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it's our business

newspad of the Employee Share Ownership Centre

Carry the flag for Eso, EU will be told at Centre seminar

A formal demand for a much more incisive approach to employee share ownership by the European Union's Council of Ministers will be heard at a Centre workshop organised for the EU in London later this month.

The European Economic and Social Committee (EESC), one of the key EU institutions, will say that it should be made easier to bring in financial participation EU-wide on the basis of common principles.

Employee share ownership can have a major role to play in ameliorating the financial distress being suffered by tens of millions of European employees in the current economic crisis, says an EESC paper to be debated by delegates at the Centre event.

"Wages and purchasing power of employees have remained behind productivity growth and revenues for shareholders. The backlash of the current crisis will also be tough for wage earners. Eso could, depending on its form, be a partial compensation for losses of purchasing power and balance recurring fluctuations," the controversial EESC report will say.

In addition, the implementation of employee-buy-outs, preferably with all-employee Eso schemes, as vehicles for business succession should be encouraged since it can boost the continuity and thus the competitiveness of European enterprises while at the same time rooting them in the regions," said the EESC.

Furthermore, employee share ownership schemes often play a major role in the successful re-structuring of hard-pressed companies during the current worldwide crisis; effectively saving many from the scrap heap, the report said. "In addition to productivity enhancement, firms may adopt EFP schemes for flexibility reasons. These schemes can provide flexibility for firms facing difficulties arising from demand and supply shocks and the competitive environment, thus enabling them to maintain the stability of profit levels and rates. In the times when restructuring is needed (as in the recent financial crisis), changes to employment and working practices, aimed at cutting costs and maintaining the level of productivity, are necessary for the firm to survive.

"Employee financial participation may have a significant role in achieving successful outcomes in bad times. It can function as a guarantee to employees that, if they make sacrifices for the good of the company, they will share the benefits when the company recovers. Employee ownership may play a significant role as it induces wage moderation by offering lower wages, since employees will be receiving a part of their income as shareholders. If ownership is associated with involvement in decision making the effects should be even stronger," added the EESC report, which is being circulated by Professor Jens Lowitzsch of Frankfurt University, the project leader, who is speaking at the Centre workshop.

These possible moves towards a Europe-wide *Model Eso Scheme* will surface for the first time at the Centre's EU workshop and seminar in London on **Friday May 20**. The EESC report said: "An optional simple, uniform incentive model, with the same tax

From the Chairman

We report in this issue Centre members' reactions to the Treasury/HMRC's 'clarifications' of the pending legislation on 'disguised remuneration.' While there may well have been cases in which the real reason behind establishing some mainly offshore trusts was to help senior executives avoid tax, sledgehammers and nuts still come to mind.

When the legislation was first mooted, there were justified fears that genuine employee benefit trusts would get caught up in the slipstream and that employee share ownership would be undermined as a result.

Although the Treasury and its operating wing HMRC have since reacted to complaints by Centre members and others - by trying more clearly to limit the reach of the Finance Bill's clauses to the more dubious trust constructs - doubts remain about whether employee share ownership will be hindered and handicapped yet again due to no fault of its own.

The standard of parliamentary legislative drafting has declined steadily in recent years, making the unintended consequences of collateral damage from poorly drafted law a racing certainty.

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arrangements and incentives throughout the EU, could considerably boost EFP, as this would make it easy to structure schemes available throughout a group of companies. Deferred taxation could be taken as a lowest common denominator basis principle for a proposed model. The EESC recommends as a first step mutual recognition of the schemes of individual EU member states; a European model with uniform tax incentives could then be a second step."

About 50 people, including SMEs, have registered for this event, which takes place at the behest of the EESC. Representatives from Small & Medium Sized Enterprises (SMEs), quoted companies, service providers, politicians, academics, employers' organisations, trade unions and media will all gather to listen and contribute. The report from London will form part of the final event in Brussels this autumn.

HMRC is sending three staffers from its share schemes team and both the Employee Ownership Association and Proshare are sending representatives at the Centre's invitation. MP Adrian Bailey (Labour Co-op) & former chair of the all-party parliamentary group on employee ownership will launch the conference.

Centre member Iain Wilson will present an LSE study, commissioned by his employer Computershare, about the reach of Eso in the UK, while Craig Dearden-Phillips, founder of Stepping Out and Guardian correspondent, will talk about the experience of transforming public sector bodies into mutuals. Other speakers will be: Centre chairman Malcolm Hurlston; Mike Landon of the MM & K consultancy; David Craddock of the Craddock Consultancy and Mahesh Varia of Travers Smith. Mahesh will deliver an SME employee share ownership case study, Mike will cover the advantages of Eso for employees and employers respectively, while David will speak about the UK tax advantaged Eso schemes. Geoffrey Bond of RM2 Partnership will speak on how Eso can improve corporate governance. Paul Maillard, president of the French Eso organisation FONDACT, will speak about the main French models for employee financial participation (Eso) and how they work in practice.

Attendance at the all-day workshop and seminar is free of charge, as the event is being financed by the European Union. Centre legal member **Travers Smith** is hosting the conference at its London headquarters: 10 Snow Hill, London, EC1A 2AL from 9:30am to 5:30pm (nearest tube/metro stations are Chancery Lane and Farringdon). The workshop forms part of 2011 'Employee Financial Participation in the EU 27' project. EESC wants to encourage broader and deeper uptake of employee share ownership throughout the UK.

The Centre's programme aims to help: communicate the many benefits of employee share ownership to the millions of UK employees who are unaware of the concept; disseminate studies/research about Eso and increase awareness of the EU 20:20 strategy; facilitate the growth of Eso among SMEs; examine the role of Eso in the public sector and promote a common platform for Eso within the EU. EESC is worried about the future of sustainable public services within the EU. It wants companies, ministries and employees to be jointly committed to providing accessible and effective services and says that the role of employee FP (Eso) in this context has been under-explored so far. There is great interest in Brussels about the UK government's announcement that at least ten percent of the equity of a soon-to-be privatised Royal Mail will be offered to postal services staff.

Almost 700,000 SMEs throughout the EU will either change hands or go into liquidation during the next decade. Three million jobs will be at stake, especially when a trade sale is not possible and when founder owners don't have siblings or other leading shareholders to whom the business can be passed on when they retire or exit. Delegates will discuss how employee share ownership can be used in business succession - often to keep the assets/plant and jobs in place.

