

NICs and Shares

Liability to pay Class 1 National Insurance Contributions (NICs): Internationally mobile employees receiving shares or other securities by reason of employment.

Introduction

This is a companion to Tax Bulletin Special Edition 7 which explained the NICs legislation introduced to mirror Schedule 22 to the Finance Act 2003. Schedule 22 made substantial amendments to the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) relating to the tax treatment of payments made by way of securities (which includes shares) and securities options. Tax Bulletin Special 7 looked in detail at changes introduced from 1 September 2003 by the Social Security (Amendment No.5) Regulations 2003. This article looks at the implications for employers with Internationally mobile employees.

A new Employment-Related Securities Manual, covering both NICs and tax, is being developed. In the meantime, this article concentrates on the main provisions relating to employment related securities options, outside of a plan providing income tax and NICs advantages, where the securities/shares are “readily convertible assets”. The article also touches briefly on other ways in which employees can receive employment related securities.

If you want to know about plans providing income tax and NICs advantages please see our website www.hmrc.gov.uk/shareschemes/employer_schemes

Tax Bulletins 60, 56 and the Guidance Note “International Aspects of National Insurance on Shares and Share Options” provided guidance on the HMRC’s treatment of share options prior to the introduction of Finance Act 2003.

Overview

Broadly speaking, where a person receives a value by way of employment-related securities, including shares, this gives rise to an amount chargeable to income tax in the UK. Where this happens outside of a plan providing income tax and NICs advantages and where the securities/shares are “readily convertible assets,” there is normally a corresponding UK NICs liability on the same amount, which or by virtue of the statutory provisions, counts as employment income. Although any tax charge on the amount of employment income may be subject to a Double Taxation Agreement, these Agreements do not apply to NICs. There are however Social Security provisions that apply to persons coming to work in the UK or going to work abroad, and these can also impact liability for NICs.

There are two main scenarios involving securities options:

1) Employee resident and ordinarily resident for tax purposes when the securities option acquired:

Section 4(4) (a) Social Security Contributions and Benefits Act 1992 under which a Class 1 National Insurance liability is “triggered” by there being an amount that counts as employment income under Chapter 5 Part 7 ITEPA 2003.

2) Employee resident but not ordinarily resident for tax purposes when the securities option acquired:

NICs liability can be “triggered” by there being an amount chargeable to tax under Chapter 3C of Part 7 ITEPA 2003.

International Social Security provisions

Whether a National Insurance liability arises on an amount of employment income under either Chapter 5 or Chapter 3C ITEPA 2003 will depend on whether:

- the employee is present, resident or ordinarily resident in the UK when the securities/shares are acquired or when the right to obtain the securities/shares is acquired.

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- the employee was in an overseas employment when a potential UK NICs liability arises.
- the employee is a EC national and falls within UK legislation by virtue of Council Regulation (EC) 1408/71. Under Council Regulations (EC) 859/2003, the provisions in co-ordinating Regulations 1408/71 and 574/72 extend to certain third country (non European Union) nationals who have been “legally resident” in a European Union State.

Resident and Ordinarily Resident

As you can see, much will depend on the residence status of the employee. Which tax and NICs rules apply depends on whether an individual is treated as “resident” or “ordinary / ordinarily resident” in the UK. There are no statutory definitions of the terms “resident” and “ordinarily resident” for either tax or NICs. For NICs we look to the various tests suggested in cases such as “Shah v Barnet Borough Council [1983] 1 All ER 226”. There is more about this approach at the end of this article.

For tax purposes, an individual will always be resident if he or she spends 183 days or more in the UK during a tax year, but may also be treated as resident depending on their intentions when entering the UK or the average length of time spent in the UK over a series of tax years if he or she visits regularly. A person who is or intends to be resident in the UK year after year is treated as ordinarily resident. The respective tax and NICs positions are explained in detail in leaflets IR 20 and NI 38, which are available on the HMRC’s website (www.hmrc.gov.uk).

Working out the tax and NICs

1) Employee granted option, resident and ordinarily resident for tax purposes

Section 4, SSCBA 1992 provides for payments to be treated as remuneration and earnings.

Section 4(4)(a) SSCBA 1992 treats as earnings for NIC purposes the amount of any gain calculated under section 479 of ITEPA 2003, in respect of which an amount which counts as employment income of the earner under section 476 of that Act (charge on acquisition of securities pursuant to option etc), reduced by any amounts deducted under section 480(1) to (6). These provisions are contained in Chapter 5 of Part 7 ITEPA 2003.

Example

Employer grants employee a nil-cost option over 100 shares. The market value of the shares at exercise is £100 each. The amount which counts as employment income under Chapter 5 Part 7 ITEPA 2003 is £10,000 and the same amount attracts a Class 1 NICs liability.

The amount subject to Class 1 NICs is the amount of employment income calculated under section 476 ITEPA 2003 - before any relief given under a Double Taxation Agreement.

Chapter 5 of part 7 ITEPA 2003, per section 474(1), applies only to those who are resident and ordinarily resident for tax purposes for the year in which the securities option was acquired.

2) Employee granted option, resident but not ordinarily resident for tax purposes

Where an employee is resident but not ordinarily resident in the UK for tax purposes when the securities option was acquired, rather than a charge under section 476 of ITEPA 2003, which does not apply in such cases, under Part 7 of Chapter C when the option is exercised a deemed notional loan will be created, equal to the amount of gain on exercising the option. The notional loan is the difference between the market value of the employment-related securities (shares) at the time of acquisition by the employee and any deductible amounts under section 446T(3)(a) (i.e. what employee paid for option and shares). There are two tax charges and two amounts potentially liable for NICs based on this notional loan:

- (1) the deemed interest on the notional loan,
- (2) the deemed write off of the notional loan.

(1) deemed interest on the notional loan

The notional loan is aggregated with any actual beneficial loans under Chapter 7 Part 3 ITEPA 2003, in accordance with section 446S(3) ITEPA 2003. Subject to the de minimis limit of £5,000, a tax charge may arise under section 175 ITEPA 2003 on an amount of interest calculated under that section. Class 1A will be calculated on the same amount which is chargeable to tax.

