On 14 September 2009, MM & K held a dinner for clients, most of whom were Board Chairmen, CEOs or Chairmen of Remuneration Committees. Over dinner, there was a discussion about:

Higher Tax Rates: Implications for Remuneration Strategy

Summary

- Remuneration should not be tax-driven, but business-driven
- Companies should not be seen to be putting in special tax-driven arrangements for people at the top
- Maximise available pension contributions
- Maximise limits under HMRC approved plans
- Retention is important – but make sure you retain the right people.

Introduction

Paul Norris introduced the principal subject for discussion: *Higher Tax Rates: Implications for Remuneration Strategy*.

1. The 2009 Budget proposes:
   - a 50% marginal income tax rate on earnings over £150,000 per year from 6 April 2010
   - a reduction in the annual income tax allowance by £1 for every £2 by which adjusted net income exceeds £100,000 (which means a marginal rate of 60% for some executives)
   - from April 2011, higher rate tax relief on pension contributions to taper back to basic rate for those earning over £150,000 per year.

- Companies may consider equity-based plans for capital gains tax treatment at 18%, or devices to defer income receipt and taxation. But no corporation tax deduction where no personal income (except in relation to HMRC approved plans).

- The context for setting remuneration strategy includes:
  - General outrage about bankers' pay in a recession widely perceived to have been caused by the banks
  - New FSA code for longer term, transparent and risk-aligned remuneration in the bank sector with likely knock-on implications for other sectors of the economy. Walker review of corporate governance in banking - principles could be applied outside the financial sector
  - The possibility (probability?) that CGT rates will rise again after the General Election next year.

Discussion

1. There was no desire for complicated tax avoidance plans:
   - It is not a good idea to play games on tax when companies are not giving returns
   - It is not like the 1970s when we had 83% income tax. We paid people in suits and other perks – please no more of that!
   - It is legitimate to introduce government approved schemes, particularly those with wider employee participation
   - It would look bad to pursue an aggressive tax driven strategy for a small number of highly paid people at the top of the company.
   - 'The jealously genie has been unleashed'

2. There was a widely-held belief that whichever party wins a general election capital gains tax will rise, possibly to 30%, which will make equity based capital gains tax plans less attractive

3. Participants questioned whether companies should be investing time and resources in finding ways to reduce taxation:
    - Companies definitely should not compensate directly for the additional tax – companies should not hold the executive harmless against tax changes
    - Some felt it might also not be necessary to look for ways of reducing taxation at no direct cost to the company because the change affects everyone in the UK
    - Nor would the changes necessarily lead to a competitive threat from abroad – the quality of life is often not so good in the lower taxed countries; there is a balance between a less onerous corporate tax regime and a more onerous environment for individuals
    - Overseas employees are used to suffering adverse effects of currency fluctuations

4. But it was agreed that a new remuneration philosophy will be needed:
    - It is the job of the whole board (and shareholders) to find a new approach to reward in a high taxation environment
    - The focus has to come back to aligning reward with strategy implementation – shareholders want to see value creation first: then they are prepared to pay
    - There is now a wider audience than just shareholders – public perception is important
    - The pressure to restore net earnings will increase as we come out of recession
    - This is an issue that goes well below the executive board.

5. There was discussion about the merits of using absolute measures of return for targetting and long-term remuneration rather than relative measures:
    - A company should set its own return goals, irrespective of what others are doing
    - Absolute measures are only part of the solution
    - TSR was roundly criticised -'relative TSR was invented by the Devil for the Devil'.

6. There was discussion about the proportion of profits that should reasonably be given to employees, and the timing of payouts:
    - Outrageous that people (especially in trading teams) should expect 50% of the profits generated by business when they are risking the company's balance sheet – why not consider requiring them to invest bonus payments in their trading activities or lend them funds for this purpose so that part of the risk is shared?
    - Depends on the nature of the business – different if the firm is agent/brokering rather than acting as principal
    - It is important to have a clawback if lots of money made this year, and next year there isn't. The reward mechanism is asymmetrical
    - Perhaps the FSA should fine individuals for misdemeanours in risk-taking
    - The private equity model – paying out high rewards on receipt of final cash – is preferable to the hedge fund model, paying out on valuation/mark to market.

7. Taxation of carried interest plans – there was wide agreement that the Obama plan to tax these as income rather than capital gains was reasonable:
    - This is earned income
    - Participants also agreed that a neutral tax regime is desirable (top rate of income tax = CGT + CT relief).

8. The discussion moved to the impact of using pay surveys to determine pay levels:
    - Wouldn't it be better to rely on supply and demand rather than automatically adjusting to survey rates?
    - We tend to rely on surveys for the salary element. Bonuses are determined more by company issues.

9. And on the need to pay very well in order to retain people:
    - Losing people is less a risk than many tend to think – I have found that losing someone is rarely a problem when it happens
    - Why bribe somebody to stay?
    - You can cope even with the CEO leaving

- Better if you develop internal succession; but this is not an option for a small company - the jump can be too great
- It is a question of retaining the right people.

10. What about signing on bonuses?
    - If people have forfeitable shares you have to buy them out to entice them
    - Will be interesting to see what happens if joining bonuses are capped.

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