Restricted stock units: the cost of vesting

Large Corporate | Employment Tax



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We consider the impact of vesting restricted stock units for UK based employees.

Key Points

What is the issue?

Restricted stock units are a promise to issue stock units in the future to employees by a company. The granting of restricted stock units has no effect but the ‘vesting’ of units has tax reporting requirements for UK based employees.

What does it mean for me?

A tax advisor needs to know the UK tax reporting and compliance obligations when advising on restricted stock units.

What can I take away?

Reviewing foreign restricted stock units vesting to a UK resident are complex with UK multi-tax reporting requirements; i.e. PAYE, capital gains tax and NICs.

Often shares or units in an employing company abroad, say the US, are granted to their UK resident employees, who may hold these grants until a ‘vesting’ date in the future when certain UK taxes are often due under compliance requirements.

The grant itself is not a UK taxable event, although certain US Internal Revenue Service requirements should be adhered to by US based employees. However, we are dealing here with staff on a UK based payroll in the examples.

The completion of Form W-8BEN (Certificate of foreign status of beneficial owner for US tax withholding and reporting) by the UK taxpayer informs the US agent (usually a US broker) that a foreign person is claiming a reduced rate of tax withholding in the US or an exemption from withholding taxes. This goes to the agent or broker to handle.

This then applies the double tax treaty relief rate withholding rate and reporting of dividends applying to UK individuals in respect of their restricted stock unit payments.

Restricted stock units

HMRC Employment Related Securities Manual explains the function of restricted stock units: Long term investment plans frequently use what are known as restricted stock units, or restricted share units. A restricted stock unit award is normally an agreement to issue stock or shares at the time the award vests. An award will vest when all the conditions laid down to be satisfied before the stock or shares may be issued have been met, such as the required duration of time, period of employment or performance criteria. Again, the particular facts of any award, rather than its label, will determine the correct tax treatment.

No shares are delivered until the employee satisfies the vesting schedule. The vesting schedule will set out when, and to what extent, the restricted stock units will

vest: for example, 20% per year over five years. At each vesting date, employees will receive company stock equal to the net value of the restricted stock units which have vested.

Companies use units instead of the actual restricted stock or shares, because they can:

- postpone shareholder dilution until the time of vesting;
- get consistent tax treatment and timing internationally; and
- even if the share price falls after the award date, the restricted stock unit still retains some value, unlike a market value share option.

US and other foreign corporations, in particular, like to structure their incentive plans using them.

Market value of shares

The market value of the shares is determined as the closing quoted share price on the vesting day. If the vesting date is a weekend or holiday, the previous day's closing price is taken.

The agent can and usually does sell sufficient of the vested shares to ensure that the UK payroll tax and NICs liability is met, as vesting is treated as UK employee pay rather than capital gains at this stage.

The spot exchange rate on the vesting date is used by the agent in conversion from $ to £, taking into account a standard withholding rate deduction of 47% by the agent to cover the UK additional rate tax (45%) and NICs (2%). Credit is then given in the UK payroll against the actual PAYE and NICs for the amount withheld by the US agent.

There may be a balancing refund due to the UK employee whose marginal rate is less – say, 40% not 45% – which is settled by a further payment by the UK payroll. See ***Example 1: Balancing refund***.

Example 1: Balancing refund

Grant, a UK resident employee of Acme Corp, had restricted stock units of 40 shares vesting in 2023. They had a market value on vesting day of $200 each ($8,000). Grant's US broker sells 19 of the vesting shares at $201 each (total $3,819) to cover the required US withholding maximum of 47% on the 40 vested shares:

$8,000 x 47% = $3,760

UK payroll then calculates the individual's actual UK tax and NICs deduction at, say, 42% (i.e. 40% income tax and 2% NICs).

$8,000 × 42% = $3,360

The spot exchange rate for $ to £ is, say, 1.25 which means UK payroll tax deduction is:

$3,360 × 80% = £2,688

£2,688 is needed by payroll to settle the UK tax element. Credit is given for the excess US withholding of:

$3,760 - $3,360 = $400

This means $400 × 0.8 has been over-withheld and is repaid by UK payroll to Grant in the sum of £320.

Capital gains

The remaining shares vesting are held by the US agent until they are subsequently sold, which will give rise to a capital gain or loss (see ***Example 2: Capital gains****)*.

A capital gain results in a UK tax charge of 10% or 20% when added to the UK resident employee's marginal rate of tax. Losses carried forward or arising in the same tax year and the annual capital gains tax exemption are taken into account.

Example 2: Capital gains

Grant later decides to sell his remaining vested restricted stock units. He therefore advises his appointed US broker to sells the balance of his 21 remaining vested shares at the market value of $250 each at that time. This creates a capital gain on

the vesting price which must be accounted for on Grant's UK self assessment tax return. Any gain would be taxable at 10% or 20% depending on Grant's marginal UK tax rate.

In this case, Grant has made a capital gain of:

21 × ($250 - $200) = $1,050

On conversion of $ into £ at, say, 1.25, this gives £840. As this is below the annual capital gains tax exemption threshold of £6,000 threshold for 2023/24, the gain on sale does not need reporting. Also, it is below the multiple annual exemption threshold for reporting (i.e. 4 × £6,000 = £24,000), so no reporting of the disposal is required.

If a loss occurred on sale, Grant would have four years in which to claim the loss.

Dividends and dividend equivalents

A distinction should be made between 'dividend equivalent' payments and 'dividend' payments.

Dividend equivalent payments

'Dividend equivalent' payments are payments made in respect of unvested shares following grant but which have not been issued. See HMRC's Employment Related Securities Manual ERSM20193.

Such 'dividend equivalent' payments are treated like salary and are taxed in the UK as in Example 1.

Dividend payments

Dividend payments are made in respect of already vested shares, following the correct submission of Form W-8BEN attracting a US 30% withholding tax, which is shown subsequently on IRS Forms 1042-S. There are usually four of these in a year as US companies typically pay dividends quarterly.

The UK reporting of such dividends and withholding tax are reported on the foreign pages of SA106 and the UK return noted accordingly.

International issues

As international companies may have internationally mobile employees working in various of the company's overseas jurisdictions, there may be a gap between grant and vesting, so that the employee was in foreign jurisdictions on the shares being granted but resident in the UK on the vesting date.

In cases such as these, the vesting award should be apportioned for only the days that the employee has spent in the UK (see ***Example 3: International issues***).

Sometimes employees on the UK payroll working are seconded to, say, the overseas head office and this may require a change in payroll administration. Since 2006/07, payroll can operate modified NICs in cases of employees who:

- are seconded abroad;
- are non-resident in UK for tax;
- pay NICs on earnings above the upper earnings figure; and
- receive part of their earnings from the payroll.

The UK payroll pays the NICs on a best estimate until the exact figures of NICs and earnings are known, which is then reported on a NIC Settlement Return.

Example 3: Internationally mobile employees

Grant has been resident in the UK since 6 April 2023, but he was previously working for the company in Singapore when shares were granted. The shares were vested on 5 February 2024.

As a UK resident on vesting, Grant will be subject to tax and NICs on the apportioned award based on the period spent in the UK from 6 April 2023 to the vesting date. The foreign tax position will not be of concern to UK payroll.

In summary

It is clear that restricted stock units are a good, if complicated, way of inspiring employees to engage with employers. However, like all employee benefits they

come with a price and tax deduction.

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