

Articles in this edition

Cliff Weight looks at the Proposed Changes to the Combined Code.

MM&K's CEO Paul Norris comments on Life after the PBR

Paul Norris discusses the latest proposals for tax relief on Pensions and Discusses the latest issues on Jointly Owned Share Plans

The latest views of the NAPF and ABI by Cliff Weight

US Legislation on the Taxation of Carried Interest by Nigel Mills

Ian Murphie gives an update on EMI's

Latest MM&K News

The **2010 Life In The Boardroom** survey covering the views of 442 chairman and non-executive directors has just been published. The survey gives information on fee levels, time commitments and attitudes to all aspects of their jobs from independent directors sitting on the boards of private, AIM and main market companies.

To order a copy please email **alex.goodrich@mm-k.com**, price £200.

MM&K and Obermatt announce strategic partnership. MM&K to be Obermatt's sole UK partner to promote the use of the Bonus Index in the UK.

Higher Talent, MM & K Group's specialist HR recruitment consultancy, has recently launched an innovative new client service offering - Higher Talent Partner (HTP). This new service offering makes Higher Talent unique in its ability to service clients' long, medium and short-term HR resourcing requirements. HTP is a network of highly skilled and experienced HR specialists providing short-term, tailored HR solutions on a project or day rate. Areas of expertise include HR strategy development, all employee reward structures, leadership development, employee relations and generalist HR support.

For more information please contact **alison@higher-talent.com** or **rob@higher-talent.com**

PROPOSED CHANGES TO THE COMBINED CODE THAT AFFECT REMUNERATION

1. Para A.1: Main Principle - Every company should be headed by an effective board which is collectively responsible for the long-term success of the company. [A.1]

Comment. The addition of the words long-term is significant. The Companies Act does not suggest any difference in the treatment of the views of long term and short term shareholders. This new Code wording implies greater weight should be given to the views of long term shareholders.

MM&K think this is a significant and important change and welcomes this proposal.

2. The old para B.1.1 has been removed. This said "The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors **keen incentives** to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code."

Comment. MM&K in its submission recommended the removal of the words "keen incentives" which we felt gave too much emphasis to short termism and failed to recognise the issues of tail risk and asymmetric rewards. We therefore welcome this change.

3. The performance-related elements of executive directors' remuneration should be stretching and designed to align their interests with those of shareholders and to promote the long-term success of the company. [New supporting principle - combination of former B.1.1 and Schedule A, paragraph 1 plus new wording on long-term success]

Comment. The new wording emphasises long-term, but does not define this. In practice this will vary from company to company.

MM&K's view is that long term should be viewed as 5 to 10 years in most industries. Many companies will need to review their 3 year (so called) "long" term incentive plans.

4. D.1.3. Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance related elements....

Comment. The words "or other performance related elements" are new. MM&K believe that share options and other equity based incentives are appropriate in many cases for non-executive directors and that to attract the right kind of non-executive they are necessary.

Most commentators have misunderstood this issue. The real issue is that the gearing should not be excessive - the remuneration package should not provide or be capable of providing rewards of such magnitude that they might compromise the independent judgement of the director.

For further information and advice on the proposed changes to the Combined Code, please contact **cliff.weight@mm-k.com**

LIFE AFTER THE PRE BUDGET REPORT

The PBR on 9 December made yet more changes to the taxation of pension contributions for high earners by reducing from £150,000 to £130,000 the level of earnings at which tax relief starts to taper. The effect is to add further complexity. As a result, those whose income is £130,000 or more (including any charitable donations and pension contributions they make personally) will be subject to tapering tax relief if, when any employer's pension contributions are taken into account, their income rises to £150,000 or more. During a consultation period ending on 3 March 2010, interested parties can submit their views to HMRC on these proposed changes.

