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PART A

1989 BUDGET EMPLOYEE
SHARE OPTION SCHEMES

3.2.89

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NEILSON 9/12

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CONFIDENTIAL

FROM: M NEILSON
DATE: 9 DECEMBER 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Culpin
Mr Burgner
Mr Ilett
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Painter
Mr Lewis
Mr Farmer
PS/IR

Ch/ I think you already have the gargantuan ESOPs pps., scheduled for discussion on 13/12. This is a v. useful summary of the main issues.
JF 9/12

ESOPS ETC (STARTERS 112, 113 AND 115)

We have been in close touch with the Inland Revenue in their work on ESOPS. The issues are difficult to pin down. But there appear to be 3 key questions:

- What benefits, in terms of Government objectives on employee share ownership, do ESOPS have to offer that cannot be achieved by current approved employee share schemes?

- What tax and legislative changes are needed to enable ESOPS to achieve these objectives?

- Are the potential benefits worth the risks?

Objectives of ESOPS

2. There are two areas in which ESOPS may help:

- They enable employees to take larger stakes in their own companies, at an earlier stage, particularly in buy outs and similar situations.

- unquoted companies, which have, by and large, not participated much in approved schemes, may find ESOPS more attractive.

3. Allowing employees to take a larger stake in their companies strikes us as desirable in principle. Making it easier for employees to participate in buy outs is also attractive, provided the buy out is on commercial terms. The price of larger stakes is of course that it take longer for the shares to pass into direct individual ownership. Nevertheless, the expectation of ultimate direct ownership could have substantial motivating effects.

4. As Mr Lewis explains the low take up of employee share schemes by unquoted companies probably reflects mainly the desire of existing owners to maintain control/ownership of their companies. There is a tension between this desire, and the Government's objective of employee participation/involvement. But the conflict is not absolute; an increased degree of employee involvement through share holding can be reconciled with maintenance of control by existing owners.

What tax changes are needed?

5. Lobbyists' proposals fall into two categories; clarification, and straight tax perks. All the lobby groups see clarification as central - they want certainty that payments made by the company into its ESOP are deductible for Corporation Tax purposes. Current tests for deductibility are not easily applied to ESOPS, and this difficulty would not, therefore, easily be solved by a Revenue Statement of Practice. The way to deal with this problem is to define in statute a particular type of ESOP trust payments into which will automatically benefit from relief. This is much more a matter of giving certainty in a grey area than offering a genuine concession.

6. Certainty of CT deductibility is the main inhibition on enabling employees to build up larger stake in public companies. It will also be of some help to private companies. But the lobbyists claim that real tax concessions are needed to tempt owners of private companies to part with their share holdings. The key priority here is CGT roll over relief. This would aim to make sale of shares to an ESOP as attractive as sale to a quoted company (which could qualify for roll over relief. But there is also a series of lower priority items which they would like.

7. No decisions are yet needed on which, if any, particular concessions are needed. **The key decision is whether you want to take any tax action to encourage ESOPS.** If you do, clarification of CT treatment is a must, and it follows that a statutory

definition of the type of trusts that can benefit will have to go in the legislation. If you decide in favour of a statutory definition, officials can then examine the other individual proposals to see if they should also be made available to this special "ESOP" trust.

8. The definition will clearly need to be more tightly drawn if more generous tax reliefs are agreed. And new restrictions, perhaps not envisaged by the lobbyists, such as requiring independent trustees, may have to be imposed. But one of the lessons of experience on PEPs and PRP is that we should begin with the minimum of restrictions, but clamp down hard on abuse as it arises, rather than attempt to anticipate all forms of abuse in advance. The main thrust of the ESOP lobby is that ESOPS should be made simple to set up - anything too complex may well undermine take-up.

Is it worth taking action?

9. We think there is a respectable case for at least some action on ESOPS. ESOPS do have potential in areas where the existing schemes are not suitable. This has been demonstrated by the setting up of a number of ESOPs, despite the existing legislative hurdles. And the key tax change is clarificatory rather than concessionary.

10. But discussions with the lobbyists have taken us little further in establishing how many firms would take up ESOPS if you made the changes they suggest. As Mr Lewis says, encouraging

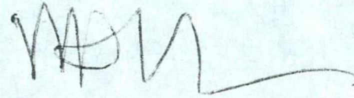
ESOPS by tax changes would be an act of faith. Nevertheless, the likely benefits probably outweigh the risks. ESOPs, for one reason or another, have broad cross-party support. So an announcement of action is likely to be popular. The risks are that the restrictions we impose, so that ESOPS meet our objectives, may be unpopular, or that, despite tax changes, ESOPS do not get off the ground. Neither of these risks seems overwhelming. They are basically presentational (in the sense that if the schemes do not take off the Government could be criticised). There do not seem to be risks to basic tax principles or tax receipts.

11. Finally, Mr Lewis raises the question of whether it is worth taking up with DTI some of the non-tax points made by the ESOP lobbyists. I attach a short note by Mr Barker setting out the problems. Our initial view is that, if you do decide to make tax changes, it might be worth asking DTI to make some clarificatory changes to that legislation. The ESOP lobby may be exaggerating these difficulties, but, in particular, the treatment of trustees under the Financial Services Act appears to run against what would be appropriate for ESOPS.

The rest of the employee share package

12. Action on the other fronts set out in the Inland Revenue papers, combined with action on ESOPS, would make a substantial employee share ownership package. We endorse the proposals for dealing with the material interest provisions. We also agree that increases in the limits on the various schemes would be sensible.

The one other option we think is worth considering is to provide for employers to offer shares at a discount to the market price, without triggering the provisions of benefits in kind tax legislation. (option D in Mr Williams' paper). This fills a potential gap in the array of approved scheme. It is less expensive for employers, compared to the 1978 scheme, and it is more simple for employees to understand than the 1980 share option scheme. It may be that if, as the Inland Revenue suggest, this can in practice already be done under the 1978 scheme, the existence of this facility should be given some more publicity.



M NEILSON

ANNEX

Financial Services Act

Certain types of ESOP may fall within the Act's definition of a "collective investment scheme". This would subject it to the same tax regime as an unauthorised unit trust, ie benefits would be subject to a double CGT charge. An automatic exemption does, however, apply where the trustees of the ESOP are in-house, ie part of the same group of companies as the company in which the ESOP is making shares available. The logic here is that an ESOP will not be caught unless the contributions to it are pooled and managed. If this is the case, then in-house management maintains a direct relationship between employer and employee. An outside trustee manager could conceivably abuse his powers in operating a unitised ESOP for profit.

It is by no means clear that many ESOPs would in fact count as collective investment schemes. For those that are caught, it is arguable whether or not an outside trustee would be appropriate. One option would be explicitly to take ESOP trusts out of the definition of collective investment for the avoidance of doubt. However, it is not necessary to take a decision at this stage. There are wider implications regarding collective investment legislation that will have to be taken into account. But the relevant section of the Act can be amended by secondary legislation.

Job Ownership Ltd have also raised the question of whether companies should be exempted from the Act's prospectus requirements when making a share offer to employees. In fact the Act does contain a specific exemption for offers that are made purely to employees and certain relatives. DTI are not clear what the exact position will be following the implementation of Part V of the Act (which has not yet been drafted) but they do not envisage that further restrictions will be put in place. The EC Prospectus Directive is relevant, but this also is not expected to restrict offers to employees (although it may narrow the scope for offers to the relatives of employees).

Companies Act

There does appear to be a genuine difficulty here in that Section 151 of the Act makes it unlawful for a company to give financial assistance for the purpose of acquisition of its own shares, except where a company provides an employee share scheme with money for the acquisition of fully paid shares. This, therefore, provents a PLC from providing a guarantee for an ESOPs external borrowings. And, in practice, many banks would be prepared to lend to ESOPs only on the security of a company guarantee.

This may well be a genuine anomaly, and one that has crept through from much earlier legislation. DTI are currently examining this question. However, if it proves necessary to amend this section of the Act, primary legislation would be required. This would mean finding space in the Companies Bill.

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: T J PAINTER
6 DECEMBER 1988

FINANCIAL SECRETARY

ESOPs: EMPLOYEE SHARE SCHEMES: MATERIAL INTEREST
(STARTERS NOS 112, 113 AND 115)

I have discussed Mr Lewis's covering note to this bundle of papers and agree generally with his assessment. I am, therefore, the more reluctant to add to a formidable bundle of paper (which reflects a formidable amount of work by those directly involved on an unusually elusive subject). But perhaps I could underline one or two points.

2. First, I suspect that you would not want to go along with the whole 'philosophy' of the ESOPs movement at least as formulated by Kelso. His thesis seems to rest in part on a variant of an old idea, namely that without Government

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Monck
Mrs Lomax
Mr Culpin
Mr Burgner
Mr Ilett
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

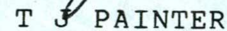
Chairman
Mr Painter
Mr Isaac
Mr Bush
Mr Pitts
Mr Lewis
Mr McGivern
Mr Ridd
Mr Elliott
Mr O'Connor
Mr H B Thompson
Mr Cayley
Mr Reed
Mr Creed
Mr Farmer
Mr Eason
Mr Weeden
Mr Fletcher
Mrs Majer
Mr Williams
PS/IR

intervention to 'redistribute' the ownership of capital assets and the income they generate, there will be a growing inadequacy of demand in the economy as direct employment income falls in relation to total income. This sits uneasily with the facts and the thrust of Government policy. So if you are attracted to an initiative to demonstrate your further, firm, support for the ESOPs movement you will probably feel that the presentation - in practice the choice of favoured objectives - needs pretty careful focusing. And there is a direct read across to the equal need for any tax incentives to be sharply focused if they are to hit their targets and be reasonably watertight. Clearly this is very much a matter of political judgment but, bluntly, I would ditch the Kelso thesis (despite the inducement under his PUBCOPs that Civil Servants would get a stake in the equity of Wormwood Scrubs and the M50). You might also see an advantage in distancing any UK proposals from the, much-criticised, US regime for ESOPs.

3. Second, our provisional assumption is that your main concern is with ESOPs as a supplementary vehicle for encouraging variants of employee share ownership, weaker perhaps than the ESS but nevertheless with a fundamental requirement that all or most of the shares should find their way into the hands of employees over a reasonably short time. Other objectives of the movement, in particular providing cheaper company capital (by subsidising lenders) or encouraging employee buy-outs are less clearly consistent with your broad policy stance.

4. Third, at the risk of confirming our Treasury colleagues nervousness that the Revenue approach will seem negative, there must be a question mark over the extent to which many companies will be inclined, even with the substantial CGT relief discussed here, to pass shares out of the family on a significantly greater scale than at present. Their overriding concern in all their representations to us is that the tax system should be positively biased towards encouraging retention of ownership within the family.

5. Fourth, there is the important question of whether you see any new Government initiative as being restricted to tax measures (paragraph 17 of Mr Lewis's note). If you see a case for a tax initiative, legislation, rather than a Statement of Practice, to specify CT deductibility for employee contributions to an ESOP employee trust seems to be the clear front runner. It would mean that the difficult job of defining a qualifying trust had to be tackled but it would meet what seems to be the main demand of the lobbies on the tax front and signal further support for the movement, while giving a further opportunity to see how things develop, and if appropriate to consult, before being committed to further tax measures.



T J PAINTER

LEWIS 6/12

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS

EXT: 6371

DATE: 6 DECEMBER 1988

1. MR PAINTER
2. FINANCIAL SECRETARY

ESOPs: EMPLOYEE SHARE SCHEMES: MATERIAL INTEREST (STARTERS NOS 112, 113, AND 115)

1. The papers attached by Mr Farmer, Mr Williams and Ms Fairfield review these starters.

2. There is, inevitably, a good deal of reading here, since you commissioned a wide review of the three approved share schemes; and, as you know, ESOPs is a wide-ranging subject with many proposals for different kinds of tax reliefs.

3. You may find it helpful to consider these papers together since they are fairly closely inter-related. For example, the material interest test (which relates to PRP as well as approved share schemes) is also high on the shopping list of the supporters of ESOPs. More generally, ESOPs may frequently involve the linked operation of one or more approved ESS, so any improvements to the ESS legislation are likely also to be helpful for ESOPs.

