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Employment Tax Update

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This year will see a number of interesting and significant developments in the taxation of employers and employees in the UK. In particular, the 50% top rate of income tax takes effect from 6 April 2010. This alert summarises potential strategies to tackle the new rate and also discusses some important case law and regulation that will be of interest to both EU and foreign nationals working in the UK and their employers.

New Top Rate of Income Tax

In the 2009 Pre Budget Report ("PBR"), the Chancellor confirmed that the UK would be introducing a 50% top rate of income tax for persons earning more than £150,000. With the measures due to take effect in the 2010 tax year beginning 6 April, employers and employees are looking for potential ways to reduce the tax burden. Certain strategies include:

Acceleration of Payments

Some companies have already accelerated salary or bonus payments to employees to fall within the current tax year. This strategy is perhaps less complicated when dealing with bonuses as accelerating salaries will leave employers exposed if the employee wishes to leave during the period for which he has already been paid.

Deferral

Conversely, some employers are considering deferral structures such as employee benefit trusts and so-called "EFRBs". Such structures involve careful planning in the knowledge that HMRC will scrutinise them very carefully.

Structuring Income as Capital

While the rate of capital gains tax ("CGT") remains at 18% (at least until the forthcoming Budget this week), the motivation for structuring income as capital will be increasingly acute as income tax increases. Options include the use of company share plans, where future growth is subject to capital gains tax treatment.

There are other structures that may assist in reducing the tax burden and that provide the requisite commercial flexibility, such as LLPs.

Tax Residence

Many commentators have concluded that the additional tax burdens will force individuals to consider leaving the UK and ceasing to be UK-tax-resident. However, such individuals will now have to think twice given a recent decision of the Court of Appeal ("CoA"). In *Gaines-Cooper*, the CoA extended the circumstances in which an individual could be deemed to be UK-tax-resident. That said, a decision of a First-Tier Tribunal ("Tribunal") in *Turberville* may provide (some) solace to taxpayers concerned about *Gaines-Cooper*.

Gaines-Cooper v HMRC (16 February 2010)

The case concerned two separate applications for judicial review (one from Mr Davies and Mr James and the other from Mr Gaines-Cooper) which were heard together in a single hearing. The taxpayers argued that (i) they were entitled to rely on the HMRC's guidance on tax residency, which was at that time contained in IR20 (now replaced by HMRC6), (ii) they were non-resident under that guidance, and (iii) HMRC had changed its practice after they departed the UK and so should be bound by its earlier practice.

Davies and James left the UK in March 2001 and started employment in Belgium in the tax year 2001/2002, but after 1 April 2001. They claimed that under IR20 they were not resident in the UK for that tax year because they had left indefinitely and for a settled purpose. HMRC argued for the opposite interpretation.

Mr Gaines-Cooper had moved to the Seychelles in 1976. He claimed that the Seychelles had been his domicile of choice since then. Between 1976 and 2004, he had at various times had beneficial ownership of property in the UK, visited the UK, and in 1993 married (in a ceremony in the UK that was subsequently blessed in the Seychelles) a woman from the Seychelles who had been living in the UK for some time and who continued to live there and applied for nationalisation in 1994. The couple also had a son in 1998, who lived in England until 2005, and Mr Gaines-Cooper had business interests in both the UK and the Seychelles. He argued that he had at all times followed the IR20 guidance to ensure his Seychelles residency, but HMRC argued that, on the basis of social and family ties, he had been UK-resident from the tax year 1993/1994 to the tax year 2003/2004.

The CoA agreed with HMRC in both cases. It did, at least, confirm that taxpayers are entitled to rely on the guidance, clarifying its legal status. However, it noted that taxpayers must show they fall within its terms on the facts (which, as Moses LJ acknowledged, is the key difficulty for taxpayers) and, on the CoA's interpretation of the relevant provisions, neither did. In spite of some evidence to the contrary, the CoA also held that there had been no change to the HMRC's policy and it was clear that the taxpayers had experienced evidential issues in attempting to prove this. Leave to appeal has been refused by the CoA.

Despite the helpful clarification of the legal status of the guidance, the judgement can clearly be seen as a "result" for HMRC. For taxpayers and advisers, it is unfortunate that as well as potentially extending the scope of residence to catch more people (on the basis that it will prove difficult for taxpayers to establish as a matter of fact that they fall within (or outside) the statements set out in IR20), it introduces confusion.

Phillip George Turberville v HMRC (3 February 2010)

The decision of the Tribunal in this case was released a few days before the final decision in *Gaines-Cooper*. Although a more helpful view of residence was taken, the higher Court authority rests with the *Gaines-Cooper* decision.

Mr. Turberville was born and raised in Scotland. Working for Shell and then TXU, he had been resident and ordinarily resident in England from tax year 1997/1998 to tax year 2000/2001. The case concerned the two tax years after that. First, in July 2001, he started work in Dallas, USA under a three-year contract with a TXU entity and stayed in a flat provided by the company, on which he spent significant sums of his own money while renovating. However, he was made redundant on 31 October 2002, when the company hit financial difficulties. He did agree to provide consultancy services to the UK administrators until January 2003. His redundancy agreement was governed by the laws of Texas. In November 2002, with his wife, he signed a one-year lease for a flat in Monaco, to start on 1 December that year. In his US tax return for 2001, he had stated that he was resident in the UK.