There is still time for members and others wishing to attend to register. Would-be delegates should contact Centre assistant director Dave Poole at Centre HQ Tel + 44 20 7239 4971: dpoole@hurlstons.com with copy to esop@hurlstons.com Travel expenses of non-London based delegates will be refundable, within limits, subject to presentation of receipts.

Hard road for Eso in public services

The concept of employee share ownership still faces a hard fight to win more friends among ministers, Centre member **Pinsent Masons** told *newspad* after studying the latest Cabinet Office consultation paper on reducing the scope of state ownership of public services. For 'employee ownership' is listed by the government as just one of five options by which various public services could mutualise themselves.

This is despite signals emanating from Whitehall suggesting that ministers are backing away from solutions involving wholesale outsourcing to the private sector – for fear of fresh ructions with trade unions, the Labour opposition and some Lib Dems in parliament.

The other *Alternative Service Models* identified by the Cabinet Office are: provision through a wholly owned company; provision through a shared service or collaboration; through a community benefit company or society or through a co-operative organisation. It defined 'employee ownership' as "involving the employees in a business acquiring the ownership of that business. There are various ways in which this can be achieved, through a cooperative structure, a not for profit company for the public benefit or ownership directly through shares or indirectly through a trust."

The Coalition Government promised last year to support the creation and expansion of mutuals, co operatives, charities and social enterprises to enable community groups to have a much greater involvement in public services and to give public sector employees a new right to form employee owned co operatives and bid to take over the services they deliver. Francis Maude, minister for the Cabinet Office, then announced that several mutuals would act as pathfinders. This was followed by the Cabinet Office announcement of the Right to Provide requiring employers to accept suitable proposals from front line staff who want to take over and run their services as mutual organisations. There has been the Green Paper *'modernising commissioning: Increasing the role of charities, social enterprises, mutuals and co-operatives in public service delivery.'* Finally, the consultation paper on the *Community Right to Challenge*, details the methodology by which the community or employees can run local authority services. Furthermore the Consultation Paper states at paragraph 3.4 that the Community Right to Challenge will be the mechanism for implementing the *Right to Provide* for local authority employees.

Local authorities faced with the requirements of significant savings will inevitably be considering alternative means of service delivery. Mutuals of various forms clearly provide options although they are not the only and indeed necessarily the most appropriate, depending on the circumstances. For more info, contact either:

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COMPANIES

Commodities trader **Glencore** is launching its eagerly awaited flotation which will turn hundreds of its employees into multimillionaires. The initial public offering (IPO) will value Glencore at about $60bn (£37bn), which could make it the biggest float ever seen in London. A group of investors, thought to include the emirate of Abu Dhabi, will take 31 percent of the shares, whose final float price will be revealed later this month. Glencore, which has its headquarters in Switzerland is the world's biggest commodities trader buying and selling metal, sugar, wheat and oil. It is also the largest shipper of coal around the world. The company is owned by its 485 traders, who will receive average payouts of more than $100m each through the flotation and four top executives will become billionaires. All the top brass have pledged not to sell their shares for at least five years.

Centre member **Killik Employee Services** (KES) launched a hosted internet-ready software service to help manage in-house share plans. Centive, KES' pioneering software can now be accessed directly via the internet, providing clients with an alternative to a manual installation of the software on company PCs. Centive is already the number one choice for a range of organisations including FTSE 100s, FTSE 250s and smaller unlisted companies. With KES hosted internet accessibility now achievable, Centive is able to continually evolve in order to meet clients' needs and expectations. Drinks giant Diageo, along with Tullow Oil have already signed up to this offering and many more are expected to take advantage of this new service. KES announced new share plan clients, including: Virgin Media, Portmeirion Group, Thomas Cook, Fidessa, Intermediate Capital Group, Spirent Communications and Falck Renewables.

Sainsbury's boss Justin King handed half of his £4m stake in the supermarket group to his wife for "financial planning purposes". A statement to the stock exchange revealed that King had gifted 700,000 of his 1.32m shares to his wife, Claire. The company said: "It is quite common for company directors to transfer shares to their spouses for financial planning purposes." Tax experts suggested there would be an income tax benefit for wealthy executives gifting shares to spouses. They said that on dividends worth around £100,000, a non-working spouse would save around £20,000 in taxes when compared to the higher rate tax paying executive. A holding of around 700,000 shares in J Sainsbury would have yielded dividends of almost £100,000 last year. King was paid £2.4m in cash and benefits last year, so any dividends he receives on his investments would probably attract the 50 percent top rate of tax. He has been busy trading his Sainsbury's shares of late and last month King sold 80,723 Sainsbury's shares "to fund the income tax and national insurance payable on [a share] award", while retaining the remaining 77,319 shares in the award. In February, King sold a further 50,000 shares.

On the move

Mark Gearing has been promoted to partner at Centre member **Field Fisher Waterhouse LLP**, but he continues to advise on the full range of equity incentives. FFW has further expanded its services overseas, with the opening of new offices in Munich and Dusseldorf. Mark is the author of Tolley's CSR company service on employee share plans and his direct line is: +44 (0)20 7861 4774

Senior practitioner **John Mooney** has joined Centre member **Abbiss Cadres**. John was formerly head of executive compensation at McLagan (Aon) Ltd and before that head of compensation plan management, at Deutsche Bank. Partner Guy Abbiss said: " John has held senior positions within the tax and HR departments of major global companies with responsibility for devising and developing tax-effective remuneration plans, such as dual contracts, year-end bonuses and deferred remuneration arrangements throughout Europe for local staff as well as expatriate employees. He has been responsible for the implementation process of such plans and the management of corporate risk in relation to cost and reputation; as such, he has been the principal liaison person on income and social security matters for these organisations with tax authorities in the UK and many other European jurisdictions. **Richard Nelson,** formerly of Computershare, has joined **Howells Associates** as md of Howells Data Services Ltd. After recovering from his leaving party at Computershare, Richard had his feet under his new desk at Howells within days. He told *newspad:* "Having enjoyed 31 fabulous years with HBOS/LBG and more recently Computershare, I am delighted to have joined forces with Peter Howells for the next phase of my career. Anyone who knows me knows my passion for customer service and the satisfaction that I get from being able to provide what the customer wants, when the customer wants it and at a price they are happy to pay. Howells Associates has many fine qualities. My priority is to build on these and the high level of respect we have earned in the marketplace by developing and expanding the scope of our services. We are well known for executive share plan administration services and for providing systems that enable companies to manage their own plans. We are perhaps less well known for our expertise in managing and formatting data. This is a service that we plan to offer more widely to companies, administrators, brokers and other professionals that will provide them with better financial reporting and regulatory compliance. We can enable greater efficiencies in situations where data is held in different formats on multiple platforms and requires transmission between in-house systems and various third parties."