<u>Material interest</u>

4. As Ms Fairfield indicates, we believe we have found a solution to the application of the material interest rules to trusts which would otherwise have prevented the John Lewis Partnership from starting a PRP scheme in 1990 (when their NIC exemption comes to an end). Virtually the same relaxation can be made for ESS, and is thus likely to be a useful change for ESOPs.

Employee share schemes

5. As you requested, Mr William's paper takes a comprehensive look at progress over the 10 years of ESS, and goes on to review possible improvements - ranging from major to minor - to the legislation.

6. You will wish to form your own view of the balance of advantage and disadvantage of each of the proposals he discusses. But we have identified at the end of the note a range of measures which we believe would be useful and which do not seem to have any significant disadvantages. With the material interest relaxation they would make a worthwhile - but not spectacular - package of ESS changes. Of these, the most significant would be substantial increases in the monetary limits which apply to the all employee share and share option schemes.

See paras 60-62 (pages 49-50) of Mr Williams' note.

7. Mr William's note also discusses the relative attractions of approved and unapproved share schemes following the IT/CGT changes in the 1988 Budget. Our conclusion is that the all employee profit sharing and share option schemes are not greatly affected. The 1984 discretionary share option scheme has completely lost its advantages in some circumstances; but in many others - in particular where disposals are spread and the annual CGT exemption is available to set against gains - significant advantages remain. For these reasons we see little attraction in Mr Philip Hardman's suggestion of abolishing all approved schemes; and his own alternative proposals would themselves require legislation and could mean there would be no effective tax charge on employee share acquisitions.

8. We have also considered - on the opposite tack in case you wished to move in that direction - whether there are structural changes which could go some way towards restoring the previous relative attractiveness of, in particular, the approved discretionary share option scheme. We have identified one possible change of that kind which would reduce CGT liability on the eventual disposal of the shares acquired; but it has a number of disadvantages, apart from the likelihood that it would be controversial.

ESOPs

9. Mr Farmer's paper describes clearly the background and present state of play. This is much the most difficult of the papers, essentially because ESOPs remain a rather amorphous concept, with varying aims, and suggestions for a long list of possible tax changes, the exact purpose of which - despite extensive consultation and our detailed questionnaire - is not always clear.

10. As compared with present approved share schemes, the main distinctive features of UK ESOPs as currently discussed seem to be

- they could hold large blocks of shares for a long period

- the release of the shares to employees might be on a discretionary basis, over a long period, and perhaps never be complete.

These features are perhaps a reflection of the fact that their objectives are not wholly, or perhaps in some people's eyes even mainly, wider share ownership by employees. In these wider contexts the owners of the company may wish to exert a continuing degree of control over shares held by an ESOP.

11. In summary, the position we have reached in looking at ESOPs as a new means of supporting the Government's employee share ownership policies is

- ESOPs have as one of their purposes the spread of employee share ownership, and to that extent their objectives are in line with Government policy. Moreover, their potential seems greatest in the unquoted company field where ESS have, for a variety of reasons, so far made least impact.

- Some ESOPs appear to have been successfully launched in the UK, but they see the need for - as they would put it - clarification of the tax position, or the removal of tax impediments, if they are to flower.

- But, when you come to examine the particular reliefs they have in mind, they nearly all look unattractive in the context of the Government's general tax policy in those fields. You will recall that this was the conclusion you yourself reached when you last examined ESOPs in some detail (with Mr Prescott) in January 1987 and last Autumn.

- Nevertheless, if you attach importance to encouraging ESOPs through the tax system, that could of course include setting up a special tax regime for them, in the same way as we have for the three different types of approved ESS, which in a clearly defined environment could include reliefs going well beyond those which you would wish to see applying at large.

- The key to such a scheme would be a new definition of a qualifying ESOP trust. Its purpose would be

  i. to direct relief specifically to situations the Government wished to encourage, and

  ii. to try to minimise the scope for abuse and cost which would exist with generous open-ended reliefs, and which might otherwise lead to criticism of the kind now being heard in the US (in contrast with UK approved ESS).

- Key features would be minimum requirements to ensure that the trustees were independent of the owners of the business, and that shares were passed on to employees on satisfactory terms and within a reasonable timescale.

- In that context, the prime candidates for relief would be a CT deduction for sums passing to the trust to acquire shares; and, possibly, a CGT roll over relief for owners selling shares into an ESOP trust. The first would parallel the relief available for 1978 ESS. The second would be a radical departure in giving roll-over relief for cash proceeds, and would be a very generous relief for those owners of unquoted companies who chose to sell their shares into an independent ESOP trust.

12. If you wished to include legislation in the 1989 Bill, we would need to consider further and in some detail with you

- the exact conditions relating to a qualifying ESOP trust

- which reliefs were to be given.

13. Of these, the first could be particularly difficult because there would be a sensitive balance to be struck between terms which were tight enough to ensure independence from company owners and genuine employee participation, but not so tight as to discourage owners - who might have a wide variety of motivations in considering ESOPs - from participating. Informal consultation might help, but that would take time and there could be no guarantee of general agreement on what the conditions should be.

14. The central point is that there is an inevitable tension between the idea of substantial blocks of shares passing to independent trustees who would hold them for the benefit of all employees, and eventually pass them into their unfettered control, and the usual concern of family businesses to retain control, which a number of the Government's other tax policies are designed to facilitate. The UCG in particular are always anxious that we should recognise that their over-riding concern is that the tax system should facilitiate the passing down of businesses within the family.

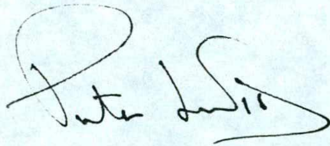
15. For that reason it is particularly difficult to judge the likely response to a package of reliefs of the type the ESOPs movement have identified if there is a strong emphasis on genuine employee share ownership as a condition for gaining the reliefs. Essentially it would be an act of faith. And there is some danger that if you proceed with a set of ESOPs proposals of that kind there may be disappointment and criticism that the reliefs have been too narrowly drawn, and that you (or, if past history is anything to judge by, more likely we) would be accused of having emasculated a good idea. Presentation, therefore, would have to emphasise from the outset that it would not be your intention to give new tax reliefs to ESOPs in whatever shape, size or form, but only to those meeting clearly defined employee share ownership objectives.

16. Even so, there is the possibility that tax reliefs for ESOPs might be seen as threatening the success of existing ESS schemes from the very fact that ESOPs have other objectives, which means that there commitment to employee share ownership is weaker. That difference is likely to be reinforced by the kind of tax reliefs the ESOP movement is seeking, which relate mainly to the existing share holders and the company itself rather than - as in the case of ESS - the employees. In short, under ESS there are no tax benefits for existing share holders and few for the company itself - for them the gain is the increased commitment of employees through their share-holdings. Under ESOPs existing shareholders and the company would benefit from the tax reliefs, but in return for a weaker commitment on their part to employee share holding.

17. If you wished to proceed with tax reliefs for ESOPs you may also wish to consider whether it should be part of a package of wider Government support for ESOPs. In particular you may wish to consider whether the Treasury should consult DTI about the Financial Services Act and Companies Act problems which have been raised (Annex D of Mr Farmer's paper). (Some of these might interact with a new tax provision since they are concerned with the status of the ESOP trustees).

18. We cannot estimate the number of pages of legislation or the Exchequer cost until proposals are developed further. But we would not expect the Exchequer cost in the first year to be large.

19. We would be happy to discuss all this with you. To keep open the option of Finance Bill legislation, our aim must be to agree with you how to narrow down the focus of further work as much as possible and as quickly as possible.



P LEWIS

FAIRFIELD 6/12 (MATERIAL INTEREST)

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: MS J FAIRFIELD
6 DECEMBER 1988

[Solution 2 looks the better one?]

1. MR FARMER Seen in draft

2. FINANCIAL SECRETARY

MATERIAL INTEREST: PROFIT-RELATED PAY AND APPROVED EMPLOYEE SHARE SCHEMES (STARTER NO 115)

1. During the Finance Bill Committee Stage debates in the summer you undertook to consider whether easements might be possible in the present material interest tests on the eligibility of a director or employee or an ex-director or an ex-employee (all referred to below as 'employee') to participate particularly in a registered profit-related pay (PRP) scheme but also in an approved employee share scheme (ESS).

2. Pressure for easier material interest tests arises from

i. John Lewis Partnership (JLP) frustration at being unable currently to introduce PRP schemes, because of their present organisational structure, when they had looked to PRP to provide some compensation for their loss, in 1990, of NIC exemption for 'partnership bonus' paid from their trust to all employees;

ii. concern expressed that the spread in this country of American style Employee Share Ownership Plans (ESOPs) would be inhibited by the tests.

3. This paper suggests a possible easement which might be introduced to the benefit of both PRP and ESS/ESOP take-up and operation. It also suggests one minor technical

amendment to the present PRP material interest provisions, which in one aspect seem to go further than intended.

4. The Annex describes the current material interest provisions in the PRP and ESS legislation, their development and the rationale for differences between them.

John Lewis Partnership problem

5. The Annex explains that in determining whether an employee has a material interest in a company the interest of his associates must be taken into account as well as his own interest, if any. The definition of associate includes the trustees of a trust in which an employee has an interest. So in the case where shares are held in a trust set up for the benefit of employees, each employee is regarded as being interested in all of the shares in the trust by virtue of his "association" with the trustees. The effect can be to give an employee an interest in his company in excess of the percentage specified in the legislation and so to disqualify him from participating in a PRP or ESS scheme.

6. JLP is structured in such a way that all the ordinary shares are held by trustees for the benefit of all employees. Each year the profits of JLP are distributed through the trust - after the deduction of tax, preference dividends, allocations to reserves etc - to all employees, in proportion to their salaries, in the form of cash bonus. Payment through the trust has hitherto provided exemption from both employers' and employees' NIC but amendments to Social Security Regulations will bring this to an end in 1990. During correspondence about these amendments, the possibility of JLP setting up a PRP scheme or schemes - thus in effect providing employees with tax relief instead of NIC exemption - was raised. Although JLP were not told in so many words that they would be able to register a scheme or schemes, it was not unreasonable for them to have assumed that they would be able to do so. But in the event because

of the definition of associate every employee is regarded as having an interest in all the shares and is therefore excluded from participating in PRP schemes.

7. Only one company other than JLP has made representations about being unable to register a PRP scheme because its employees have a material interest in the company by virtue of their "association" with the trustees of a benefit fund. The report on the market research by IFF Research Ltd suggests that this was not a problem mentioned by any of the 2,000 companies without PRP schemes interviewed by the researchers. As for ESS, we believe there are no more than a handful of companies impeded by the test.

8. It could be argued that organisations similar to JLP should be excluded from PRP and ESS. Arrangements of the JLP type already confer on their employees considerable involvement and identification with the business. Relaxing the material interest test to allow organisations like JLP into PRP and ESS would mean that the tax relief would go to employees already benefiting from profit-sharing arrangements and presumably already motivated by their entitlement to a share in the profits.

9. On the other hand, JLP-type employees have only a remote interest in the equity of the company; they cannot share in fluctuations in its value; and they are not in practice able thereby to influence the way the company is run. It is for this reason as well as for the reasons in paragraph 2 that Ministers asked us to seek an easement to the material interest tests.

ESS and ESOPs

10. A separate submission addresses the possibility of new tax reliefs or concessions to encourage the spread of ESOPs in this country. The use in that context of Employee Benefit Trusts as a warehouse for shares in which employees

are interested, and the use of ESS to distribute these shares at some stage to individual employees, makes the possibility of an easement in the ESS material interest tests a matter of some importance to ESOPs.

Possible solutions

11. Any possible solution would involve some exclusion from the definition of associate of the trustees of a trust set up for the benefit of employees (employee benefit trusts). This might enable companies like JLP to register a PRP scheme for their employees. But safeguards would be needed to ensure that employees who should continue to be excluded because of a real material interest in their company remain excluded.

12. We have looked at several possible solutions and have concluded that the answer does not lie in the blanket exclusion from the definition of associate of the trustees of employee benefit trusts. Such an exclusion could easily lead to abuse. It is, for instance, possible to set up a trust which appears superficially to be for the benefit of all employees but which in reality is for the benefit of only one or two of them. So there would need to be some restrictions on the type of employee benefit trusts which could be excluded. But the difficulty with this is that it is likely to work only in the case of newly created trusts. In the case of existing trusts it would almost invariably be impossible to reorganise the trust to incorporate the required restrictions because settlors rarely reserve powers to vary trusts which they have created. It has been suggested in the past that trustees of existing trusts could give an undertaking to the Revenue not to exceed specified restrictions when exercising their future discretion. However it is unlikely that this would work in practice as it is a fundamental principle of trust law that a trustee cannot fetter the future exercise of his discretion in this way.

