

**Financial Reporting Council: Review of the Effectiveness of the Combined Code  
Progress Report and Second Consultation**

We have set out below our comments in relation to the Remuneration section of the Consultation and, more specifically, the FRC's consideration of Recommendation 33 of the Walker Review.

**Context for Hammonds' response**

By way of context for Hammonds' comments on the Recommendation and Consultation, Hammonds acts on behalf of numerous listed companies, including entities in the FTSE 100, and is actively involved with assisting with the administration of share plans as well as the drafting of remuneration reports. Hammonds is therefore keen to ensure that the consequences of, and practicalities for, companies implementing the numerous recommendations contained in the FRC Review are fully considered.

**Hammonds' response**

The proposal of the use of claw-back in both the Walker Review and the FRC's Review of the Effectiveness of the Combined Code appears to accord with the current clear trend towards the introduction of claw-back provisions into remuneration structures in the UK. However, as the issue of claw-back has only come to the forefront of remuneration considerations in relatively recent times (in no small part due to the current difficult economic circumstances), there is currently a lack of clear common practice and guidance on how best to introduce and utilise claw-back provisions.

Despite this, it is likely that there will be problems with enforcement of certain aspects of claw-back provisions in the UK. For example, measures that are designed to penalise an individual, or act as a restraint of trade, are likely to be unenforceable. However, for the purposes of this response, the legal and employment related difficulties associated with introducing a claw-back ability into companies' remuneration plans are ignored. Instead, this paper focuses on the tax consequences of a successful implementation of claw-back.

**Tax position on claw-backs**

The current UK tax position on most remuneration and rewards is that an income tax charge arises on payment of bonuses / vesting of awards. This is currently at the rate of 40% in relation to income tax, although this is rising to 50% from April 2010 for those earning over £150,000. In addition, there are employee (at 1%) and employer (at 12.8%) National Insurance contributions to consider, which are also proposed to rise.

A tax issue arises on the treatment of such remuneration when a claw-back is successfully activated. Currently, a repayment of income tax / National Insurance contributions can only be made when there was an initial unintentional overpayment of remuneration. The payment of tax on an award that is later clawed back would not constitute such an overpayment; instead, such action would be a recovery of amounts thought appropriate at the time of payment but later discovered to have been excessive due to misstatement, misconduct etc.

**The problem**

Companies are therefore faced with two possibilities when considering implementation of a claw-back provision in remuneration plans:

- (i) First, the company could insist on a repayment by the employee of the gross amount of the award originally paid by the company. This would ensure that the company is put

back into the position it would have been had the payment not been made. However, the employee will not only be required to repay the net amount received, but also to make a payment in respect of the income tax and National Insurance deducted at source. This would therefore put the employee in a substantially worse financial position than had the award simply never been made.

- (ii) Alternatively, the company could require the employee to pay back an amount equal to the net value of the award. This would put the employee into the position he or she would have been had the award not been made; however the employer would have expended a greater amount in making that award due to the income tax and National Insurance that would have been deducted. This option does not therefore put the employer into the position it would have been had the award not been made.

Whichever approach is chosen, as the law currently stands, the claw-back will result in one party suffering income tax and National Insurance contributions on an amount that is effectively reversed. If the FRC is keen to ensure that claw-back is introduced, it should take steps to remove the disincentive to companies introducing claw-back measures that is presented by the current tax regulations.

### **Hammonds' solution**

We suggest that HM Revenue & Customs is involved in any discussions in relation to introducing claw-back into remuneration plans so as to remove these anomalies. Where awards are clawed back as part of a new regime of effective remuneration, as is encouraged by the Combined Code and the FRC, the tax treatment should not result in either the company or the employee being at a financial disadvantage as a result of the claw-back due to an irrecoverable tax burden. It would be helpful for HM Revenue & Customs to be encouraged to introduce a policy that, where genuine claw-backs are made, there is also an ability to recover the income tax and National Insurance contributions in relation to those awards. This would of course have to be closely regulated and only applicable in genuine claw-back scenarios. It is possible that HM Revenue & Customs will consider it necessary for this change to be implemented through a change to primary tax legislation.

As an additional point, there is an anomaly between the tax treatment of the claw-back of a cash bonus as opposed to the claw-back of a share award. If a cash bonus is clawed back, a tax set-off may be available and, if so, it would most likely serve to reduce the tax liability of the employee in the year in which the claw-back takes place. However, if a share award is clawed back, on the basis of the current tax regulations, no such set-off would appear to be possible. HM Revenue & Customs should also be approached with a view to harmonising the two regimes so that the same tax treatment applies to the claw-back of both types of award.

### **Summary**

If you wish to have a clear and consistent approach to claw-back introduced into remuneration structures in the UK it is essential that the associated tax treatment is clear, logical and appropriate.

If you need any further information on any of the issues referred to in this submission, please do not hesitate to contact Aredhel Darnley, Lawyer, Hammonds LLP, [aredhel.darnley@hammonds.com](mailto:aredhel.darnley@hammonds.com), 0207 655 1530.