There was, in addition, a (surprisingly indiscriminate) sideswipe at bankers' bonuses. No-one could have been surprised at an attack on those the Government holds culpable for much of the current economic mess but the 50% bankers' bonus tax applies to bonuses of more than £25,000 paid to anybody who works for a banking group (including fund managers and those whose job is to earn fees for the bank from corporate transactions). Goldman Sachs initially announced plans to pay bonuses which would result in a windfall £1bn tax payment to the Treasury but has since capped individual bonus awards at £1m and HMRC has admitted that certain discretionary share-based payments (ie. payments to which the recipients are not contractually entitled) may not be caught by the new payroll tax. Could it be that HMRC has recognised that payments made in the unfettered discretion of trustees of a properly constructed EBT can effectively (and legitimately) avoid a charge to tax in certain circumstances?

Otherwise, the PBR is noteworthy for what it did not contain, omissions which, at least for the time being, allow life to continue unchanged. For example, the PBR did not include:

- an attack on avoidance through the use of EBTs, FBTs, jointly-owned share plans or other plans designed to convert income into capital
- any increase to the rate of CGT
- an attack on the tax reliefs associated with salary sacrifice schemes or on accelerating bonus payments (similar to the pensions "forestalling" rules).

A possible sting in the tale is that HMRC is consulting on the possible extension of the disclosure of tax avoidance scheme (DOTAS) rules to encompass EBTs and certain "income to capital" plans.

The closing date for comments is 19 February. MM&K will be keeping a close watch for developments.

In advance of income tax rising to 50% in April, a number of companies are considering the acceleration of salary and bonus payments to bring them within the current 40% change

For further information and advice on the implications for your executive remuneration strategies, please contact paul.norris@mm-k.com or nigel.mills@mm-k.com.

PENSIONS

We have referred elsewhere to the further tinkering with changes to proposals to reduce tax relief on pension contributions. Needless to say, employers are looking at ways to mitigate the effects of these changes on their employees. One such idea is an EFRBS, set up for the purpose of providing pension benefits for an executive and his/her family. An EFRBS is not a "registered pension scheme" but each EFRBS must be registered with HMRC.

Advantages include:

- the EFRBS can be funded or unfunded
- there are no income tax or NIC charges on contributions regardless of amount and no additional tax charges if limits applicable to registered schemes are exceeded
- the lifetime allowance (£1.75m for 2009/10) is not applicable
- there are no restrictions on investment
- the EFRBS can make loans to beneficiaries and the company
- there is no requirement to buy an annuity
- there is no specified retirement age (but from April 2010 only those aged 55 and over can receive benefit)
- the amount of any loan outstanding on death reduces the executive's estate for IHT purposes
- no NICs (although income tax will be payable) on pensions received if paid after cessation of employment and before the executive's 75th birthday
- no NICs (although income tax will be payable) on lump sum payments of not more than 25% of the fund value.

Disadvantages include:

- only the company can make contributions to an EFRBS
- CT relief is available only when benefits (but not loans) are received
- the value of the fund is subject to a periodic IHT charge (up to 6% at current rates) on each 10th anniversary of its creation.

An EFRBS draws inevitable comparisons with an EBT with which it shares a number of features. However, an EFRBS is not an EBT. For more information about EFRBS versus EBTs, contact paul.norris@mm-k.com.

JOINTLY OWNED SHARE PLANS

At a dinner hosted last September by MM&K for Chairmen, Chairmen of Remuneration Committees and CEOs, the theme for discussion was the impact of higher tax rates on executive remuneration planning. Guests felt strongly that companies should not compensate executives for higher tax rates and were keen not to see a return to the tax avoidance mentality prevalent in the 1970s. It was recognised, however, that steps taken legitimately to mitigate tax could have commercial benefit in retaining key executive talent, especially when income tax increases to 50% and if CGT stays at 18%.

Jointly owned share plans (JOSPs) offer an opportunity for participants in LTIPs to pay only CGT on any increase in value of shares awarded to them under the plan.

Under most LTIPs, executives only become the owners of the shares awarded to them at the end of the plan period and pay income tax and NICs on the then market value of those shares. Under a JOSP, all the shares to which the executive might become entitled if the performance targets are hit are owned from the outset jointly by the executive and a trustee on terms which entitle the executive (subject to performance and continued employment) to participate only in any increase in value of those shares. The trustee retains the rights to the value of the shares at the time of acquisition.