13. It is necessary therefore, if a solution is not unreasonably to discriminate against existing trusts, to look to the way in which trusts are operated, rather than the way in which they are capable of being operated. The present provisions, by concentrating on the latter, have arguably proved too stringent, ignoring the situation where there has been no history of the trust's operating to benefit individuals enjoying a significant material interest, and where there is no present intention that they be operated in future to benefit them.

14. We have considered a variety of possibilities looking at the way trusts are operated, against the background that in the cases of both PRP and ESS the current material interest tests have to be observed only at defined points in time (viz in the case of PRP, when payments are made; in the case of ESS, both when Finance Act 1978 schemes shares are appropriated, or when share options are granted and when they are exercised, and also at any time during the 12 months preceding the relevant points in time).

Two options

15. There are two possible solutions, both of which involve excluding the trustees of a trust set up mainly for the benefit of all or most employees from the definition of associate provided certain conditions are met. In both cases the conditions are the same; the options differ only in the consequences which follow from failure to continue to meet the conditions.

16. The first solution would depend on the following conditions being met, with a failure leading to the consequences described in paragraph 19.

- First, the trustees have not distributed shares to an employee at a time when he, and/or his associates other than the trustees, whether as a result of that distribution or not, had (or in the case of ESS had

during the previous 12 months) an interest in more than 10 per cent (25 per cent) of the shares of the company.

- Second, they have not distributed benefits to an employee at a time when he, and/or his other associates, whether as a result of that distribution or not, had (or in the case of ESS had during the preceding 12 months) enjoyed benefits from more than 10 per cent (25 per cent) of the shares of the company. (Where the trust also held investments other than shares in the employing company concerned, it would be necessary to deem distributions to have come to the maximum extent possible from the shares held in the company.)

17. The first solution would exclude the trustees from the definition of associate for as long as the conditions set out above are met. (Distributions made before the announcement of the change to the definition of associate for material interest purposes ie before the trust could know of the conditions would be disregarded). But once the trustees had made a distribution which did not satisfy these conditions they would be counted as associates of all those employees who were potential beneficiaries of the trust.

18. In operating the material interest tests, the scheme employer or responsible company (PRP and ESS respectively) would have to measure the material interest of each employee participant - as they have to at present - but that measurement would exclude the shares held by the trustees of the trust of which the employee was a beneficiary so long as the conditions were met. Where shares had already been appropriated to the employee (or to his close relatives) by such a trust, then those shares (if still held) would as now fall to be reckoned as part of his personal holding; shares still held in the trust and not yet appropriated would not.

19. But if the trust offended against the conditions, the scheme employer or responsible company would thereafter have

to regard every employee who was a potential beneficiary of the trust as having an interest in all the shares held by the trust. This would effectively mean, in most cases, that all employees would be regarded as having a material interest in the company ie including as at present those who do not have, together with their close relatives, more than a minimal personal shareholding and are unlikely to benefit to any great extent from the trust.

20. The second possible solution would mean that in measuring an employee's material interest the trustees would not be regarded as his associates unless he personally had received a distribution which did not meet the conditions set out in paragraph 16. The trustees would continue to be outside the definition of associate for any employee who had not received such a distribution. So in measuring the interest of the latter employee, the scheme employer or responsible company would disregard the shares held by the trustees. Any shares already appropriated to the employee, or to his close relatives, by the trust would, if still held, be reckoned as part of his personal holding. The employee might in the past have received distributions of income from the trust but so long as they - together with distributions on shares held personally by him and his other associates - had not related to shares exceeding the 10 per cent (25 per cent) limits, the trust's holding would again not be reckoned as entering into his material interest.

First solution or second?

21. It could be argued that the second solution is not dissimilar to a blanket exclusion from the definition of associates of the trustees of certain trusts which is rejected in paragraph 12, since in either case once the trustees distribute shares to an employee so that his holding exceeds the material interest limit, that employee is no longer able to participate in ESS/PRP schemes because of his holding, although other employees can continue to do so. However the solution suggested in paragraph 20 is more

demanding than a blanket exclusion. Firstly, it requires the trust's holding to be counted in measuring the interest of an employee who has had a material interest even if he has since then disposed of sufficient shares to fall below the material interest limits. And secondly, it takes account of distributions other than shares, so that it is not possible for an employee to avoid the test by receiving his distribution from the trust in, say, cash rather than shares.

22. There is a risk of abuse with both solutions, and particularly with the second solution. We have been unable to find a solution which both meets the reasonable interests of PRP employers (JLP in particular) and of ESOP proponents, and also avoids any risk of abuse. There is a possibility with both solutions that a company may set up a trust ostensibly for the benefit of all employees but in reality with the intention of issuing the majority of shares - or devoting most of the income - to only one beneficiary (who would thereby have a material interest in the company). The trustees of the trust could delay issuing the shares - or distributing the income - for a number of years and under the proposed relaxation their shareholding would not be taken into account in calculating whether any employee had a material interest. So the intended beneficiary could be granted and exercise an option under an approved discretionary scheme. Once the option had been exercised, the trustees could issue the shares - or the income - to the intended beneficiary. Thus he would have benefited from tax relief under ESS, whilst in reality having a material interest in the company because of his interest in the shares in the trust which were in fact being held for his benefit.

23. In the case of the second solution there is the added risk that a trust's holding would continue to be disregarded in respect of another employee who will in due course receive a distribution which will not satisfy the conditions set out in paragraph 16. For instance, there might be a

trust set up for the benefit of all employees but with the intention of giving shares - or income - in excess of the material interest limit to directors and senior executives (whose relationship with each other is not close enough for them to be associates of each other) at different times in the future. Under the first solution, once the first intended beneficiary had received his shares - or income - the trust's holding would for the future be reckoned as part of each employee-beneficiary's interest ie including the remaining intended beneficiaries. Under the second solution the trust's holding would not be counted as part of the remaining intended beneficiaries' interest until they actually received their distributions.

24. We think that the risk of abuse is fairly remote. The first type of situation is most likely to arise with family companies, when the intended beneficiary would most probably be a close relative, and therefore an associate, of the settlor, and would thus be caught by the material interest test even in its new form. And we doubt if the second situation would arise very often.

25. The risk is more pronounced in the ESS field than PRP, because the tax reliefs associated with the latter are much smaller. We have therefore considered the possibility of introducing the relaxation for PRP only. But we suggest this would be an over reaction to the risk of abuse. It seems preferable to keep the tests for PRP and ESS aligned so far as possible; and to deny the relaxation for ESS would excite criticism from the ESOPs lobbies.

26. In summary therefore:

The first solution excludes from the definition of associate the trustees of those trusts which are intended to benefit a substantial proportion of employees. Once trustees bestow benefits on an employee who already has a significant interest or bestow significant benefits on selected employees, then

the trustees are once again counted as associates of all employee-beneficiaries. There is a slight risk of abuse. On the other hand, if trustees bestow benefit on one employee with a significant interest, thereafter all employees will be regarded as associates of the trustees.

The second solution extends the relaxation to all employee-beneficiaries who do not personally have a significant interest in the trust, even though the trust may have distributed benefit to an employee with a material interest. It is, thus, more generous than the first solution. It is more susceptible to abuse.

27. Either solution seems likely to meet the interest of PRP employers (JLP particularly) and ESOPs proponents. The second is attractive because it is fairer (other employees are not penalised because the trustees have given someone else a material interest) and may enable more employees to participate in PRP/ESS schemes. But there will be a greater possibility of abuse. The choice between solution 1 or 2 seems fairly evenly balanced.

28. If a relaxation is introduced for ESS, then it should also apply to close company interest relief (Section 360, ICTA 1988). The same companion changes were made in 1987 when the material interest tests were last changed. The risk to be avoided in this way is that employees might in certain circumstances be able to claim interest relief on the basis that they had a material interest in a company, while participating in an approved ESS on the basis that they did not.

Administration

29. In operating the revised material interest requirements, it might be necessary for the scheme employer or responsible company (in the case of PRP and ESS respectively) to obtain from the trustees an undertaking

that the trust met the conditions set out in paragraph 16 above and that they (the trustees) would give notice whenever they make a distribution to employees. It would then be for the scheme employer or responsible company to check such notice at the relevant points in time (paragraph 14 above). A possible difficulty here might be that the trustees would be unwilling to give such an undertaking, but it is likely that in most instances the trustees and the employer (or company) would be the same people, or would be closely identified with each other, in which case it would be unlikely that there would be any problem. In any case, how an employer (or company) in practice arranged to make the necessary checks would be a matter for him, in the light of his circumstances. It would not be a matter for law. But failure by a scheme employer or responsible company to observe the material interest requirements would, as now, be grounds for cancellation of the registration of the PRP scheme or withdrawal of approval of the ESS scheme, and possibly for the recovery of tax relief already given.

PRP: Minor amendment

30. Paragraph 7(1) of Schedule 8, ICTA 1988 provides that a person who has, or who is an associate of a person who has, a material interest in a company may not participate in that company's PRP scheme. Paragraph 7(2) defines a person with a material interest as one who with or without his associate owns or controls more than 25 per cent of the company's ordinary share capital. The effect of these two sub-paragraphs taken together is that the interest of the associates of a person's associates must also be taken into account in applying the material interest test. This goes further than equivalent provisions for ESS, close company interest relief etc and further than was originally intended. We think this counting of associates of associates should be removed, and we therefore recommend an amendment to this effect. Subject to Parliamentary Counsel's advice, the amendment needed is the repeal of a few words in paragraph 7(1). This would bring the PRP

legislation in line with other legislation which applies an equivalent to paragraph 7(2).

31. For convenience, we have ignored this (PRP) counting of associates of associates throughout this paper and the Annex.

Legislative and revenue cost

32. Legislation to give effect to our proposals might require up to 1 page of Finance Bill space. The revenue cost is estimated as negligible in 1989/90 and up to £5m in each of 1990/91 and 1991/92.

Conclusion

33. When Ministers have decided whether their preference is for solution 1 or 2, we suggest that we should first consult JLP - informally and without commitment - to establish whether that approach would indeed meet their needs. Assuming that it did, it would then be for them to introduce a PRP scheme or schemes which satisfied the other legislative requirements. If Ministers are content that this informal consultation should be undertaken, and if the outcome is confirmation of the adequacy of the approach suggested, we would then proceed to instruct Counsel as proposed.

Janice Fairfield

MS J FAIRFIELD

ANNEX A

THE MATERIAL INTEREST TESTS

Rationale

1. Approved ESS and registered PRP schemes can convey valuable tax reliefs to employee participants in respect of the share interests and PRP they receive under them. Inter alia these schemes and the associated reliefs are designed to foster employee incentive and motivation, and a sense of involvement in the prosperity of the company in which they work.

2. Some employees may reasonably be regarded as already having such motivation and involvement to a significant extent, however, as shareholders in the company, and their participation in an ESS or PRP scheme would not be capable of serving the policy purposes underlying the tax reliefs. Such employees, further, are likely to be in a position to influence the introduction, design and operation of these tax-assisted schemes, and so in effect to manipulate the tax reliefs in their own favour. The material interest tests seek to exclude such employees from participation in these schemes, in order to ensure that the tax reliefs are directed where they will serve their objectives and will not be wasted, and that the reputation of the schemes is not damaged.

The Measurement of material interest

3. An individual employee's tangible interest in his company may take a variety of forms. It may be his beneficial ownership of ordinary shares in the company ("shares"); or his ability to control, directly or indirectly, shares; or his ability to enjoy shares eg where he has bonus or voting rights rather than shares or control; or, in the case of a close company, the right to have

apportioned to him a proportion of the whole distributable income of the company.

4. In determining whether an employee has a material interest in his company the interest of his associates (whose actions he may be able to influence) must be taken into account as well as any interest he may himself have in the company. Associates (as defined in Section 417(3) ICTA 1988) include:

i. certain defined (close) relatives

ii. the trustees of any trust in relation to which the employee or any such relative is or was a settlor

iii. the trustees of any trust in which he has an interest

iv. the personal representatives of any estate in which he has an interest.

