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Punitive Windfall Tax on UK Bankers' Bonuses – and other Recent Developments in Executive Remuneration

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1. UK Government Announces Punitive Windfall Tax on Bankers' Bonuses

Alastair Darling, the UK Chancellor (finance minister) announced yesterday in his pre-budget report a one-off "windfall" tax on banks that pay bonuses of over £25,000. The aim of the temporary tax is to address the remuneration practices that contributed to excessive risk taking in the financial services industry, and to use the tax proceeds to fund job support for the young, the old, and the unemployed. The 50% bank payroll tax will affect bonuses paid out by a UK bank (or a foreign bank operating within the UK) to employees engaged in "Banking Employment" between 12.30pm on 9 December 2009 and 5 April 2010 (although the pre-budget report states that the Government may extend this period). Contractual bonus obligations existing at the time of the Chancellor's announcement are exempted, and there is some debate as to whether the investment advisory and asset management arms of banks will be caught.

Even before the punitive tax was announced, the measure was heavily criticized by investment bankers including Bob Diamond, president of Barclays and head of Barclays Capital. Diamond warned that the measure could weaken the London financial markets, as "both financial capital and human capital are extremely mobile", and argued that it goes against the principles agreed by the G20 earlier this year. At the moment, action of this kind does not seem likely or under way in any other country.

What Should Employers Do Now?

Where bonus amounts are to be determined wholly or partly at the employer's discretion, employers will need to decide whether to pay bonus and the punitive tax, to reduce bonus below the threshold level, or to defer bonus payment until after 5 April, 2010. Employers opting to reduce bonus will be helped by the Court of Appeal's decision in *Commerzbank v Keen [2007] IRLR 132,* which confirmed that the exercise of an employer's discretion should not be "irrational or perverse", but that a court should not substitute its own judgment for that of the employer making the decision. Where representations have been made that a certain amount will be paid out, employers should also consider whether a claim for misrepresentation or reliance on a promise (i.e. promissory estoppel) may arise.

If you are an employer requiring advice on these issues, please contact one of the team (contact details below).

2. Financial Services Bill

The new Financial Services Bill (the "Bill"), introduced by the UK Chancellor to the House of Commons on 19 November 2009, follows a range of measures that have recently been introduced in response to the global financial crisis, including the Financial Services Authority's (the "FSA") publication of a new Remuneration Code (which applies to large UK banks and building societies) the Walker Review of corporate governance and the banking crisis, and the G20 agreement on remuneration.

The Bill contains significant reforms that provide greater rights and information for consumers and increase the strength of regulation in the financial services sector. These measures include provisions about executive remuneration and new FSA duties and powers to regulate remuneration.

New FSA Power to Require Disclosure of Executive's Remuneration

The current draft of the Bill will give HM Treasury the power to make regulations about the preparation, approval and disclosure of executive remuneration reports. "Executives" include employees, officers and other individuals with a "prescribed connection" to a firm, including those who directly or indirectly provide services (with the effect that firms cannot "hide" high-earners' remuneration packages by hiring them as independent contractors, rather than employees). Regulations may make it an offence for firms not to report executive remuneration, and require firms to file remuneration reports with Companies House or the FSA that will be available to the public.

New Regulatory Powers and Duties for the FSA

If enacted, the Bill will amend the Financial Services and Markets Act 2000, so that it includes a requirement for firms to regulate the remuneration of specified officers, employees and others. The Bill places a duty on the FSA to ensure that firms' remuneration policies are consistent with effective risk management and in line with global standards. The FSA would be able to make provision for the recovery or "clawback" of contractual payments if firms fail to do so.

Unsurprisingly, the Bill has been criticized for giving the FSA the power to "tear up" bankers' contracts if they fail to promote effective risk management or to secure compliance with global standards.

The Bill will likely mean an end to multi-year guaranteed bonuses (often used by firms as a recruitment tool) and large bonuses paid as a lump sum at the end of a financial year. The FSA's new power to require banks to claw back bonuses is especially controversial, given the legal difficulties associated with recovering such payments. Interestingly, the U.S. Federal Reserve has recently proceeded in a similar fashion. It has proposed guidelines for "second incentive compensation" that both prohibit unsafe and unsound practices, and that impose strong accountability standards directed towards assuring that incentives are structured in a manner that discourages excessive risk-taking and that involves longer-term performance, vesting, and risk of forfeiture periods. The Swiss FINMA has issued similar regulations, suggesting a global impetus consistent with the executive compensation principles emanating from the G-20's Financial Stability Board.

