THE GREENBURY REPORT: ALL CHANGE?

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The Greenbury Report on Directors' Remuneration published in July 1995 resulted in immediate changes, and more changes will follow. This article reviews the main changes, actual and likely, and considers how the landscape may look post Greenbury.

New Rules for Executive Options

The most widely publicised change - and the most hotly debated - is that to the taxation treatment of options granted under Inland Revenue approved discretionary share option schemes. Such schemes are also known as executive schemes because (in contrast to the "all-employee" schemes discussed later) options under them need only be granted to selected employees. In practice, most employers were selective in their grant of executive options and it was the resulting "fat-cat" publicity (mainly in relation to utilities) which lies at the root of Greenbury.

Prior to 17th July 1995, the tax position was governed by section 185 and Schedule 9 ICTA 1988. There was no income tax charge on grant and no income tax charge on exercise (either under s.135 ICTA 1988 or any other provision of the Taxes Act) provided that the exercise was not less than 3 nor more than 10 years after the grant, nor within 3 years of an approved exercise. Instead, a charge to CGT arose on the ultimate disposal of the shares acquired on the exercise of the option.

A deferral of the tax liability was thus achieved and the taxpayer had the possibility of taking advantage of his annual CGT exemption (although, of course, as widely noted in the tabloid press, the true "fat-cats" would have already used their exemption in their wider investment portfolio).

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In a Press Release dated 17th July 1995 - the same day as the publication of the Greenbury Report and in response to it - the Chancellor announced the immediate withdrawal of the income tax reliefs for executive options "so that any gain from the exercise of options will be taxable as income rather than as capital gains". The change was to take effect in relation to both grants **and** exercises on or after 17th July.

Following 10 days of intense criticism and comment, on 27th July a second HM Treasury Press Release followed. This stated that while the Chancellor remained of the view that "there is no longer a case for different tax treatment to favour one particular form of executive incentive" he now accepted that the change prejudiced those holding subsisting options on 17th July. The old tax treatment is thus to continue to apply to a holder of executive options granted before 17th July and to those options granted on or after that date where a written invitation to apply for options was made formally before that date.

Legislation to implement this change is to be introduced in the 1996 Finance Act; prior to that time the Chancellor welcomes representations on "all-employee" schemes - he will doubtless receive them on executive schemes too. For the moment then, we have an interregnum - discussed below.

History and Internal Tensions

These events will come as little surprise to those who have seen share incentives develop over the years. History has shown that the tax treatment is subject to the whims of the government of the day. Thus, for example, on 7th May 1966 James Callaghan effectively reversed *Abbott v Philbin* (which in itself had overruled *Forbes Executors v Commissioners of Inland Revenue* 38 TC 12) by announcing that "income tax and surtax shall be charged in respect of all options exercised on or after today". Interestingly, in light of the difficulties it gave the present Chancellor, James Callaghan dealt with the thorny problem of retrospection by stating that "in the case of options granted before [7th May 1966], any increase in the value of the shares which took place before [7th May 1966] will be left out of account".

Such changes - it is unlikely the Finance Act 1996 will see the last of them - are, in part at least, attributable to the internal tension which arises from using shares (or an interest therein) as part of a remuneration package.

On the one hand, there is the desire that share incentives should foster a continuing link between the company which awards them and the employee. If this aim is to be achieved, the employee must be encouraged and enabled to hold the shares. If he sells them, then a cash bonus (perhaps a phantom scheme) would achieve much the same result, at least in commercial terms.

On the other hand - and pushing against the above desire - is the view that as the share or share option is received in return for services it is an emolument and as such should trigger an immediate income tax charge. The resultant tax bill then forces (at least in some cases) the sale of the shares, thus defeating the goal of long term share ownership.

This tension has surfaced again in the recent debate and in the Greenbury Report itself. The Report states (in para 6.41):

> "Remuneration committees should continue to encourage Directors to acquire and retain significant shareholdings in their company so as to reinforce alignment of the interests of Directors and shareholders."

