Newsletter

July 2009

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Latest MM & K News

Damien Knight, one of the U.K.'s most respected remuneration consultants, has left Watson Wyatt and joined MM & K. Damien has over 30 years of experience of working with companies helping them with their remuneration and human resource problems. His particular specialism is in executive compensation. Damien was a director of the Hay Group where he worked for over 20 years, most recently he was a Senior Consultant with Watson Wyatt.

TSOC has appointed **Giuseppina Pucino** to the team from 17 June 2009. Giuseppina was previously with Halliwell Integra and brings with her several years of share scheme administration and management experience. She will undoubtedly enhance the already excellent service TSOC has to offer.

The Manifest/MM&K **Executive Director Total Remuneration Survey 2009** is now available and has the most comprehensive analysis of top pay available. The survey offers a comprehensive review of this topical issue across the UK market. For more info please click here.

Planning Executive Pay Strategy

Paul Norris, Chief Executive Officer - paul.norris@mm-k.com

All will be aware of the Government's proposals for "high earning" executives, namely:

- 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.

"Forestalling" legislation (designed to prevent executives from making additional pension contributions to maximise tax relief before 2011) has been in place since 22 April and HMRC will enter into a period of consultation regarding the way the pension tax relief proposals are to work in practice. Until that period is over, it will not be feasible to implement concrete plans in this area at least.

Understandably, executives and their employers are concerned about the implications for executive pay strategy. But tax is only one of the issues. Good corporate governance, the corporate culture, what fits best with the company's business and remuneration strategies, the potential risks (to employer and employee) and the costs (in terms of equity dilution, cash and accounting treatment) are also relevant considerations.

Whilst it is clear that the burden of income tax will increase and that the differential between income and capital gains tax rates will widen, there is time to work out the right response for your company.

This note offers some guiding pointers but we do not suggest that this guidance is applicable or even suitable, for all companies and it does not amount to advice about the action which will be appropriate to any individual company. Each company should seek its own independent advice on executive remuneration and, as a leading independent adviser, MM & K would be pleased to help.

When thinking about whether to adopt plans designed to produce gains taxed as capital instead of income, remember that there is no corporation tax relief for executive benefits taxed as capital. If executives pay income tax and NICs on benefits they receive, their employing company will also have to pay employer's NICs (13.3% from April 2010) but should qualify for corporation tax relief on the gross value of the benefit plus the associated employer's NICs.

MM & K believes that there should be a direct link between executive reward and business strategies. A potential danger of using tax to drive remuneration is that the essential connection between pay and performance might be lost. On the other hand, if tax-efficient plans encourage executives to stay with a business in difficult times, the commercial advantages could be significant. It is worth considering the issues in a wider context than simply the difference between the rates of income tax (and NICs) and CGT.

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However, tax efficiency is now on the agenda and examples of plans designed to produce capital gains include:

- Jointly-owned share plans in which the executive is awarded an interest in any future increase in value of shares, which he owns jointly with, typically, the trustees of an employee benefit trust ("EBT")

The value of the initial award to the executive is subject to income tax (but this value is likely to be modest) and adoption by listed companies will require shareholder approval. Some institutional investors have expressed concerns but this type of plan is likely to receive greater consideration by companies, remuneration committees and executives.

- Partly-paid share plans are also likely to receive more attention. The executive acquires employing company shares but pays only part of their then market value. The amount outstanding is subject to income tax annually as if it were an employment related loan, until either the full price is paid or the executive is released from the obligation to pay up the balance.

Partly paid plans tend to be utilised mainly by private companies, as they can be particularly tax-efficient in a close company (especially if the availability of entrepreneurs' relief reduces CGT to 10%). There are obvious risks if the share price falls but it should be possible to introduce an element of stop-loss and, on the upside for executives, share price gains are taxed as capital.

- Flowering or Growth Shares in which executives acquire a new class of share, the value of which is dependent on the added value generated from a future event or series of events. If the shares are gifted to executives, there will be an inital income tax and NIC charge, which should be modest bearing in mind that the the flowering shares have no rights to participate in present value and the uncertainty of their future value. Any growth in value is a capital gain.

Discretionary "EBTs" which are widely used by listed and private companies in connection with share and cash linked incentive plans, can be used to accumulate wealth and to defer income tax charges until the trustees decide to distribute trust property to executives. In this respect, an EBT can be likened to a pension plan, although company contributions do not qualify for a corporation tax deduction, which is deferred until benefits subject to income tax are received by employee beneficiaries. An executive does not cease to be a beneficiary of an EBT simply by virtue of ceasing to be employed, which means that the flexible nature of discretionary EBTs can be utilised to provide benefits after the point at which an executive has ceased to be subject to the highest marginal tax rates. EBT's may also be used to allow for deferred incentive payments to be set aside for named employees and their families without triggering an immediate tax charge on the employee/beneficiary. Income tax, NICs and the availability of CT relief are deferred until the trustees make a distribution.

