Effective Share Incentives

Share values and share incentives are on the rise. After one of the longest recessions in history share values are recovering and transaction volumes increasing. The Financial Times Stock Exchange (FTSE) 100 and New York Stock Exchange (NYSE) 100 indexes are currently at around 6,500 and 7,900 respectively. Five years ago they were both at 3,500. Share awards are typically made with three year performance or vesting periods, awards made in the past five years are likely to be standing at significant profits.

We are therefore seeing a growing volume of share incentive transactions as employees exercise share options and other awards vest. Alongside this there is a growing international focus on tax compliance for share plans. I have focused on UK developments but the key points about sourcing, withholding and reporting will apply in many countries.

Most companies use share incentives as a standard part of executive remuneration. Nearly all listed UK and US companies have some form of share incentive. The technology sector in particular uses share incentives at all levels. Properly structured share incentives ares a powerful retention and motivation tool. They align employee and shareholder interests and often provide a mechanism for participants to make significant, life changing gains.

Share Incentives becoming a 'Disincentive'

The purpose of this article is not to focus on the tax complexities of share incentives. There is a real risk that these complexities can lead to significant tax costs for the company. I therefore want to alert you to key compliance areas and cost saving opportunities. You can then ensure that your incentives work and don't become an unexpected cost to the company or participants.

Payroll compliance has always been complex particularly for internationally mobile employees. Companies are often exposed to costly settlements where they do not deduct the right amounts of tax and social security. Compliance problems often lead to unexpected tax bills plus interest and penalties. As a rough guide, the 'worst case' cost to a company of settling a UK payroll failure is roughly equivalent to the original taxable gain i.e. if an employee made a gain of £100,000 the cost of payroll errors could be around £100,000.

Failures can often go unnoticed for years, leading to large settlements. In many cases we see faultless payroll systems for local hires but significant issues on internationally mobile employees.

These issues can turn an incentive into a problem. Employees are not tax experts and expect their employer to deduct the right amount of tax and social security.

Let's take an employee who exercises share options and makes a gain of £30,000. He is pleased and uses the gain to buy a car costing £30,000. 18 months later the HR department contacts him to explain that tax and social security of £15,000 should have been withheld and can he now make a payment? The car is scratched, he doesn't have £15,000 and may have to fund a penalty to the taxman. The glow of the £30,000 gain (the incentive) has turned into a nightmare for which he will probably blame the company (the disincentive).

We may say that he should have expected to pay some tax and is partly responsible for this situation. This is a difficult message, especially where the company has been remiss. Whilst we are thinking about this, add a zero to the gain and think about how your company would handle a director who has a £150,000 problem on a £300,000 gain?

Key Compliance Traps

In this article I have focused on three key compliance issues, withholding, reporting and sourcing.

Withholding

When mobile employees exercise share options or Restricted Stock Units (RSU) awards vest there will generally be tax to pay in one or possibly more countries. In order to ensure that employers meet the tax and social security obligations the company will usually have arrangements in place designed to ensure that the correct amount is withheld. Most share plan rules include withholding clauses. In the majority of countries the company is responsible for deducting tax and making payment to the tax authorities, which is key when dealing with any payroll problems.

If withholding is incomplete for whatever reason, most employers will cover the costs of the unpaid tax and social security as well as any interest or penalties. While some companies may see these as costs which should be claimed from employees, this is often difficult in practice. In particular it is very difficult to reclaim funds from ex-employees. There are also legal points – if a plan provides a 'window' for a company to withhold at the time of exercise or vesting there may be no right to require participants to make payments at any other time. Settlements cover existing and former employees, if the company decides that it is not going to pursue the former employees it may be uncomfortable with asking existing employees for money or advised against this by employment lawyers.

Where employers cover liabilities on behalf of the employees, HM Revenue & Customs (HMRC) may also insist on a 'gross up' of that amount as in effect payment of the tax liability is a benefit to the employee. This is rare but costly as the taxable gain often has to be roughly doubled and then taxed.

The other particular 'nasty' in terms of extra cost is application of the punitive S.222 liability. Currently a S.222 charge will mean that an employee paying tax at 45% will have an extra 20.25% tax cost, which the employer will often fund.

A S.222 charge may occur where funds are not withheld and paid over to the company within 90 days of the option exercise, RSU vesting or other tax point. Where S.222 applies the employee is treated as receiving extra taxable income equal to the unpaid tax. A welcome change from 6 April 2014 will mean that there will be no S.222 charge provided payroll tax is collected from the employee within 90 days following the end of the tax year in which the taxable event occurred.

As stated above in many payroll cases the employer ends up settling the whole bill – 45% tax, 13.8% employers National Insurance Contributions (NIC), 2% employees NIC, 20.25% S.222 and NIC on S.222 together with interest and penalties. This can all add up to an effective tax rate of around 100%!