The executive's right to participate in any future value itself has a value, which is subject to income tax unless the executive pays for it at market value (to be agreed with HMRC). However, the value of this right should be modest owing to the uncertainty about future performance and share prices. In addition, the executive could be granted an option to acquire the trustee's interest in the jointly-owned shares, which would give the JOSP the same economic effect as an approved CSOP which is not limited to £30,000 worth of shares.

There are some disadvantages. For example, any income tax payable by the executive cannot be recovered if the share price falls, all shares need to be acquired at the start and there is no CT relief on any increase in share value (because this is treated as capital in the hands of the executive). However, shareholders will recognise that executives benefit only if the share price rises and specified performance targets are hit. Remember also that HMRC is currently consulting on the possible extension of the DOTAS rules. It remains to be seen if this exercise will have any adverse effect on JOSPs.

For more information about JOSPs and other forms of tax-efficient equity participation, please contact ian.murphie@mm-k.com or michael.landon@mm-k.com.

UPDATE ON VIEWS OF THE NAPF AND ABI

Both the ABI and NAPF have recently updated their remuneration guidance for quote companies. Remuneration Committees should make themselves aware of these updates.

On 13th November 2009, the NAPF issued a press release and also wrote to the Chairmen of Britain's top 350 companies. The key points were:

1. To urge executive pay restraint
2. To make it clear that company remuneration should be aligned with the long term interests of shareholders, including pension funds
3. Boards should pay close attention to how profits are apportioned between capital, remuneration and dividends to shareholders. This follows a year in which many companies have raised capital and many dividends have been cut
4. The growing trend of deferring parts of bonus payments into shares is good practice and the NAPF expects that more companies will go down this route in 2010
5. We (i.e. the NAPF and its members) see bonuses as a form of profit share and therefore if profits are down we expect bonuses also to be lower

The NAPF has also questioned whether current remuneration structures serve management and shareholders well and suggested a review of 'best practice' is now warranted.

The full text of the NAPF letter to the chairmen of the FTSE 350 can be viewed by [clicking here](#).

The alignment of long term interest has also been noted in the proposed changes to the Combined Code. MM&K agree with this and the support the trend to defer more of bonus.

However, MM&K do not see bonuses as a form of profit share. Whilst this might be the case in some business sectors, we do not think such a "one size fits all" dogmatic creed is helpful. MM&K believe incentives should motivate managers to achieve targets and should reward them for their success in achieving targets, which should be designed in such a way as to lead to long term success.

ABI Guidelines on Executive Remuneration

The 15 December 2009 update to the ABI Guidelines on Executive Remuneration will be a disappointment to many. The amended guidelines fail to deal with some of the key structural deficiencies in executive pay practice and guidance – a contributory factor to the downturn – although the ABI has inserted 53 words to emphasise the need to take risks fully into account when devising pay policies and practices.

The opening section of the guidelines sets out the principles, and here an addition to the text highlights the need to ensure that risks are fully taken into account: *"Boards are responsible for adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term. The policies and practices should be demonstrably aligned with the corporate objectives and business strategy, taking risks fully into account, and reviewed regularly."* [the addition is the underlined text]

In the guidelines on the Remuneration Committee and their responsibilities, the opening sentence of the main provisions now includes a reference to risk.

Later in the main provisions, in a paragraph dealing with arrangements for other senior executives, the ABI suggests a link to the Enhanced Business Review: *"Remuneration Committees should also pay particular attention to arrangements for senior executives who are not board members but have a significant influence over the company's ability to meet its strategic objectives. In this context, they should have oversight of all associated risks arising throughout the firm as a result of remuneration. Boards should consider disclosure of these risks and how they are managed in accordance with their obligations under the Enhanced Business Review."* [addition is underlined text]

While the additions certainly improve the guidelines, they do little to address areas of key concern. The review of best practice called for in the NAPF's letter to FTSE 350 Chairmen evidently remains outstanding.

On performance measures, the ABI guidelines continue (in our view) to over-emphasise TSR, including a reference to it in the first sentence under the section on performance criteria at the expense of encouraging performance measures that are appropriate to the company's circumstances. *"Total Shareholder Return (TSR) relative to a relevant index or peer group is one of a number of generally acceptable performance criteria"*.