3. Age Discrimination in Remuneration Scheme

The Employment Equality (Age) Regulations 2006 prohibit both direct and indirect age discrimination, unless an employer can show that the treatment is "a proportionate means of achieving a legitimate aim".

In *Pulham v London Borough of Barking and Dagenham* the employer operated a remuneration scheme under which employees were entitled to various pay increases if they had 25 years' continuous service and were aged 55 or more. In anticipation of the Age Regulations, the employer reviewed the scheme and concluded that it was potentially discriminatory. It therefore negotiated with the relevant trade unions and agreed that the scheme would be closed to new entrants, whilst current scheme members would have their payments frozen. Ms. Pulham, who was under 55, was therefore prevented from joining the scheme; she brought a discrimination claim on the basis that she was treated less favorably than employees who were 55 and over.

The Employment Tribunal found that Ms. Pulham had been subjected to direct age discrimination. However, it held that the less favorable treatment was objectively justified by the need to prevent the scheme from breaching the Age Regulations. Accordingly, the agreement that had been negotiated with the trade unions was an appropriate and necessary means of achieving the legitimate aim.

Ms. Pulham appealed to the Employment Appeal Tribunal, which held that although the discrimination in this case was capable of justification, the Tribunal had attached too much importance to the fact that the employer had negotiated the continuation of the scheme with relevant trade unions. The EAT also noted that the employer had not provided sufficiently precise evidence of the cost of opening the scheme to new entrants who met the length of service criterion, but not the age criterion. It warned that employers in a similar situation will need to show sufficient evidence of the discriminatory impact and cost of any measures, as well as the financial background against which the affordability of those costs would be judged. The case was remitted to be heard again by a different Tribunal.

4. High Earners' Tax Bills and Pensions

Background

The 2009 Budget will have a very significant impact on the income of high earners in the UK, with resulting ramifications for their employers.

Previously, saving through a pension scheme provided an attractive tax-planning route for high earners, due to the tax relief granted on all pension contributions. However, the UK Government's intention to restrict the tax relief on pension savings for high earners with effect from 6 April 2011 will see the relief being tapered away for those earning £150,000 - £180,000 per annum so that, for earnings over £180,000, it will only be available at the basic rate (currently 20%).

This development is coupled with the Budget's introduction of a 50% income tax rate for those with a taxable income above £150,000 from 6 April 2010 and a phased withdrawal of personal allowances for those with taxable income over £100,000 from the same date.

It should also be noted that a further increase of 0.5% on employer and employee national insurance contributions has been announced in yesterday's pre-budget report, applying from 6 April 2011 (in addition to the 0.5% increase to national insurance contributions announced in last year's pre-budget report).

Interim Measures: 2009-2011

If high earners do not change their existing pattern of regular pension savings, subject to certain exceptions below, they should continue to receive higher rate tax relief on all those contributions until 6 April 2011.

If irregular payments are made, however, individuals may lose some or all of that relief if the following criteria are satisfied:

- an annual income of £150,000 or more, consisting of taxable income plus any salary sacrifice pension contributions after 22 April 2009 and any contributions to registered pension schemes in excess of £20,000 (this can be present in any tax year between 2007/08 and 2010/11);
- an increase in pension contributions after 22 April 2009 (this can be via either increased employee or employer contributions); and
- total pension contributions (inclusive of employer contributions) in 2009/10 or 2010/11 exceeding £20,000.

If the above criteria are met, a "special annual allowance charge" will be implemented (currently 20%) via self assessment. This will in effect cancel out any applicable higher rate tax relief on any increase in total pension savings on or after 22 April 2009. It should be noted that if an individual's regular pension savings are less than £20,000, the tax charge will be on the "excess" pension savings over £20,000; however, if regular pension savings are already over £20,000 per annum the full amount of the increased pension savings will be subject to the charge.

Increases to the value of an individual's expected benefits under a defined benefit scheme (for example, a final salary scheme) will also be subject to similar tax treatment.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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