes do not affect our advice to employers about utilising the incentive credit by deducting it from future payments.

Invalid National Insurance number prefixes for 2004-05 and 2005-06

Temporary National Insurance numbers starting with TN must not be used in the National Insurance number field. Returns sent on paper will be sent back if temporary numbers are used. If the actual number is not known, the National Insurance number field must be left empty and the date of birth and gender fields completed. Temporary numbers allocated by software during the year must be removed before the Return is sent.

National Insurance number prefix ‘PZ’ is also not acceptable for 2004-05. National Insurance numbers starting PZ must be removed before the Return is sent.

Details of all the initial validation rules that can cause a paper Return to fail are on Page 2 of *Finishing the tax year 2004-05* (booklet E10) available on the Employer’s CD-ROM 2005. National Insurance number prefixes NC, NK, NO, ZZ, XX and QQ will not be acceptable on Returns for 2005-06 and later years.

P35 tax avoidance schemes

New rules putting an obligation on promoters and users of certain tax avoidance schemes and arrangements to disclose details to the Inland Revenue were announced on 17 March 2004. Initial plans to add a question about tax avoidance schemes to the P35 from 2006-07 have been deferred while the Inland Revenue evaluates the extent to which employers use tax avoidance schemes.

Any employers using a tax avoidance scheme should continue to send a completed form AIU4 to The Avoidance Intelligence Unit, 22 Kingsway, London, WC2B 6NR. Blank forms are available at www.inlandrevenue.gov.uk/aiu/index.htm .

How to get another P35

Employers who need a duplicate or additional P35, for example to send amended information, can contact their Inland Revenue office. Additional P14s are available from the Employer’s Helpline on 0845 7 646 646. You should get your stationary within five days of ordering it. So remember to place your order in time for you to send your complete Return by 19 May.

Do it online: Online filing and electronic payment handbook

There is much more information about online filing in the recently updated *Do it Online: Online filing and electronic payment handbook*, available at www.inlandrevenue.gov.uk/employers/onlineindex.htm .

The taxation of Share Options: Internationally mobile employees: an update

Share options

Share incentives available to internationally mobile employees can take various forms. This article is about share and stock options and **updates previous guidance given in TB55** in the light of international consensus reached at the Organisation for Economic Co-operation and Development (OECD). This article supersedes Tax Bulletin 55 and also incorporates the relevant parts of Tax Bulletin 60. In particular, this Article explains how gains arising from the exercise of options are to be sourced on the employment exercised between grant and vest when considering a Double Taxation Agreement (DTA) (except for the US) on a workdays basis. This article is also published on the Share Schemes Website.

Employees can be granted options to acquire shares in their employing company or a company in the same group. Typically the employee is granted options to acquire a specified number of shares at a price fixed at grant - the "option price". This may be set at the market value of the shares at the date of grant or at a lower figure. The option will then be exercised some time later, when the employee buys shares at the option price. The shares then belong to the employee and can usually be immediately sold.

Domestic legislation

The UK tax treatment of such options in the hands of the employee depends on factors such as:

- Whether or not it was granted under a plan providing income tax advantages - the Inland Revenue approved Company Share Option Plan, a SAYE share option plan or an Enterprise Management Incentive (EMI) option;
- The employee's residence status at the dates of grant and exercise;
- The period over which the option can be exercised;
- Whether the option was granted at a price below the market value of the shares at the time of grant.

This article is concerned only with options granted under an unapproved share option plan and non-qualifying exercises of options granted under an Inland Revenue approved plan. A "non-qualifying" exercise here means one where the conditions for income tax relief have not been followed so that there is an income tax charge. An EMI also provides income tax exemption on the exercise of certain share options but income tax may be due if the options were issued at a discount to the share price or there has been a disqualifying event. To the extent that gains on such options remain in charge to income tax, this article applies to them in the same way as to unapproved share options.

Further information on approved plans and EMI can be found at www.inlandrevenue.gov.uk/shareschemes.

There will normally be UK income tax implications only if the individual was resident in the UK at the date of grant, or the option was granted in respect of duties carried out in the UK. As the option over the shares is acquired by reason of employment an income tax charge may arise at:

- The date the option was granted;
- The date the option was exercised; or
- The date the shares acquired at exercise are disposed of. (This generally relates to options granted to individuals who are not ordinarily resident in the UK at the date of grant – see Example 4).

Capital gains tax may be due where gains on the disposal of shares are greater than the gain chargeable to income tax under the Income Tax Earnings and Pensions Act (ITEPA). Examples are where:

- The sale price exceeds the exercise price, or
- The individual was not resident in the UK at the date of grant.

Capital gains tax may arise where individuals are either resident or ordinarily resident in the UK at the date of disposal or if they are within the scope of the temporary non-residents rules contained in Section 10A, Taxation of Chargeable Gains Act (TCGA) 1992. There are special rules for the tax year of commencement or cessation of residence and for non-UK domiciled individuals.

A UK tax charge may be triggered by other events, such as the assignment or release of an option to acquire shares or the conversion of shares acquired by reason of employment from one class of share into another class of share. This article cannot cover every possible situation but guidance about circumstances not dealt with here is available from the contacts listed at the end.

Interaction with Double Taxation Agreements

If the employee moves between countries a tax charge may also arise in another country when the option is exercised, assigned or released. This article sets out the Revenue's practice from April 2005 for dealing with possible double taxation in the most common scenarios.

The UK has been actively involved with work at the OECD to reach a common international consensus on the treatment of share option gains. Discussion papers have been published as that work progressed and on 3 September 2004 the OECD announced that additional guidance would be incorporated in the next update of the OECD Model Taxation Agreement (the “Model”) and Commentary scheduled for 2005.

If there is no Double Taxation Agreement (DTA) with the other country then both countries are free to tax income in accordance with their domestic laws. In accordance with its normal rules the United Kingdom will grant its residents unilateral relief in respect of foreign tax suffered on income that arises in another country but is taxed in the UK on the basis of residence.

