Board Walk

Briefing for Remuneration Committees

mm&k

APRIL 2016

This edition of Board Walk includes:

The challenge of demonstrating executive pay is fair – with a nod to the man in the Panama hat

Paul Norris considers a major challenge for remuneration committees.

There but for the grace of God

Recently, we all received a stark lesson about the value of clear, unambiguous and timely communication. By his own admission, the Prime Minister's predicament following revelations about benefits derived from an off-shore investment fund owes much to the way that he has handled the news. It has further promoted deep-felt feelings of unfairness – that there is one rule for the rich elite and one rule for others. The fall-out is damaging to his reputation and public image.

How many remuneration committee chairs of main board listed companies are thinking: "*There but for the grace of God go I*"? The situation they have to deal with is similar to that faced by the Prime Minister. There is growing moral outrage at the level of CEO pay and the pace at which it is moving away from the pay of the average worker. To many (including some executives!) the link between executive pay and performance is opaque. Justifying executive pay simply on the grounds that it is necessary to "*attract, retain and motivate*" the necessary executive talent, results in scepticism, lack of trust and, potentially, reputational damage.

In 2017, many listed companies have to go back to shareholders for a binding vote on their future remuneration policy. Early indications from voting in the 2016 AGM season suggest that, once again, remuneration committees will be in the firing line.

The nature of the challenge

There will always be those who criticise the (un)fairness of executive pay. BP is one recent subject of such criticism.

They will tend to focus on:

- amounts paid
- CEO pay relative to the average worker
- weak performance targets
- payments for failure
- a perceived lack of sensitivity.

Some of the criticisms are justified.

Remuneration committees will be aware of the complexity of the challenge. The wide variation in strategies, cultures, capital structures, risk profiles and business sectors to be taken into account when designing remuneration policy makes it impracticable to convey here the depth of the

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

challenge. The diagram (fig. 1) below illustrates the range of factors to be taken into account.

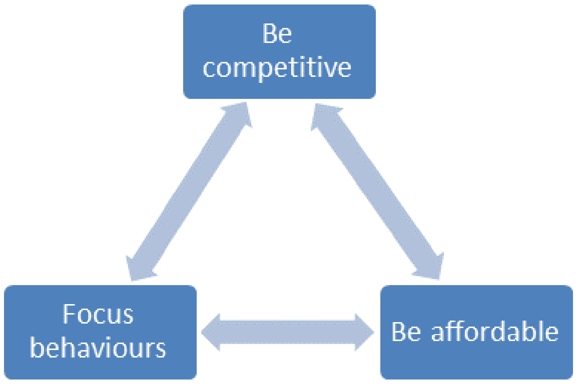
Figure 1:

If Remuneration Committees could play one card, what should it be?

MM&K's approach to executive pay is that it is a means of helping company boards deliver their company's strategy. It does this by communicating the required behaviours and the rewards payable for success.

A challenge for remuneration committees is to design policies which take into account and balance three competing policy objectives (see fig. 2).

Figure 2:



Few would argue with the need to pay the "going rate". Being affordable means balancing employment costs, dividends and the amounts required for re-investment. All are essential elements of a sustainable business.

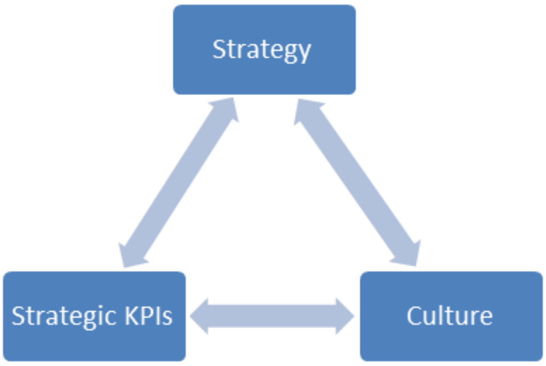
Focusing on and encouraging the right behaviours is, arguably, the most challenging element. To get this right, remuneration committees need a thorough grasp of the company's long-term strategy, the strategic key performance indicators and the value created if the agreed strategy is successfully implemented and of the company's culture (see fig. 3).