(2) deemed write off of the notional loan

When the securities are sold, a specific tax charge arises under section 446U ITEPA 2003 on the discharge of the notional loan, equal to the amount of the original notional loan relating to the securities sold. The loan is treated as discharged when in accordance with section 446U, there is a disposal of the employment related securities or when any liability to pay for partly paid shares is released, transferred or adjusted.

The amount of the notional loan that is discharged also counts as employment income under section 446U(2) and is therefore subject to Class 1 NICs by virtue of Regulation 22(7) SSCR 2001.

It should be noted that the amount of the notional loan that determines the charges to tax under sections 446S and 446U may reflect an apportionment between UK duties and overseas workdays. The notional loan is proportionately reduced to take into account overseas workdays in the period between grant and when the employee is first entitled to exercise the option (the vesting date) where the employee was not ordinarily resident. Class 1A and Class 1 NICs are operated on the amount chargeable to tax.

Example

On 5 October 2003 an employee is granted an option over 10,000 shares at current Market Value of £1 per share. On 5 October 2004 he exercises the option when the Market Value is £3 per share. On 5 October 2007 he sells the shares when the Market Value is £10 per share.

The employee is resident but not ordinarily resident for tax purposes both when the option is granted and when he exercises the option and 80% of his working days between grant and vesting are in the UK.

Because the employee was resident but not ordinarily resident when the share option was granted to him, Chapter 5 ITEPA does not apply to the option. Instead, on exercise of the option a notional beneficial loan is deemed to arise by virtue of section 446S in Chapter 3C and this notional loan continues until the employee sells the shares. Before taking UK and overseas workdays into account for tax purposes, the amount of the notional loan is the Market Value at exercise less the cost of the option. (£30,000 less £10,000 = £20,000)

However, apportionment for tax between UK and non-UK duties over the period between grant and vesting has the effect of reducing the notional loan to £16,000 (£20,000 x 80%). Assuming an official rate of interest 5%:

In 2004/05 the taxable amount of the notional loan would be $£16,000 \times 5\% \times 6/12 = £400$

In 2005/06 and 2006/07 the taxable amount of deemed interest would be £800.

Under Section 10 SSCBA 1992 Class 1A NICs is due each year on the same amount.

When the shares are sold, the portion of the gain on exercise that has been regarded as a notional loan, is deemed to have been written off; that is, $£20,000 \times 80\% = £16,000$.

This amount is charged to tax under section 446U and will therefore also be subject to Class 1 NICs under Regulation 22(7) SSCR 2001 and section 6 Social Security Contributions and Benefits Act 1992 (SSCBA 1992).

Because:

- section 180 Part 3 to Chapter 7 ITEPA 2003 imposes a de minimis limit of £5,000 on aggregated beneficial loans (notional and real),
- if the gain on exercise in the above example was £6000 the amount regarded as a notional loan would become £4,800 (£6000 x 80%).

there would be no tax and therefore no Class1A NICs charge on the deemed interest on the amount treated as a beneficial loan. But the tax charge on discharge of the notional loan is unaffected by the de minimis limit, so on sale of the securities there would be a tax charge and, consequently, a Class1 NICs liability on £4,800.

The Chapter 3C (securities acquired for less than market value) rules are effective from 16 April 2003. Securities acquired before 16 April 2003 remain subject to the old rules under which the discharge of the notional loan is subject to a charge under section 195 ITEPA 2003 (as originally enacted) and a Class 1A NICs liability arises on the same amount.

Contributions Provisions relating to Internationally Mobile employees

The paragraphs above explained the basic provisions for employment related securities options showing that where the NICs liability is triggered by reference to a tax charge, the liability will depend on the tax residence status of the individual. In addition to these basic rules, for NICs liability to arise, the employee must also meet the conditions of residence and presence for NICs purposes, or, if working overseas, be liable for UK contributions by virtue of UK legislation or an international agreement.

Relevant European Union legislation

EC Regulation 1408/71 and EC Regulation 574/72 govern the Social Security treatment of workers who move between Member States of the European Economic Area and Switzerland. These regulations co-ordinate the Social Security schemes of the Member States and, amongst other things, are intended to prevent double charging where national rules overlap or prevent gaps in social security cover.

- The EC Regulations are directly applicable in the UK and can over-ride the way that the UK's Social Security legislation applies to people moving between the UK and other Member States.
- The rules on determining the applicable legislation aims to ensure that a person is insured according to the legislation of a single Member State at a time. The basic rule is that a person must be insured in the State where they work. (Article 13 EC Regulation 1408/71).

- There is a system of certificates - the E101 - to keep people insured in their home State when they are sent by their employer in their home State to work in another EEA Member State. This applies only if the work is not expected to last longer than 12 months, and the person has not been sent to replace another employee whose contract has ended. (Article 14 EC Regulation 1408/71).
- Form E101 may be extended, for a further 12 months, using form E102.
- The E101 shows that the issuing State is responsible for insuring the employee. The certificate will prevent demands for contributions from the host State on the same income.
- Article 14 (2) contains provisions relating to persons who normally work in more than 1 Member State.
- Under Article 17 - in exceptional circumstances and subject to agreement between EEA Member States, an E101 may be obtained for longer periods.
- There are special rules for certain trades e.g. transport workers, mariners and civil servants.

Amongst other things, the EC Regulations decide which National legislation applies, but can also over-ride liability conditions in the UK's Social Security (Contributions) Regulations 2001 – particularly:

- the "52 week" waiting period before liability starts for certain "not ordinarily resident people" working for foreign employers; and
- for certain types of foreign students; and
- the "52 week" limit on NICs liability for people sent from the UK to work abroad.

(Here ordinarily resident means ordinarily resident for Social Security purposes.)