If a comprehensive DTA exists it will normally have an employment income Article along the lines of Article 15 of the OECD Model Tax Convention. Gains realised from the exercise of options granted to an employee fall within the provisions of this Article rather than those Articles that deal with other income or capital gains.

Article 15(1) provides that if a resident of one country performs the duties of his employment in the other country, then the latter country retains any domestic rights to taxation of remuneration and benefits from that portion of the employment. The OECD has now considered in detail how this applies to share options, where the entitlement to benefit from them accrues over a period of time when work may have been carried out in more than one country.

The OECD identifies two main sorts: American- and European-style options. In the UK virtually all the options we have seen follow the American pattern. These are granted with a future period of service required in order to qualify for exercise. The first date that they can be exercised is also known as the vesting date and the actual date of exercise may be then or afterwards.

The OECD concluded that:

- Up to the point that an option is exercised the gain derives from employment and is governed by the Income from Employment Article in a typical double taxation treaty;
- At that point the employee makes an investor decision to use his or her own money to exercise and decisions from then, to sell or hold onto the shares, are those of a normal investor. So from that date the gain is a capital gain and within the Capital Gains Article if the relevant treaty has one;
- The period of employment on which exercise is contingent will run only to the date that exercise can first take place – the vesting date;
- The correct method of allocating taxing rights is by straight-line time apportionment, as the right to exercise is based itself on time spent in employment;
- Whether the gain on a share option is charged at grant, vesting, exercise or on sale of the shares acquired it should be regarded as the same source and credit available accordingly.

The new UK/Australia DTA has an Exchange of Notes that follows these lines.

Our existing guidance was set out in Tax Bulletins 55 and 60. This stated that where an employee:

- was granted a share option in the UK during the course of an employment,
- exercised that employment in the other country during the period between the grant and exercise of the option,
- remains in that employment at the date of the exercise and,
- would be taxed by both of them in respect of the option gain; and
- is not resident in the UK at the date of exercise;

then the UK would give relief in calculating the tax charge for the proportion of the option gain which relates to the period or periods between the grant and exercise of the option during which the employee exercised the employment in the other country. This was also the line followed in the new UK/USA DTA. (The 5 factors above are those referred to in Frequently Asked Question 1 later in this article).

The Revenue has reviewed this existing practice in the light of the OECD’s published document. Whilst the OECD accepts that countries may, in their bilateral agreements, opt to apportion up to the date of exercise, the OECD recommendation is that the apportionment should be based on the period of grant to vesting. The UK seeks, as far as possible, to interpret its DTA in accordance with the OECD Commentary. **With effect from 6 April 2005**, for options exercised on or after that date, the UK will base any apportionment on the period of employment up to the vesting date unless the DTA in question specifies another treatment (e.g. the UK/US Treaty). This will apply even when an option could have been exercised before 6 April but was not.

Where an option is exercised prior to 6 April 2005, the UK will continue to give relief for periods of employment in the other country up to the date of exercise. However when a taxpayer considers that it would be to their advantage to take the date of vesting, in accordance with the OECD recommendation, the UK will do so, unless the other country

involved is the USA. Where the other country is the USA, apportionment of the gain between grant and exercise must continue as we have a specific Exchange of Notes in the new UK/USA double taxation agreement to that effect.

The OECD Report draws a distinction between “vesting” and “irrevocable vesting”. The Revenue has been asked to comment on these terms. Examples to demonstrate the concept of “irrevocable vesting” are not readily available. The OECD refer to there being “a condition that is applicable **after** the option becomes exercisable and under which the option will be lost if employment is terminated before the option is exercised.” Suppose an option is exercisable after 3 years employment but that the individual also has to be an employee at the date of exercise. The option vests at the 3 year point as this is when the individual becomes entitled to exercise the option. However, the option will only irrevocably vest when the individual actually exercises the option as at that point the final condition (of being employed at the date of exercise) disappears. References to the vesting date in this article refer to the time of “vesting” and not “irrevocable vesting”.

The gain will be time-apportioned on a straight-line basis by reference to **workdays** in the period of grant to vesting (or grant to exercise if the Treaty involved is the US/UK Treaty). OECD suggests a typical year can be taken as 260 workdays once, say, weekends and leave are excluded. We would expect to use the same measure of workdays for calculating relative periods in each country. Periods not in that particular employment are left out of account so that the apportionment is still made on the basis of relative periods of employment in each country. The OECD work produced no justification for using any other basis.

Where the individual is resident for tax purposes in the UK at the date of the taxable event then credit relief may be appropriate. In accordance with the normal rules for credit, the amount due will be that relating to relevant periods of employment overseas. Any excess should be reclaimed from the other tax authority.

In the following examples:

- All the share option plans are unapproved so that tax is due under UK domestic rules;
- All references are to the ITEPA unless otherwise stated;
- There is a comprehensive DTA with the overseas country containing a provision along the lines of Article 15 of the OECD Model (but the country is not the USA);
- All the options are American-style ones.

Example 1

Mr. A is resident and ordinarily resident in the UK and working here on 1 January 2001. On that day he is granted an option to purchase 1,000 shares in the company in four years’ time at the 1 January 2001 market price of £1. On 1 January 2004 he is moved to another country and is still in the employment there when the option is exercised on 1 January 2006. At that date the shares are worth £5 each. The first date on which he could have exercised the option was 1 January 2005.

A is resident and ordinarily resident in the UK at the date of grant and is therefore liable to income tax under Part 7 of ITEPA on any gain realised at exercise. The gain is calculated as the difference between (a) the value of the shares at the date of exercise and (b) the option price paid plus any consideration given for the option itself; in this case the gain is 1,000 x £4 = £4,000. This amount is classified as specific employment income under ITEPA and is therefore taxed without regard to the individual’s residence status at the date of exercise.

Between the date of grant and the date of vesting (1 January 2005) the employment has been performed in the UK for 3 years and in the other country for one year. 75% of the gain (£3,000) will therefore be assessed in the UK and 25% (£1,000) will be regarded as attributable to the other country.