Elsewhere (para 6.36) the Report recommended (in what was for many its bête noire):

> "that gains from executive share options should, in future, be taxed as income at the time of exercise rather than capital gains on disposal."

As indicated above, this rallying call was followed by the Government who chose to turn a blind eye to the fact that this may force a sale of shares, the Press Release of 27th July effectively dismissing this as an invalid criticism. Greenbury was directed at options held by directors; the change extends to all options granted under discretionary schemes.

Interregnum

As a result of the developments described above, we have something of an interregnum, with all the uncertainty that brings. The broad scope of the new rules is known, but we await the detail. This is barely satisfactory but taxpayers and their advisors must make the best of it. For some the decision appears to be to take no action during the interregnum in the hope (which the writers' feel to be remote) that the Chancellor may relent (or repent?) and the former income tax advantages restored to approved share option schemes.

Approved Schemes

During the interregnum, the Inland Revenue are continuing to approve schemes. The advantage of obtaining approval are (assuming there is no change in the Chancellor's stated views), however, limited. They include the avoidance of a capital gains charge on an exchange of options in the event that the company in which the options exist is taken over. (There would be no income tax charge in these circumstances, whether the scheme was approved or not, as a result of s.136(1) ICTA 1988.) An approved option grant would also benefit from the provisions of s.149A TCGA 1992.

In addition, approval does, of course, result in a corporation tax deduction for the cost of establishing the scheme.

Reacting to Greenbury

Quoted companies in particular cannot be inactive during the interregnum. Greenbury urges action.

The Greenbury Report requires quoted companies to establish remuneration committees of non-executive directors and then charges the remuneration committees with submitting an annual report to shareholders explaining the company's approach to executive remuneration. The committee must ensure that the remuneration package of directors links reward to performance and aligns the interests of directors and shareholders. The package should also be sensitive to pay and conditions elsewhere in the company.

Greenbury also stresses the need to find the right balance between "fixed" elements of directors' pay (basic salary, benefits in kind and pension rights) and "performance related" elements (annual bonuses, share options and other long-term incentive schemes). The report concludes (in para 6.16) that "in many companies ... there will be a case for a high gearing of performance - related to fixed pay" although "the gearing which suits one company may be quite unsuitable for another".

Companies should thus test their existing share schemes against the touchstone of Greenbury and weigh them against the alternatives.

Retaining Options

Quoted companies which, having followed the process outlined above, decide to retain their executive option scheme (or indeed introduce one) must then review the scheme itself to see if it is "Greenbury friendly". The recommendations made in the Report include not granting options at a discount and granting options over time rather than in a single block (para 6.29). Companies should thus consider a programme of regular grants; not only will this reduce the impact of sudden movements in share price but have a "handcuff" effect as options could be forfeited if an employee leaves.

The Report also recommends that "challenging" performance criteria should attach to future option grants (para 6.30); where necessary, companies should consider amending existing schemes to provide for performance targets. In 1994 KPMG published a survey ("Executive Share Options and Performance Targets") of over 400 listed companies, which provides some interesting data on the use of performance targets. Companies will wish to select the performance criteria most appropriate for them. This is recognised in the Report; its only real guidance being that general movements in the stock market should not be rewarded and that companies should consider (para 6.39):

> "criteria which measure company performance relative to a group of comparator companies in some variable, or set of variables, reflecting the company's objectives such as total shareholder return."

Other Options

Urged by Greenbury to consider the wider picture, and in light of the new tax rules, many companies - quoted and unquoted - are likely to consider replacing their share option schemes or supplementing them with other forms of incentive. Greenbury has words of guidance on this process: "new long term incentive schemes ... should preferably replace existing schemes or at least form part of a coherent plan incorporating existing schemes" (para 6.35). Greenbury also recognises "there may be a case for part payment of [annual bonuses] in shares to be held for a significant period".

Until the new tax rules are in place, it is difficult to predict the exact landscape post Greenbury. There seems little doubt, however, that restricted stock schemes are likely to increase in popularity.