- Under Council Regulations (EC) 859/2003, the provisions in co-ordinating Regulations 1408/71 and 574/72 extend to certain third country (non European Union) nationals who have been "legally resident" in a European Union State.

The "third country national" provisions only apply to people moving between Member States. For example a US national living and working in the UK will not be covered by the EC Social Security Regulations unless they move to another Member State. In the UK, whether a person is "legally resident" in the UK is determined by the Home Office. The "third country national" provisions do not apply in Denmark.

Although they signed up to 1408/71 Switzerland, Iceland, Liechtenstein and Norway do not currently apply the "third country national" provisions.

More detailed guidance on the NICs rules for workers moving between the UK and the EEA can be found in the HMRC's National Insurance Manual, which is available at www.hmrc.gov.uk/manuals/nimmanual/nim33000.htm

The following examples illustrate the NIC treatment that will apply to a person's earnings when they move between EEA States, and how the liability accrues in the State where the person was insured when they performed the duties from which the earnings derive. Also, as with options, the liability to Class 1 and Class 1A is dependent on the residence status of the individual.

Example 1: EEA - Option granted in UK and exercised while on short secondment to France (EEA)

Alan is resident, ordinarily resident and working in the UK on 1 June 2003 when his UK employer grants him an option to buy 1,000 company shares in two years' time at the 1 June 2003 Market Value of £1 a share. On 1 July 2004 Alan is seconded to work in France for 12 months only and is still employed there when he exercises his option on 1 June 2005. At that date the Market Value of the shares is £5 each.

Alan is resident and ordinarily resident in the UK at the date of grant and is therefore liable to income tax under Chapter 5 of Part 7 ITEPA 2003 on any gain realised at exercise.

Under Article 14.1(a) EC Regulation 1408/71 Alan is a 'posted worker' and remains subject to UK legislation. Section 4(4)(a) SSCBA 1992 provides for a Class 1 NICs liability on the amount of any gain which counts as employment income under Chapter 5 of Part 7 ITEPA 2003. 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 $1,000 \times (£5 - £1) = £4,000$.

As regards the impact of a double taxation treaty, it is likely in these circumstances that Alan would remain resident in the UK for treaty purposes for 2005/6. The UK would therefore tax the £4,000 gain on exercise in full but allow credit for any tax charges in respect of the 11 months between the date of grant and the date the option became exercisable.

Example 2: EEA - Option granted in the UK by UK employer and exercised when on long secondment to Netherlands (EEA)

Peter is resident, ordinarily resident and working in the UK on 1 October 2003 when his UK employer grants him an option to buy 1,000 company shares in two years' time at the 1 June 2005 market value of £1 a share. On 1 June 2005 Peter is sent to work in the Netherlands for 2 years and exercises his option on 1 October 2005 when he is in the Netherlands. At that date the market value of the shares is £5 each.

No application is made for an E101 to subject Peter to UK legislation for the period in the Netherlands as Peter does not qualify as a posted worker for the purposes of Article 14(1). Peter is therefore subject to Netherlands legislation under Article 13.2(a) of EC Regulation 1408/71. On the date of exercise Peter would not be subject to UK legislation on his salary for work in the Netherlands but the gain derived from the option is treated differently as the grant of the option relates to the UK employment.

Peter is resident and ordinarily resident in the UK at the date of grant and is therefore liable to income tax under Chapter 5 of Part 7 ITEPA 2003 on the gain realised at exercise. A Class 1 NICs liability arises under Section 4(4)(a) SSCBA 1992 on the exercise of the option.

The gain is the amount of employment income calculated under Chapter 5 of Part 7 ITEPA 2003 and this is 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 $1,000 \times (£5 - £1) = £4,000$.

Although Article 13 applies to Peter when he works in the Netherlands, the amount he received on exercise of the option relates to the grant of the option in the UK, at a time when he was insured here. Peter is not insured in both the UK and the Netherlands in relation to the period of October 2003 during which Peter was working in the UK and remunerated for that work.

As regards the impact of a double taxation treaty, Peter would probably have become dual resident by October 2005 and the result would depend on how this was resolved under the UK/Netherlands Double Taxation Agreement (DTA). If resolved in favour of the UK, then as for example 1 the UK would charge the whole gain of £4,000 and allow credit for any Dutch tax paid in respect of the period of employment there. If resolved in favour of the Netherlands, the UK would restrict its assessment to the proportion that derived from employment here, 20 months out of 24. The Netherlands would be able to tax the gain under their normal rules.

Example 3: EEA - Option granted in the UK by UK employer and exercised when in different employment in Germany (EEA)

The facts are similar to example 2, with Barbara working in the UK at the time of the grant, except that Barbara leaves her UK employment on 1 October 2003 to work for an employer in Germany, who has no connection with the UK employer, on a 3-year contract. Barbara is resident and ordinarily resident in the UK at the date of grant and is therefore liable to income tax under Chapter 5 of Part 7 ITEPA 2003 on any gain realised at exercise.

Under Article 13.2(a) of Council Regulation EC1408/71 Barbara would be liable to pay social security contributions under the legislation of the EC country of employment. On date of exercise Barbara would normally not fall within UK legislation. But as the gain on the share option was realised from a former period of employment in the UK, liability to pay Class 1 NICs on that gain arises under UK legislation in the normal way and on the same amount as for Peter.

Note: Example 2 and 3 set out the UK's view. However, the treatment of Share options is not yet an area where the EU Member States have co-ordinated practice and it is possible that not all States will follow the same approach as the UK. The HMRC is working towards securing an agreement on this but in the meantime, should you encounter conflict, with the UK and another State requiring contributions on the same income, then please let us know and we will link with the other country to prevent a double charge arising. Please write to:

HMRC
Centre for Non-Residents
Benton Park View
Newcastle upon Tyne
NE98 1ZZ

As regards the impact of a double taxation treaty, although the option could not be exercised until 1 October 2005, Barbara left the employment on 1 October 2003, so the implication is that the gain is a reward for services up to that date. As Barbara did not leave the UK until then, the whole gain derives UK employment and the domestic tax position is not disturbed.