As board members, remuneration committees should have no difficulty getting to grips with strategy. Listed companies are required to report on strategy in their Annual Reports. The Strategic Report must describe the company's financial and other KPIs to give the reader "*an understanding of the development, performance or position of the company's business*"[1]. But, what many companies describe as their KPIs are not strategic and only reflect historical results. They should not be the principal performance measures to which long-term incentives are linked.

[1] [The Companies Act 2006 (Strategic Report and Directors' report) regulations 2013]

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

Figure 3:



If the remuneration committee could play only one card, it should be the ace: forward-looking strategic KPIs.

Why this card?

By identifying clear strategic KPIs, the remuneration committee:

- demonstrates it understands the company's strategy
- shows it understands what needs to be done and knows what signposts to look for to indicate if management are doing the right things and the company is on track
- provides itself with a means of justifying and communicating the amounts of remuneration paid in relation to the value created.

What is a strategic KPI? Strategic KPIs look forward and indicate the progress the company is making towards its business plan goals; goals, which, if achieved, should produce the financial results and positive share price performance reflected in many currently stated KPIs and incentive plan targets. For example, a retail business might look to the number of new store openings, net promoter score, growth in sales and margin. An oil company might look to its projected free cash flows and growth in asset values or reserves replacement.

FRC guidance goes further than the legislation in recommending that the Strategic Report should include both financial and non-financial KPIs necessary to give *"an understanding of the development, performance and position **or future prospects of** the company's business".*

Historical financial measures, which by their nature look backwards, are not strategic KPIs and may not reflect the achievement of business plan goals. Nor is total shareholder return (TSR), once much-loved by institutional shareholders but waning now as a favoured measure of executive performance, a strategic KPI. TSR is a lottery when measured relative to a peer group or index and, in either its relative or absolute form, owes too much to market sentiment and not enough to the value created through direct management action.

That said, TSR remains the ultimate measure of value for investors.

How does this help demonstrate pay is fair?

In his paper entitled "Fair or Unfair? getting to grips with executive pay",[2] Peter Montagnon, Associate Director of the Institute of Business Ethics ("IBE") makes the sage observation that fair pay does not mean low pay. The IBE paper is wide-ranging and there is much in it which echoes MM&K's approach.

Large amounts of pay may be justified but are likely to attract criticism. This is inevitable. It is essential that remuneration committees can and do communicate, internally and externally:

- how remuneration policy supports the company's strategy and
- that amounts paid are reasonable in terms of the value created.

Clear strategic KPIs, used to determine incentive payments, help to demonstrate the link between pay and performance and create a platform from which to justify and communicate executive pay awards in a clear, unambiguous and timely fashion.

[2] "Fair or Unfair? getting to grips with executive pay" published by The Institute of Business Ethics in February 2016

Conclusion

It will not be possible to demonstrate to all that executive pay is fair. But remuneration committees must rise to the challenge.

Whilst an exclusive focus on strategic KPIs will not provide the whole answer, it does require remuneration committees to address and rehearse factors which will enable them to present a cogent argument and one which they can credibly support.

Next year many listed companies will have to submit their future remuneration policies to a binding shareholder vote. In addition, from 30 April 2018, companies employing more than 250 people must comply with new legislation on gender pay gap reporting – another challenge for remuneration committees (see page 9).

To discuss this article, please contact:
paul.norris@mm-k.com

STOP PRESS

IA Working Group publishes interim report

Paul Norris comments on the IA's progress towards pay simplification.

Set up in September 2015 to report on simplifying executive pay, the Investment Association's Executive Remuneration Working Group published its interim report on 21 April 2016.

This is a precursor to round-table discussions with "important stakeholders" about alternative pay structures and parameters or guidance on how they might work for different companies.

The headline-grabber is the working group's view that the current approach to executive pay is not fit for purpose. But the really important points lie in the report's comments about:

- getting fund managers engaged on incentives
- no one size fits all
- performance measures; particularly the shortcomings of relative measures
- remuneration committees exercising judgement and being held accountable.

Having concluded that salary, annual bonus and pension are standard elements in all executive packages, the report focuses on long-term remuneration and alignment with shareholders.