The exercise of the option will be within the scope of PAYE by virtue of Section 696 if the shares are readily convertible assets (see IR’s Employment Income Manual EIM 12400). Under Section 696(2) the amount on which PAYE should be operated is the amount which, on the basis of the best estimate that can reasonably be made, is the amount of income likely to be chargeable to UK income tax. So if the employer has sufficiently accurate information on periods of employment spent abroad they may be able to operate PAYE for the non-resident employee only on the UK proportion.

Example 2

The facts are the same as for example 1 except that A takes the whole of 2002 as a sabbatical year when he does not exercise his employment anywhere.

Three years have been spent in employment over the period between the grant and vesting of the option. The total gain in value of £4,000 is apportioned 67% to the UK and 33% to the other country.

Example 3

Mr. B is resident and ordinarily resident in the UK and working here on 1 December 1999 when he is granted a share option. He works overseas during 2000. He returns to the UK on 1 January 2001 and is still in the employment here when the option vests and he exercises that option on 1 January 2005.

As B is not resident in the other country either when the option is granted or when it is exercised it is unlikely that any tax would be charged there in respect of the share option. As he is resident in the UK at both grant and exercise, the UK will tax the whole gain. If any tax has been paid in respect of the option in the other country for the year spent working there then the UK will give credit for this against the domestic income tax charge.

Example 4

Mrs C is resident but not ordinarily resident in the UK when an option is granted. She is still resident in the UK when she exercises the option and sells the shares. The charge on exercising options in Chapter 5 of Part 7 is predicated on the employee being resident and ordinarily resident in the UK at the time of grant so within the general charge under section 15 (Chapter 4 of Part 2) or section 21 (Chapter 5 of Part 2). Instead, Mrs C will be liable to UK income tax under Chapter 3C of Part 7 at the time of disposal of the shares as well as a possible annual charge under the benefits legislation. The charge is on the difference between the market value of the shares at the time of exercise less any amounts paid. This is treated as a notional loan written off within Section 446U and is taxed as specific employment income.

If an individual is resident in the UK at both the date of grant and the date of exercise the UK will have primary taxing rights even where a treaty partner country wishes to tax the gain under its own domestic legislation. A claim under the DTA for credit relief may be relevant if the duties of the employment have been carried out in the other country during the period between grant and vesting of the option and double taxation has occurred. Currently, where an option is granted to an employee resident but not ordinarily resident in the UK who performs the duties of the employment both in and outside the UK, the Revenue treats a proportion of any gain on exercise of the option as relating to an employment not within the charge to UK tax. This calculation is based on the proportion of workdays in the period between grant and vesting (or grant and exercise if considering the US) that are outside the UK. This apportionment would not include any part of the period after the employee becomes resident and ordinarily resident.

Mrs C may be liable to UK capital gains tax on any gain she makes on selling the shares acquired by exercising the option. Her allowable cost will be the total of the amounts she paid for the option and shares together with any amount charged to UK income tax other than the annual benefits charge. There are special capital gains rules for non-UK domiciled individuals at Section 12, TCGA 1992.

Example 5

Mrs D is not resident and not ordinarily resident in the UK when her employer grants her an option to purchase shares. At some time before exercise she moves to the UK and performs the duties of the employment there. She exercises the option when working in the UK and sells the shares.

Mrs D will not be liable to UK income tax on any gain realised at exercise, unless the grant of the option is clearly related to duties performed in the UK. In this case there could be a liability under Chapter 3C although all relevant facts and circumstances would need to be considered before determining whether or not a liability arises.

She may, however, be liable to UK capital gains tax on any gain realised as a result of selling the shares acquired following the exercise of the option. This would be so if she is either resident or ordinarily resident in the UK at the date of disposal or if she is within the scope of the temporary non-residents rules contained in Section 10A, TCGA 1992. There are special capital gains rules for the tax year she commences UK residence and for the case where she is a non-UK domiciliary. Mrs D's allowable capital gains

cost would be the total of her payments for the option and shares, together with any amount charged to UK income tax.

Even though exercise will not normally trigger a UK income tax liability in this case, it may well give rise to a tax charge in another country. Where tax has been paid in a treaty partner country, the OECD view now is that the part of the gain up to the date of exercise should be treated as falling within the provisions of the employment income Article of the relevant double taxation agreement, regardless of the eventual type of tax levied in each country under their domestic rules. The UK will therefore allow the relevant proportion of the foreign tax paid as a credit against the UK capital gains tax:

- If the options are exercised and the shares sold on the same day, the whole gain is treated as falling within the provisions of the employment income Article of the relevant DTA.
- If the shares are disposed of at a later date, part of the gain may be treated as falling within the employment income Article of the agreement. The appropriate calculation of relief will be straight-line time apportionment in line with OECD views.

Frequently asked questions

Some FAQs on this topic were discussed in Tax Bulletin 60. We have also updated these.

Q1. Is relief by allocation of taxing rights ONLY available if the five factors detailed in TB55 and above are present ?

We are able to give certainty in the most common situation where double taxation arises, which is when all five factors are present (NB the second factor should now be read as 'exercised that employment in the other country during the period between grant and vesting of the option'). There are other situations in which some relief by allocation of taxing rights may be appropriate, for example if the employment ceased shortly before the options were exercised. However there are many permutations possible and it is not possible to deal with all of these in that article. Cases that do not fall within the circumstances described will continue to be considered on their own facts and in the light of the new OECD guidance.

Q2. Does an employment "continue" if the employee changes contractual employer on being relocated?

If the employers were in the same group of companies and the change did not affect the employee's stock option rights, then the UK would normally regard it as one employment for the purposes of apportioning the option gain attributable to the UK.

Q3. Previously it has been possible to use methods of apportionment other than the straight-line time method. TB55 endorsed this "very occasionally".