Example 4 - Netherlands National - not resident or ordinarily resident in UK and employed overseas - Option granted in Netherlands and in relation to Netherlands duties exercised in UK - seconded to UK employer (EEA)

Petra is Dutch and is living in the Netherlands on 1 June 2003 when her Dutch employer grants an option to buy 1,000 company shares in two years' time at the 1 June 2003 market value of £1 a share. On 1 July 2004 Petra is seconded to the UK for 30 months to work for the UK subsidiary and is still in this employment there when she exercises her option. At that date, the market value of the shares is £5 each.

Although Petra would be insured in the UK under Article 13, the exercise of her option granted in respect of her duties when insured in the Netherlands would not be subject to UK NICs.

Where an option is granted to an employee in respect of an employment not within the charge to UK tax at the date of grant, the exercise of that option will not fall within Chapter 5 or Chapter 3C of Part 7 ITEPA 2003.

The right or opportunity to acquire securities pursuant to an option arises when that option is granted. If the employee was resident wholly overseas (and the grant were not in prospect of taking up the UK employment or otherwise in respect of duties performed in the UK) Chapter 3C of Part 7 ITEPA 2003 cannot apply. With no income tax trigger there is no NI liability.

As regards the impact of a double taxation treaty, although there would be no income tax charge at exercise, capital gains tax would be chargeable if Petra was resident for tax purposes in the UK when the securities were sold, subject to the rules on domicile and remittance basis. The UK would allow relief for any Dutch tax paid in respect of the period of employment there.

Example 5 - Netherlands National - not ordinarily resident in UK is sent by Netherlands employer to work in the UK on secondment for 3 years - Option granted in UK (EEA).

Carla is Dutch and lives in the Netherlands when her Dutch employer sends her to work in their UK subsidiary for up to 3 years. She arrives in the UK on 1 June 2003 and her UK host employer grants her an option to buy 1,000 company shares in two years' time at the 1 June 2003 market value of £1 a share. Carla is insured in the UK under Article 13 when working in the UK. On 1 July 2005 Carla is working in the UK when she exercises her option. At that date, the Market Value of the shares is £5 each. Chapter 5 of Part 7 ITEPA 2003 does not apply because Carla was not ordinarily resident in the UK at grant.

UK tax would be due on an amount under section 446S Chapter 3C of Part 7 ITEPA 2003 - notional loan. Section 10 SSCBA 1992 ensures that a Class 1A liability arises on the same amount which is chargeable to tax.

The disposal of the shares acquired on exercise of the option gives rise to a charge under section 446U Chapter 3C of Part 7 ITEPA 2003 - discharge of notional loan. This triggers a corresponding Class 1 NICs liability under Regulation 22 (7) SSCR 2001 and section 6 SSCBA 1992 on the same amount which counts as employment income under section 446U. If in this example Carla moved back to the Netherlands shortly before exercise of the option for UK duties, NICs could still be payable under the terms of Article 13 because they relate to duties when she was UK insured. However, the liability will depend on whether a new tax year has commenced since transfer back to Netherlands. Section 421E(2) ITEPA 2003 exempts a tax charge under Chapter 3C if there are no "general earnings" to which Chapter 4 or 5 of Part 2 would apply.

As regards the impact of a double taxation treaty, the whole of the gain on the option derives from work performed in the United Kingdom. If Carla does not move back to the Netherlands shortly before exercise, it is likely that by then she has become resident for tax purposes in the UK and we would tax it in full and expect the Netherlands to either exempt it from Dutch tax or credit the UK tax against liability there. If she moved back shortly before exercise then we would tax the appropriate portion.

Reciprocal Agreements (RA) Countries / Double Contribution Conventions

The UK has a number of bi-lateral Social Security agreements with other countries outside the EEA. These generally apply to residents of each state (but some restrict eligibility to nationals of the two states). There is some difference between the various agreements and they should be considered individually. However, there are some common features.

An employee may remain liable for Class 1 NICs if:

- they are employed in the UK; and
- are posted by their employer to work in another RA / DCC country; and
- the posting is for a period not exceeding the maximum posting period allowed by the terms of the RA (the maximum period of posting will depend on the RA / DCC country).

Some reciprocal agreements contain Articles for working in both states for the same period. If so, liability is normally placed on the state where the employee is ordinarily resident.

The employer can obtain a certificate of continuing liability (similar to E101) from the HMRC's Centre for Non-residents to prevent a demand for payment of contributions in the RA /DCC country. Extensions of the posting periods can be obtained in agreement with the foreign authority, similar to EC Regulations.

The USA Reciprocal Agreement is typical. The RA with the USA is incorporated into UK law by the Social Security (United States of America) Order 1997, which amended the 1994 Order.

Article 4 (1) provides the basic rule that where a person is employed within the territory of one of the countries they shall, with respect to that employment, be subject to the laws only of that country. The basic rule is that the employee pays contributions where they work.

Article 4(2) contains an exception to the general rule in Article 4(1), so that employees can remain in their home Social Security scheme. Under Article 4 (2) a person who is normally employed by an employer in one of the countries, but is sent by the employer to work in the territory of the other country, remains subject to the legislation of their home state. The rule applies as if they were still in their home state.

Article 4(2) applies for postings of up to 5 years but can be extended.

Example 6: Reciprocal Agreement (RA) - USA national working for UK employer and option granted by UK employer

Caroline is a USA national working for an UK employer. She is resident but not ordinarily resident for tax purposes in the UK when she is granted an option on 1 June 2003 over 1000 shares. Caroline is still resident and working in the UK when she exercises her option and sells the shares on 1 July 2005. The option price is £1 per share and the market value at 1 July 2005 is £5 per share.

Under Article 4 of The Social Security (United States of America) Order 1997 ('USA RA') Caroline is subject to UK legislation.