To some readers, the report may not reveal much new thinking but it is evidence of a strength of feeling that something must be done about the worst excesses of executive pay. The report describes a "suite of alternative (long-term) remuneration structures" upon which the working group invites discussion. We would be concerned if the outcome was a menu of approved long-term structures from which remuneration committees may choose. We think it would be consistent with the important principles of accountability and ensuring remuneration is tailored to the needs of each company, to leave it up to remuneration committees to propose and justify the structures they think will work best in their companies.

The focus should be on supporting remuneration committees and providing that the processes for holding them to account are fit for purpose.

We will keep abreast of the working group's progress. MM&K's Damien Knight will be joining its round-table discussion with the QCA.

To discuss this in more detail, please contact: paul.norris@mm-k.com and if there are any points you would like us to raise in discussion with the IA, please contact: damien.knight@mm-k.com

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Developments in MM&K's private equity and venture capital compensation services

Jonathan Brigginshaw describes some exciting developments for the private equity sector.

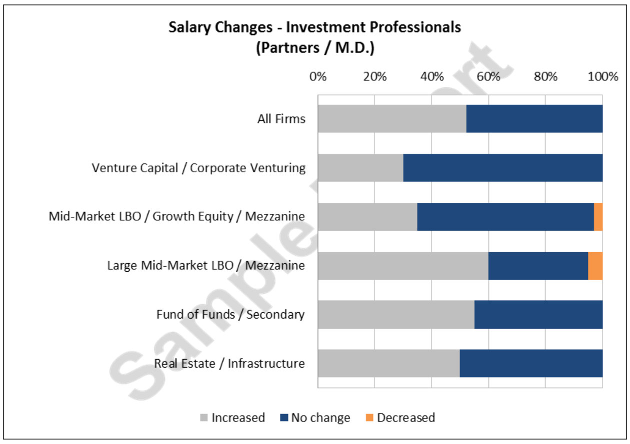
In 2015, MM&K became a member of GECN - a global strategic alliance of leading independent advisory firms, focused on helping clients build value through their governance and compensation practices. As a result MM&K has broadened its capabilities to provide global remuneration advice and products.

The private equity sector is already benefiting from this alliance. MM&K produces one of the leading annual surveys on remuneration, carry plan and HR practices in UK and continental Europe private equity and venture capital firms. Outside GECN, MM&K partners with Holt Private Equity Consultants and Buyouts Insider (formerly part of Thomson Reuters) in the USA to produce separate reports for the UK and Europe and for North America.

Additionally in 2016, we are very pleased to be working with GECN partners, HCM International AG, a leading Swiss consultancy and Carrots for Financial Services in Singapore, to enhance the survey's global coverage. HCM have designed numerous remuneration and carry plans for their clients in Europe. Carrots specialise in people-pay-performance management strategies, with a focus on Asian PE/VC compensation.

We are looking forward to attracting even greater participation levels in 2016 from this strong global alliance and enhanced coverage. Specifically, the UK and continental Europe report will contain a detailed analysis of Swiss PE/VC remuneration practices. We will also be working closely with Carrots to help them produce a standalone Asian survey, which will complete our series of three PE/VC compensation reports covering the **UK** and continental **Europe**, **North America** and **Asia**.

The following diagram shows an example of the survey output:



This diagram is for illustration only and does not contain "real" data

Our 21st *Global Private Equity & Venture Capital Compensation Survey* was launched at the beginning of April 2016 and is now open to firms wishing to participate this year. The European survey covers 32 investment and non-investment roles in a range of alternative asset management strategies, including:

- Buyout
- Growth Capital
- Venture Capital
- Seed Capital
- Distressed/Turnaround
- Debt
- Secondary
- Fund of Funds
- Infrastructure and Real Estate
- Mezzanine

In addition to the report, we offer a management summary table which shows, role by role, a comparison between a participating firm's own remuneration levels and the market quartiles.

For more information or to participate, please contact: jonathan.brigginshaw@mm-k.com or visit www.mm-k.com

Life in the Boardroom - The Chairman and Non-Executive Director Survey

Jonathan Brigginshaw reports on Life in the Boardroom.