The Inland Revenue has always maintained that time-apportionment should be the expectation and in practice few cases have been seen claiming another basis – a handful only in the last 3 years. And in some of those the other country involved agreed to accept straight-line time apportionment after discussions. In the light of the new OECD guidance and international consensus we would not expect to agree cases using any other method of apportionment.

Q4. Is it necessary for the country of residence to actually tax the gain?

The normal expectation would be that tax would actually be levied. Exchange of information powers may be used to ensure the other country is aware of the option gain so can tax it if their domestic legislation permits.

Q5. If the employee is resident and ordinarily resident in the UK both when the option is granted and when it is exercised, can the gain ever be time-apportioned in the UK? Example 4 of TB55 implied that it can.

The statement that "a claim may be relevant under the employment income Article…." does not mean that relief would be due by leaving out of account a part of the gain that related to overseas employment. It was meant to reflect that relief by means of credit might be available if the UK recognised that another country had a valid claim to tax part of the gain because it could be said to be derived from employment performed there. We have reworded Example 4 in this article to make the position clearer.

Q6. Does it matter whether the option is over shares in an overseas or a UK company?

In general, no. The source for double taxation treaty purposes will be the employment, and where it is carried on.

Q7. Is any relief due on an option gain if an employee were resident in the UK at the date of grant but resident in a non-treaty country at the date of exercise?

Assuming the individual is also ordinarily resident at the date of grant, the whole gain is taxable in the UK under ITEPA. If there were overseas tax payable on any part of the share option gain, the UK would consider unilateral relief on a claim. However, unilateral relief is only available to credit overseas tax paid by a UK resident, or a person who is treated as such by section 794 of the Income and Corporation Taxes Act 1988, not by taking any amount out of account by time-apportioning a gain. The amount of unilateral relief may never exceed what would be available if a double taxation treaty with the country existed.

Q8. Is it possible to provide guidance on some other important issues, such as periods of residence in a third country, or short-term business visitors now that work at OECD has been completed?

Example 8A

Mr. E is granted share options on 1 January 2000 when he is resident and ordinarily resident in the UK and working here. He goes to country A on 1 January 2001 for a year then to country B on 1 January 2002. He is still living there on 1 January 2005 when the options vest and he exercises immediately. By then he is tax resident in Country B.

If Country B taxes option gains on exercise it will have the full right to tax Mr. E as he is resident there at that time. If a claim is made under the DTA between the UK and Country B, then the UK will regard one year's worth of the option gain as derived from UK employment so, in accordance with Article 15(1) of the OECD Model will restrict taxation to 1/5 of the gain as this is the proportion that is sourced here.

Example 8B

Mrs. F is granted share options on 1 January 2000 when she is resident and ordinarily resident in the UK and working here. She spends 5 months from 1 January 2001 working in country A for her UK employer so that no tax is due in Country A and she remains resident for tax purposes in the UK. She then moves to Country B to work, becomes tax resident there and is still in Country B when the options vest and are exercised on 1 January 2005.

When the options are exercised the UK is not the country of residence so would confine taxation to the fraction of the gain that is derived from employment in the UK, i.e. one year's worth out of the five.

Example 8C

Mr G is awarded restricted shares on 1 January 2000 as part of the bonus scheme for 1999. He immediately goes to work in Country A and becomes tax resident there. The restrictions will not lift until 1 January 2005, when he can sell the shares freely. UK IT is due at that date. He claims that the gain should be wholly apportioned to Country A under the relevant DTA.

Although the same principles will apply to other forms of share-based earnings besides options, the underlying facts may mean the result is different. Here the share award derives wholly from employment up to 1 January 2000. The period when restrictions on sale are imposed is merely a blocking period. The whole gain on sale therefore derives from UK employment and no reduction in UK taxing rights is made under the DTA.

Q9. What if the individual is a director?

Article 16 in the OECD Model DTA provides special rules for directors and takes precedence over Article 15. The Commentary to this will be expanded to make clear that share options are also within these special rules to the extent that they were granted to a person in their capacity as a member of a Board of Directors.

Q10. I work for a European multi-national and think therefore that the options I have been granted whilst working in the UK are not American-style ones.

This will be a question of fact. European-style options are usually a reward for past service and vest on the day they are awarded even though they cannot be exercised for a given period. In such a case time apportionment will not be appropriate unless work was carried out in another country before the date that the options were granted.

Q11. How will apportioning UK workdays operate in practice?

An employee is resident and ordinarily resident and working in the UK on 1 January 2003. He's granted an option to purchase shares at a price of £1 conditional on remaining in that employment until at least 1 January 2006. On 31 December 2004, he moves to work in Country B where he becomes resident. He exercises the option on 1 July 2006

and sells the shares immediately. The benefit should be regarded as income from employment covered by Article 15.

The UK may tax the part of the stock option benefit that was derived from employment carried on in the UK, on the proportion of those days that were relevant for the stock option plan. If each year has 260 workdays then the days relevant to the stock option plan are 3x260 = 780. The UK may tax 520 (2x260) days of this and B may tax 260 days. The remaining days of employment between vesting (1 January 2006) and exercise (1 July 2006) are not relevant to the stock option plan so are ignored.

Further advice

Tax Bulletin 56 deals with National Insurance Contributions, and other issues around share incentives for internationally mobile employees are covered in Tax Bulletin 60. Updated guidance on National Insurance Contributions will be issued shortly.

For further advice on domestic legislation governing the charge to tax on share options, contact:

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Goodwill and Incorporation

Introduction

In recent years many sole traders have transferred their businesses to newly incorporated companies in which they have a controlling interest. In some cases the transfer will involve the company buying the goodwill of the business. This article explains when the Inland Revenue might challenge the value attributed to transferred goodwill and the tax consequences where it is established that the payment for goodwill exceeds its market value.

For simplicity this article focuses on transfers by sole traders. Similar considerations apply to the transfer of goodwill from individuals who carried on business in partnership.

When might the value of goodwill be challenged?