She is resident but not ordinarily resident and UK tax would be due on an amount calculated under section 446S Chapter 3C ITEPA 2003 - notional loan. Under Section 10 SSCBA 1992 a Class 1A liability arises on the same amount which is chargeable to tax.

The disposal of the shares acquired on exercise of the option gives rise to a tax charge under section 446U Chapter 3C of Part 7 ITEPA 2003. This triggers a corresponding Class 1 NICs liability under Regulation 22 (7) and section 6 SSCBA 1992 SSCR 2001 on the same amount which counts as employment income.

As regards the impact of a double taxation treaty, the whole of the gain on the option derives from work performed in the United Kingdom. The UK would tax it in full and expect the USA to credit the UK tax against any liability there.

Example 7: RA - USA national and option granted by USA employer; subsequently seconded to UK and option exercised

David is a USA national working for a USA employer. He is neither resident nor ordinarily resident in the UK when a stock option over 1000 shares in his US employer is granted in recognition of his USA services. He is subsequently seconded to work in the UK, remaining under contract to the US company but attached to a UK subsidiary of the US employer for a period expected to exceed 6 years. David falls to be insured in the UK under Article 1 because of the expected length of the secondment (in excess of five years). He exercises his option when working in the UK.

The right or opportunity to acquire securities pursuant to an option arises when that option is granted. If the employee were then resident wholly overseas (and the grant were not in prospect of taking up the UK employment or otherwise in respect of duties performed in the UK) Chapter 3C of Part 7 ITEPA 2003 will not apply and therefore no NICs liability arises when the option is exercised.

If in the example above, the option had been granted in relation to future service in the UK, there would be a Chapter 3C charge and a Class 1A liability under Section 10 SSCBA 1992 on the notional loan and a Class 1 NICs liability on the discharge of the notional loan.

As regards the impact of a double taxation treaty whether or not the option was granted in respect of UK employment, under the UK/USA double taxation treaty David would probably have become resident in the UK at some time during the secondment. If the relevant taxable event (exercise or sale of shares) occur when David is resident here, the UK liability under domestic legislation would remain due in full and HMRC would expect the USA to tax only the proportion of the gain that derived from employment there between grant and the date the option became exercisable as sourced there. If David also paid tax on a citizenship basis, the USA would expect to give relief for UK tax relating to the employment here.

Example 8: Reciprocal Agreement (RA) - USA national working for USA employer and granted deferred share award in respect of previous USA employment under an LTIP (Long Term Incentive Plan) whilst not resident and not ordinarily resident in the UK

Steve is seconded to his USA employer's UK subsidiary for 6 years and is resident and ordinarily resident in the UK when Steve acquires his shares in December 2005. Steve has no certificate of coverage from the USA for 5 years, keeping him insured in the USA because the length of the secondment is for more than 5 years and under Article 4(1) of the UK/US agreement he is liable to pay NICs in the UK scheme.

If the award is a nil or nominal cost option granted in the US then he will not be liable to pay income tax or NICs because the residence test is at grant, not vesting. Under the UK/USA agreement, the award relates to the employment in the USA and would not attract UK NICs.

Under the UK/USA double taxation agreement the UK would be entitled to tax the gain on disposal of the underlying shares, assuming he remained resident for tax purposes at that date. However the UK would give credit for USA tax paid in respect of the period of employment there between grant and the date the option first became exercisable.

Example 9 - USA National working for USA employer, seconded to work for the employers UK subsidiary and awarded restricted shares in respect of her work for the UK subsidiary.

Dana acquires these shares under an agreement providing that the shares cannot be sold for a period of 2 years after they were acquired.

Dana is resident and ordinarily resident in the UK when the shares were acquired:

The shares acquired fall to be treated as restricted securities by reason of Section 423 ITEPA 2003. A tax charge arises (under Section 62 ITEPA 2003) which, in the absence of a tax election treating the shares as unrestricted (for tax purposes) when they were acquired, is based on the market value of the shares reflecting the specific restriction. The right here is not subject to forfeiture.

Dana is still UK resident and ordinarily resident 2 years after the shares were acquired, when the restriction is lifted. A further tax charge will arise at that time by reason of section 426 ITEPA 2003 and based on the additional value received by the lifting of the restriction (section 428 ITEPA 2003).

If Dana is in possession of Certificate of coverage from the USA when the shares were acquired no UK NICs are due.

With respect to the UK/USA double taxation agreement the UK can tax the gain derived from the option in full. Any tax paid in the USA would be because of Dana's citizenship and the USA would therefore be required to give credit against this for UK tax paid.

Dana is resident but not ordinarily resident in the UK when the shares were acquired:

Whilst the shares acquired are employment-related securities by reason of section 421B ITEPA 2003, Dana's residence status on acquisition means that the shares do not fall to be treated as restricted securities (section 421E ITEPA 2003).

A tax charge arises when the shares are acquired (under section 62 ITEPA 2003) based on the market value of the shares reflecting the specific restriction. There is no additional tax charge arising under section 426 ITEPA 2003 when the restriction is lifted.

If Dana is in possession of Certificate of coverage from the USA when the shares are acquired no UK NICs are due.

There is no change to the position under the UK/USA double taxation agreement for tax.

Example 10: RA - UK National, option granted by UK employer; subsequently seconded to USA and option exercised

Elena is resident, ordinarily resident and working in the UK on 1 June 2003 when her UK employer grants an option to purchase 1,000 shares in the company in two years' time at the 1 June 2003 Market Value of £1 a share. On 1 July 2004 she is seconded to the US for 4 years and is still employed there when she exercises her option on 1 June 2005. At that date the shares are worth £5 each.

Elena is resident and ordinarily resident in the UK at the date of grant and is therefore liable to income tax under Chapter 5 of Part 7 ITEPA 2003 on any gain realised at exercise. Under Article 4(2) of the Social Security (United States of America) Order 1997 she is subject to UK National Insurance legislation. Liability for NICs is on the amount which counts as employment income under Chapter 5 of Part 7 ITEPA 2003.