Under such a scheme an executive is awarded shares, but his entitlement does not vest until a specified date and can be made subject to achieving performance targets. Although there are (as yet) no statutory rules, it is usually possible to agree with the Inland Revenue that no tax charge crystallises until the executive becomes entitled to the shares. He is then subject to income tax at that time. In the interim, he can receive the dividends - he will be taxed on these (what is less clear is whether this charge is under Schedule E or Schedule F; this is likely to depend on the exact form of the scheme). Greenbury comments favourably on such schemes, stating "they might be as effective, or more so, than improved share options schemes in linking rewards to performance, encouraging Directors to build up shareholdings in their companies and thus in aligning interests of Directors and shareholders" (para 6.32).

"All-employee" schemes may also come into increased focus as quoted companies look, in conjunction with human resource experts, at the wider picture. For the time being at least, Inland Revenue approved SAYE and profit sharing schemes retain their tax advantages. Again, however, the full picture will only emerge post the 1996 Finance Act.

Whatever forms the new long term incentive schemes take, those in which directors can participate (irrespective of the form of payment) will require shareholder approval before adoption.

For unquoted companies, it is the tax rules rather than Greenbury which will underpin any changes. Such companies often favoured the greater flexibility of an unapproved option scheme, perhaps coupled with an employee benefit trust, and so unapproved options may still continue to appeal to them. The issue of shares partly paid may become an alternative for close companies - giving the recipient an immediate share interest but (if issued at market value) no immediate tax charge. Section 162(1) ICTA 1988 is not a problem if the individual would otherwise qualify for relief under s.360 ICTA 1988 (although s.162(6) would still require to be considered on a sale of the shares).

Greenbury: the Wider Picture

Despite the publicity the share option issue has generated, Greenbury is not only (indeed, not primarily) about share incentives. The rôle of the Committee was to introduce a new code to improve corporate remuneration practices. Greenbury's central themes are accountability, responsibility, full disclosure, alignment of director and shareholder interest, and improved company performance. The recommendations of the Committee have been widely reported and summarised and this is not the place to repeat the process. The following areas are, however, likely to see key changes.

First, disclosure. Greenbury urges a new philosophy of full transparency. This theme has been endorsed by the Stock Exchange: for accounting periods ending on or after 31st October 1995 the annual shareholders report of listed companies must have a self-contained section specifying both the general remuneration policy for directors and the specific details (which will be subject to audit) of each director's remuneration. The Greenbury Report contains illustrative formats for the disclosure of share options (the Greenbury recommended basis of disclosure is in line with the 1994 Accounting Standards Board's Urgent Issues Task Force Abstract 10) and other forms of long term incentive schemes. The Stock Exchange proposes to make a tabular form mandatory.

Many of the new disclosure provisions go beyond present company law requirements - for example, until now, directors working overseas have been excluded from annual report details. Their emoluments will now need to be disclosed. In the case of expatriates, the package may have a number of elements to recognise cost of living and other differentials, which will need to be clearly explained.

Second, pensions. The Report will have far reaching implications in terms of pensions, given its recommendations that the cost of pension contributions and payments should be shown in full. To take just one example: if a director's pensionable pay increases during the year, the whole of the back services pension cost will have to be disclosed in that year. The cost to be disclosed could be up to 10 times the pay increase itself and the potential implications for shareholder relations will need to be considered carefully. Greenbury also states that if annual bonuses or benefits in kind are to be pensionable (and it recommends they should not), a company's annual report should explain this and justify the position.

Third, service contracts and compensation. Greenbury makes a strong case for setting notice or contract periods at, or reducing them to, one year or less. If it is necessary to offer longer contracts (such as 3 years) to recruit directors from outside, these should be reduced after the initial period. Remuneration committees should take a "robust line" on payments of compensation where performance has been unsatisfactory.

The Future

Greenbury is unlikely to be the last word. The 27th July 1995 Press Release stated "good corporate practice and not the tax system should determine how employees are rewarded". This is to ignore the fact that the two are inextricably linked. Greenbury or no Greenbury, the next set of changes will be heralded by the 1996 Finance Act. Until then, we have the relative tranquillity of the interregnum.