We are most likely to challenge cases in which we think that a transfer of goodwill may have taken place at overvalue. One concern is that any overvaluation of goodwill could, if unchallenged, allow the excess value to be wholly or partly sheltered from tax (because of various Capital Gains Tax (CGT) reliefs) while simultaneously inflating a loan account balance against which a participator could withdraw sums without attracting any tax liability. There may also be concerns when the goodwill acquired by the company falls within the Intangibles Regime[1]. Or if it seems that the type of goodwill reportedly sold to the company was associated with the personal skills and attributes of the sole trader so that it was not capable of being transferred to a company.

The Inland Revenue offers a free Post Transaction Value Check service[2] under which CGT valuations can be referred to Tax Offices for checking after the transaction has taken place but before the relevant return is submitted. Each request for a valuation check should be made on form CG34, available from the Inland Revenue website.

1 FA02/Sch29
2 Capital Gains Manual CG16600

Capital Gains

For the purposes of CGT where an individual disposes of goodwill to a company in which he (or he and persons connected with him) have a controlling interest the transfer is treated as having taken place other than at arm's length. This means that for CGT the disposal by the individual and the acquisition by the company are deemed to have taken place at market value[3].

Excess value may be employment income

Where the goodwill was deliberately overvalued when it was sold to the company as an inducement for the individual to take up employment with the company, or in return for future services to be provided by the individual to the company, the excess payment will be taxable as earnings within Section 62 ITEPA 2003[4]. Where, exceptionally, excess value is paid in respect of the transferor's employment but it cannot be characterised as 'earnings' the overvalue may be chargeable as a benefit under Section 203 ITEPA 2003.[5] Section 201(3) deems that any benefit provided by the employer is "by reason of the employment".

In such cases the reporting obligation on the employer will depend on whether the excess value is regarded as earnings or a benefit. Earnings should be subjected to PAYE. A benefit should be reported on form P11D.

The Employment Income Manual (EIM)[6] provides guidance on the general rule for calculating the value of a benefit for income tax purposes and explains the concept of "making good". The benefit charge can be reduced or extinguished by the employee paying some or all of the cost of the benefit or "making good" to the employer/provider. In certain cases the director may wish to repay some or all of the excess value and reduce the benefit chargeable to income tax.

The excess value is also liable for Class 1 National Insurance Contributions (NICs), because it derives from the employment and is therefore a payment of "earnings" as defined in Section 3(1)(a) Social Security Contributions and Benefits Act 1992. This treatment applies irrespective of how the payment has been characterised for income tax purposes. There is no provision for "making good" for NICs. So even if the tax charge on the benefit is reduced by making good, Class 1 NICs must be accounted for on the original excess value.

The charges would be considered to have arisen on the day the goodwill transaction took place.

Where the excess value is treated as employment income it may give rise to a Case I deduction for the cost borne by the company.

3 TCGA92/s17, s18 & s286
4 Employment Income Manual EIM00700
5 Employment Income Manual EIM21660
6 Employment Income Manual EIM21102 and EIM21120

Excess value may be a distribution for tax purposes

But in many cases the goodwill will have been transferred from a sole trader to the company before the company has commenced trading. There may be no evidence that any excess value constitutes earnings (or is a benefit).

So, in the majority of cases in which goodwill is transferred from sole trader to company we expect that the transferor will have received any overvalue in his capacity as shareholder, rather than as an employee/director[7]. In such cases the excess value will, for tax purposes, be treated as a distribution by virtue of ICTA88/s209(2)(b) or s209(4).

For NICs purposes, where the transferor receives any overvalue in his capacity as shareholder, rather than as an employee/director, that is derived from a shareholding and not employment. The overvalue cannot therefore be classed as earnings under section 3(1)(a) SSCBA 1992 and does not attract NICs.

Distribution: impact on individual

Where it is established that the excess value is a distribution the individual will be treated as having received Schedule F income equal to the amount of the excess value plus the associated tax credit. If the individual is liable to income tax only at the lower and basic rates this tax credit will be sufficient to cover the ordinary rate Schedule F charge. If he pays income tax at the higher rate the tax credit will not cover all of the Schedule F liability and further liabilities will arise[8].

Distribution: impact on company

Where the goodwill is transferred before 1 April 2004 the characterisation of excess value as a distribution will not affect the company's tax position.

For transfers on or after 1 April 2004 the distribution will have to be taken into account in computing corporation tax liability at the non-corporate distribution rate[9].

'Inadvertent' distributions may be unwound

Because of the uncertainties in establishing the value of goodwill there will clearly be occasions where a transfer is inadvertently caught by ICTA88/S209(4). If it is clear that there was no intention to transfer the goodwill at excess value, and reasonable efforts were made to carry out the transaction at market value by using a professional valuation, then the distribution may be 'unwound'.

The distribution may not be unwound if there is attempted (or actual) avoidance, or if the overvaluation was intentional, or if no professional valuation was obtained[10].

7 Company Taxation Manual CT1529
8 ICTA88/s1B & s20
9 ICTA88/s13AB, http://www.inlandrevenue.gov.uk/news/ncdr.pdf
10 Company Taxation Manual CT1529a

In this context we would normally regard 'professional valuation' as including one carried out by a named independent and suitably qualified valuer on an appropriate basis. But in some instances it may be necessary to establish what steps were taken to arrive at the value, what instructions/information were given to the valuer, whether it was reasonable for the parties to rely on the valuation provided etc. before an application for unwinding can be accepted.

Where it is agreed that an inadvertent distribution may be unwound the individual must repay the excess value to the company. Where the original sale proceeds were credited to a loan account that credit should be reduced, effective from the date of the original transaction. If the individual has drawn from the loan account on the strength of the original credit, rewriting the loan account to reflect the unwinding of the distribution may result in the loan account becoming overdrawn. If so, the company may be liable to tax under ICTA88/s419 (Loans to participators etc.)

Intangibles Regime

From 1 April 2002 the new Intangibles Regime allows companies to claim an income deduction for tax purposes based on the goodwill amortisation shown in their accounts. Where the goodwill was acquired from a related party (such as a sole trader who controls the company) the Intangibles Regime will only apply if the goodwill was created wholly after 31 March 2002[11].