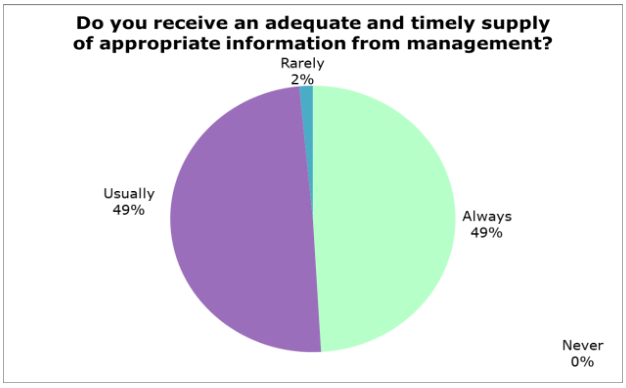
In December 2015, MM&K published its annual chairman and non-executive director survey, *Life in the Boardroom*, marking its 25th anniversary. MM&K produces the survey in partnership with Preng & Associates, the global energy search consultancy. This connection will enable us again this year to produce a special supplement for oil & gas companies.

Life in the Boardroom is unique in that we collect data directly from the directors themselves, not from company staff or annual reports. This defining feature, together with the broad range of thought-provoking topics and opinions presented in the report, helps to secure a high level of participation each year. 285 chairmen and NEDs took part in our latest survey, representing 593 board appointments.

The report is divided into two sections. The first provides statistics on chairman and NED fees, fee increases and time commitments.

The second section recounts participants' views on a variety of board practices and governance issues. This section includes general comments and comments specifically related to each type of company ownership.

The increasing level of responsibility both internal and external remains a key topic. Internally, NEDs need to establish an adequate flow of information from management, to ensure transparency and that they have the right tools to guide the Board effectively. Last year, a number of respondents spoke strongly about the problems of receiving timely and complete information. The responses were more positive this year:



Some participants offered advice on how to approach the issue and a procedure to follow if relevant information is not forthcoming:

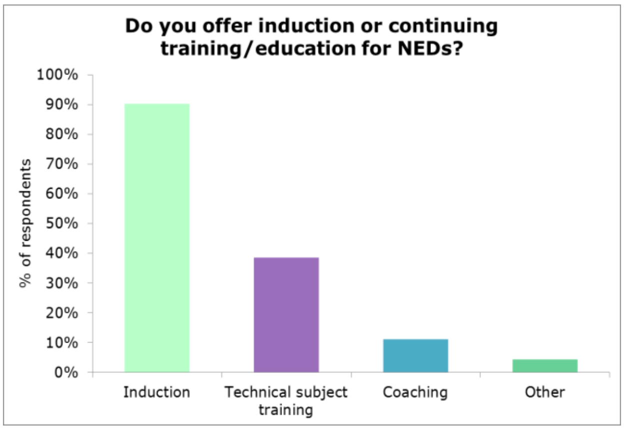
- "NEDs should articulate clearly exactly what information they want and explain the reasons why they feel this is necessary for them to perform their role. Rather than just criticising something, NEDs should propose workable solutions."
- "Talk to the chairman; if not satisfied talk to the senior NED; if not satisfied raise it with other NEDs; if not satisfied, seek board appraisal by an external adviser; if not forthcoming, resign."

Participants also noted increased external demands, with a number pointing the finger at heightened regulation and compliance:

- "Too much time and even more energy is being taken up by governance processes, leaving too little time for conceptual thinking and strategy."
- "Some stability in regulation and legislation would be most welcome. Most NEDs need some catch up time if we are to provide the support owed to our companies."

Keeping pace with fast moving regulatory change is time-consuming, so do NEDs feel they have sufficient and relevant educational resources to keep up?

With only 40% of respondents receiving technical subject training and only 3% of a NED's time being spent on learning, it is difficult to conclude that NEDs have sufficient support to meet growing external demands.



Given the increased pressure on their role, it is no surprise that the proportion of NEDs who feel their fees have not kept pace with increasing demands has risen to 42% compared with 38% last year. However, they may take encouragement from the evidence that chairman and NED fees, for the first time in recent years, seem to be increasing faster than executive directors' salaries!

Life in the Boardroom *is available free to participants in electronic form and in hard copy on request. Non-participating individuals may purchase the report for £250. The cost for firms is £1,000. VAT, where applicable, is payable in addition. To purchase the report or to participate in the next survey, please contact: jonathan.brigginshaw@mm-k.com*

Life in the Boardroom Breakfast Seminar

This year's seminar will be held on 17 May at the RAC in Pall Mall, London.