During this period, Mr. Turberville had a number of ties to the UK. In the tax year 2001/2002, he spent 130 days in the UK. For example, he had owned a house in the UK throughout the disputed period. The Tribunal held that they had to take into account the facts that had upset the regular order of his life, including his redundancy, his short-term consultancy work in the UK and his house hunting in Monaco – all factors that meant “it was possible to say he did not have a regular order of life anywhere”. Accordingly, they held he was not ordinarily resident in the UK.

Employment Related Securities: *Gray’s Timber Products v HMRC* (3 February 2010)

In the judgement of the Supreme Court, which was handed down on 3 February 2010, the Court considered the circumstances in which an income tax charge could be triggered by the sale of an employment-related security (i.e. shares in a company) at above “market-value”.

The case concerned a taxpayer (Mr Gibson) who, through his employment as the managing director of Grays Timber Products Limited (“BTPL”) had acquired certain shares in BTPL. He subsequently entered into a “shareholder and subscription agreement” with his fellow shareholders. This agreement provided that, should the company be sold, he would be entitled to a share of the sale price according to a formula contained in that agreement, and not simply in proportion to the number of shares he held. The formula would operate to multiply his potential gain by more than 300%.

When BTPL was sold to Jewson Ltd in 2003, HMRC contended that the difference between the £400,000 he would have received on a pro rata basis and the £1.4m he actually received was taxable as income. Mr Gibson argued that he should be instead charged for the capital gain between the £1.4m and the original price paid for the shares.

The case turned on the construction of Part 3D of Part 7 to the Income Tax (Earnings and Pensions) Act 2003, which provides that where employment-related securities are disposed of for consideration exceeding their “market-value”, income tax is chargeable. The critical issue was whether rights under the shareholder agreement could be taken into account in valuing his shares. The court held, agreeing with HMRC, that they should be excluded because such rights were personal to Mr Gibson and would not pass to the purchaser.

It would appear that this income tax charge would not be triggered if the right to receive the additional consideration was included in the relevant company’s articles and clearly expressed not to be personal to the employee, but rather to accrue to any holder of the shares. *Gray's* clearly highlights the importance of considering the employment-related tax regime in corporate transactions involving the disposal of shares in companies by employee shareholders.

Payments in Lieu of Notice: *Clinton v HMRC* (2 December 2009)

Following the 2007 decisions in *EMI* and *SCA Packaging*, it has been clear that payments in lieu of notice ("PILONs") can be treated as earnings and, as such, are subject to income tax where an express PILON provision is incorporated (either specifically or by reference) in the relevant employment contract. The recent case of *Clinton v HMRC* concerned whether such clauses could be deemed included in an employment contract by custom and practice.

Mrs Clinton resigned in 2003 from a job she had held since October 1996. She alleged constructive dismissal on the part of her employer, Bristol Meyers. Although the employer did not accept her claims, it offered to pay a lump sum equal to three months' notice. HMRC alleged that this payment was taxable as at least one of the following:

- A contractual PILON under the terms of her employment agreement;
- A PILON implied into her employment agreement by custom or practice; or
- A payment pursuant to the agreement to terminate her contract.

The Tribunal rejected HMRC's argument. They held that, as Mrs Clinton had argued, the payment was either made *ex gratia* or in settlement of her alleged claims against the company.

The verdict in this case emphasises that, if tax certainty is sought, it is vital to ensure that in any relevant correspondence with an ex-employee the reasons for the dismissal and any related payment are set out clearly.

New EU Regulations for Social Security Payments for Employees

Beginning 1 May 2010, new EU regulations will come into force and, as a consequence, certain NIC rules will change. HMRC has published guidance on these changes, which will principally be of interest to employers whose staff work in more than one member state.

The basic rule for social security contributions is that they are payable in the state where the work is carried out. Thus, if a UK citizen takes a job in Germany, he or she will pay social security in Germany and cease doing so in the UK. However, subject to certain transitional provisions, those who work in multiple member states or who have been temporarily posted abroad should note the following:

- Beginning May 1, persons posted temporarily to another member state will remain subject to UK NICs if it is anticipated at the outset that their post will last fewer than 24 months (rather than 12).
- Employees who work in more than one state will be subject to the social security legislation of the state in which they reside if either: (i) they pursue a "substantial" part of their activity in that state; or (ii) they are employed by various businesses or organisations with registered offices or places of business in different states.

- Provisions aimed at better cross-border enforcement of social security debts and information-sharing between tax authorities are included in the new rules.
- The UK has chosen to opt out of the new rules for third-party nationals (e.g. US citizens).

New Procedural Requirements for Foreign Nationals Working in the UK

When an individual comes to work in the UK, they need to be integrated into the PAYE system and HMRC needs to be notified that the individual will need to file a tax return. HMRC has recently made certain procedural changes to its system for doing so, which differ depending on whether the employee is seconded to the UK or is a foreign national directly employed in the UK. It should be noted that, as of January 2010, HMRC may impose penalties where employers fail to notify it of the engagement of any such employees.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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