It is likely that by the date of exercise Elena will be regarded as resident for tax purposes in the USA. Under the UK/USA double taxation treaty she may claim that the UK reduce its assessment to the amount derived from employment here between grant and the date when the option could first be exercised. The USA would be entitled to tax the whole gain but would be expected to give credit for UK tax paid.

Example 11: USA national working for US company seconded to UK subsidiary, granted options in UK in respect of UK duties. Exercise of Option after Certificate of Coverage expires

Ken is a USA national working for a US employer and is not ordinarily resident in the UK. He is under contract to the US company but seconded to the UK subsidiary of his US employer for a period expected to be less than 5 years. Ken has a certificate from the USA and is

insured in the US FICA scheme under Article 4 (2). In the second year of his secondment Ken is awarded an option over 1000 shares in the UK company in recognition of his services to that company. Ken remains in the UK for a further year after his 5 year certificate expires and he is required to contribute to the UK scheme. He exercises his option in year 6.

Although UK income tax will be due, no UK NICs are due where the option is granted in relation to employment duties when the employee is FICA insured.

In this example we assume Ken has become UK resident for tax purposes by the date of exercise. Under the UK/USA double taxation agreement the UK can tax in full. There were no duties in the USA relating to the award of the option, so any tax payable there would be in respect of his citizenship and the USA would therefore be required to give credit against this for UK tax paid.

Rest of The World (ROW)

Employee sent from Rest of the World country to the UK to work in the UK

Where a person comes to the UK from a country with which the UK does not have an agreement, and they are paid earnings in respect of their employment in the UK, they are subject to the liability conditions in the Social Security Contributions and Benefits Act 1992 (SSCBA 1992) and Case F of the Social Security (Contributions) Regulations 2001.

Regulation 145(1)(a) SSCR provides that a person is liable to UK NICs if :

“that employed earner is resident or present in Great Britain or Northern Ireland (or but for any temporary absence would be present in Great Britain or Northern Ireland) at the time of that employment or is then ordinarily resident in Great Britain or Northern Ireland.”

Mere “presence” in the UK at the time of employment is sufficient to meet the residence test.

Regulation 145(2) SSCR contains a 52 week exemption for a person who comes to the UK and:

- is not ordinarily resident; and
- not ordinarily employed in the UK; and
- they are here in pursuance of employment which is mainly employment outside the United Kingdom.

This “52 week” rule would take a person coming to the UK from a country not covered by an agreement, out of NICs if they are not ordinarily resident and who would normally work for their employer outside the UK.

In addition to the primary Class 1 NICs which can be deducted from the earnings of an employee, the “secondary contributor” - usually the employer - is liable to pay a secondary contribution. Regulation 145(1)(b) SSCR 2001 sets out the residence condition for the secondary contributor. It provides that the secondary contributor “(in this case referred to as “the employer”) is resident or present ... when such contributions become payable or then has a place of business in Great Britain or Northern Ireland..”

Schedule 3 to the Social Security (Categorisation of Earners) Regulations 1978 lists persons to be treated as secondary Class 1 contributor in respect of particular employments.

The most significant for internationally mobile workers is paragraph 9 of Schedule 3, which covers employment by a foreign employer where:

- in pursuance of that employment the personal service of the person employed is made available to a host employer; and
- personal service is rendered for the purposes of the business of that host employer; and
- that the service began on or after 6/4/1994.

Example 12: ROW - Peruvian national normally works in Peru for a Peruvian employer on secondment from ROW country to UK employer. Option granted by UK employer

Year 1

Nolberto is a Peruvian national who arrives in the UK on secondment from his Peruvian employer to work for a UK employer. He is resident but not ordinarily resident for tax purposes in the UK when he is granted an option on 29 April 2004 over 1,000 shares.

Under regulation 145(2) SSCR there is a 52 week period of exemption from liability to pay a Class 1, Class 1A or Class 1B contribution beginning from the date of entry into the UK.

Year 2 and 3

Nolberto is still resident and working in the UK when in year 3 he exercises his option and sells the shares.

The option price is £1 per share and the market value at 29 April 2007 is £5 per share.

When he exercises his option, Nolberto will be liable to UK income tax under section 446S Chapter 3C Part 7 ITEPA 2003 - notional loan provision. Under Section 10 SSCBA 1992 a Class 1A NIC liability arises on the same amount which is chargeable to tax under section 446S ITEPA 2003.

The disposal of the shares acquired on exercise of the option gives rise to a tax charge under section 446U (Chapter 3C of Part 7) ITEPA 2003 - discharge of a notional loan. This triggers a corresponding Class 1 NICs liability on the same amount which counts as employment income.

The amount subject to tax and NICs is $(1,000 @ £5) - (1,000 @ £1) = £4000$.

The UK "host employer" would be the secondary contributor for NICs and required to account for the Class 1A and Class 1 NICs due.

The UK does not have a double taxation agreement with Peru. Any UK tax liability therefore remains chargeable in full. No work has been carried out elsewhere so there is no foreign tax to be credited.

Working in ROW Countries

Employees sent to a "Rest of the World" country are liable for NICs in the UK for the first 52 weeks working abroad if they are:

- ordinarily resident in the UK; and
- resident before they commence work abroad; and
- have an employer with a place of business in the UK

If the employee breaks the 52 weeks with periods of work in the UK, this will trigger a further 52 week period of liability.

Example 13: Rest of the World (ROW) - UK national, options granted by UK employer; subsequently seconded to Nigeria and option exercised

Frank is resident, ordinarily resident and working in the UK on 1 June 2003 when his employer grants him an option to buy 1,000 company shares in two years' time at the 1 June 2003 market value of £1 a share⁷. On 1 July 2004 he is seconded to Nigeria on secondment for 3 years and is still employed there when the option is exercised on 1 September 2005. At that date the shares are worth £5 each.

Frank is resident and ordinarily resident in the UK at the date of grant and is therefore liable to income tax under Chapter 5 of Part 7 ITEPA 2003 on any gain realised at exercise.