Sonia Gilbert has been promoted to partner at **Clifford Chance** and joins Kevin Thompson, Robin Tremaine and Daniel Hepburn as partners in the Clifford Chance Employee Benefits team.

Annual conference Cannes July 7 & 8

A case study from leading world education group Pearson is one of the highlights of the Centre's 23rd annual conference in Cannes on Thursday July 7 & Friday July 8 at the five-star Majestic Hotel. The speaker will be **Steve Leimgruber**, Pearson Group share plans manager and his presentation is entitled: *"The challenges of operating an international all-employee share plan from the perspective of an in-house share plans manager."* Centre member Pearson owns the *Financial Times* and the book publishers *Penguin.* **Angela Gibson** of **YBS Share Plans** will present a client case history under the banner '*Outsourcing Global Share Plans*' during which she will look at the planning process, plan design, the employee engagement process and on-going administration.

A key presentation will be given by **Patrick Neave** from the investment affairs department of the Association of British Insurers (ABI), which represents insurance companies and key investment houses. Patrick will discuss the Association's latest guidance on executive remuneration incentive reward schemes. Institutional shareholders are increasingly demonstrating their stewardship responsibilities, sometimes by voting against controversial remuneration reports at company AGMs. Delegates will be able to question him on the implications of the ABI's remuneration guidelines and in private, about specific cases.

Louise Jenkins of Ernst & Young will speak on 'Executive remuneration trends in the financial services sector in the current regulatory environment.' Louise will examine the new requirements imposed by the FSA Remuneration Code (and European equivalents, following the introduction of CRD3) and how these are impacting design and practice in executive compensation strategy.

Centre international director **Fred Hackworth** will moderate a 40-minute open debate on the regulation of executive equity incentives. He will ask delegates for their views on whether: *Risk is being factored out of the game by raising base salaries and reducing the role of performance-based equity bonuses? *Whether the regulators gone too far? *Can claw back for 'under-performance' ever work? and *Reward schemes – the new benchmarks. A very lively discussion is promised.

Other confirmed speakers include **Sara Cohen** from Lewis Silkin LLP, **Justin Cooper** from Capita Registrars, **Professor Jens Lowitzsch** of Frankfurt University; **Richard Nelson** of Howells Associates; **David Craddock,** who runs a UK share scheme consultancy and Centre chairman **Malcolm Hurlston**.

Service providers and corporate plan issuers are invited to this key event, for which two speaking opportunities remain. Speakers benefit from our reduced package deal attendance price, which includes two nights (July 6 & 7) accommodation in the Majestic Hotel, plus breakfasts, lunches, refreshments and cocktail party invitation for **£895** per person (no VAT added). This is an excellent offer, as the hotel rooms (two nights), conference facilities and day delegate rate package, including lunches and the cocktail party, cost the Centre £625 per delegate (*thanks to plunging sterling*). If speakers bring with them a plan issuer client, to deliver a joint plan case history, the package deal charge for a co-speaker *issuer* will be only **£525**, or the client can attend free of charge, provided he/she finds and funds his/her own accommodation. Centre service provider delegates will pay **£995** (no VAT) each. Non-member service provider delegates pay **£1,450** each for the same package. Centre member *issuers* pay **£599** each as delegates or **£780** if non-members. The programme contains equity plan case histories; executive reward trends in both the EU and USA under the new regulatory regimes; the impact of government intervention, disguised remuneration, corporate governance, options expensing and other accounting issues, cross-border tax strategies, EBTs, trusteeship, communication strategies, aspects of plan administration and wealth management. Go to the Centre website at: www.hurlstons.com/esop and click onto 'news' and 'events.'

The brochure, which can be downloaded from the events window, is co-sponsored by leading provider of offshore legal, fiduciary and administration services **Appleby Global** and by **RBC Corporate Employee & Executive Services**, a leading global provider of employee benefit plans and private equity and property fund administration. RBC CEES manages more than 600 plans for 450 corporate client groups, including companies listed on major stock exchanges and privately-owned businesses worldwide.

This two-day conference provides an ideal forum for reviewing latest employee equity developments, forging new business opportunities and networking. Please email Fred at fhackworth@hurlstons.com to reserve a delegate place or speaker slot and copy in esop@hurlstons.com.

Conference dates for your diary:

Dates have now been set for the Centre's key annual events in the Channel Islands. Guernsey will host on **Friday September 9** and Jersey on **Friday December 9**. The programmes in each jurisdiction will ask: *"What now for EBTs after the disguised remuneration legislation?"* Centre members who wish to speak at either, or both, these events should contact Centre assistant director Dave Poole asap with a brief summary of what their topic presentation would look like. Although several speakers at each event will concentrate on the fall-out from the disguised remuneration legislation, other topics, especially of interest to trustees, will be covered. Dave's co-ordinates are: dpoole@hurlstons.com and tel: +44 (0) 20 7239 4971.

Hastings-Bass rule doomed?

In a decision that will be significant for offshore tax planning and trust matters, the English Court of Appeal has effectively reversed the so-called 'Rule in **Hastings-Bass**' that has developed over the past 20 years, mostly in offshore tax jurisdictions like Jersey and the Isle of Man. In ***Pitt v. Holt***, 2011, the Court of Appeal held that the law took "a seriously wrong turn" 35 years ago, and that Hastings-Bass does not support the rule that has been so often invoked by trustees to unscramble transactions that had unintended tax consequences, reported lawyers *Borden Ladner Gervais.* The 1975 Court of Appeal decision ruling the Hastings-Bass case was conveniently summarized in *Sieff v. Fox* (2005) as: *"Where trustees act under a discretion given to them by the terms of the trust, in circumstances in which they are free to decide whether or not to exercise that discretion, but the effect of the exercise is different from that which they intended, the court will interfere with their action if it is clear that they would not have acted as they did had they not failed to take into account considerations which they ought to have taken into account, or taken into account considerations which they ought not to have taken into account".*

The rule has been criticised as being the 'morning-after pill' or 'get out of jail free card' for trustees, who invoke Hastings-Bass to set aside their own decisions that had unintended tax consequences. For most of this time, HM Revenue & Customs sat on the sidelines while the rule was developed and applied.