A breakfast buffet at 8:30am will be followed by:

- a short presentation of the survey findings
- a question and answer session
- a talk from guest speaker, Richard Moon, on the evolution of the Chairman and NED roles and their relationships with executive management.

Formerly Chief Executive of Racal Electronics and Thales UK plc, Richard is Chairman of Acal plc, Seven Technologies Holdings Ltd and Synergie Business Ltd.

The seminar ends at 10:30am. Each guest will receive a complimentary copy of *Life in the Boardroom*.

To attend or to receive further information, please contact: jonathan.brigginshaw@mm-k.com.

The end of pensions for top executives?

The UK Government's measures to reduce the costs of tax relief for pensions are causing employers to have a radical re-think of their pension arrangements for top executives – and even for less senior ones.

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

From 6 April 2016:

- The amount of pension savings that can be made in any year by or on behalf of an individual under all registered pension schemes (the "Annual Allowance") has been capped for those whose "adjusted annual income" is more than £150,000. The standard Annual Allowance of £40,000 will be tapered by £1 for every £2 by which their incomes exceed £150,000, which means that for those with incomes of £210,000 or more the maximum contributions without incurring tax penalties will be £10,000 per year. "Adjusted annual income" means taxable income (including dividends and interest) plus the value of any pension contributions, whether by the employer or the employee. Those with taxable incomes above £110,000 could therefore be affected by the reduction in the Annual Allowance.

- The amount of benefits that can be saved by individuals in registered pension schemes (the "Lifetime Allowance") has been reduced from £1.25 million to £1 million. Any additional benefits are subject to the "lifetime allowance charge", which is at 55% if the excess funds are taken as a lump sum. Some less senior executives could be impacted by this charge. For example, an individual retiring with 25 years of service and pensionable earnings of £120,000 will have built up a fund worth £1 million through a 60ths defined benefit scheme, even with no AVCs. Executives affected by the reduced Lifetime Allowance (who have not previously registered for one of the protections) will need to register for Fixed Protection or Individual Protection 2016 to preserve their pension benefits as at 5 April 2016. In most cases, they will not be able to have any further pension contributions or to accrue further benefits.

For an increasing number of executives, participation in their employer's registered pension schemes will no longer be attractive. What should employers do instead? In the past, many companies have just paid additional cash in lieu to executives affected by the Lifetime and Annual Allowances. However, it will become less justifiable to make large cash payments which are neither tax-effective nor linked to performance.

Tax-advantaged pensions will necessarily become a less significant part of the executive remuneration package and special enhanced pension entitlements for directors are likely to disappear. There will be some consolidation of pension contributions into salaries; but companies must take account of the consequential increase in value of salary-related items, such as bonuses, long-term incentive awards and life cover.

Over the shorter term, companies may decide to modify salaries, target annual bonuses and expected value of long-term incentive awards to put executives in broadly the same position as before, for example:

Current package	
Salary	£200,000
Target annual bonus (50%)	£100,000
LTI expected value (35%)	£70,000
Pension contribution (15%)	£30,000
Total	**£400,000**
Revised package	`
Salary	£216,000
Target annual bonus (50%)	£108,000
LTI expected value (35%)	£76,000
Pension contribution	£0
Total	**£400,000**

Over the longer term, we can expect pensions for all employees to be gradually transformed into arrangements to allow employees at different stages to accumulate capital for other lifetime events, which may include provision for mortgages and children's education as well as retirement.

To discuss this article, please contact:
michael.landon@mm-k.com

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

The QCA 2016 Remuneration Committee Guide for small and mid-size quoted companies

Cliff Weight, who was involved in its drafting, previews the forthcoming QCA guidance on remuneration.

The Quoted Companies Alliance champions the interests of small to mid-size UK quoted companies. It is independent and has nearly 2,000 members, representing 85% of all quoted UK companies. QCA members employ approximately 1.4 million people, which is 5.5% of the UK private sector workforce.

The QCA is about to publish an updated version of its remuneration guide, last published in 2012. Since then, the new Directors' Remuneration Reporting Regulations, which apply to all UK premium-listed companies, have been introduced.