5. Material interest is defined as more than 25 per cent of the company's ordinary shares for the purposes of approved all-employee share schemes and PRP schemes, and more than 10 per cent for approved discretionary share schemes. In the case of approved ESS the test is applied only to close companies. The test for PRP applies to all companies and also, suitably modified, to unincorporated associations. The test is applied for approved ESS not only at certain defined points in time (eg when share options are granted), but also during the preceding 12 months. For PRP it is applied at the time PRP payments are made.

History

6. In 1978 the approved profit sharing schemes legislation was drafted with a 5 per cent material interest test. This was relaxed to 25 per cent at Report Stage in response to Opposition pressure. Ministers accepted that 5 per cent was

too restrictive and that it might discourage the growth of profit-sharing schemes in close companies. The same limit was included in the 1980 approved all-employee share schemes legislation. A more restrictive limit of 10 per cent was included in the 1984 approved discretionary share option scheme legislation, which provided particularly valuable tax relief likely to be enjoyed only by directors and top executives and which was therefore more susceptible to abuse. In 1987 the PRP legislation included the 25 per cent limit but applied it in the case of all companies and unincorporated associations.

7. The definition of associate used to include any person interested in a trust (or an estate of a deceased person) in which the employee had an interest. This meant that the personal holdings of all the beneficiaries of a trust (or an estate) had to be aggregated with the trust (or estate) holdings and those of the employee and his relatives for the purpose of measuring the individual employee's material interest. This rule proved unnecessarily restrictive. It could operate to prevent employees with particularly remote interests under trusts from participating in ESS schemes, and it also provided a possible opportunity for the malicious totally to prevent a company's operation of ESS schemes. These problems were removed by the relaxation announced in November 1986 and introduced by FA 1987. This amended the definition of associate to exclude from an employee's reckonable interest the personal holdings of fellow beneficiaries of a trust. At the same time the 1987 amendments enabled the employee to disclaim irrevocably his interest in a discretionary trust, and also ensured that shares held by the trustees of an approved profit sharing scheme pending appropriation would be disregarded.

8. Under ESS employees are generally exempted from any income tax charge on acquisition of their shares. Any charge is limited to capital gains tax at the point when they dispose of shares. Before 5 April 1988 this could provide an especially valuable benefit to higher rate

taxpayers (ie a maximum 30 per cent CGT charge in place of a maximum 60 per cent IT charge). While the alignment of IT and CGT rates announced in this year's Budget has reduced this benefit, much of the attractiveness of ESS schemes remains.

Differences in the tests

9. The differences in the various material interest tests for ESS and PRP purposes are referred to in paragraph 5.

10. One difference is that, in the case of ESS, the test is restricted to close companies only. This was because it was considered that the situation in which an already significant shareholder would seek to accumulate further capital in a company through an approved scheme was much more likely to occur in the case of a close company, and so special provisions were made to prevent this happening. However, in the case of PRP it was considered that employees with a material interest in companies other than close companies might seek to use the PRP tax relief to their own advantage, and so the wider definition was used. PRP schemes do not, of course, have first to be approved by shareholders, and - again unlike most ESS - they can be established for the benefit of only a small part of (or employment unit within) a company.

11. Another difference is that the test for approved all-employee share schemes and for PRP is more generous (25 per cent) than for approved discretionary share schemes (10 per cent). The reasons for this are that in the case of the former:

i. the required all-employee basis is buttressed by a requirement that participation be on similar terms. There is therefore less scope to favour a particular group of employees ie those with a material interest;

ii. the limits on the tax reliefs available are much lower and the scope for abuse is therefore significantly less.

12. The third difference is that for ESS the test has to be observed both when share options are granted and when they are exercised, or when Finance Act 1978 schemes shares are appropriated, and also during the 12 months preceding these relevant dates. For PRP it has to be observed when PRP payments are made. The purpose of the "preceding 12 months" requirement is to prevent an employee participating in ESS by transferring his material interest in a company to a trusted non-associate shortly before a relevant date. The risk of an employee avoiding the material interest test in this way for PRP is considerably less, since the tax reliefs for PRP are much smaller.

FARMER 6/12 (ESOPs)

Inland Revenue

CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: J D FARMER
DATE: 6 December 1988

FINANCIAL SECRETARY

ESOPs (STARTER No 113)

1. This paper reports on our assessment of the case for fiscal assistance for "Employee Share Ownership Plans" (ESOPs) in this country. The ESOPs movement

- have a wide variety of objectives and ambitions for ESOPs;
- suggest a range of inadequacies and obstacles in present law;
- seek a wide range of tax reliefs;
- have changed their targets as time has passed;
- and in a number of respects, appear to have different priorities.

Treasury officials have commented on this paper in draft.

2. We address the subject as follows:

Background; what are ESOPs?	- paragraphs 3-10 and Annex A
UK Employee Share Scheme Legislation	- " 11-13
Examination of what UK ESOPs' proponents seek	- " 14-31, and Annexes B-D

Are fiscal encouragements needed;
if so, which? - paragraphs 32-40

Conclusion - " 41-43

Background

3. Interest has been growing for some time now in special tax reliefs to assist the spread of ESOPs. Representatives of Job Ownership Ltd (JOL) brought a leading US proponent of ESOPs, Senator Long, to see you in December 1986; you met JOL again a year ago: two substantial New Clauses to the Finance Bill were tabled by Conservative backbenchers this summer; and you have recently had several meetings with individual lobbiers - including the reputed American father of ESOPs, Louis Kelso.

4. In approaching this assessment of ESOPs, we saw our first task as being to obtain from the two main sets of proponents - JOL/IOD; and the newly-formed ESOP Centre - as clear as possible a statement of their aims and prescriptions, and to encourage them to coordinate these statements. We sought this in the first instance by means of meetings held in August, and the consequent issue of an exhaustive questionnaire. The following description of ESOPs and of the ambitions of their present proponents in this country takes account, therefore, of the answers received, and of what has been said at the meetings and seminars attended, and in the papers seen, over the past few months. (The latest of these seminars, held by JOL/IOD on 9 November, was notable for a cautious address from Mr Tebbit, attendance heavily weighted towards the ESOP-committed and consultants and commentators, and almost non-existent participation from the ESOP Centre.)

What are ESOPs?

5. Since ESOP proponents have drawn both inspiration and support from the American experience, we start with a

description of that experience, to serve as background to consideration of the case made for UK ESOPs.

6. In the USA, legislation developed over more than a decade is estimated to have resulted in some 8,000 ESOPs covering over 7-8 million employees. These arrangements centre on employee trusts funded by the business with contributions deductible for tax (but often using finance borrowed from banks - which enjoy a measure of special tax relief on their interest income). The trust acquires shares for appropriation to employees, whose entitlement to them ('vesting') is gradually established with time eg 100% after 10 years. While the shares are in trust, the employee pays no tax on them. When actually received by the employee he becomes liable to tax, and may subsequently retain or dispose of them (with the trust having the right of first refusal).

7. ESOPs in the USA are described as having several uses: as

- an employee benefit plan
- a means of buying shares from an existing owner
- a technique for borrowing money more cheaply
- part of an effort to integrate employees into the company
- a way to save failing firms
- a tax-efficient way of acquiring or divesting subsidiaries or whole companies.

8. In answer to Mr Satchwell's minute of 11 October, Annex A offers a short description of the reasoning which led to the development of the ESOP concept (Kelso's "Binary

Economics"). The Annex briefly notes also a number of less well-developed variants on the ESOP idea which Kelso has identified for use in different situations.

9. It is clear from this brief description that US ESOPs have two particular features not shared by current UK employee share participation arrangements:

i. In most ESOPs the ownership of capital by the individual employee is deferred until the employee separates from the company, ie often until retirement.

ii. ESOPs are seen as providing direct benefits to the company (or at least the current owners/management), by assisting the financing of companies or acting as a protection against takeovers.

10. Arising from these, criticisms have been heard of features and effects of the US ESOPs legislation and its practice. In particular

- ESOPs have replaced, or have been introduced instead of retirement pension plans. This carries the obvious risk for employees that their retirement benefits are in the same basket as their employment, and are not protected by diversification.

- ESOPs have acquired their shares at greatly inflated prices, which means that employees receive fewer shares than are warranted by the size of the tax benefits accruing to employers.

- ESOPs have been used as "poison pill" devices to resist takeovers and to entrench existing owners and management. Employees may enjoy few of the rights of shareholders while the shares allotted to them are still in trust.

In the USA, some have also argued that leveraged ESOPs are established primarily for corporate purposes and not for the benefit of employees - commonly by failing companies. The Reagan administration's May 1985 tax reform proposals (Treasury II) included a reform of leveraged ESOPs that would have required earlier distribution of shares to employees in order to achieve direct employee stock ownership (and its incentive effects). In the event the 1986 Tax Reform Act took no action on this proposal. There was some criticism in Congress (and elsewhere) in 1987 of the tax reliefs for ESOPs; and renewed examination of them is expected in 1989.

UK Employee Share Scheme Legislation

11. By contrast with US ESOPs, the UK's approved employee share scheme (ESS) legislation with its associated tax reliefs is not intended to assist in the financing of companies and their protection against takeovers, or in the provision of more substantial retirement benefits to employees. The direction taken here is different. Certainly employee motivation and incentive, improved corporate performance etc are similar goals, but particular benefits are seen in countering "them and us" attitudes at work, and in increasing individual responsibility and self-reliance in financial matters, and improving understanding of capital (and producing a taste for shareholding in particular). These objectives have been seen as best served by tax reliefs directed not to the company (or its owner) but to the individual employee, for which he qualifies after only a few years - 5 in the case of the all-employee schemes. Once that qualifying period is up, he is an ordinary shareholder, free to enjoy and vote or dispose of his shares.

12. In 9 years, the number of employees who have participated in approved all-employee share schemes (ESS) is estimated at well over 1.5 million, covering shares or interests in shares to an initial value of around

£4 billion. (The number of employees equals some 7 to 8% of the total UK employee population - about the same as the proportion participating in ESOPs in the US.) The ESS legislation has been regularly improved over the years to provide greater individual limits and flexibility; it has been the means of providing substantial employee participation in privatisations; and its reputation and progress have not been damaged by any major points of criticism or by abuse of the valuable tax reliefs provided. Take-up and operation of approved schemes remain at high levels.

13. This success story is sometimes ignored by ESOP proponents, whose publicity tends to portray ESOPs as the sole means of securing widespread employee share ownership. For example, Ian Taylor's pamphlet of 9 November (a draft of which was attached to Mr Satchwell's minute of 25 October) makes only fleeting - and then critical - reference to the Government's approved ESS legislation over the past nine years; and falls into the error of comparing all-employee with discretionary scheme take-up on the basis of scheme approvals rather than employee participants.

What do UK supporters of ESOPs want?

14. The UK proponents of ESOPs see them as working here on lines only broadly comparable with their US equivalents. A trust is set up to acquire, hold and distribute shares for employees. It could take loans for the purpose from outsiders, and it would be funded by the company. Share distributions to individual employees, when made, would be by sale, or by gift, or through an approved employee share scheme.

15. UK ESOPs can already be set up - nearly a dozen have in fact already been established - but the lobbies urge that Government encouragement is necessary, and that obstacles should be removed by means of a variety of tax easements.

Since the latter generally take the form of easements for companies and their owners, rather than for employees, the aim of the lobbies amounts essentially to an amalgam of what they see as the attractive features of both countries' different approaches. They would wish to augment the machinery and reliefs currently provided for employee share acquisitions in the UK with arrangements qualifying companies and their owners for further benefits of the kind now available in the USA.

16. It seems evident from their questionnaire replies that they might now be prepared to see somewhat more stringent conditions attached to these reliefs than their New Clauses in the summer contemplated, and more stringent conditions than at present operate in the US - eg a time limit for the transfer of trust shares to individual employees, a minimum proportion of such shares having to go to all employees on similar terms, etc.

17. Questions nevertheless arise. What would be the effect of concessions to the ESOP protagonists' case on future take-up and operation of the present, hitherto successful approved ESS, and on the continued achievement of their objectives? Might ESOPs indeed serve these objectives better? These are questions to which we return below, after examining the detailed proposals for UK ESOPs now being urged.