In the past year, however, HMRC has intervened in cases in both the UK and offshore jurisdictions, seeking to put the brakes on the application of the Hastings-Bass rule - in order to safeguard potentially important revenue streams. On March 9 this year, the Court of Appeal allowed appeals in *Pitt v. Holt* (2010) and *Futter v. Futter* (2010) in which lower court judges had applied *Hastings-Bass* to set aside decisions of trustees that had unwanted tax consequences. The Court of Appeal performed a thorough review of the cases, and reached the conclusion that the 1975 decision of *Hastings-Bass* does not support the so-called rule that has developed in the past two decades. The Hastings-Bass case only concerned a trustee's exercise of the power of advancement. In regards to acts of a trustee that are within their powers but have unintended financial consequences, the Court of Appeal in *Pitt v. Holt* summarized the correct approach as follows:

- The trustee's act would be voidable, not void
- It would only be voidable if there was a breach of fiduciary duty by the trustee
- If it is voidable, it may be set aside upon the application of a beneficiary (<u>not</u> a proceeding commenced by the trustee)
- Equitable defences and the Court's discretion would apply.

Fiscal considerations, such as tax liability, are among relevant matters that a trustee must take into account when exercising discretion. However, if a trustee receives professional advice on tax matters, it cannot be ruled that there was a breach of fiduciary duty.

In the *Futter* case, the trustees relied upon the tax advice of the law firm *Withers*. The tax advice turned out to be wrong, but that did not mean that the trustees were in breach of their fiduciary duties. The Court of Appeal held that the decisions of the trustee therefore could not be "voidable", and the Court could not intervene.

The *Pitt* case involved a fund established for a brain-injured person. The Court agreed that the same principles apply in the adult guardianship context as in private discretionary trusts. The fiduciary received professional advice that did not take into account tax liabilities. In consequence, the guardian could not be said to be in breach of her fiduciary duty, and the transaction was not voidable. The *Pitt* case raised the issue of whether voluntary payments by an individual could be set aside on the basis of mistake. Courts in offshore jurisdictions such as Jersey have set aside voluntary transactions (such as transfers from a trust fund) that had unintended tax consequences. The Court of Appeal in *Pitt v. Holt* agreed with the trial judge that the transaction could not be set aside on the basis of mistake, as adverse tax liabilities were merely a "consequence" of the transaction. There was no mistake in regards to the effect of the transaction itself.

In both situations (Hastings-Bass and mistake), the Court of Appeal seems to be saying that a trustee should look to their professional advisors (or their insurers) for compensation, rather than seeking to set aside the transaction, if there were adverse tax consequences that could have been avoided. The trustees have filed an appeal of the *Pitt v. Holt* decision with the UK Supreme Court, and the appeal may not be heard until 2012. In the meantime, courts in offshore jurisdictions may have to decide whether they will follow the Court of Appeal's decision or continue to apply Hastings-Bass.

Early move on Prospectus Directive?

The Government issued a consultation on the early implementation of two of the changes to the EU Prospectus Directive exclusions/exemptions which companies may apply to employee share plans, writes **Clifford Chance**. As things stand, member states have until July 1 2012 to implement the changes, which are supposed to make employee share plans easier to operate. The two areas under consideration for implementation a year early are:

* The exemption which applies to offers made to fewer than 100 employees per member state is to be increased to 150 employees per member state.

* The exclusion which applies where the value of the offer over a period of 12 months is less than €2.5m (across the EU) is to be increased to €5m.

Early implementation in the UK would be very helpful, although companies making multi-jurisdictional offers in the EU will still need to consider the relevant limits in the other EU states because other states may not implement the changes as quickly as in the UK, warned Clifford Chance.

"Unfortunately, the consultation does not also extend to the changes to be made to the scope of the employee share plans exemption. These changes will mean that the prospectus exemption is extended to all companies whose head office or registered office is in the EU (regardless of whether or not they are listed)."

In addition, companies which are established outside the EU will qualify for the exemption if they are listed on an EU regulated market (as is the case under the original exemption wording) or if they are listed on a 'third country market' which has been approved by the EU Commission. There is no indication that these changes will be implemented prior to July 2012. "We are lobbying for these changes to be implemented as soon as possible so that a wider variety of both EU and non-EU companies can take advantage of the employee share plans exemption," said CC partner Kevin Thompson.

Disguised remuneration

Centre member **Linklaters** was unhappy about the '"areas of doubt" regarding the application of the disguised remuneration legislation. The top law firm said that the Treasury had cast its net too wide in an attempt to nail tax avoiders. Although HMRC issued some FAQs, which provided reassurance to employee share plan sponsors and advisers on most points, the Finance Bill had given rather less assurance and had opened up some new areas of doubt.

For example, the exemptions from the upfront income tax charge do not apply:

To free share arrangements which have a vesting period of more than five years;

To options which are exercised more than five years from the grant date;

Where awards are granted by the parent company or the trustee rather than the employer.

In addition, said Linklaters there is uncertainty about the availability of the exemptions, arising in part from conflicts between the actual legislation and the latest version of HMRC's FAQs. For example:

- The FAQs state categorically that there is no upfront charge where funds are put into the trust and used to buy shares if there is no earmarking in relation to specified named employees. But the legislation is not so clear;

- The exemption for HMRC approved schemes only seems to apply if the number of shares in trust is limited to the maximum number reasonably expected to be required for the approved schemes over the next five years – potentially a problem where trusts hold shares for a combination of approved and unapproved share plans;

- The exemption for unapproved plans only applies if at the time of grant there is a "reasonable chance" that the award will lapse. The FAQs indicate that "bad leaver" provisions will be sufficient to satisfy this test, but there must be doubt in cases where (as is often the case – particularly with bonus deferrals) the award only lapses if the employee is dismissed for misconduct and/or in one of the malus events mentioned in the FSA's remuneration code;

- The exemption seems not to apply where there is the possibility of early vesting (e.g. on leaving employment). In addition, the FAQs seem to say the exemption does not apply if the plan rules contain discretion to allow a bad leaver to retain awards. This would be a serious problem for many companies.

