



## **Global Reward Update**

### United Kingdom – Implications of withholding errors on equity income

#### **Background**

While many companies have clear processes in place to operate withholding when a tax charge arises relating to their share plans, occasionally errors may be made and PAYE withholding is not applied when it should be.

In these circumstances an additional charge to tax known as a “section 222 charge”, may arise for UK employees. This charge can significantly increase the cost implications of such failures.

HMRC have recently released further guidance concerning this charge, and the circumstances in which it may apply.

#### **The s.222 Charge**

The aim of s.222 ITEPA 2003 is to ensure that an employee receiving equity (or other “notional”) income is no better or worse off than one simply receiving a cash payment, where PAYE and social security apply. The original intention of the legislation was to prevent abusive schemes designed to avoid income tax. However it can be applied to situations in which an employee does not make good their income tax and social security on an equity-related taxable event.

In summary, a s.222 Charge may apply where a withholding obligation arises which is not “made good” by the employee within 90 days of the end of the tax year in which the relevant taxable event takes place (whether or not the employer actually pays the tax due via PAYE). The amount not “made good” by the employee to the employer is treated as additional earnings liable to PAYE and NIC, and reportable through the annual summary of benefits, P11D.

In settlement situations, companies often choose to bear this tax and NIC cost rather than pass it on to employees, which can significantly increase the costs to the employer.

### **HMRC's new guidance**

The updated guidance provides commentary on key cases, namely the Chilcott case (Court of Appeal) and the Benedict Manning case (First Tier Tribunal). The conclusion from these cases is that whilst the application of s.222 should not concern the "fairness" of the charge, the application is not an automatic process. HMRC should consider all the relevant facts in a reasonable manner and conclude on whether or not the requirements of s.222 are or are not met.

Whilst the wording of s.222 is clear and unambiguous, the Courts urge HMRC to consider the unique facts of each case and whether applying a s.222 Charge would fall within the intention of the legislation.

### **Use of indemnities**

Many share plans include a requirement for the employee to fund income tax and social security payable on their awards; an indemnity clause.

The Benedict Manning case (found in favour of the taxpayer) highlighted the importance of the inclusion of an indemnity agreement which created a contractual liability on the part of the employee to reimburse the employer the PAYE and NIC due. The Court determined that this (along with the true intention to apply it) was sufficient to determine that s.222 should not apply.

The inclusion of such an indemnity within the terms of equity awards is therefore key, however the guidance emphasises that the inclusion of the indemnity is by itself, not enough to fall out of the charge. The intention that it would be applied in the relevant circumstances should be demonstrated. Again this highlights that the facts of each unique case should be considered on their own merit.

### **Action**

The inclusion of an appropriate indemnity agreement within equity award documents is key to potentially minimising the charge should it ever become relevant. It must also be demonstrated that the intentions of the relevant parties was always to apply the indemnity. In many cases this will be clear from other equity transactions for example because the employer has a clear "sell to cover" process in place. If an employee actively accepts their award, this also supports the intention that the employee agrees to pay the PAYE and NIC.

Companies should ensure that new and existing equity arrangements include appropriate wording and that the relevant individuals are made aware of their obligations under PAYE where equity (or other "notional") payments are received.

Companies in the process of discussions with HMRC on past payroll failures should consider the following:

- whether an appropriate indemnity exists in any form (this may extend beyond award documents);
- how and why the PAYE failure arose; and
- whether any other mitigating factors arise.

Deloitte has significant experience of supporting such discussions with HMRC and could support you in this process.

As mentioned above, although the s.222 tax liability is strictly an employee liability, it is not uncommon to see employers covering the tax cost on an employee or ex-employee's behalf where this has arisen through a company process failure. This means that any mitigation of the charge may reduce the cost to the employer.

## People to contact

For assistance with these issues, or any other issue related to the operation of your global equity plans, please contact your usual Deloitte adviser or email us at [globalshareplans@deloitte.co.uk](mailto:globalshareplans@deloitte.co.uk), and an adviser will contact you.

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