ESOP CENTRE/JOL PROPOSALS

18. Annex B summarises the replies received from the two main UK ESOPs proponents to the questionnaires referred to in paragraph 4 above. We consider the various aspects in detail below, but three general conclusions can be drawn immediately:

i. no new tax reliefs are proposed for employees acquiring employer shares (except in some particular circumstances, eg employee buy-outs). Instead, the replies stress the increase and extension in employee ownership generally which they foresee (Ian Taylor has described the progress made towards wider share ownership generally as "precarious");

ii. the failure of the two Finance Bill New Clauses in the summer to provide for individual - as distinct from collective - employee share ownership has been mitigated, but not wholly remedied. Not only would allocation of shares to individual employees from the employee benefit trust (EBT) be capable of delay for 10 years, but only one half of the EBT's shares would have to be allocated on an all-employee (though this is not clear) and "similar terms" basis, which could leave the rest to be sold or allocated to only a very few directors or top managers;

iii. a number of differences of approach and emphasis remain between the ESOP Centre and JOL.

19. We have also received a set of replies from the Co-operative Development Agency (CDA), the director of which is both a member of the ESOP Centre and a director of JOL. This response looks to ESOPs, particularly in the case of private companies, to ensure:

- individual employee share ownership

- EBT distribution of shares on an "all-employee" basis

- that such distributions take place within 5 years

- that a minimum of, say, 80% of EBT shares should be so distributed.

Particular tax proposals

20. Annex C briefly assesses the following tax reliefs or easements sought - together with some other changes - to assist the spread of UK ESOP-type arrangements (another is the subject of consideration in a separate Starter: No 115, easement of the "material interest test" on an employee's eligibility to participate in an approved employee share scheme).

Suggested changes concern -

I. for owners of companies	a. CGT relief
	b. IHT relief
II. for companies	a. CT deductibility for payments to an EBT
	b. relief from tax charge on close company loans to EBTs
	c. shares permitted for use in ESS to include those of a company controlled by a sole corporate trustee
	d. shares held in an ESOP (EBT) should be treated as held personally by employees/directors

e. adjustment of employee pre-emption rules for shares used in ESS

III. for employees

a. additional interest relief and BES relief for employee acquisitions in employee controlled companies

b. CGT reliefs where employees acquire shares subject to IT

c. new CGT and IT reliefs in respect of acquisitions of shares or options in "unapproved" circumstances

d. tax exemptions for EBT capital gains or income from employee securities.

21. In addition to tax easements, the ESOP proponents have also sought action on certain alleged FSA and Companies Act difficulties. These are the subject of Annex D.

22. This list of easements is substantial. As Annex C shows most raise difficulties of one kind or another when viewed against the Government's present tax policy in these fields. Nevertheless we have considered what easements are needed, or would help significantly to encourage ESOPs and what their effects might be.

Arguments adduced for fiscal encouragement

23. The two ESOPs lobbies seek, with different emphasis, to

- promote the further spread of employee share interest
- extend employee participation in buy-outs
- encourage company owners to sell shares to employee trusts
- assist companies' access to finance
- improve exit routes for employee shareholders.

In each case the objective is improvement in present facilities or the easing of certain obstacles, not the removal of any actual block to the introduction of ESOPs.

How real are the present difficulties?

24. Taking each objective in turn, the further promotion of employee share interests is said to be necessary because the success of employee share ownership in quoted companies is "beginning to falter", because such share ownership should be fostered to the stage where it is as significant to the employee as his pension benefits and his equity in his home, and because take-up of approved schemes by private, independent companies has been poor and needs further assistance. Particular difficulties cited include Investment Protection Committee (IPC) limits on share issues to employees, the limited availability of shares for scheme operation, the provision of a market for employee share disposals, the risk of loss of family control of companies, the material interest test on employee's eligibility to participate in approved schemes, etc.

25. These difficulties seem exaggerated. There is, at least as yet, no particular reason for believing that the success of the employee share scheme legislation hitherto is beginning to falter. The IPC limits, of significance of course essentially only to public companies, do not appear widely to be seen as a difficulty, and can fairly readily be

avoided by purchasing shares for share schemes in the market (so avoiding adverse dilution effects and the cost of additional equity servicing). In the case of private companies, shortages of shares, or concern about loss of control, or the provision of a market for leavers' shares can all fairly readily be dealt with - the more easily since the Finance Act 1986 permitted the use of shares subject to the restriction that they had to be sold when the employee left ("pre-emption").

26. This leaves two more major points. One is the material interest test (Starter No 115 - dealt with separately). The other is the suggested relaxation in the Finance Act 1986 pre-emption provision. This is sought only by the ESOP Centre, not JOL/IOD, and is unattractive (as explained in Annex C II.e.) because it would introduce a significant distinction between shares acquired by virtue of employment and shares acquired and held by others, eg family owners (who may also be employees).

27. The second objective, the extension of employee participation in buy-outs, is sought by JOL/IOD rather than the ESOP Centre. Whereas the former seek the tax relief discussed in Annex C III.a., the ESOP Centre ask for no new reliefs specifically to encourage employee buy-outs (EBOs - as distinct from management buy-outs, MBOs), saying that while their proposals will facilitate the full range of possible employee stakes in their company it is expected that most cases will involve a substantial minority stake. Buy-outs in total in 1988 are predicted to reach a value of over £3.2 billion, maintaining the high level reached in 1987 (1986 £1.2 billion); we do not have any figures, but our own impressions confirm JOL's statements that only a small proportion of buy-outs are EBO rather than MBO in character. (JOL views MBOs as suspect in their effects on general employee attitudes.) Annex C III a. discusses the particular JOL/IOD request, which Ministers have previously rejected.

28. The third objective, the encouragement of owners to sell shares to EBTs, is sought by the CGT and IHT reliefs discussed in Annex B (I.a. and b.). Again a difference of emphasis is seen in the respective ESOP Centre and JOL/IOD replies, the latter attaching more importance to these easements than the former. It is of course extremely difficult to assess what the value of these easements would be in terms of encouraging/diverting owners' sales of shareholdings to EBTs rather than to non-employee interests (eg predators). But this looks as though it could be a very significant new relief.

29. The fourth objective is to improve companies' access to finance. The argument here is that positive assistance for the establishment of ESOPs could enable companies more easily and cheaply to raise finance for expansion, to turn their fortunes round, etc. Companies would be assured of CT relief for contributions to EBTs which the latter used to service and repay borrowings employed to purchase company shares (the ESOP Centre in particular would hope that, later on, lenders might obtain a US-type tax relief on their interest income, leading to a further reduction - at second remove - in companies' own capital servicing costs).

30. It is not clear how ESOPs can enable companies more easily and cheaply to raise finance. In the absence of any new tax relief for lenders' interest income, such easier and cheaper finance seems likely to be available only if

- lenders can be found willing to provide finance at specially favourable rates and to accept poorer security (eg because employee share ownership is the end result - the Unity Trust bank is a possible case in point), and

- existing shareholders are willing to accept substantial dilution of their interests.

Otherwise companies might be at least as well served by direct borrowings on their own account. It is worth noting also, in this connection, the very topical concerns being expressed currently in the US about the extent of 'leveraging' of the high level of takeover and buy-out activity.

31. The fifth objective is the provision of an exit route for employee shareholders in non-listed companies. The argument here is that employees may find it difficult to sell, and to sell at reasonable cost, the shares they have obtained, and that EBTs can provide a useful market for this purpose. The provision of such a facility is, of course, open to any company already, and no particular action, fiscal or otherwise, seems necessary.

How important are fiscal encouragements?

32. This discussion of the ESOP proponents' arguments for fiscal encouragement suggests that, in relation to a good many of the proposals, the case is not compelling. Indeed the following statements indicate that they recognise this themselves:

- "The need for legislation lies primarily in the argument for the Government to signal its support for the concept of ESOPs and for their development, rather than in any significant fiscal encouragement."
  (ESOP Centre)

- "Statutory confirmation of the CT deductibility of company contributions to an EBT would be valuable on its own."
  (ESOP Centre)

- "When can we expect to see ESOPs widespread in Britain? Very soon. Even without specific ESOP legislation

there will nevertheless be companies, both private and quoted, who feel a sufficient commitment to employee participation."

(ESOP Centre)

- "We are seeking to <u>remove obstacles</u> to employee share ownership and not to introduce politically contentious 'tax breaks' or otherwise disturb the existing structure of the UK tax system." "The top priority is to remove fiscal <u>uncertainties</u>."

(JOL/IOD)

33. Against this background, both you and we have asked the two lobbies what <u>individual relief</u> or easement would be valuable on its own ('any one' - JOL/IOD; certainty as to CT deductibility - ESOP Centre), and whether <u>a minimum package</u> would achieve the objectives sought. Replies to the latter have been:

<u>ESOP Centre</u> - CT deductibility; relief from ACT on close company loans to EBTs; material interest (this reply to the Revenue questionnaire was confirmed at your dinner with the Centre - Mr Satchwell's minute of 29 September).

<u>JOL/IOD</u> - CGT rollover relief; CT deductibility; relief for close company loans to EBTs. Special interest and BES reliefs to encourage EBOs.

34. It is reported that already 9 ESOP companies are in existence (including MFI Furniture Group and Roadchef), and five more are well advanced down the road. So the introduction of ESOPs is already possible; the ESOP protagonists seek to make it easier.

Should easements or reliefs be given to ESOPs; if so, which?

35. The foregoing suggests that if Ministers wished to signal their sympathy with the ESOP movement they might do so in a wide variety of ways, ranging from a general expression of goodwill unsupported by any new tax or other tangible assistance at one extreme, to a large package of measures including the most attractive from among those identified by the present ESOP lobbies at the other.

36. You indicated your interest in and sympathy for the underlying purposes of ESOPs both in the Finance Bill Standing Committee debates last summer, and in your speech to the Wider Share Ownership Council Forum on 7 September. On the former occasion you indicated your concern that employee share ownership should be individual, not collective in character. On the latter you said that to make tax changes to encourage ESOPs you needed to be persuaded "that the current generous tax reliefs were not sufficient to facilitate them, and that the benefit of ESOPs really did make further tax changes inevitable".

37. In reaching a view now, Ministers may consider that the following factors suggest a degree of caution:

i. the uncertain extent to which new reliefs would actually lead to any substantial increase in individual employee share ownership. While much of course might depend on the range and nature of reliefs provided, and the current surge in management (if not employee) buy-outs may indicate a large potential, it can at present be a matter only of speculation how many companies and their owners might wish to go down the ESOP road to substantial employee share participation - and how many employees might be involved. US experience is no guide here.

Present indications are that the number of UK ESOPs will continue to grow without special fiscal encouragement;

ii. the uncertain effect which new easements or reliefs would have on the continuing operation of existing approved ESS and on the future take-up and operation of these schemes. A success story could be jeopardised. Depending on the range and nature of the reliefs provided, ESOPs could prove more attractive to at least some companies and their owners by providing cheap financing possibilities, alternative and cheaper employee retirement benefit arrangements, greater and longer control over employee shareholdings, and ways to realise capital without losing control. Encouragement would be given to collective employee share ownership in the enjoyment and use of which employees had little real say, by contrast with individual employee share ownership; individual employees might acquire their personal holdings much later than under present ESS arrangements (eg shares held first in a 'collective' EBT; then only 5 years after FA 1980 scheme options were granted). The proponents of ESOPs would not wish to exclude the ability of EBTs to sell shares to employees rather than distribute them through approved - or unapproved - schemes;

iii. the ESOPs already established in this country are all young, and while those close to some of these cases are enthusiastic about the benefits of surging employee interest and performance, none have yet stood the test of time (the National Freight Corporation example, sometimes cited here, is inapt of course, because that company went employee-owned on the basis of individual employee share ownership from the outset);

iv. some very substantial, complex and stringent legislation might be needed if many of the proposals were accepted. There are two main reasons. First, the individual reliefs themselves generally relate to quite complex parts of the tax code which, in defined circumstances, will need amendment. Second, the reliefs themselves would need to be confined to ESOPs meeting defined conditions which could be designed to ensure they were granted in ways consistent with the Government's objectives for employee shareholdings.