"Effectively, we are in a state of limbo until these uncertainties are resolved – but the law is already in force.

"More generally, it is unfortunate that, rather than imposing tax in very specific circumstances, the legislation applies in very wide circumstances, far beyond the true target – the tax avoider - and then provides a large number of very detailed and complicated exemptions, and reliefs which are designed to avoid double taxation in cases where the upfront charge applies. (The legislation on disguised remuneration runs to nearly 60 pages!)," added Linklaters.

This view was echoed by David Pett, senior partner at centre law firm member **Pett, Franklin & Co. LLP.** The style of drafting in the Bill was "convoluted and difficult to follow," he said.

"The vagueness of the terminology used (and in particular the continued use of the term 'earmarking') and the fact that the government is determined to cast the net wide and then provide for specific exemptions in relation to what it considers to be benign situations, means that it is very difficult to say at this stage with any certainty exactly what a tribunal or court (as opposed to HMRC) will regard as being caught (giving rise to charges to Income Tax and NICs at an earlier stage than taxpayers and employers might normally expect) and what will not. As drafted, there appear to be many opportunities for a company and the employees of its employees' trust to fall foul of the new rules," added Mr Pett.

For PAYE purposes a payment falling within the disguised remuneration rules is treated as being made on the latest of the date the relevant step is taken, the date employment starts (where an award is made to a new starter) and the day which is 30 days after the day on which the Finance Act 2011 is passed, said Linklaters. This should help where steps which result in assets being earmarked are taken in the next few weeks so that the normal PAYE and NIC payment rules should apply. There are still a lot of uncertainties and the legislation may well change again, but it is effective now, in the sense that it applies to any steps taken by employers from 6 April 2011 onwards. Until things are clarified, it is risky to provide employee trusts with new funding or to grant awards which will be satisfied by a trust. It is liaising with HMRC to try and clarify the uncertainties, and we will report on developments.

The Bill had revealed significant changes on disguised remuneration compared with the first draft legislation that was released on December 9 2010, said Centre member **Deloitte.** For the most part, the changes give effect to the carve-outs emerging during HMRC's extensive consultation process for bona fide remuneration arrangements, as foreshadowed in HMRC's first draft FAQs. While these were welcomed, the scope of the legislation had been widened and there are many grey areas. Extreme care was now required in all areas of remuneration planning, in particular with share schemes and deferred remuneration, to avoid tax charges that can be penal in quantum and/or timing. Generally speaking, the disguised remuneration legislation would not apply to the grant and exercise of stock options or the award and vest of other share based incentives, said Deloitte. However, a tax charge under the 'earmarking' provisions could arise where such options or awards are hedged with shares; i.e. where shares were held with a view to obligations under the scheme being met.

Further regulations and the corresponding NIC provisions had yet to be published, so this was not yet the final story. Based on the latest FAQs and Finance Bill as it stood, while impossible to be exhaustive, Deloitte had considered a number of scenarios across all elements of reward, highlighting what is and is not caught and what changes may need to be made to typical arrangements currently in place or under consideration.

Approved share plans: The exclusion for approved share plans is now extended to cover the funding via employee benefit trusts etc. However, the exclusion does not apply unless the sole purpose of the arrangement is to grant approved options or award shares under an approved SIP, and must not be connected directly or indirectly with a tax avoidance arrangement. Further, the exclusion is limited to the number of shares that might reasonably be required to satisfy those tax advantaged awards within five years of the date on which the shares are earmarked within the EBT. Particular care will need to be taken in relation to funding strategies for SAYE options with a five-year (or seven-year) savings contract. Similarly, care will need to be taken in respect of options which become exercisable solely on an exit and do not therefore have a specified vesting date (such an approach is quite common particularly in relation to EMI options).

Nil price options, LTIPs, unapproved options and phantom options: Where such options/awards are hedged with shares, an earmarking charge will arise unless certain conditions are satisfied. Phantom options are also included within these earmarking provisions that allow for hedging using shares to deliver amounts payable in cash on vesting. In each case, the exclusion from an earmarking charge is subject to similar conditions as those applying to deferred consideration, in particular: *The option is not exercisable before the vesting date; *The vesting date is no later than five years from award; *The option terms must contain provisions whereby it will be forfeitable in its entirety if specified conditions are not met on or before the option vesting date (and, at grant, there must be a reasonable chance of not all the specified conditions being met on or before vesting date, giving rise to forfeiture).

As noted above in A2 above, HMRC's latest FAQs (No. 17) confirmed in the context of deferred remuneration, that "even if the only circumstances that would result in the specified conditions failing to be met are that the employee departs from the employment as a "bad leaver" the test will be met. But this will only apply if there is no possibility of the employee receiving the reward if the conditions for forfeiture are triggered." As the same conditions are used in the context of share schemes, Deloitte presumes the same interpretation of "reasonable chance" applies.

The revised legislation does provide some flexibility in the way that funding the trust with shares to satisfy the options/awards can begin within a limited period of three months before the award/option is actually granted. However, there are some significant traps for the unwary, particularly in relation to options (where the tax charge does not necessarily arise at vesting):

*If options have a maximum vesting period of five years, there should be no charge under the legislation when shares are earmarked for the option holder. However, if the options are <u>not</u> exercised within five years of the grant date, a charge can arise under the disguised remuneration legislation on the fifth anniversary of the grant date based, broadly, on the value of the shares at that time less the exercise price to be paid.

*If options/awards have a vesting period in excess of five years, and shares are earmarked in a trust, a charge would apply at the time of the earmarking. The charge would be based on the value of the shares at the time of earmarking less the exercise price (if any) to be paid. The effect is that if market value options are granted with a vesting period in excess of five years and the shares are 'hedged' at the time of grant, there would effectively be no charge under the disguised remuneration legislation – either on earmarking, the fifth anniversary or the vesting date.

