Davis Polk

UK executive compensation round-up

November 7, 2024 | Client Update | 8-minute read

Recent and upcoming changes affecting UK executive compensation include the UK Government's Budget, new Investment Association guidelines and the UK Government's Employment Rights Bill. Our client update discusses key provisions of each.

UK Government's Budget

The UK Government's Budget on October 30, 2024 introduced certain changes to tax rates that could influence how incentive schemes are used in the UK. The main changes are outlined below.

Capital gains tax

The rate of capital gains tax that applies to the disposals of shares increased with effect from October 30, 2024. The rate has risen from 20% to 24% for higher and additional rate taxpayers and from 10% to 18% for basic rate taxpayers. Despite this rise, the differential between the tax rates for capital returns and income returns remains substantial, with the top rate of income tax remaining at 45% and the top rate of employee's National Insurance contributions remaining at 2%. This means that it will remain attractive to structure incentive arrangements so that they deliver a capital return rather than an income return, such as through the use of restricted shares or the UK tax-advantaged plans.

Employers' National Insurance contributions

The rate at which National Insurance contributions (NICs) will be paid by employers will increase by 1.2% from April 6, 2025, rising to 15%. In addition, the earnings threshold at which employers start to pay employers' NICs will be reduced from £9,100 to £5,000 per year. Employers may wish to explore the use of UK tax-advantaged plans where, generally, no NICs are payable on the gains made by employees. Alternatively, in the case of non-tax advantaged share options or restricted stock units, employers can, with the agreement of the employees, pass on the cost of the employers' NICs to the participants.

Carried interest

The rate of capital gains tax applied to carried interest will increase from 28% to a special rate of 32% from April 6, 2025. Then, from April 2026, "qualifying" carried interest will be taxed as trading income but at an effective rate of approximately 34.1% rather than at full income tax rates and NICs. In addition, the government will consult on whether there should be additional conditions imposed on the carried interest that will benefit from this reduced tax rate, such as a minimum co-investment requirement and/or a minimum period between the making of an award and the receipt of proceeds.

New Investment Association guidelines

On October 8, 2024, the Investment Association (IA), representing members of the UK investment management community, published a new version of its influential "Principles of Remuneration" (the Principles) which are relevant to companies with a listing on the main market of the London Stock Exchange. This year's version of the Principles was released almost a year later than usual as the IA carried out consultations with its members against a backdrop of increased calls for investors to support companies listed on the London Stock Exchange in competing with global companies, and particularly with US-listed companies, in terms of the design and quantum of executive remuneration. The IA has responded to those calls by introducing more flexibility into its Principles and recommending more effective shareholder engagement and disclosure by companies.

The main changes to the Principles are set out below.

- **Increased flexibility** – there is considerable emphasis in the new Principles that they should be regarded as guidelines rather than a set of prescriptive rules and that companies should adopt executive remuneration structures that are most appropriate to their business.
- **Greater shareholder engagement and disclosure** – the Principles recommend that remuneration committees can be more flexible in their remuneration arrangements but encourage those committees to engage with shareholders and explain their proposals and decisions, especially where they vary from market practice.
- **Use of hybrid schemes** – the Principles refer for the first time to hybrid schemes being acceptable in certain circumstances, such as where companies have a significant US footprint and/or compete for global talent, and where they can be justified by the remuneration committee. These schemes are typically a combination of long-term performance-based awards and non-performance restricted share awards. Where restricted shares are used in a hybrid plan, the Principles expect a minimum performance underpin to apply to the vesting of the awards and recommend that the typical discount to a performance award should be 50% to reflect the lower risk and higher certainty of vesting. However, annual vesting of restricted shares is discouraged, with an expectation that they should vest after a three-year period and be subject to a holding period for a further two years.
- **Greater flexibility on bonus deferral** – the expectation that any portion of an annual bonus in excess of 100% of salary should be deferred into shares has been removed. In addition, where an executive director has met their shareholding guideline, investors may support a reduction in the level of annual bonus deferral, provided malus and clawback provisions can still be applied to the bonus.
- **Greater flexibility on dilution limits (use of new issue shares and treasury shares)** – the dilution limit for "executive" share plans of 5% of the issued ordinary share capital in any rolling 10-year period has been removed. The overall dilution limit for all share plans (both executive and all-employee) remains at 10% over 10 years, but the Principles now state that a higher limit may be used in exceptional cases for recently listed high-growth companies.
- **Use of positive discretion** – the Principles refer for the first time to the potential use of positive discretion by remuneration committees when assessing executive remuneration outcomes, suggesting that these could be used to reward exceptional achievements or contributions that are not captured by pre-defined performance measures or targets.
- **Shareholding guidelines** – the appropriate minimum shareholding requirement for executive directors is now specifically referred to as being equivalent to the long-term incentive grant size.
- **Setting pay levels** – if a company is deriving significant revenues from particular markets such as the US, or is competing for talent globally, then the remuneration committee is encouraged to disclose the impact of attracting global talent on the positioning of its executive remuneration. In addition, if benchmarking is used to justify pay levels then the comparators should be disclosed together with an explanation as to why their selection is appropriate.