38. This last point requires further explanation. If the individual employee share ownership purposes of the existing ESS legislation were also to underlie any new reliefs or easements intended to encourage ESOPs, and if that purpose was accepted as best served by arrangements for the benefit of "all-employees" on similar terms, then the components of any major package of reliefs would require careful limitation. With any large package of the type put forward - involving the acquisition, ownership and disposal of shares by an EBT - there would be a strong case for making the reliefs conditional on requirements relating to the nature, constitution, powers and duties (or at least the actions) of the trust. This could certainly not be done by way of Statement of Practice. It would probably involve inter alia the statutory definition of the trust etc, and possibly its formal approval by the Revenue as a precondition for operation of the reliefs. In any event a variety of conditions would have to be considered for inclusion in the legislation, on such matters as

- who the trustees should be (controlling - family - owners, or not?);

- whether the trustees' discretion to use their shareholding should be unfettered save by general trust law;

- how long shares acquired by the trust with the help of tax reliefs could be retained before sale, distribution or appropriation to individual employees;

- whether such employees should exclude any with a material interest in the company;

- whether all or a specified minimum proportion of share disposals by the trust should be to "all employees" on similar terms, and whether such disposals should always be through approved ESS or might alternatively be arranged in other ways eg by sale or by unapproved schemes.

(As it happens these were the kinds of issue alluded to by Mr Tebbit on 9 November - paragraph 4 above.)

39. If any extensive package of tax reliefs to assist ESOPs was contemplated, therefore, it seems probable that those reliefs would be untargeted, would be open to abuse, and would threaten to undermine the existing and future success of the present ESS legislation, unless substantial and complex legislation was devised and enacted. This appears unattractive unless positive and substantial benefits in terms of increased employee share ownership are assured.

40. As indicated in paragraph 35 therefore, the choice of action on ESOPs lies somewhere in the range between

i. an expression of goodwill, sympathy and continuing interest (supported perhaps by a suggestion that other action being taken is likely to assist in this context, eg increased ESS limits and a relaxation in the material interest test); and

ii. a package of tax reliefs/relaxations linked with a specially defined employee benefit trust, these specific reliefs being chosen from among those

particularly stressed by the lobbies. The leading candidates here seem to be CT deductibility and CGT roll-over relief.

Conclusion

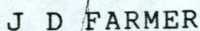
41. Despite the ESOP proponents' persistent and energetic efforts to demonstrate the merits and potential of ESOPs, and to explain the attractions of their case for a far-reaching package of measures to facilitate the spread of ESOPs in this country, their likely potential to increase employee share ownership (whether collective or individual) remain entirely a matter for speculation. They may have such potential; but it is not at present self-evident. Significant tax reliefs might encourage them to develop on a much wider scale, and in a form consistent with the Government's employee share ownership objectives. But again, the likely behavioural responses can only be a matter for speculation. As Annex C indicates, most of the components of such a package would have difficult implications. To guard against these - and at the same time to try to guard against undermining the success hitherto of the existing ESS legislation - would imply some quite substantial and complex legislation.

42. These considerations suggest that a response to the ESOPs lobbies might perhaps be cautious. They have reduced their demands quite significantly over the past two years but there continue to be differences of emphasis between them (some seeking much greater insistence on early, individual employee share ownership than others appear prepared for). ESOPs are possible now, and ESS changes will help them. There is a case for waiting for a few more ESOPs to come into being, so that you can see how well you like them in practice, and which are their better or less attractive features before deciding whether the Government should put its weight behind them with a powerful package of tax reliefs.

43. Against this background, and the analysis in Annex C, we should be grateful to know

i. whether Ministers favour, and would like us to work up further, any particular package to encourage ESOPs. If so, which individual components they would wish to see included, and whether they agree that these should be linked to the operation of a statutorily defined employee benefit trust;

or ii. whether there is any alternative approach they would wish to consider, on which they would like our further advice.



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ANNEX A

US RATIONALE FOR ESOPs; VARIANTS ON ESOPs

1. Rationale

The philosophical basis for ESOPs, as expounded by Kelso, is that while production and the creation of material prosperity may in the past have been regarded as deriving primarily from the employment of labour, increasingly both labour and capital lead to prosperity - indeed technological progress has led to the dominance of capital. So fast has this progress been that he concludes that "capital now produces affluence; labour produces subsistence". He asserts that modern industrial economies have failed to adjust to this fact, but that preservation of the capitalist system requires that effective adjustments are made. Political democracy has led only to the adoption of income and wealth redistribution policies, social welfare programmes etc, which are ineffective, costly and inefficient. The absence of "economic democracy" implies also that since the sources of consumer income have not changed in line with the changing significance of capital as a factor in production, the free enterprise economy is not reaching its potential in terms of the good of all who participate in it.

2. This analysis has attracted considerable sympathy in the USA, as has Kelso's prescription that it is up to Governments to remove obstacles in the way of employees' participation in the ownership as well as the operation of the businesses in which they work, so that while working they earn both labour income and - largely deferred until retirement - capital income. The encouragement of ESOPs, assisted by positive Government support, is seen by Kelso as infinitely preferable to nationalisation, compulsion or

other draconian, socialist means of achieving the necessary preservation of individual self reliance, enterprise and expression. As capital increasingly outweighs labour as the preponderant element in modern production he sees the need for the spread of ESOPs as pressing.

3. Variants on ESOPs

This paper deals with the most widely used of Kelso's prescriptions - ESOPs - but we note in passing that he has also identified a number of variants (less well-developed) for different situations and for the benefit of different categories of those without capital:

MUSOPs : Mutual Share Ownership Plans, to cover small groups of companies.

CSOPs : Consumer Share Ownership Plans, generating share ownership for customers of consumer co-operatives.

GSOPs : General Share Ownership Plans, generating for specified categories of people (eg customers, local residents etc) share ownership of specified assets (eg public utilities).

ICOPs : Individual Capital Ownership Plans, to assist defined categories of people to acquire shares in companies subscribing to the plan.

COMCOPs: Commercial Capital Ownership Plans, to assist specified categories of people to acquire shares in commercial "real estate" assets.

PUBCOPs: Public Capital Ownership Plans, to assist public servants and others to acquire shares in privatised capital assets (eg roads, prisons, schools etc).

RECOPs : Residential Capital Ownership Plans, to facilitate individual house ownership with cheap loans and tax relief on purchase price.

Each is seen essentially as a tool for financing new capital formation or for financing the acquisition of existing capital assets, or both, while it simultaneously raises the capital-orientated earning power of otherwise economically underpowered consumers. Tax reliefs assist the financing of capital acquisition out of the earnings of the capital acquired.

Annex B

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ANNEX B

SUMMARY OF RESPONSES TO INLAND REVENUE'S ESOPs QUESTIONNAIRE

Replies provided in September 1988 to the following questions by

- the ESOP Centre (sponsoring members include BZW, Clifford Chance, Kleinwort Benson, K M G Peat Marwick McLintock, New Bridge Street Consultants, Unity Trust Bank)

- Job Ownership Ltd - Institute of Directors - Field Fisher Martineau (JOL).

1. List main aims and objectives of your proposals in order of importance

Encouragement of employee share ownership.

Extension of employee participation in buy-outs.

Removal of existing obstacles to these aims in particular by making it more attractive for company owners to sell/transfer shares to employees (ESOP Centre).

Raising of new capital (from external and internal finance) for expansion, through employee benefit trusts (EBTs).

Provision of exit route for employee shareholders in non-listed companies (JOL).

1. a. Do these objectives include individual employee (and ex-employee) share ownership?

Yes, but EBT ownership of shares for the benefit of employees for some period is necessary.

EBT holding seen as enabling retention of private company control, protecting employees from risks of shareholding, preserving benefits of shareholding for employees, and giving employees opportunities to benefit in large stakes in the company, and to benefit on special occasions like buy-outs, privatisation, flotation (ESOP Centre).

b. Do these objectives include employee control?

Yes, but most cases will involve no more than a substantial minority stake.

c. Do these objectives include improved employee access to tax reliefs associated with approved employee share schemes?

Yes, with particular reference to private companies.

d. Do these objectives include protection of small or family companies (their employees, communities etc) from take-over?

Where family owners wish to or must sell, sales to an EBT will give greater power to employees (local communities, regional economy) to protect their interests.

Such sales at present discouraged by lack of CGT roll-over relief (JOL).

e. Do these objectives include retention of existing control while realising capital?

No, but we do not wish to inhibit significant partial disposals (JOL).

No, except insofar as control is pro-rata to disposal. Suggested that selling owner (and any nominee) should not be the sole or controlling trustee of the EBT (ESOP Centre).

3. What are the present (and any other significant) obstacles to the attainment of each of your objectives

Commercial obstacles include Investment Protection Committees reservations and institutions' reluctance to lend to ESOPs - which may need fiscal incentive (ESOP Centre).

Tax uncertainty over CT deductibility of company contributions to EBTs.

Charge to ACT on close company loans to EBTs.

The "material interest" test on an employee's eligibility to participate in an approved employee share scheme.

CGT and IHT liabilities on owners disposing of shares to EBTs (JOL).

The inability, under present approved share scheme legislation, to distinguish between employee and other shareholders in operating a regime of enforced selling of shares - ie pre-emption (ESOP Centre).

Company law and Financial Services Act obstacles.

4. For which kinds of companies are easements in present difficulties sought?

Predominantly independant private companies, though benefits would accrue also to public companies.

5. How many companies and how many employees might be concerned?

A matter of speculation, but "not unreasonable to contemplate that the tens of thousands of private companies in England would operate thousands of employee share schemes if the ESOP proposals were adopted".

6. <u>What tax reliefs or easements - in order of priority of importance - are sought for the benefit of companies?</u>

a. <u>owners of companies?</u>

CGT and IHT reliefs.

b. <u>companies themselves?</u>

Company contributions to an EBT to be CT-deductible (confirm by statute - ESOP Centre; a clearance procedure - JOL).

Removal of tax charge on close company loans to EBTs. The shares which may be used in approved employee share schemes should include those of a company which is controlled by a trust with a sole corporate trustee*; EBT shareholdings should be treated as personal holdings by employers or directors to enable such shares to be used for approved schemes; and approved schemes should permit employee pre-emption rules to discriminate between the circumstances of share acquisition and of departure from employment* (ESOP Centre).

c. <u>directors and/or employees</u>

Easement of the "material interest test" on an employee's eligibility to participate in an approved employee share scheme.

Extension beyond the present 12 months of the interest relief for employee acquisitions in employee-controlled companies*; BES relief, subject to conditions, for employee acquisitions of shares in their non-listed employee-controlled companies* (JOL).

Miscellaneous reliefs from CGT in respect of employee acquisitions of shares which involve an income tax charge on an under value*, and in respect of 'roll-overs' on

unapproved share options*; extension of the exemptions from the FA 1988 tax charges on 'unapproved' share acquisitions (which replaced Section 79 FA 1972) which apply where the company is "employee-controlled", to circumstances where trustees hold shares for the benefit of directors and employees*; tax exemption for EBT capital gains or income from employee securities. (ESOP Centre).

[* These proposed reliefs do not appear to be directly concerned with easing the main obstacles faced by ESOPs.]

7. Would any individual relief or easement be valuable on its own - if so, which?

Yes: the certainty of CT deductibility for company contributions to EBT (ESOP Centre).

Each item mentioned at 6 would be of value on its own - particularly CGT roll-over relief for owners, a clearance procedure for CT deductibility, and an extension of employees' interest relief for acquisitions in employee-controlled companies (JOL).

8. Is a minimum package of reliefs/easements necessary to achieve your objectives - if so, which?

Yes: certainty of CT deductibility, relief from ACT on close company loans to EBTs, and easement of the "material interest test" (ESOP Centre).

To make any significant impact: CGT roll-over relief, a clearance procedure for or statutory right to CT deductibility; relief from ACT on close company loans to EBTs. To encourage employee buy-outs, removal of the 12 month limit on employee interest relief and BES relief (JOL).

9. What precise benefits are intended for employees and should their provision be mandatory (eg as a condition for operation of the tax reliefs)?

Increased opportunities for employee share acquisition. Conditions could (JOL)/should (ESOP Centre) be attached to the tax reliefs to require distribution from the EBT within a set time (and with a minimum level of participation by all employees - ESOP Centre).

10. Within what timescale should employee benefits be provided?

10 years.

11. Would all directors and employees be entitled to benefit - if not, how should such beneficiaries be selected?

Trustees of EBT would decide on beneficiaries. Suggested requirement that trustees ensure at least half of shares which they distribute over any 5 year period be provided on "similar terms" basis to employee recipients (ESOP Centre).

EBT holdings will indirectly benefit employees. These shares will "largely" be made available to employees through approved schemes (where a discretionary FA 1984 scheme is used, options should be offered on an all-employee, "similar terms" basis). Direct sales to employees at less than market value should be made on a similar terms basis, if the trust acquired the shares concerned with tax-relieved contributions (JOL).