*A specific exemption has been introduced in respect of awards that vest only on an exit (broadly, a sale or flotation). Where shares in an unlisted company (but not cash or listed shares) are earmarked in a trust and the proceeds of disposal of the shares would be used to make cash payments to an employee on the occurrence of an exit, no charge would arise when the shares are earmarked. In this scenario, there is no five-year limit but to meet the conditions, the awards would, perhaps surprisingly, have to be settled in cash.

Deferred bonuses: As promised in the FAQs, funding for an award of deferred remuneration is excluded from an earmarking charge, provided certain conditions are met. The three main conditions are that the award (which may be in any form, whether cash, shares or other assets) must:

*Vest not later than five years from award;

*Contain provisions whereby it will be forfeitable in its entirety if specified conditions are not met on or before the vesting date (and, at award, there must be a reasonable chance of forfeiture because not all the specified conditions will be met on or before vesting date);

*Be fully taxed as PAYE employment income at the vesting date.

Optionally, the terms of the award may also allow for partial forfeiture on other specified conditions. If the award is neither forfeited nor delivered to the employee by the vesting date, a relevant step is deemed to occur at the vesting date.

There is no distinction between compulsory and voluntary awards. While employees may voluntarily agree to defer part of their remuneration, they would not normally expect the deferred amount to be subject to forfeiture. This is likely to mean that, in practice, voluntary deferral arrangements will not benefit from this exclusion that will have more applicability for mandatory deferral plans. Such deferral plans may become more popular in anticipation of a potential reduction in the highest rate of tax at some point over the next few years.

The legislation does not prescribe the type of forfeiture provisions that may be included it just requires that they must be specified and there must be a reasonable chance that not all the specified conditions will be met. In US deferral plans, forfeiture solely for acts of gross misconduct is not, on its own, sufficient to defer tax under US deferred compensation rules. In contrast, HMRC's latest FAQs (at No. 17) confirm that "even if the only circumstances that would result in the specified conditions failing to be met are that the employee departs from the employment as a "bad leaver" the test will be met. But this will only apply if there is no possibility of the employee receiving the reward if the conditions for forfeiture are triggered."

This point dovetails well with the FSA Code, which requires that forfeiture of deferred awards should, as a minimum, relate to either employee misbehaviour, material negative financial performance of the relevant business unit, or a material failure of risk management of the relevant business unit. However, it is disappointing that the legislation does not align with the FSA Code in respect of the deferral period: the FSA recommends a minimum of 3 to 5 years, so deferral periods of greater than five years, will be subject to the disguised remuneration rules.

A further potential problem is that many US executive deferred remuneration plans are also supplementary pension plans, yet the new exclusion does not apply to pension schemes.

Finally, the requirement that vested awards must be PAYE employment income is unnecessarily restrictive. If, say, securities are not readily convertible assets, they may not be PAYE employment income and so the exclusion will not apply. Examples would be shares awarded by a subsidiary company whose parent is listed on a recognised exchange and whose shares are corporation tax deductible, or shares in a family company where there are no trading arrangements.

Sale of shares (or assets): A credit will now be given where employees sell assets (including shares) to a third party for no more than market value. In this case, the value of the shares (or assets) sold may now be deducted from the payment received, provided:

*The shares (or assets) are transferred before, at or about the time the payment is received; and

*The shares (or assets) are not transferred by way of a loan.

In such cases, only if the shares (or assets) are sold for an amount in excess of market value would there by a disguised remuneration charge. However this would give rise to a tax charge in any event under general principles – overlap provisions will prevent a double tax charge. Note that this measure will also exclude share for share exchanges where there is no uplift in value

****Deferred consideration:*** The same rule covers the case where shares are acquired by an employee for consideration payable at some point after the acquisition. In such cases, as the consideration is not paid at or before the shares are received, the value of the shares acquired would give rise to a disguised remuneration charge. Deferred consideration arrangements can be used in certain Joint Share Ownership Plans, as well as other share-based plans, so (where new awards are to be made) existing plan rules should be reviewed in light of the Finance Bill provisions.

****A big "Thank you" to all those members who sent us their comments on the disguised remuneration developments. We have summarised several above, but cannot use them all in this edition for fear of creating confusion and duplication.***

INTERNATIONAL

More and more managers of small and medium-size companies in Belgium are deciding to refinance their companies through the granting of stock options to their employees, said CMS DeBacker. This financing source enables companies to limit their banking credit and to share their capital with their employees. For a long time, stock options plans were exclusively reserved to managers of big multinational companies. This phenomenon was at its peak at the end of the 90s, personified by Jean-Marie Messier who granted himself a small salary but who bought himself yachts and luxury hotels on Fifth Avenue thanks to his famous Vivendi stock-options. However, cometh the economic crisis, the practice of granting stock-options to managers of big multinational companies became far more discreet. The mechanics of setting up option schemes did not disappear, but was transformed instead.

The granting of stock-options by a company to its employees or managers (or to their management companies) is considered to be remuneration but the taxation of stock-options can be extremely favourable: by respecting the required fiscal conditions it is possible, in certain circumstances, to decrease the tax liability to three or four percent of the market value of the shares at the time of the options issue (by applying a taxable base of 7.5 percent of the underlying value).

"As a result of this attractive tax rate, we see that more and more creative entrepreneurs are deciding to re-finance their company via the granting of stock options to their staff. This financing source enables companies to limit their bank loans and to share their capital with employees. Thus the economic and financial crisis has auto-generated the transformation of a symbolic element of capitalism towards a participative model for the employees," said CMS DeBacker.