Where goodwill has been acquired from a sole trader and income deductions are made under the Intangibles Regime, we will be concerned to confirm both that the goodwill was created wholly after 31 March 2002 and that for tax purposes the value of goodwill equates to its market value[12].

interpretations

Non domiciled employees working in the United Kingdom: Dual contract arrangements

Introduction

Dual contract arrangements are popular with foreign domiciled employees who work both in and outside the United Kingdom (UK). Although there is nothing to prevent an individual from entering into an employment contract with more than one employer, we have become increasingly concerned that employers, employees and their advisers are providing us with written contracts that do not reflect the reality of the situation. This article explains a change of emphasis in the way that our offices will approach enquiries into dual contract arrangements. In summary, we believe that the commercial reality in some cases may be that the employee has just one employment.

Statutory position

The question of the existence or otherwise of an employment usually arises for tax purposes where there is doubt over whether income derives from employment or self-employment. Once it has been established that an individual performs services as an employee, there is generally little difficulty in attributing earnings to a particular employment relationship.

The Employment Income parts of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) charge to tax earnings "from" employment. Although ITEPA does not attempt a comprehensive definition of employment, section 4(1) provides that "employment" includes "any employment under a contract of service".

Chapter 5 part 2 ITEPA contains the rules for determining the taxable earnings of employees (and office holders) who are resident, ordinarily resident or domiciled outside the UK. Section 21 taxes the full amount of any general earnings for a tax year in which the employee is resident and ordinarily resident, but not domiciled, in the UK except to the extent that they are "chargeable overseas earnings" for that year. Section 22 provides that the taxable amount of chargeable overseas earnings is the full amount remitted to the UK in that year. Section 23 describes how to calculate chargeable overseas earnings. By section 23(2), "general earnings for a tax year are overseas earnings for that year if:

- in that year the employee is resident and ordinarily resident, but not domiciled, in the UK,
- the employment is with a foreign employer, and
- the duties of the employment are performed wholly outside the UK."

"Foreign employer" is defined in section 721(1) ITEPA as meaning "in the case of an employee resident in the United Kingdom, an individual, partnership or body of persons resident outside the United Kingdom and not resident in the United Kingdom or the Republic of Ireland, …"

Where the employment is in substance one whose duties fall to be performed outside the UK, the requirement that the employee performs the duties of the employment wholly outside the UK is subject to section 39. This provides that duties performed inside the UK, which are "merely incidental to" duties performed outside the UK, are to be regarded as performed outside the UK. In Robson v Dixon 48 TC 527, Pennycuick V.-C. observed that:

11 Corporate Intangibles Research and Development Manual CIRD11680
12 FA02/SCH29/PARA92 & Corporate Intangibles Research and Development Manual CIRD45010

> "the words "merely incidental to" are upon that ordinary use apt to denote an activity (here the performance of duties) which does not serve any independent purpose but is carried out in order to further some other purpose."

So duties performed in the UK that are of the same type as those performed overseas are not merely incidental, even if performed for only a very short time.

The calculation of chargeable overseas earnings is set out in three steps in section 23(3). The first step is to identify the full amount of overseas earnings. The second and third steps adjust this figure by deducting allowable expenses and applying any limit required by section 24. Section 24 imposes a limit on how much of an employee's general earnings are chargeable overseas earnings where the duties of an associated employment are performed in the UK. The limit is the proportion of the aggregate earnings for that year from all the employments concerned that is reasonable having regard to the nature of and time devoted to the duties performed outside and in the UK respectively and to all other relevant circumstances.

Dual contract arrangements

The legislative scheme outlined above is advantageous to employees or office holders who can show that they are:

- resident and ordinarily resident but not domiciled in the UK, and
- perform duties of an office or employment under a foreign employer wholly outside the UK.

As chargeable overseas earnings are taxed on remittance, there is a clear incentive to ensure that such earnings are paid overseas and to minimise the amount of earnings remitted to the UK. However, the requirement that the duties of the employment are performed wholly outside the UK presents problems to foreign domiciled employees whose jobs require them to work partly in the UK and partly abroad. Earnings from an employment with duties performed in and outside the UK would be taxable under section 21 wherever received. An employee may therefore be offered two employment contracts, for example:

(1) covering the performance of duties in the UK, and

(2) with an associated employer resident overseas, covering duties performed in the rest of the world, excluding the UK.

The intention is that earnings from employment contract (2) will be chargeable overseas earnings and therefore taxable under section 22 only when remitted to the UK. For this reason, dual or multiple employment arrangements are popular with foreign domiciled employees whose duties are performed partly in the UK and partly outside the UK. The arrangement is generally that the individual enters into two separate written contracts, frequently referred to as the UK employment contract and the overseas employment contract.

Inland Revenue response to dual contracts

Inland Revenue offices may make enquiries in order to check whether the earnings under the overseas contract are chargeable overseas earnings. They may also consider whether there is in fact a single employment contract notwithstanding the production of two written contracts. This approach has generally been deployed where there is concern that there has been an attempt to split a single employment to exploit the legislation that provides for chargeable overseas earnings to be taxed on remittance.

Employers, employees and their advisers maintain that there are separate and distinct employments. They invariably argue that the employee performs a different role with different responsibilities under each contract of employment and that the duties under each do not overlap and are not dependent on each other. In many cases written contracts have been drafted that fairly represent the true employment relationships and include a proper job description along with details of the remuneration package and other entitlements (annual leave etc) relating to each employment. Care has been taken to ensure that the roles described in each contract are capable of independent existence with proper regard given to what would happen on termination of one of the employments. Best practice has recognised the importance of maintaining separate payroll and expenses regimes and different line management and reporting arrangements.