Under regulation 146(2) Social Security (Contributions) Regulations (SSCR) 2001, liability to pay UK social security contributions continues for the period of 52 weeks from the date of leaving the UK to work abroad. This is treated as an absolute "cut off date" and payments made after that date are not included in earnings subject to NICs. As the exercise of the option is after the period of continuing contribution liability, the HMRC's practice is that no Class 1 NICs are payable.

The UK does have a double taxation agreement with Nigeria so Frank may claim relief under that if he has become resident for tax purposes there by the date of the exercise. The UK would limit its liability to the proportion of the gain that derived from employment here between grant and the date the option could first be exercised. Nigeria would be entitled to tax the gain in full if it wished but should give credit for UK tax.

Other Securities Payments treated as earnings

So far we have looked at securities options and explained how the National Insurance liability requires a UK tax charge as a trigger for liability, and how this can be affected by the various special provisions for internationally mobile workers. There are other ways of receiving employment related securities. For reasons of space, this article cannot cover them all but here is some guidance on other scenarios.

Payments treated as earnings

Regulation 22(7) SSCR 2001 provides for amounts:

- which count as employment income of the employed earner in relation to employment-related securities (within the meaning given by section 421B(8) of ITEPA 2003); and

- to which section 698 of ITEPA 2003 (PAYE: special charges on employment-related securities) applies

to be treated as earnings for NIC purposes and subject to Class 1 NICs.

Employee is resident and ordinarily resident in the UK when awarded restricted securities/shares - Chapter 2 of Part 7 ITEPA and Regulation 22(7) SSCR 2001

If an employee acquires employment-related securities subject to restrictions these fall within Chapter 2 of Part 7 ITEPA 2003. The restrictions may include the inability to sell the securities/shares, restrictions of rights given by the securities/shares or may be forfeitable if certain performance conditions are not met. Such securities are subject to Regulation 22(7) of the Social Security (Contributions) Regulations 2001.

In the following **example**

John is awarded 1,000 shares (worth £1 each) by his employer. He will forfeit the shares if he leaves his employment within two years and he cannot sell the shares for another year after that. Assume that the shares are readily convertible assets.

The restricted Market Value on acquisition is £800 (£1,000 if shares unrestricted). Market Value at end of year 2 would be £1,500 if there were no restrictions on the shares, but only £1,350 because John cannot sell them for another year. The unrestricted MV (because the employee can now sell the shares) at end of year 3 is £1900.

The NICs (& tax) position is that:

- No liability arises on acquisition as the shares are subject to a forfeiture restriction;
- NICs (& tax) charge on £1350 arises at year two when the forfeiture restriction is lifted. The value of the shares is reduced because they cannot be sold for another year, equal to 10% of Unrestricted Market Value. So the formula in section 428 produces a calculation of $£1,500 \times (1.0 - 0.0 - 0.1) - 0 = \mathbf{£1,350}$;
- NICs (& tax) charge also arises at year 3 when the second restriction is lifted - NICs/tax is due on the percentage of the value that has not been previously taxed/NIC'd. Section 428 formula produces calculation of $£1,900 \times (1.0 - 0.9 - 0.0) - 0 = \mathbf{£190}$.

However, Chapter 2 of Part 7 ITEPA allows an employee and employer to elect to pay tax & NICs on the full market value of the shares at the time of acquisition, as if there were no restrictions applying. If this happens, no further NICs/tax liabilities arise on the shares and any subsequent increase in value is accepted as capital growth and therefore subject to Capital Gains Tax.

So, in this example, John and his employer could elect to pay tax and NICs on the full value at acquisition, that is £1,000, and face no more tax/NICs charge. If John does pay tax and NICs up front but later forfeits the shares he cannot claim any relief against the Income Tax or NIC charges but will get Capital Gains Tax losses.

Different rules apply if the forfeiture restrictions apply for 5 years or more - in this case tax/NICs liability arises on acquisition and again on each occasion when the forfeiture restriction and sale restriction is lifted:

Acquisition – charge on money's worth value of £800
 End year 2 – section 428 – $£1,500 \times (0.8 - 0.0 - 0.1) - 0 = \mathbf{£1,050}$
 End year 3 – section 428 – $£1,900 \times (0.8 - 0.7 - 0.0) - 0 = \mathbf{£190}$

Employee is resident but not ordinarily resident in the UK for tax purposes when awarded restricted securities/shares - Chapter 2 of Part 7 ITEPA and Regulation 22(7) SSCR 2001 do not apply

Because Chapter 2 of Part 7 ITEPA 2003 only applies if the individual is resident and ordinarily resident, an award to a person who is resident but not ordinarily resident falls to be taxed under Section 62 ITEPA 2003. The tax charge is on the restricted value of the shares. This amount is also subject to Class 1 NICs. There are no further charges on lifting of the restrictions.

Employee resident and ordinarily resident for tax - Convertible securities - Chapter 3 of Part 7 ITEPA and Regulation 22(7) SSCR 2001

The NICs charge also follows the tax charge for convertible securities, based on Chapter 3 Part 7 ITEPA 2003 and Regulation 22(7) SSCR 2001. Assume in this **example** that:

- Julie's employer gives her 100 shares worth £5 each for no consideration and says that if she maintains her work performance the shares will be converted into shares of higher value in three years. The underlying value of the shares ignoring right to convert is £2 each, with the right to convert worth £3.

NICs/Tax charges will arise:

- under s3 SSCBA (s62 ITEPA) on £200 when the original shares are first awarded; and
- under s 439 Chapter 3, Part 7 ITEPA there is also a chargeable event giving rise to a tax charge:
 - when the shares are converted into more valuable shares (say the shares acquired on conversion are worth £10 each at the time of acquisition, and the underlying value of the original shares ignoring right to convert is £4. NICs/tax are chargeable on £1,000 less £400 value of old shares to give gain of £600); or
 - if the shares are sold when they are still convertible; or
 - if a payment is received for the release of the shares (for example, for the return of the shares to the employer) when they are still convertible; or
 - if any money or money's worth is received in connection with the shares when they are still convertible, for example, the employee receives a further payment or benefit from the employer because the shares are not performing well on the markets.