Bonus corner

Deutsche Bank, one of the Government's inner-circle of financial advisers, is opposing HMRC in a bid not to pay taxes on £92m worth of bankers' bonuses. The German-owned bank is appealing against a decision by an HMRC tax tribunal which ruled against a long-standing attempt by Deutsche to avoid paying payroll taxes on bonuses. Deutsche, which employs 8,000 people in London, is leading the sell-off of Northern Rock and advised the Treasury on bank bail-outs during the financial crisis. News of the legal battle comes after George Osborne, the Chancellor, announced plans to bring in £3.77bn in tax over five years by closing loopholes similar to the one used in this case. Deutsche did nothing illegal, but it is clear from the tribunal judgment that the bank was operating in a grey area. It is similar to a case involving UBS – also to be the subject of an appeal. Deutsche's complex tax avoidance scheme involved the use of an offshore trust to attempt not to pay income tax and National Insurance Contributions. Judge David Williams, who presided over the tribunal, found that the scheme was "created and co-ordinated purely for tax avoidance purposes." The 2004 scheme involved the creation of a Cayman Islands-registered investment vehicle called Dark Blue Investment. Rather than receive bonuses in cash in the UK, the bankers involved agreed to pool their bonuses into one pot of £92m. That sum was used to invest in Dark Blue, shares in which were then allotted to the individuals. If they did not sell their shares over the five-year life of Dark Blue, the scheme was wound up and the shares sold, with the date of redemption December 31 2009. Deutsche argued tax was not due as the sums paid could not be regarded as the earnings of any individual employee at the time the shares were purchased. But after hearing evidence from both the German bank and HMRC, Judge Williams ruled the scheme's "purpose was that of utilising advantages... so that the Deutsche Bank employees paid no income tax on the sums given to them under those [income tax] exemptions or NIs to which they might be liable... and that the Deutsche Bank group itself paid no employer's NICs on those sums." The ruling will prove to be embarrassing for Deutsche given its close relationship with the Treasury. The Chancellor has announced legislation to stamp out disguised remuneration, closing up a series of loopholes in a measure expected to affect 50,000 highly paid people, many of them bankers. The practice was widely used over the past decade to help those earning more than £250,000 a year to avoid paying income tax and NICs. A Deutsche spokesman said: "This was a one-off arrangement from seven years ago and hasn't been repeated. "We believe it met all the requirements and are appealing against the decision."

Goldman Sachs bankers faced a bonus challenge from four orders of nuns. The Sisters of Saint Joseph of Boston, Sisters of Notre Dame de Namur, the Sisters of St Francis of Philadelphia and the Benedictine Sisters of Mt Angel – all investors in the bank – put their name to a proposal to review its remuneration policies after it emerged its five most senior employees were collectively awarded £43m in reward last year. The Securities and Exchange Commission disclosed the challenge in a filing ahead of Goldman Sachs' agm in May. The nuns asked: "shareholders request that the board's compensation committee initiate a review of our company's senior executive compensation policies and make available a summary report of that review by October, 2011 (omitting confidential information and processed at a reasonable cost). We request that the report include: 1. An evaluation of whether our senior executive compensation packages (including, but not limited to, options, benefits, perks, loans and retirement agreements) are 'excessive' and should be modified. 2. An exploration of how sizeable layoffs and the level of pay of our lowest paid workers impact senior executive pay. 3. An analysis of the way in which fluctuations in revenues impact: a) the company's compensation pool; b) the compensation of the company's top 25 senior executives; and c) the company's shareholders." Ceo Lloyd Blankfein saw his total reward reach $14m in 2010, with four other senior executives receiving a similar amount. Goldman said it would resist the request: *"Shareholders already have access to the information necessary to understand and assess the compensation decisions made with respect to our senior executives, and the firm as a whole. Our board believes that the preparation of the requested report would be a distraction to our compensation committee and our board, would entail an unjustified cost to our firm and would not provide shareholders with any meaningful information."* Goldman was among several Wall Street firms willing to restrict bonuses and payouts in the light of the financial crisis and the resulting government bailout. The firm received $10bn from Washington in 2008. In 2010, the bank's revenue fell 13 percent to $39bn. Nevertheless, Mr Blankfein's compensation last year includes a cash bonus of $5.4m and stock awards of $7.7m. He was granted restricted stock valued at $12.6m, which is not counted in the total annual package because the stock vests over three years.

The nuns who challenged Goldman Sachs's executive-pay policies, are but the tip of an iceberg, said The Economist. Thanks to a 'say on pay' clause in last year's Dodd-Frank financial reform law, the pay of every senior executive of an American public company is now subject to a shareholder vote. So far in this spring's corporate annual meeting season, the management has lost such votes at four firms, the most prominent being Hewlett-Packard, the computing giant. Given the current mood of banker-bashing, it will be no surprise if there are similar results at Goldman Sachs and other financial firms. A new study by the Corporate Library, a research body, finds plenty for shareholders to vote against. It looks at those big companies that had, by March 20, reported their bosses' pay—about a fifth of the S&P

500. Almost all reward them for long-term performance without considering whether similar firms are doing better. More than 75 percent of ceos still have “golden parachute” severance deals worth at least twice their annual pay. In the past year things have got worse in three main respects, argues the Corporate Library. The difference between the ceo’s pay and that of other executives has grown. The dilution of other shareholders by awards of shares to executives has increased. And retirement benefits have become even more excessive. It remains unclear how managers will respond to losing a vote on executive pay, as these votes are not binding. Occidental Petroleum, one of three firms that were defeated in the far smaller number of “say on pay” votes held last year, is rumoured to be working on big changes in its pay policies, following criticism of the bounty enjoyed by its ceo, Ray Irani. However, says Robert McCormick of Glass Lewis, a firm that advises shareholders on how to vote, some managers are already trying to avert defeat by giving in to shareholder pressure before the issue goes to a vote. Disney issued a new proxy form (the document describing what shareholders will vote on) that cut the size of its bosses’ golden parachutes, after investors’ grumbles. Experience from the UK, which introduced say-on-pay in 2002, suggests that US shareholders can expect more improvements in the responsiveness of executives. Although few pay packages have been voted down by shareholders, that is because it is now routine for British executives to consult investors on pay policy long before it goes to a vote. Colin Melvin of **Hermes Equity Ownership Services**, which advises institutional investors on such matters, says the overall result has been much better communication between managers and shareholders. In contrast, he says, American bosses still seem disinclined to have such a dialogue. Executive compensation remains a hot topic on the boardroom agenda because earlier this year the SEC adopted Say on Pay rules that allow investors to vote on executive compensation at publicly traded companies. Boards do not necessarily have to listen, however, as the votes are considered non-binding. Say-on-pay, which originally started in the UK, grants shareholders a voice on salaries, bonuses and golden parachutes. According to Inside Investor Relations, one of Britain’s biggest businesses is likely to lengthen its executive remuneration scheme from three years to five, a change that would put pressure on other major companies to change the way they reward the UK’s most senior managers. This would probably create conditions in which other businesses could face pressure from some institutional shareholders to follow suit “In the US, it is possible that several large-cap companies might consider lengthening their executive remuneration timeline in response to the developments in the UK,’” said Sanjay Shirodkar, counsel to DLA Piper’s public company and corporate governance group: “Some of the larger companies might take a second look at their cycle, but it is unlikely we will see a large number of companies switching over to a five-year cycle in the short term.”