To help avoid potential withholding issues the best advice is to withhold at source at the employees prevailing tax rate. Failing this, the safest method is to use the top rate of tax and social security. Ideally, shares should not be transferred to the employee until the tax withholding has been satisfied. Typically clients do this, work out the actual liability through payroll and repay any excess funds withheld.

Reporting

In the UK, annual returns for all share incentive plans and employee share transactions are due to be filed with HM Revenue & Customs (HMRC) each year. Returns are due by 6 July each year and record all transactions in the year ended 5 April.

This year is the last year of paper annual returns. From 6 April 2014 new and existing share incentive plans will need to be registered online.

Recent experience with HMRC has also highlighted the extent to which information in the Form 42 is monitored and reviewed. HMRC are undoubtedly increasing their focus on share plan tax compliance. The introduction of electronic filing will help them to identify errors

Sourcing – do you know where your employees are?

It is always best to seek advice on mobile employees and maintain accurate employee movement data in order to assist with sourcing calculations. The rise of short term business trips and the 'super commuter' adds complexity.

Problems with withholding may arise where employees are internationally mobile and companies are unsure where the gain is to be taxed. Questions include: where to operate withholding, on what gain and at what rate? The tax and social security treatment could be aligned or the gain subject to tax in one country and social security in another. In many cases local legislation determines the tax position, if not it is necessary to consider double tax agreements. Mobile employees are often tax equalised or protected, if so the company will have to work through the complex implications of being subject to tax in multiple jurisdictions.

New UK sourcing proposals

This area is constantly evolving as tax authorities are realising that substantial amounts of tax revenue are being lost. In the UK there are proposals for a new sourcing system which will apply from 6 April 2015 and bring the UK into line with OECD principles. The Budget on 19 March 2014 contained proposals for this change to apply to all awards existing on 6 April 2015. Share options granted to non UK residents are not generally subject to UK tax, this is well known. The new rules will means that there will be a potential UK income tax liability if an employee spends any time working in the UK during the life of an award.

Companies will need to ensure that payroll and employees are aware of the new rules.

The 2015 changes are significant, accurate employee data and tracking will be key to good compliance. Companies will have to identify and payroll these gains with HMRC possibly taking a close interest via the new electronic filing regime.

Safeguards against Traps

There are a number of things that you can put in place in order to help safeguard the company. Effective communication between head office, local management and local country payroll is key. In some cases share incentive awards are highly confidential and are not shared with local payroll, these cases frequently lead to payroll problems.

An understanding between all parties is therefore needed to ensure everyone is aware of the payroll and reporting processes for share incentives, and any withholding required on gains made by employees. Usually best advice is to withhold tax and national insurance contributions at the top rates when a gain is made and then detailed calculations can be performed to see what rates the employee should actually be paying.

With internationally mobile employees the sourcing of the share incentives is imperative. Countries have different rules and treaties to apply but generally there is a principal against double taxation. Companies typically need to consider the rules in allcountries where the employee was located between award and vesting / exercise.

Good employee communication is critical. Ensuring employees understand current share incentives and benefits can lead to a greater appreciation and realisation of the value of awards and may be useful in dealing with communications when things go wrong.

Optimise Share Incentives

There are also a number of things that can be done to protect and enhance the company position. Whilst it is natural for an international company to want to use one share plan for all countries, this approach will typically lead to higher tax costs. Some element of country by country personalisation can optimise the tax position whilst still operating within the broad parameters of the main plan.

The first priority has to be a robust withholding system and good employee communications.

The maximum effective UK rate is typically just under 55% (it can be as high as nearly 70%). In many cases it may be possible to use an approved or qualifying sub plan to reduce the tax cost. In the UK it may be possible to use an approved plan and achieve a tax rate of 28% or lower. There are a number of different plans which may be suitable for all employees or for senior executives.

There are a number of approved plans that can be implemented in the UK in order to optimise the position for the employee including all employee plans like the Share Incentive Plan and discretionary plans like the Company Share Option Plan.

The cost of share incentives for companies can be optimised. The simplest way for the company to keep its share incentive costs down is to transfer the 13.8% employers NIC liability to the employee. This is fairly typical, especially for US parented companies.

A recharge agreement should also be considered. A recharge agreement is an agreement between the parent and a foreign subsidiary where the subsidiary agrees to reimburse the parent for the costs associated with issuing the parent company's shares to the subsidiary's employee. The idea is that the recharge payment will not be taxable to the parent as a dividend or otherwise but will be deductible by the local subsidiary. A word of caution is that for some countries (in particular in Eastern Europe and Asia), a recharge can change the employer social security position and increase company social security costs.

Summary

Share incentives are likely to continue to be a key part of remuneration for many mobile employees. Share price growth over the past years means that more value will be flowing throughplans. In the UK and other jurisdictions the tax authorities are striving to address perceived flaws in the taxation of mobile employees. Forward planning and robust systems are vital to protect companies and ensure that the positive messages around share incentives are not lost or diluted.

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