The Employment Rights Bill

On October 10, 2024, the UK Government published its long-awaited Employment Rights Bill (Bill) together with a related policy paper, "Next Steps to Make Work Pay". The wide-ranging Bill brings forward 28 individual employment reforms, including the introduction of "day-one" rights and tighter regulation of "fire and rehire" and zero-hours contracts. Many of the key reforms will be subject to consultation and secondary legislation and are not intended to come into effect until 2026. An overview of the Bill's key provisions is set out below.

- **Unfair dismissal protection from day one of employment** – the current two-year qualifying period for unfair dismissal protection will be repealed. However, employers will be able to use a statutory probationary period (potentially for up to nine months) during which an employer will be required to use a "lighter-touch" dismissal process to dismiss someone who is not right for the job. The Government intends to consult extensively on these reforms and does not expect them to take effect until at least Autumn 2026.
- **Collective redundancy consultation** – the circumstances in which an employer will be required to carry out a collective redundancy consultation will change so that the requirement to consult where an employer plans to dismiss

20 or more employees within 90 days will apply to redundancies across the entire business rather than just at a single establishment.

- **Zero hours contracts** – workers on zero hours contracts, or on low guaranteed hours who regularly work extra hours, will have the right to guaranteed hours contracts that reflects the number of hours they regularly work over a 12-week reference period. Workers will also be entitled to reasonable notice of any changes in shifts, with proportionate compensation for any shifts cancelled or curtailed at short notice. These measures will extend to agency workers.
- **"Fire and re-hire" practices** – it will be automatically unfair (i) to dismiss an employee where the employee refuses to agree to a variation to their employment contract, or (ii) if an employee's contract is terminated so that they can be re-engaged, or replaced, on a contract with different terms but carrying out substantially the same duties. There will be an exemption for companies in financial difficulties.
- **Right to flexible working** – employers will have to demonstrate that it is reasonable to refuse a request for flexible working on one of the existing eight statutory grounds (which includes increased costs or detrimental impact on performance, quality or meeting customer demand).
- **Sexual harassment protections** – employers will be liable for third parties harassing their employees unless they can show that they have taken all reasonable steps to prevent the third party from doing so.
- **Statutory sick pay (SSP)** – all workers will be entitled to SSP from their first day of absence (rather than the fourth day as currently applies), and the lower earnings limit for SSP will be removed.
- **Family aspects** – it will be unlawful to dismiss an employee who is pregnant, on maternity leave, or in the six-month period after her return except in specified circumstances. Workers will have the right to paternity leave, unpaid parental leave and bereavement leave from day one of employment. The scope of bereavement leave will be expanded.
- **Trade union aspects** – employers will be required to give workers a written statement that the worker has the right to join a trade union. Unions will have the right to request access to an employer's premises for the purposes of meeting, representing, recruiting or organising workers, or facilitating collective bargaining. The thresholds for unions to become recognised and for industrial action ballots will be lowered.
- **Equality action plans** – businesses with more than 250 staff will be required to publish and implement equality action plans with regard to prescribed matters relating to gender equality (including gender pay gaps and supporting employees going through menopause).
- **Creation of the Fair Work Agency** – this entity will be a new single enforcement body with the aim of strengthening the enforcement of workplace rights.

The Government outlined other reforms that it intends to implement in the future, including those listed below.

- A "right to switch off", preventing employees from being contacted out-of-hours except in exceptional circumstances.
- A consultation on moving towards a single status of "worker" and a clearer framework to differentiate between workers and the self-employed.
- Delivery of the Equality (Race and Disability) Bill, which will extend pay gap reporting to ethnicity and disability for large employers and extend equal pay rights to workers who suffer discrimination on the basis of race or disability.
- A review of the parental leave and carers' leave systems.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Neil Sharpe
+44 20 7418 1055
neil.sharpe@davispolk.com

Will Pearce
+44 20 7418 1448
will.pearce@davispolk.com

Dominic Foulkes
+44 20 7418 1394
dominic.foulkes@davispolk.com

Sophie Vacikar Bessisso
+44 20 7418 1093
sophie.vacikarbessisso@davispolk.com