Transocean's senior management team will donate bonuses they received for the company's 2010 safety performance to a memorial fund benefiting families of the 11 men who died in last year's explosion of Transocean's Deepwater Horizon rig. The company said in filings last week that 2010 was its "best year for safety performance" based on data it gathered — despite the 11 deaths April 20 when BP's Macondo well blew out, destroyed the drilling rig and triggered a massive oil spill. The executive team was eligible for 115 percent of safety-related bonuses, although that was reduced to 67 percent of the target bonuses because of the deaths.

News of the bonuses drew outrage from regulators and the public. "Some companies just don't get it," said William Reilly, former co-chair of the presidential commission that investigated the disaster. "I think Transocean just doesn't get it." The company apologized and said the funds will be donated to the Deepwater Horizon Memorial Fund.

Goodyear Tire and Rubber Co’s president and ceo, Richard Kramer, gained a 69 percent rise in his annual compensation to $8.5m in 2010, according to an *Associated Press* calculation from a regulatory filing. Kramer, who became the company’s ceo on April 13, 2010, claimed the chairman title on October 1 that same year. During this time, he received a base salary of $929,924, which shows an increase of 37 percent in 2010 as the company reversed a 2009 decision to freeze executive officers’ salaries Bloomberg reports. Meanwhile, the largest U.S. tyre maker reported a loss of $216m for 2010, which included a $160m charge to close a 1,900-employee factory in Tennessee. In fact, executive bonuses are rewards for past performance against goals established at year’s end by the executive and approved by the board of directors. Goodyear is a good example of those U.S. companies that are granting bonuses to their executives despite suffering a loss in revenues.

Bonus payouts in the City for 2010-11 fell by eight percent to £6.7 bn, down from £7.3 bn in the previous fiscal year. But lower bonuses have not put an end to the culture of high reward levels, when employees continue to earn bumper pay packets bolstered by rising base pay, according to research by the Centre for Economics and Business Research (Cebr). Cebr estimates that average regular pay for City employees in the first quarter of 2011 was seven percent higher than a year ago and much higher than growth of just two percent for the UK as a whole.

Willie Walsh, who led a merger between **BA** and Spain's **Iberia** took his first bonus in three years, despite continued knife-edge relations with cabin crew unions. The group's annual report cites "an improvement in industrial relations" as one of Walsh's bonus criteria. He was awarded the £420,000 bonus for the last nine months of 2010, paid in addition to base salary and benefits worth £564,000. The bonus was partly in recognition of his efforts to create IAG, the Iberia combination as well as for returning BA to profitability after three years of record losses and securing a long-awaited alliance with American Airlines. The bonus payout sparked objections from union figures. They claim the BA boss, now ceo of BA and Iberia's parent company, International Consolidated Airlines Group (IAG), has been financially rewarded for seeking to cut back terms and conditions for many among the airline's workforce.

Companies should be forced to spell out in simple form how they use their profits, stating how much is invested back into the businesses, how much is paid in dividends to shareholders and how much is handed to staff to help investors gauge whether bonuses can be justified. Under the proposal being developed by Robert Talbut, chief investment officer of **Royal London Asset Management**, companies should be required to publish three years of such information in their annual report and accounts. Talbut, a member of the independent High Pay Commission, said: "Far too much of the debate over remuneration takes place in isolation with little relation to the context of the company and its strategy." He hopes his idea will allow a more sophisticated debate to take place about the ability of each individual company to pay out bonuses, dividends and invest in their businesses – particularly at a time when some companies are adding to the complexity of their bonus schemes. Talbut's idea for a distribution schedule of how profits are used is intended to make it easier for shareholders to discuss company strategy with management teams. "The distribution schedule could over time become a central focus for how shareholders engage with management and clearly establish the linkage between strategy, investment, risk and remuneration," he said. "For each company we could see how profits earned by the business have been used, firstly through the amount of investment in the business that has been undertaken; secondly the amount of dividends that have been paid to the shareholders; and then lastly how much was paid to both all staff but then also to the executive team."

Pension plans criticised

Lord Hutton's recommendations, which would force public sector workers to work longer for a lower pension income, will be met with anger and confusion unless the UK-wide financial literacy deficit is addressed at the same time, according to Killik Employee Services. MD, **Martin Osborne-Shaw**, said: "For any public sector worker, today's recommendations are a blow. Individuals will be expected to work longer, pay more and all for less money at the end, due to career averaged pension income. Most people agree that the current level of pension pay-out is unsustainable, but employers must address the likelihood that many people will now be tempted to opt out of pension schemes altogether. Those staying in their schemes will see a decrease in take-home pay as well as a drop in their pensionable income. Personal debt levels will increase unless guidance is provided to help employees cope with a lower take-home pay, and those nearing retirement need assistance now to ease concerns about pension planning and the impact of working longer. With such a fundamental change in pension provision, employers owe it to their employees to help them understand the impact this will have on their finances now and going forward," he added.

The focus of the Hutton Review does not pick up on emerging attitudes in the private sector where employers are now starting to plan for the provision of financial education to employees. Killik Employee Services, through the development of its employee financial education resource Money in Mind, has identified a trend for some organisations to consider financial education as an important part of their employee benefits provision.

Hutton Review main points**:**

- Defined benefit structure will remain in place; future and current members will be moved to career averaged pension income; existing scheme members will retain their link to final salary
- Uniformed public sector workers pension age will be increased to 60 Retirement age for non-uniformed workers will move in line with state pension retirement age – 66 for men and women by 2020
- Amount scheme members must contribute will soon be increased (three percent increase likely)
- Greater flexibility on when members can retire; pension income to be adjusted on an actuarially fair basis; caps on pension accrual to be removed or significantly lifted and schemes to issue regular benefit statements to active scheme members, at least annually.

The Employee Share Ownership Centre Ltd is a members' organisation which lobbies, informs and researches on behalf of employee share ownership.