AIM companies and some main-board listed companies are not bound by the regulations or the UK Corporate Governance Code. However, they are encouraged to develop strong governance procedures and to adhere to the QCA good governance guidance, which is designed to cater specially for the needs of growing companies.

A new section 4 of the QCA remuneration guide will provide a high-level explanation of the 2013 changes to the legal regime on remuneration reporting.

Reflecting the increased focus on shareholder relations, the new QCA guide also includes an expanded section on Communicating with Shareholders (section 6) and a separate section on the Remuneration Report (section 7).

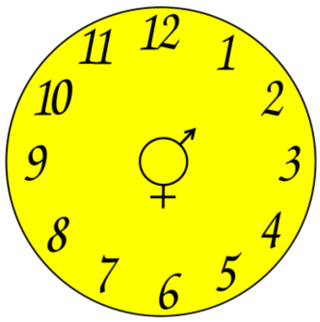
The new QCA remuneration guide stresses:

- remuneration arrangements play an important part in motivating executive directors to create value for shareholders
- remuneration should be proportionate, rational and measured; clarity and transparency are important for building trust between companies and shareholders
- it is vital for companies to disclose openly the reasons for remuneration committee decisions; similarly, shareholders must engage with companies on remuneration
- clear and transparent engagement on matters of remuneration will build trust, respect and mutual understanding between companies and their shareholders
- dealing with remuneration in an appropriate manner lies at the heart of good governance; remuneration committees must ensure that companies adopt appropriate performance measurement tools which motivate executives to do the right things and support a positive culture in the company
- its purpose is to provide practical guidance to small and mid-size quoted companies and to support the development of effective remuneration packages for executive directors.

For more information, please contact:
cliff.weight@mm-k.com

Gender pay gap reporting – the countdown is about to start

Stuart James considers the government's new legislation on gender pay gap reporting.



All companies, public or private, with over 250 UK employees will be required to report on their gender pay gap as at 30 April 2017.

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

Timing

New legislation, due to come into force on 1 October this year, has yet to be enacted but the clock is about to start ticking. MM&K has made representations to the Government to clarify the level of reporting required but we do not expect the draft legislation to change significantly.

Information required

Each relevant employer must publish:

- differences in mean and median pay between male and female employees during the "pay period"
- differences in mean bonus payments over the last 12 months
- the proportion of male and female employees who received a bonus
- the distribution of males and females within quartile pay bands.

Practical questions

Detailed HMRC guidance is awaited but questions we are already considering with clients include:

- What is the company's current gender pay gap position?
- Do internal systems exist to capture the necessary information?
- Who will sign off the gender pay gap disclosure?

Action to be taken now

To ensure the task is completed, the first step is to allocate responsibility for collecting and analysing the data to an appropriate person (or team) within the company. This could fall to the HR, Company Secretarial or Legal function.

Whilst the "snapshot" reporting date is 30 April 2017 (with disclosure due within 12 months) we encourage all companies likely to be affected by the new rules to undertake a review now to ensure that they are ready to make the requisite disclosures in 2017 (a "dry run" as at 30 April 2016 may be useful preparation).

An early review of the data will also allow companies time to make strategic decisions regarding future pay and bonus awards.

We recommend that, once the information for 30 April 2017 has been collected, verified and analysed, the executive responsible for publishing the data should draft an accompanying note to explain or support the numbers. Whilst this is not compulsory, it may be helpful to avoid uninformed interpretation of the data.

For more information, please contact:
stuart.james@mm-k.com

Technical Briefing

Proposed changes to LP legislation for private equity investments

JD Ghosh examines the effect on private equity firms of proposed changes to the legislation governing limited partnerships.

The UK limited partnership is the most commonly used structure for European private equity and venture capital funds. It provides a flexible, tax-transparent vehicle and limited liability for fund investors (provided they have no management role). LPs are governed mainly by the Limited Partnership Act 1907, the Partnership Act 1890 and the rules of equity and common law, which have remained broadly unchanged for over a century.

To protect their interests, many fund investors include consultation and approval rights in partnership documentation. It is hard to tell from existing legislation when such rights might cross over from protection to management and the industry has been lobbying for clarifying amendments.

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

On 23 July 2015, the Government responded with a consultation paper seeking views on proposed amendments to the Limited Partnership Act 1907. The proposed changes were contained in a draft Legislative Reform Order (LRO). They are intended to apply only to private fund vehicles and create a new register of "private fund limited partnerships" (PFLPs).