12. What means of conveying any benefits to directors/employees is contemplated?

It is not proposed that any specific means of conveying shares to employees be singled out for use with an EBT (ESOP Centre).

EBT distribution of shares "mainly" through approved schemes; also through employee purchase. EBT also to act as market for share disposal (JOL).

13. a. <u>Would the ESOP trust have any minimum holding?</u>

No. (JOL: but some tax reliefs might be limited to cases where EBT and employees hold together a minimum percentage, say 26% or 51%).

b. <u>Would the trust have freedom to retain shares permanently?</u>

Yes, but not with continuing tax reliefs (10 year limit for distribution if reliefs not to be cancelled).

c. <u>What trustees (to exclude majority shareholders or their representatives?) would the ESOP trust have ?</u>

To be chosen by "the parties", but a controlling or ex-controlling shareholder should not be sole or controlling trustee (ESOP Centre).

Substantial shareholders should not compose majority of trustees. Perhaps trustees from management, non-management employees, independent third parties (JOL).

d. <u>Would the ESOP trustees include or comprise employee representatives?</u>

Not mandatory (ESOP Centre).

Should be two elected employee representatives (JOL).

e. Would the ESOP trustees have freedom to vote shares and use resources as they think fit in the interest of directors/employees?

Yes, subject to general trust law, and possibly to obligation to ballot beneficiaries for their views in exceptional circumstances, eg a takeover bid (ESOP Centre).

Ordinary trust law principles to apply, though possibly a case for canvassing beneficiaries' views or even taking their instructions (JOL).

f. Would the ESOP trustees have an obligation to appropriate income, shares to employees, eg through FA 1978 scheme (time limit? all-employees?), to vote retained shares at discretion of employees or employee representatives?

No. EBT would be bound in conscience and fiduciary duty to distribute shares within 10 years, with one half going "through similar terms scheme" (ESOP Centre).

Regarding shares purchased with tax-relieved contributions, distributions of income and capital should be by reference to "need" or on a similar terms basis. Otherwise 10 and 13c above (JOL).

14. What is your estimate of the likely impact of legislation of the kind you propose on future levels of take-up and operation of approved employee share schemes?

Very significant (ESOP Centre).

Many more non-selective schemes (JOL).

ANNEX C

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ANNEX C

I. RELIEFS SOUGHT FOR OWNERS OF COMPANIES

a. CAPITAL GAINS TAX ROLLOVER RELIEF

1. Both the ESOP Centre and JOL propose that CGT rollover relief should be available to individuals who sell shares to the trustees of ESOP trusts or approved profit-sharing schemes and reinvest the proceeds in other shares or securities within a limited period of time (6 months is suggested). JOL also suggest that the relief should in addition be granted where the proceeds are reinvested in gilts.

2. CGT deferral is available - and will continue to be so - on gifts to employee trusts. The ESOP proponents are concerned with sales, where deferral is not available.

3. They cite the comparison with the CGT deferral given on share reorganisations and exchanges of shares and securities. The comparison is not relevant. The deferral they refer to is intended to cater for cases where the character of the investment has not really changed - for example where shares of one class in a company are exchanged for shares of another class. In substance what the investor has is a continuing investment, and he has received no cash. In contrast, the ESOP proponents are asking for deferral where someone sells shares to an employee trust and acquires a completely different investment.

4. The proposal has been looked at several times in the fairly recent past. It would involve a major change in the circumstances where CGT deferral is thought appropriate. This would undoubtedly be seen as a precedent for others who wanted to press for deferral on sales of assets to other "worthy" bodies. At present, for example, there is an immediate charge where assets are sold (rather than given)

to charities for cash. And it might fuel representations that rollover should be available for investments generally.

5. It is not clear how far the proposal would actually further employee trusts.

6. If the proposal were accepted, it would be necessary to define the assets in which reinvestment could take place. JOL suggest quoted stock, gilts and shares in family companies. But if one were to accept the principle of deferral it is not obvious why one should draw the line there rather than allow reinvestment in shares or securities generally as the ESOP Centre suggest. Where the reinvestment was in exempt assets (eg gilts), we would need special machinery to ensure the deferred gains did not fall out of charge - but there are precedents for that.

7. When a proposal of this kind was debated in Standing Committee this year, reference was made by the Opposition to avoidance possibilities. We would almost certainly need to include some anti-avoidance provisions to ensure that the transactions were truly arm's length and that the sale was to a genuine employee trust.

8. At the end of the day, the decision here must be a political one: whether Ministers feel that, despite the risk of creating a precedent which others could cite, a relief of this kind is desirable in order to encourage employee trusts and wider share ownership.

b. INHERITANCE TAX RELIEF

1. At the dinner with the Financial Secretary on 27 September, David Reid of Clifford Chance (a founder member of the ESOP Centre) described the IHT problem a "peripheral". JOL too do not include it on their list of main priorities.

2. Liability to IHT may arise when an individual sells shares for less than their value (or gives them) to an employee trust but not when he sells them as part of an arm's length transaction.

3. The ESOP Centre propose that an individual who sells shares to an ESOP trust should not forfeit any business property relief from inheritance tax which he would otherwise have had if he had retained them. The purpose of this relief however (which reduces the IHT liability by 30% or 50%), rests on the recognition of the potential vulnerability of a business in discharging tax bills and in illiquid assets. But where a person disposes of his qualifying shareholding to an ESOP trust for cash there is no longer a justification for the relief.

4. If a special case were made for individuals selling to ESOP-type trusts, it would be likely to increase the pressure for similar treatment to be given to qualifying shares sold in other circumstances during the 7 years prior to the vendor's death.

5. JOL suggest that IHT can be a major obstacle to families wishing to sell at a reduced price to employee trusts less than a majority of their shares. They consider that there is a good case for distinguishing the transfer of shares to employee trusts from transfers to other shareholders or third parties.

6. Under present legislation, exemption is granted only if at, or within 12 months of the transfer, the trustees hold more than one-half of the ordinary shares in the company and have voting control of the company. JOL's proposals would grant IHT relief where the trustees hold more than one-quarter of the ordinary shares and have voting power which, if exercised, would yield one-quarter of the total votes available.

7. This proposal would substantially relax the conditions enabling a transfer of shares or securities by an individual to an employee trust (as defined in the Inheritance Tax Act 1984) to qualify for relief from IHT. The condition that the employee trust must have voting control of the company whose shares it acquires is designed to ensure that the company will be run for the benefit of the employees as well as the other shareholders. If the trust has only a minority shareholding and the former owner of the shares, or his family, continues effectively to run the business, there can be little assurance that reasonable dividends will be paid to the trustees (and, therefore, to the employees). The family could, for example, direct most of the profits to themselves, by way of salary and directors' fees.

8. The removal of the control restriction could thus open up considerable scope for tax avoidance, and measures to prevent abuse would be lengthy and complex.

II. RELIEFS SOUGHT FOR COMPANIES

a. CORPORATION TAX RELIEF FOR PAYMENTS BY COMPANIES TO ESOP-TYPE TRUSTS

1. Both the ESOP Centre and JOL list as their first priority the need for fiscal certainty for the deductibility of company contributions to employee benefit trusts. They seek formal confirmation that a CT deduction will be allowed for any payments to such trusts used to service and repay loans raised for the purpose of acquiring shares, to finance the acquisition of shares (whether from the market, including existing employee shareholders, or from new issues by the company), to finance losses realised on share disposals, to comply with contractual obligations to make such payments, or to meet the trust's operating expenses.

2. To qualify for relief under present law, contributions by trading companies to employee benefit trusts must be

i. revenue, not capital in nature; and

ii. made wholly and exclusively for the purposes of the contributing company's trade.

Whether or not a payment satisfies each test depends very much on the facts of the individual case.

3. Both the ESOP Centre and JOL say that the absence of certainty is deterring companies from establishing ESOPs. It is not clear how important this point is since, as noted earlier, nearly a dozen ESOPs have already been set up. Nevertheless, we accept that the lobbies have a point; this is a rather grey area of the law and the few legal judgements we have had in individual cases do not help much in providing clear ground rules.

4. There are essentially two reasons for the difficulty. First, as noted above, the tests which the law provides for determining whether or not a payment is deductible are very general ones, so particular facts and circumstances are the more likely to produce different results in different cases. Second, so far as we can see, individual ESOP schemes are particularly likely to vary one from another, precisely because it is their flexibility (compared for instance with the tight rules applying to 1978 profit-sharing schemes) which is attractive to the lobbies.

<u>What sort of ESOP arrangements would qualify for a CT deduction under existing law?</u>

5. Very broadly, the position is this. A CT deduction would almost certainly be due for payments made by a company into an EBT which were part of a regular series of payments and which were made solely in order to enable the EBT to

- buy shares in the company over a period and hold them for allocation to employees;
- provide finance to repay loans incurred to buy the shares;
- finance any losses incurred on disposal of the shares (ie if the trust sells or gifts them for consideration lower than acquisition cost);
- pay the EBT's operating or administrative expenses.

6. The initial payment made to set up an EBT of this kind would not rank for a deduction, because it would be a capital, not a revenue payment. But that should not pose insuperable difficulties, because the initial payment could be a nominal one only.

7. The essential point here is that, in circumstances of this kind, the payments by the company would be made solely in order to retain or motivate the company's employees, and so are broadly akin to the payment of wages and salaries. But, unlike wages and salaries, the payments would not be taxable in the hands of employees; and in view of the scope for manipulation, by, in particular, closely controlled companies, there is clearly a need for caution in expressing any general view of the law.

Payments which would not qualify

8. Difficulties would arise in circumstances where the company's payments into the trust were not made solely for the purpose just described, but for instance where a purpose was also to provide a market for shares held by existing shareholders other than employees who had already acquired their shares under an approved employee share scheme. So, to take an extreme example, CT relief would certainly not be due if directors of a family company put money into an employee benefit trust primarily for the purpose of providing a source of funds for the purchase of their own shares at some time in the future. (Nor, indeed, we suggest, should relief be due in principle in these sorts of circumstances.)

9. To take a less extreme example, however, there would also be difficulties in giving a deduction where the company's intention was to finance an employee buy-out via an EBT. Here again, one of the purposes of the company's payment into the trust would clearly be to provide a market for the company's shares. JOL/IOD is apparently keen to encourage employee buy-outs via EBTs; and it follows that they would inevitably be disappointed that we could not give them the sort of assurances about deductibility that they would like.

Establishing the purpose of payment

10. The difficult issue is often to establish the purposes for which a payment to an EBT is made. To do so it is necessary to have regard not only to the express intentions of the payer but also to the relevant facts and circumstances occurring at the time payment is made. We cannot just accept, without looking any further, what the payer tells us is the motive behind the payment.

Desirability of a Statement of Practice

11. We have been doing some work on a draft of a possible Statement. We could certainly produce something which set out the legal background in general terms, and this could be issued as part of the Budget Day package. Nevertheless the issue of any Statement seems likely to be met with the response that it does not go far enough. To claim that such a Statement was of real assistance to ESOPs might well therefore appear exaggerated.

Statutory entitlement to CT relief

12. This leaves then the possibility of an express statutory entitlement to CT relief for payments to ESOP trusts (as in the case of approved FA 1978 shares schemes). As explained in paragraphs 37-38 of the main note, we

consider it would be necessary to link any such express provision to a statutorily defined trust.

b. ACT RELIEF

1. Both the ESOP Centre and JOL propose as one of their main priorities removal of the special tax charge on loans made by a close company to an ESOP trust which holds shares in that company.

2. Briefly, the position is that where a close company makes a loan to members or their associates, it is required under Section 419 ICTA 1988 to account for tax on the amount of the loan at a special rate equivalent to ACT - the purpose being to prevent those persons from receiving the benefit of a loan which might run more or less indefinitely, in a non-taxable form. If and when the loan is repaid, the company recovers its tax.

3. Closely controlled family companies are by their very nature more open to manipulation than other companies. Both the ESOP Centre and JOL see ESOPs as being more attractive to independent private companies - many of which are likely to fall into this category. Section 419 is designed to counter, by means of a tax charge, one of the more obvious and common tax avoidance devices used by such companies - that of allowing their members (or associates) to enjoy the profits of the company free of tax by means of loans. Because of the ease with which trusts can be used for avoidance, particular care was taken in defining "associates" in the close companies legislation to include the trustees of any trust under which a "participator" in a company (broadly a shareholder) might benefit.