Where there are two employment contracts and the written contracts reflect this, dual contract arrangements provide a legitimate way to structure an individual's employment relationships. Where the Revenue is satisfied that the arrangements reflect the true employment relationships, enquiries focus on:

- whether the employee has in fact performed substantive duties under the overseas contract in the UK,
- whether a section 24 adjustment is needed to address an imbalance between the earnings from the UK and overseas contracts.

Given the way in which modern business operates and the ease and speed of communication, some employees may find it increasingly difficult to avoid performing substantive UK duties under their overseas contracts. For example, an employee who is responsible under their overseas contract for servicing the business of overseas clients may have to respond to a telephone call or e-mail from a worried

overseas client with an urgent problem when the employee is in the UK. Formulating and communicating a response to such a problem would be regarded as a fundamental duty under the overseas contract. It follows that the performance of such duties in the UK will not be merely incidental to the performance of duties outside the UK as they will be of equal importance to the overseas duties. It is the quality of the UK duties and not the time devoted to their performance that determines whether they are merely incidental.

Current developments

We are increasingly seeing arrangements where the duties required under each purported employment contract are defined according to where those duties are performed. For example, the UK contract states that the duties of the employment are all those duties performed in the UK whereas the overseas contract states that the duties of the employment are all those duties performed wholly overseas. We are asked to accept that all overseas duties are duties of the overseas employment and all UK duties are duties of the UK employment. On that analysis, duties performed in the UK in connection with the business of the overseas employer are performed under the terms of the UK contract and are not duties of the overseas employment.

We do not consider that the existence of separate and distinct employments is determined by the terms of written contracts where the main distinction between the duties required under each contract is geographical. We have become increasingly concerned that arrangements of this nature artificially divide a single job so earnings attributable to overseas duties can be treated as chargeable overseas earnings. We have now received legal advice that supports a robust challenge to such arrangements.

Change of emphasis

As a result of the legal advice referred to above, we intend to change the emphasis in the way in which we currently approach enquiries involving dual contracts. In our view, a dual contract arrangement based solely or mainly on a geographical split of employment duties without commercial underpinning is vulnerable to challenge on the grounds that there is in reality a single employment with duties in and outside the UK. When we come across such cases, we intend to fully investigate the facts and circumstances including the commercial rationale and context and to assess an employee to tax where the evidence shows that there is in fact a single employment. If necessary, we will defend such an assessment in formal appeal proceedings.

We take the view that a dual contract arrangement is unlikely to work unless there are two distinguishable jobs. For example, a French resident employer ‘A’ sends employee ‘B’ who is domiciled outside the UK to establish an office in London for its UK subsidiary ‘C’. A requires B to work in its Paris office servicing their existing portfolio of French clients two days per week. On the other three days, C requires B to work in London. This is likely to constitute a proper basis for B holding separate employment contracts with A and C.

In order to decide whether the arrangements create two employments, rather than artificially divide a single employment for tax purposes, it is appropriate to look at the economic advantage that an employer gains from the employee’s activity. If the contractual arrangements are to have any meaning, they must be seen in the context of the underlying commerciality of the arrangements. Regardless of there being two written contracts, we would not accept that there were two employments if the risks and rewards relating to work done in the UK and overseas were in fact substantially borne and received by a single employer. Moreover, an arrangement requiring a written contract between an employee and a UK employer which provides only for the performance of duties in the UK would appear artificial if the employer’s business extends outside the UK.

An employer’s interest does not lie in having the employee work in a defined geographical area but in an economic activity that benefits the employer. An employee may perform duties overseas that directly benefit the business of the UK employer. When performing those duties, the employee is not working for the overseas employer but for the UK employer overseas. If the arrangement were genuine, the employee would not be paid by the overseas employer to work for the UK employer overseas. If that is what the contract requires, it would indicate a lack of commerciality. Conversely, an employee who performs duties in the UK that directly benefit the business of the overseas employer is working for the overseas employer in the UK. It is difficult to imagine circumstances in which contracts that can require an employee to work for the benefit of a UK employer whilst being paid by an overseas employer or vice versa would be offered by employers that were not associated.

Various mechanisms exist for allocating costs to another entity that benefits from an employee’s services. These include transfer pricing adjustments. It has been suggested that such adjustments restore the commercial equilibrium and thus support the existence of separate employments. We do not find this persuasive. The fact that such adjustments are necessary indicates that the employer has misjudged the commercial reality of the arrangements. Separate employers do not for sensible commercial reasons pay employees to work for someone else, with or without transfer pricing.

Dual contract arrangements are sometimes used when a UK resident employee holding one employment with worldwide duties first becomes ordinarily resident. We have also seen cases involving individuals who are self employed before they arrive in the UK but become employees with dual contract arrangements on attaining UK resident and

ordinarily resident status without any significant change in the way in which they carry out their professional activities. In other cases, recruitment material suggests that the employer has a single vacancy to fill and a dual contract arrangement is only implemented following the appointment of a non-domiciled individual. In such scenarios, we would aim to test whether the facts reflect commercial reality.

Overseas contracts and UK duties

Where the commercial reality shows the existence of separate employment contracts, it is sometimes argued that contractual terms that prohibit the performance in the UK of duties connected with the business of the overseas employer, preclude the Revenue from arguing that the employee has performed duties of the overseas employment in the UK. These arguments are based on the UK duties being "ultra vires".

We do not consider that the presence of such clauses means that we should ignore the performance of duties in the UK that clearly benefit the overseas employer. To that end, both employers ought to be closely monitoring the employee's UK activities. For example, where the employee has performed substantive duties in the UK that directly benefit the overseas employer, we would expect the UK employer to mark the fact that the employee is effectively abusing its time and take appropriate disciplinary action. And if the UK work in question was valuable, we would not expect the overseas employer to take it into account when calculating bonus entitlement. We think that clauses like this are frequently waived or ignored and may be inserted to create a misleading impression.