Broadly, the proposed amendments cover:

- registration, ongoing filing and notification requirements
- the role, function and rights of limited partners and
- obligations of and restrictions on, limited partners in respect of capital.

These proposals are intended to ensure that UK limited partnerships remain competitive globally and continue to set the market standard structure for private equity and venture capital funds.

In March 2016, the Treasury published a summary of responses and the government's decisions on policy design. In summary, the main changes are:

- designation as a PFLP is by application; only limited partnerships (including existing limited partnerships) constituted by a written agreement and qualifying as a collective investment scheme may apply
- a proposed, non-exhaustive, "white list" of activities PFLP limited partners may engage in which do not constitute management
- PFLP limited partners will not be required to (but may, as now) make a capital contribution and capital may be withdrawn without any requirement to declare capital contributions on the register
- PFLP limited partners will be exempt from some specific duties that currently apply to all partners in a limited partnership
- PFLP limited partners will be permitted to appoint a third party to wind up the partnership (without a court order) where the general partner has been removed.

The Government's intention is that Parliament will approve the LRO containing the draft legislative amendments so that they may become fully operational within a year.

The amendments are intended to create greater certainty for limited partners in respect of the activities in which they may engage without prejudicing their limited liability.

Investment managers and fund investors should be thinking now about the changes they may need to make to their fund structures to accommodate these changes.

For more information, please contact:
jd.ghosh@mm-k.com

Taxation of performance-linked "carried interest" paid to asset managers

JD Ghosh looks into the effects of proposals to change the taxation of carried interest.

Please note that the proposed changes do not apply to carried interest treated as "employment related securities"; an individual receiving carried interest by reason of employment, will not be affected.

On 8 July 2015, HMRC published a consultation document with the aim of clarifying the tax treatment of carried interest. Carried interest arising from investment activity is to be subject to capital gains tax (CGT) but carried interest arising from trading activities is to be subject to income tax.

The current test for distinguishing between "investment" and "trading" activities has been developed through case law, based on the so-called "badges of trade". But, this distinction can be difficult to determine in certain businesses, including asset management.

The Government was concerned about arguments by some asset managers that annual fund performance fees, typically taxed as income, should be subject to CGT because they arose from funds invested for tax purposes, not as part of a trade.

Having gone out to consultation, the Government plans to introduce new "income based carried interest" (IBCI) rules, to determine, from 6 April 2016, whether carried interest arises from investment activities (taxed as capital) or trading activities (taxed as income).

Under the IBCI rules, the tax treatment of carried interest will be determined by the length of time for which an investment has been held. If the "average holding period" is less than 36 months, 100% of the carried interest will be taxed as income. This reduces on a sliding scale to the point at which 100% of the carried interest will be subject to CGT if the average holding period is 40 months or more.

Subject to exceptions contained in the IBCI rules, the average holding period is calculated at the time carry is paid, taking into account:

- the amount of the original investment
- the time that investment was made
- the amount of the original investment disposed of
- the timing of the disposal.

The IBCI rules work by, first, treating everything received by investment managers as trading income (or as a disguised investment management fee) unless it is already taxed as trading or employment income. Carried interest is then excluded from that trading income and retains its tax status as a return on investment activity, subject to the application of the new IBCI rules. To the extent the IBCI rules apply, the relevant portion of the carried interest will be treated as trading income.

For more information, please contact:
jd.ghosh@mm-k.com

No reduction in the rate of carried interest gains

From 6 April 2016, the 18% and 28% rates on capital gains are being reduced to 10% and 20% respectively. However, the reduced rates do not apply to receipt of carried interest and for chargeable gains on disposals of residential property that do not qualify for private residence relief which remain taxable at 18% and 28%, as applicable.

For more information, please contact:
jd.ghosh@mm-k.com

MM&K is a partner to the Global Governance and Executive Compensation Network

The Global Governance and Executive Compensation Network (GECN) is a network of independent remuneration advisory firms with offices in USA, UK, Switzerland, Singapore, China and Australia. GECN membership provides access to global knowledge and expertise and enhances MM&K's capacity to advise clients on governance and remuneration on the international stage.

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