The amount of the tax charge is set out in sections 440 and 441 ITEPA 2003. Regulation 22(7) SSCR 2001 and section 6 SSCBA 1992 provides for a Class 1 NICs liability on the amount of employment income subject to PAYE.

Employee resident but not ordinarily resident for tax - Convertible securities

Chapter 3 only applies if the individual is resident and ordinarily resident. An award to a person who is resident but not ordinarily resident falls to be taxed under Section 62 ITEPA 2003. The tax charge is on the actual value of the shares including the right to convert. This amount is also subject to Class 1 NICs.

Employee on long secondment working overseas for a UK employer, receives a straight forward payment by way of shares/ securities at undervalue – not conditional shares, not convertible, no option involved, no risk of forfeiture involved, value not artificially depressed or enhanced.

In this article we have concentrated on payments by way of shares where the NICs liability is dependent on there being an amount treated as employment income for tax purposes. However, there is a situation where a NICs liability can arise when a person works overseas and where the NICs liability is not dependent on there being an amount chargeable to tax in the UK. This occurs where a person receives a straight forward payment of earnings in shares, where the shares are:

- Readily Convertible Assets,
- outside a scheme with tax and tax and NICs advantages, and where the shares are not:
 - acquired under a securities option
 - conditional, or
 - convertible, or
 - the value is not artificially enhanced or depressed.

Providing the employee meets the conditions as to residence and presence for National Insurance purposes, or is liable for Class 1 National Insurance purposes by virtue of EC Regulations, a Reciprocal agreement, Double Contributions Convention or Regulation 146 SSCR 2001, the employee (and the UK employer) is required to pay contributions on the shares, under Section 3 SSCBA 1992. The residence provisions work in the same way as they would if the employee had been paid in cash.

Example

Nadia is sent by her UK employer to work in the USA for 5 years. She remains UK insured, and eligible for benefits under the UK/USA reciprocal agreement and continues to pay contributions in the UK. Her duties are performed at the offices of their US client in Dakota and Nadia moves to Dakota for the 5 years. Nadia is non-resident for tax purposes. In Year 3, as part of her bonus, Nadia's employer gives her 100 listed shares worth £5 each for no consideration. As Nadia is covered under the UK's Social Security scheme, National Insurance is due on the payments although no tax liability arises.

Under the UK/USA double taxation agreement, Nadia is not resident in the UK and none of the share award relates to employment in the UK. The UK will not seek any income tax on the award, and the USA will be entitled to tax it in full.

These are only the main provisions. Further detail on the shares provisions can be found in the National Insurance Manual 06866 onwards which is on the HMRC website at:

www.hmrc.gov.uk/manuals/nimmanual/nim06900.htm

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List of Agreement Countries

European Economic Area Countries

Austria
Belgium
Cyprus (Republic of Cyprus not Northern Cyprus)
Czech Republic
Denmark
Estonia
Finland
France
Germany
Greece
Hungary
Iceland
Republic of Ireland
Italy
Latvia
Liechtenstein
Lithuania

Luxembourg
Malta
Netherlands
Norway
Poland
Portugal
Spain
Slovakia
Slovenia
Sweden
Switzerland

Reciprocal Agreement Countries

Barbados
Bermuda
Bosnia-Herzegovina
Canada
Croatia
Guernsey
Israel
Jamaica
Japan
Jersey
Macedonia
Mauritius
Montenegro
New Zealand (Social Security Benefits only)
Philippines
Republic of Korea
Serbia
Turkey
USA

NICs and Ordinary Residence

As Ordinary Residence is not defined in the legislation, it takes on its ordinary meaning. In *Shah v Barnet*, where the House of Lords considered ordinary residence in relation to an educational grant, it was stated that ordinarily resident;

“refers to a man’s abode in a particular place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of short or long duration.”

In considering whether a person is “ordinarily resident” for NICs the HMRC take into account the following factors in order to build up an overall picture of the person’s position:

	Factor	Indication
1	Will the person be returning to Great Britain or Northern Ireland during the period of employment abroad?	<p>Yes - indicates ordinary residence continues during the period(s) abroad, especially the more frequent or longer the return visits.</p> <p>No - indicates the person ceasing to be ordinarily resident.</p>
2	What will be the purpose(s) of the return visit(s)?	<p>Visit(s): to see family who have remained at the person's home in Great Britain or Northern Ireland; and/or as holidays spent at the home, indicate ordinary residence.</p> <p>If the visit(s) is in connection with the employment abroad, for instance, training, this is not such a strong indication of ordinary residence.</p>
3	Will the person's family - spouse/partner and/or children - be going abroad as well?	<p>Yes - indicates that the person is no longer ordinarily resident, especially if they do not maintain a home in Great Britain or Northern Ireland (see factor 4).</p> <p>No - indicates ordinary residence continuing during period(s) abroad.</p>
4	Will the person retain a home in Great Britain or Northern Ireland during their period abroad?	<p>Yes - indicates ordinary residence continuing during period(s) abroad.</p> <p>No - indicates that the person is less likely to remain ordinarily resident.</p>
5	If the person retains a home, will it be available for their use when they return?	<p>Yes - indicates ordinary residence continuing during period(s) abroad.</p> <p>No - because, for instance, it is let on a long lease, then it is less likely that the person will remain ordinarily resident.</p>
6	Will the person be returning to Great Britain or Northern Ireland at the end of the period abroad?	<p>Yes - indicates ordinary residence continuing during period(s) abroad.</p> <p>No - indicates that the person is no longer ordinarily resident, especially if they do not retain a home in Great Britain or Northern Ireland during their absence abroad (see factor 4 above).</p>
7	How long has the person lived in Great Britain or Northern Ireland?	The longer the period, the stronger the indication that the person is ordinarily resident.

CONTENT

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