Tax impact where dual contract arrangements fail

Where the facts indicate that there is, in commercial reality, only one employment contract whereby the employee performs duties for the benefit of one employer both in and outside the UK, all of the employee's general earnings will be taxable under section 21 ITEPA. As earnings attributable to overseas duties will not be chargeable overseas earnings, tax will be charged on receipt rather than on remittance to the UK. The identity of the "employer" will depend on all the facts and circumstances of the individual case. However, the UK entity that receives the benefit of an individual's services will be obliged to apply PAYE to all payments of PAYE income made to the employee during the period that the employee works for that entity. This is because the UK entity will either be the employer or (for the purposes of section 689 ITEPA) the relevant person.

If there are genuine separate employments but the employee has performed substantive duties in the UK for the overseas employer, then all earnings from the overseas contract will be taxable under section 21 in the relevant year. They will not qualify as chargeable overseas earnings under section 22 because the duties of employment with a foreign employer will not have been performed wholly outside the UK in the year in question. There is unlikely to be an obligation to operate PAYE on earnings from the foreign employer, as that employer will not have the necessary presence in the UK for PAYE purposes, and the UK employer will not be the relevant person in relation to duties performed by the employee under the separate overseas employment.

National Insurance

Where for tax purposes the facts indicate that despite the existence of two written employment contracts, there is a single employment covering UK and overseas duties, there could also be National Insurance consequences. If it is found that the earnings relating to overseas duties are attributable to employment with the UK employer, there will be liability to pay further National Insurance.

miscellaneous

Form 42

Employment-related securities and options - Form 42 for year to 5 April 2005

A copy of the information return Form 42 to be used for the year to 5 April 2005 is now available. (**www.inlandrevenue.gov.uk/shareschemes/42-2005.pdf**). This is the form on which companies need to tell us about employment-related shares and securities. Details of the events that have to be reported can also be found there. Only those sections of the form where there is something to report, and the declaration in Section 7, have to be completed.

Companies can continue to use a substitute form provided it is in the same format and provides the same information requested by Form 42. Companies incorporated in the year ended 5 April 2005 that have issued unrestricted shares only need to complete sections 5 and 7 of Form 42. We have also provided on this website, a simple form for these companies to use.

Form 42 will only be issued to companies where we think that there are likely to be reportable events. In such cases we will issue the form **on or after 6 April 2005**. If a company is issued with the form it must complete the form and send it back **by 6 July 2005**. Where a company is issued with the form and has nothing to report it must make a 'Nil' return by ticking the box in Section 6, signing the declaration in Section 7 and returning the form **by 6 July 2005**. Failure to do this may lead to penalties being imposed.

Where a form 42 is not issued to a company, it must still tell us about any reportable events **by 6 July 2005**. A copy of the form can be downloaded from the website to use for this

purpose. Failure to tell us about reportable events within the time limits may lead to penalties being imposed. Companies do not have to make a 'Nil' return where they have not been issued with a form 42 and there are no reportable events.

Detailed guidance to help companies complete the form is also available on the website (**www.inlandrevenue.gov.uk/shareschemes/form42guidance.pdf**).

If you have any enquiries about Form 42 or how to complete it you can e-mail us at shareschemes@ir.gsi.gov.uk

Recognised Stock Exchanges

Please note this article replaces the article entitled Recognised Stock Exchanges Overseas in Tax Bulletin Issue 40

The phrase "recognised stock exchange" occurs throughout the Taxes Acts and in various regulations.

The definition of a recognised stock exchange is at Section 841 ICTA 1988. It includes the London Stock Exchange and any such stock exchange outside the UK as is designated by an Order of the Board of the Inland Revenue.

The list of recognised stock exchanges in Tax Bulletin 40 is no longer up to date. The current list of recognised stock exchanges can be found on the Inland Revenue Website at http://www.inlandrevenue.gov.uk/fid/rse.htm.

Please note that recognition under Section 841 ICTA is for income tax, corporation tax, capital gains tax and, to a limited extent, SDRT purposes only. Section 841 does not extend to Inheritance Tax, although, in practice, an exchange under section 841 will also be regarded as recognised for the purposes of Inheritance Tax. Recognition for these tax purposes does not imply recognition or approval for regulatory or other purposes.

Amendment to an article in Tax Bulletin 70

EU Enlargement and NICs

The telephone number for the Centre for Non-Residents (CNR) has now changed. The new number is for calls from outside the UK: dial the international code then: 44 191 2037010.

The link to the Home Office website as shown, no longer works.

You should check the **Home Office's** website (www.homeoffice.gov.uk) if you require further details on the new workers registration scheme.

Inland Revenue Statements of Practice and Extra-Statutory Concessions issued between 01/02/2005 to 31/03/2005.

Extra Statutory Concessions

There have been no Extra Statutory Concessions for this period

Statements of Practice

There have been no Statements of Practice for this period

You can get the latest copies of SPs and ESCs by telephoning Chandra Chandramohan, on 020 7147 2363.

CONTENT

The content of Tax Bulletin gives the views of our technical specialists on particular issues. The information published is reported because it may be of interest to tax practitioners. Publication will be six times a year, and include a cumulative index issued on an annual basis.

- You can expect that interpretations of the law contained in the Bulletin will normally be applied in relevant cases, but this is subject to a number of qualifications.
- Particular cases may turn on their own facts, or context, and because every possible situation cannot be covered, there may be circumstances in which the interpretation given here will not apply.
- There may also be circumstances in which the Board would find it necessary to argue for a different interpretation in appeal proceedings.
- The Bulletin does not replace formal Statements of Practice.
- The Board's view of the law may change in the future. Readers will be notified of any changes in future editions.
- All the names used in examples and illustrations are imaginary and have no relation to real persons, living or dead, except by coincidence

Nothing in this Bulletin affects a taxpayer's right of appeal on any point.

Letters on any article appearing in Tax Bulletin should be sent to the Editor, Mr Shell Makwana, Room 2c/09,
1 Parliament Street, London, SW1A 2BQ or e-mail Shell.Makwana@ir.gsi.gov.uk. We are sorry though that neither he nor our contributors will normally be able to enter into correspondence about Tax Bulletin or its contents.

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