Do not forget some of the obvious HMRC approved methods of providing tax-efficient remuneration. With marginal income tax rates going up to 50%, HMRC approved CSOP and savings related share option schemes and share incentive plans ("SIPs") all enable executives to benefit from CGT treatment for any gains. A note elsewhere in this newsletter describes how SIP can be used in executive remuneration planning and to deliver material cash-flow advantages for employers. Executives in smaller companies may be granted options over shares worth up to £120,000 and will pay only capital gains tax on any option gains realised on sale if they and their companies qualify for the Enterprise Management Incentive plan.

Tax is making the headlines but to the future planning of executive pay strategies, in which tax will play its part, requires a broader approach.

Bankers' Pay and the Combined Code Review

Cliff Weight, Director - cliff.weight@mm-k.com

The Finacial Services Authority's (FSA) new remuneration guidelines, the recent Financial Stability Group (FSG) recommendations on bankers' compensation and the Walker report all identify the key issues highlighted as long ago as my article in Financial World in May 2008 - risk alignment of bonuses, the measurement of true profit, short-termism, and a need for bonus deferral and clawback mechanisms.

The FSA and FSG have recommended a vastly increased role for the remuneration committee. Companies are going to struggle to find non-executives with the expertise and time willing to serve on remuneration committees to do this work. One solution they are adopting is to outsource much of the work to independent remuneration consultants. MM & K, is seeing a big growth in demand for our services in this area.

The Financial Reporting Council (FRC) are currently consulting on revising the Combined Code, which applies to all companies listed on the London Stock Exchange and sets a global standard of best practice.

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When Sir Christopher Hogg, the FRC Chairman, launched the review in March, he commented that he thought the Code was not broken, although it might need fine tuning. I disagree as far as the Remuneration sections of the Code go.

MM & K has submitted a detailed 29 page report to the FRC explaining the problems and offering proposals for a future Code.

We have four main recommendations:

1. There must be a five year comparison of the chief executive's total remuneration against that of the average employee and shareholder returns.

2. All fees earned by everybody who advises the remuneration committee must be published.

3. The totals of remuneration awarded and realised each year must be clearly spelt out.

4. Non executive directors on the remuneration committee need more support to consider properly the alternatives and any unpopular recommendations.

The Treasury Select Committee reviewing the banking disasters and Peter Montagnon of the ABI have both called for a code of ethics for remuneration consultants. I agree with them and have prepared a draft, central to which is the requirement for remuneration consultants to be honest, open and truthful in their work. Now in my experience many are highly ethical; others try, but find it difficult to say no to executive management. And I have no doubt there have been some who have given executives just what they wanted with an eye to future business.

Remuneration is the area where there is the greatest potential conflict of interest and our proposed code of ethics (and disclosure of consultants' fees) will help to protect shareholders' and public interests.

Other of our Combined Code recommendations are designed to improve the clarity of company reports on directors' remuneration. Whilst everyone agrees that linking pay to performance is a good idea, current disclosure restricts rather than fosters clarity. Our proposals ensure that executives' remuneration will be reported in a clear, transparent way so that shareholders can see both the historical and projected future linkage (or lack of it) between pay and performance.

In recent years, the longer-term emphasis in incentive pay has switched from 10 years to 3 years. Previously, share options, with a ten-year life, were the main type of long-term incentive. This gave the executives an interest in the long-term share price performance: particularly strong when the share price had increased and the options were significantly in the money.

Following the 1995 Greenbury Report there has been a shift away from share options towards performance shares, and this gained momentum with the introduction of the accounting charge for options. The use of performance shares has been encouraged by the Combined Code which talks of relative performance. The result has been the introduction of three-year relative TSR plans, with no payout for below median performance and maximum payout, usually, for 75th percentile performance.

Students of gaming theory will realise that, to maximise their income from such relative TSR plans, many executives will be tempted to increase the volatility of the share price rather than aim for steady growth. One way to increase the volatility of the share price is by making an acquisition. Another is to increase gearing by taking on more debt and paying back cash to shareholders. Remuneration committees have also encouraged an acquisition culture by linking salary to company size: hence the inherent incentives in the remuneration system have encouraged growth by acquisition and merger. (Note too that the advisers to companies who so strongly encourage acquisitions, mergers and higher debt all receive their advice fees at the time of the deal.) A whole edifice has arisen which encourages short termist behaviour and what President Obama in his Inaugural Speech called "greed and irresponsibility".