It is disappointing that a more thorough overhaul of the guidelines has not been considered.

Also on December 15th the ABI issued a position paper on executive remuneration, which "does not seek to supplant the Guidelines, which provide a detailed reference point for what shareholders will routinely regard as acceptable, but aims to highlight those elements of the Guidelines that are currently of particular relevance." Three points are worthy of note:

1. Performance-related remuneration seeks to reward business performance in line with corporate strategy which should aim at sustainable long-term value creation.
2. Tax efficient incentive schemes are being promoted as a means of providing incentive arrangements which are taxed as a capital gain rather than income. As a matter of principle remuneration policy should not seek to compensate directors for higher tax rates. Any tax efficient schemes should take account of the need not to incur extra costs through higher overall payments or an increase in the company's own tax bill.
3. The Remuneration Report should also include the nature of the work performed by the remuneration consultants during the year (both for the committee and management) and the level and nature of fees paid.

MM&K agree with all these three points. The use of the word sustainable in point 1 is new and particularly notable.

This very detailed paper appears to offer lots of scope to justify remuneration proposals and so will be welcomed by many executive compensation practitioners. In 2010, do not be surprised to hear companies bemoaning that shareholders are unhappy with pay policies, despite the company's policies being "broadly consistent with the ABI Guidelines"!

US LEGISLATION ON THE TAXATION OF CARRIED INTEREST

On 9 December the US House of Representatives passed the Tax Extenders Act of 2009 (the "Extenders Act") which includes a provision taxing carried interest earned from investment partnerships or LLCs as compensation income subject to ordinary income tax.

If enacted the proposal would be effective for income recognised on or after 1 January 2010 regardless of when the investment partnership/ LLC was formed or when the partnership/ LLC made the underlying investment.

It will apply to investment professionals earning carried interest from an investment partnership/ LLC, including a private equity, hedge fund or real estate investment partnership/ LLC. Under current US law, the tax character of carried interest is determined at the partnership level based upon the character of partnership income, so that carried interest received by many investment funds is taxed at the federal long term capital gains rate of 15%. The Extenders Act, if passed, would increase the effective rate of federal tax on carried interest to a rate in excess of 37% after factoring in employment taxes.

The Act will now be considered by the Senate. In 2007 and 2008 the Senate rejected similar legislation and it is therefore uncertain whether the Extenders Act will be passed, although the Democratic Party has a larger majority now in the Senate than when previous votes were held. President Obama has said that he will sign the Act if it passes the Senate. Latest news however seems to suggest that this part of the act will not be passed this time round. But it does seem it is no longer a question of if it will be passed, but when!

Interested observers in the UK, notably the whole Private Equity and Hedge Fund industries will be watching developments on this closely. Clearly it could, if the legislation is enacted (whether now or next year), impact on policy thinking on carried interest elsewhere including in the UK. It will be interesting to see what the reaction is from our next government. One stance might be to leave the current very favourable tax treatment of carried interest in the UK as it is, to show the financial world that "Britain is a supporter of Private Equity and Hedge Funds". The other stance would be to follow suit and also tax carry as employment income.

There could also be a "half way house" – leave carry to be taxed (mainly) to capital gains tax, but remove the anomaly of the "base cost shift". We remain of the view that any new Government is bound to increase the rate of CGT, so the tax take from carry should rise. This of course begs the question as to how many carry plans are actually going to pay out in the foreseeable future. Not many by our reckoning!

For more information please contact nigel.mills@mm-k.com

EMI – changes to qualifying criteria announced in PBR

The 2009 Pre-Budget Report confirmed HMRC's announcement in August 2009 that in consequence of the European Commission granting state-aid approval for enterprise management incentive ("EMI") share options, amendments will be included in the Finance Bill 2010 to extend the definition of an EMI qualifying company to require companies to have a UK permanent establishment.

This will replace the current requirement that for a company's trade to qualify for EMI it needs to be carried out wholly or mainly in the UK.

For more information please contact ian.murphie@mm-k.com