So, our final recommendation is to change the Combined Code's Schedule A guidance on performance related pay for executive directors so that it encourages:

i. steady growth over volatility
ii. long-term performance rather than short-term
iii. absolute returns to shareholders

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SIP Tax Advantages are Worth Revisiting

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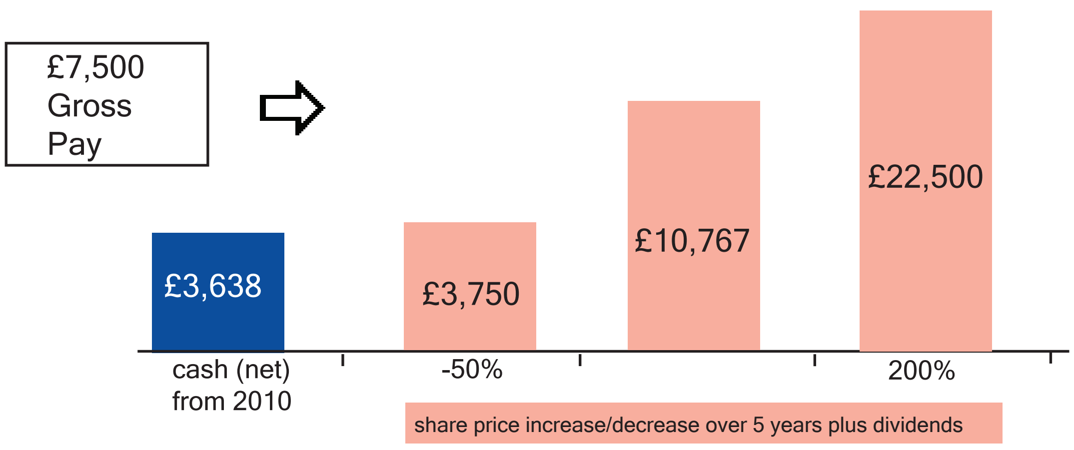
Since the 2009 Budget, there have been numerous recommendations as to how those affected by the new 50% tax rate in April 2010 can effectively manage to 'legally' avoid paying tax through implementing share incentive based plans and making the most out of Capital Gains Tax (currently set at 18%).

The emphasis has been placed on the effective utilisation of HMRC approved plans such as the CSOP, SAYE and options under the Enterprise Management Incentive plan, but, has anybody really thought about the advantages of implementing the HMRC approved Share Incentive Plan (SIP)?

The SIP allows companies to offer their employees the opportunity to acquire up to £1,500 p.a. worth of shares from their pre-tax salary, and, once the shares have been held for 5 years in a trust, they will also be free from income tax and National Insurance. This becomes even more attractive to employees whereby a typical growth in the shares during the 5 year term could treble the initial investment for higher income tax payers. Also, whilst your shares are held in trust, any increase in value will be protected from Capital Gains Tax.

SIP delivers more net pay than cash in most cases...........



If the tax saving is not enough of a sweetener for employees, companies may also consider offering a free share award (max. £3,000 p.a.) in conjunction with the SIP (click here for details of SIP). This is commonly being used as an alternative to a cash bonus.

Employers can further incentivise employees through the SIP by awarding a specific ratio of matching shares (limited to 2:1) for partnership shares purchased within the plan. These will be subject to the same holding period as partnership shares and will also come with the same tax advantages. In short, the SIP is definitely worth revisiting as it provides income tax relief for all who participate.

HR Partner

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There are three items that have received a great deal of recent press in the HR field:

1) "Fit Note" - Consultation

The Government are currently in the middle of a twelve week consultation on the design of a new medical "Fit Note", this will replace the "Sick Note" and aim to get rid of the sick note culture and assist people back to work. The new certificate will ensure that people get the best possible advice about staying in work, and practical ways in which they can return sooner. The consultation is sure to have some interesting conclusions which will be worth looking out for.

2) New ACAS Code

On the 6th April the statutory Disciplinary and Grievance Procedures ceased, and were replaced by a new ACAS Code of practice "the Code". At the present time there has been little press about case law and other effects of the change. Most firms of solicitors are urging employers to review their Disciplinary and Grievance policies and all other related policies.

3) Pandemic Planning

More cases are being reported week after week, including the recent high profile case of premiership footballer Micah Richards. On the 11th June the World Health Organisation raised its threat level to phase 6, meaning that there is definite human to human infection and the pandemic is underway.

It is important that organisations are prepared for the implications of the pandemic. Senior public policy adviser Ben Willmott advises firms to:

- "to put in place strategies to allow them to run on skeleton staff levels" in case of an outbreak of the virus in the UK and;

- "in the case of a pandemic, to formulate clear advice for staff on symptoms of the virus and the importance of staying at home and seeking medical advice at the soonest opportunity."

MM & K HR Partner can assist organisations with the planning and strategy related to the three items above. In addition, HR Partner also offers a range of human resource services, typically beginning with an assessment of overall people risk including HR processes and procedures.

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