4. The difficulty with the ESOP proponents' proposal is that to grant a blanket exemption to Employee Benefit Trusts, as defined by the IHT Acts, would effectively emasculate the anti-avoidance provisions in Section 419.

All companies would need to do would be to make loans to such trusts, which would then pass on the money to members or their associates. And to restrict relief to specific kinds of Employee Benefit Trusts - such as, for example, only those ESOP trusts designed to pass all the trust property and income to all employees on similar terms within a short timescale - would require lengthy and complex legislative provisions both to limit the scope of the relief and to combat tax avoidance.

5. It is not clear why loans from companies are seen as necessary (neither of the two groups says why), given that the basic idea of ESOPs is that the employee benefit trust raises loans from external sources, which are then serviced and repaid by company contributions.

c. OPERATION OF APPROVED SHARE SCHEMES BY COMPANIES CONTROLLED BY A SOLE CORPORATE TRUSTEE

1. The ESOP Centre have suggested that a company controlled by a trust with a sole corporate trustee should be permitted to operate approved share schemes. This they say, would require an amendment to the ESS legislation.

2. The ESS provisions require shares used in an approved scheme to be those of a company not under the control of another company, those of a quoted company, or those of a subsidiary which is itself quoted or the subsidiary of a quoted company. Shares in the unquoted subsidiary of an unquoted parent can not be used, because there is scope for the value of those shares to be manipulated, in order to exploit the approved ESS tax reliefs.

3. We are not sure what the ESOP Centre have in mind here. A company controlled by a trust with a sole corporate trustee which is the company itself is permitted to operate an approved scheme using its own shares, irrespective of the nature of the company (viz quoted or unquoted) because it is

not under the control of another company. If it is envisaged that a connected company is to be the trustee, and a subsidiary company is to be used, then the company would in effect be under the control of its subsidiary - which would seem to be a nonsense. If, however, it is intended that a totally independent company should be the trustee (eg a company which specialises in this area) there is no present objection to this, so long as - as indicated above - the company which is the trustee is quoted. There have been no (other) requests to amend the legislation in this particular respect, and we should need to know precisely what the problem is (if indeed there is a problem) before considering the matter further.

d. SHARES HELD IN AN ESOP SHOULD BE TREATED AS BEING HELD PERSONALLY BY EMPLOYEES/DIRECTORS

1. A further technical easement suggested by the ESOP Centre is that shares held in an ESOP trust should be treated as being held personally by employees or directors for the purposes of determining whether a company is employee-controlled.

2. The "employee control" (and other) requirements attaching to shares in the ESS legislation are designed to ensure that approved schemes are operated to the benefit of employees. If a company has more than one class of shares, then those used in its approved employee share scheme must either satisfy a number of conditions or must be employee control shares. Shares are employee control shares if the persons holding them are, by virtue of their holdings, able to control the company and those persons are, or have been employees or directors of the company, or of another company under its control. The purpose of this provision is to make sure that the shares to be used in a scheme are 'real shares' and not a separate class of shares whose value could be manipulated to the possible disadvantage of employees.

3. Because the shares held in the ESOP trust will not be held personally by employees and directors, they will not qualify as employee control shares. The ESOP proponents envisage shares being held in the ESOP trust for a period of up to 10 years, without allocation to individual employees. Both groups of proponents are vague as to whom the trustees will be, and as to the extent they will include employee representatives (not necessarily at all, in the ESOP Centre's response). And both groups propose that the trustees should have considerable freedom in the exercise of the voting power of the shares during the period they remain in the trust.

4. As i. the shares held in the ESOP trust may remain in the trust for a considerable period without appropriation to employees, and as ii. the voting power of the shares will not necessarily be exercised under the direction of the employees as a whole, or for their benefit throughout this period, there seems to be no case for treating them as held personally by employees or directors for the purposes of the 'employee control' test.

e. ADJUSTMENT OF EMPLOYEE PRE-EMPTION RULES FOR SHARES USED IN APPROVED EMPLOYEE SHARE SCHEMES

1. Relaxations introduced in the Finance Act 1986 permit the use in approved schemes of shares subject to a disposal requirement where certain conditions aimed particularly at protecting the interests of employee participants are met. These conditions require the company's articles to stipulate the terms on which the employee shares will be sold and to apply those terms to all employee sales of shares of the same class. They were deliberately designed to prevent undue discrimination against scheme shares and ensure a fair price upon disposal.

2. The ESOP Centre has included in its list of suggested easements a proposal made by Mr Laurie Brennan on a number

of occasions over the past two years or more: that approved schemes should be permitted to use shares which are subject to a "sell-back" obligation in a company's articles differentiating between employee shareholdings by reference to whether they were acquired by reason of employment, or otherwise. The desire, now as then, is to permit a company with an approved employee share scheme to operate a regime of enforced selling of shares on leaving or retirement limited to employees who obtained their shares as participants in the scheme. So family members, for example, who acquired their shares by other means would not have to sell them upon departure. The ESOP Centre also suggests differentiation between employee shareholders on the basis of the reason for leaving service; but they do not explain what they have in mind.

3. If the rules were to be modified as the ESOP Centre suggest, the essential safeguards for employees in the 1986 legislation would be undermined. And, in the case of the all-employee schemes, the basic requirement that all participating employees must do so on similar terms would be breached. Mr Brennan and the ESOP Centre apart, there has been no pressure for a relaxation in this area. It is not clear why such a relaxation is necessary in the interests of promoting ESOPs, and the matter seems best left for consideration, therefore, on a subsequent occasion if it is pressed further.

III. RELIEFS SOUGHT FOR EMPLOYEES

a. INTEREST RELIEF ON LOANS TO EMPLOYEES TO BUY SHARES

1. JOL suggest that a valuable encouragement to employees to buy shares in their own companies would be the removal of the provision which restricts interest relief available to individuals on loans to acquire shares in an employee-controlled company to loans relating to such

acquisitions made within 12 months following the company first becoming employee-controlled. And the recent Ian Taylor paper entitled "Shares for all the Workers" suggests that the denial of relief to such employees could jeopardise the capacity of the company to remain employee-controlled. This proposal - or variations upon it - has been made several times by JOL and their associates - but no-one else.

2. The interest relief for employee buy-outs introduced in 1983 gives help for employees taking over and running their own businesses. The condition that the shares should be bought before, or within 12 months after, the company becomes employee-controlled is intended to confine relief broadly to the start up period, generally the most critical time for the survival of such a venture. But once the buy-out has been successfully launched, there is not the same need to give relief to new employees - or further relief to existing employees. To do so would in effect transform the provision from one aimed at the buy-out event to a continuing relief available regardless of when the share-buying occurred in relation to the buy-out.

3. Ministers have consistently refused this alteration in the past, because the relief is specifically targeted at providing some initial help for employees wishing to take over their company. It was not intended to provide relief for employee share-buying in general or for increasing the size of the company's equity base.

b. BUSINESS EXPANSION SCHEME RELIEF

1. JOL suggest that "BES relief (possibly limited to a total of £10,000) should be available for acquisitions by employees of shares in non-listed employee-controlled companies" provided the employee concerned

a. owns less than 5% of the company's ordinary share capital; and

b. does not and will not within 5 years participate in a discretionary share scheme operated by the company.

2. There are two types of BES relief: IT relief at marginal rate on investments made in the shares of unquoted companies, and CGT relief when and if the shares are finally sold. Employees are specifically excluded from the relief because it was considered unnecessary to give such a generous tax incentive to encourage investment from those so closely associated with the company.

3. JOL clearly have in mind the extension of this relief to employees investing in their own companies. The purpose, as indicated in the recent Ian Taylor paper entitled "Shares for all the Workers" is to encourage them to do so. Ministers have in the past rejected the extension of BES relief in this way

i. as unnecessary - employees (as opposed to members of the public) are more likely to invest without the relief;

ii. because there is scope for tax avoidance by "round tripping" (ie the cash put up by the employees could effectively be repaid to them through higher wages. Although the employees would not directly gain through this, because the income tax liability on the higher wages would cancel out the BES relief, the company would benefit from the reduction in the profits chargeable to corporation tax);

iii. because either the total cost of BES would be increased, or the investment might be diverted away from other more deserving BES investments.

4. These arguments seem valid in relation to JOL's proposal, which in any event does not appear central to the encouragement of ESOPs.

c. CGT RELIEF WHERE EMPLOYEES ACQUIRE SHARES SUBJECT TO IT

1. The ESOP Centre propose that where employees obtain shares at an undervalue and are charged income tax, they should be able to take the charge into account in computing any CGT liability upon the disposal of the shares.

2. The suggestion is that a problem arises where new shares are issued to an individual (as opposed to a normal transfer of existing shares). In such a situation, the base cost for CGT purposes is limited to what he actually pays for the shares. But if the employee pays less than market value for his shares, he faces an IT charge on the difference between market value and the price he actually pays. Technically, therefore, he is liable to income tax and CGT on the same amount.

3. However, we would not in practice charge CGT on amounts which have already borne IT. No action is therefore recommended at this juncture. But if the ESOP Centre can provide evidence of real difficulties, it is certainly something we could look at.

d. CGT RELIEF ON ROLLOVER OF UNAPPROVED OPTIONS

1. Another proposal from the ESOP Centre is that the relief given against an income tax charge on the rollover of an unapproved share option should be extended to provide relief from a CGT charge. They do not advance any reasons in support of their case.

2. Where an option to acquire shares is assigned or released in exchange for another right to acquire shares, there is no charge to income tax; any taxable benefit arising on the old option is effectively rolled over into a benefit on the new option. CGT is however chargeable at that point, except in very limited circumstances.

3. It is not appropriate to draw an analogy between income tax and CGT because they operate in different ways. For Schedule E purposes, there is some force in saying that no emolument has been realised, whereas for CGT there is a disposal - albeit in exchange for a new asset - and therefore an occasion of charge in the normal way.

4. There has been no other pressure for a relaxation in this respect. In most cases, employees holding options would not face a charge to CGT because any gain would be below the annual exempt amount (currently £5,000). A change would therefore be likely to affect few people, and have little impact. At worst, the individual's ultimate overall CGT liability under present rules would be exactly the same, but for some people a CGT charge on the exchange is actually advantageous, because it enables them to take advantage of two annual exemptions - one at the date of the exchange of option, and another at the date the shares are finally sold.

5. In the light of the foregoing, there does not seem to be a need to amend the CGT legislation as the ESOP Centre seek (and indeed the proposal does not seem central to the encouragement of ESOPs).

e. TAX EXEMPTION FOR EBT CAPITAL GAINS OR INCOME FROM EMPLOYER SECURITIES

1. This is the final suggestion made by the ESOP Centre in their reply to the questionnaire, and it appears to have

been added almost as an afterthought. It is the first and sole representation suggesting beneficial tax treatment for the employee benefit trust itself. The ESOP Centre do not present any arguments in support of the proposal, but the intention is presumably to maximise the share benefits available under such trusts.

2. Income tax is generally chargeable at basic rate and at additional rate (currently 10%) on the income of discretionary trusts. The purpose of the additional charge is to reduce the use of such trusts as tax shelters and to reduce the tax lost when they are so used. Beneficiaries are, however, given credit for the tax paid by the trustees on any payments made to them which are treated as their income for tax purposes.

3. Approved pension scheme trusts can claim exemption from IT and CGT on most of their income and gains, as can charitable trusts - but only to the extent that the funds are used for charitable purposes.

4. There has from time to time been pressure for full or partial tax exemption for their discretionary trust funds from a number of bodies such as the Air Travel Trust, heritage maintenance funds, disaster funds and children's trusts. This has consistently been resisted.

5. Unlike pension entitlements, which are strictly defined in the scheme rules, the potential benefits available to employees under the present ESOP proposals are ill-defined and rely, to a considerable extent, on the trustees' discretion. Any tax concessions for ESOPs trusts (apart, of course, from those already provided through linked approved profit-sharing scheme trusts) would therefore have to be hedged about with detailed conditions, to guard against

abuse. But this point would need to be considered in more detail if you decided on specific reliefs for a defined category of qualifying ESOP.

ANNEX D

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ANNEX D

PERCEIVED DIFFICULTIES WITH THE FINANCIAL SERVICES ACT AND THE COMPANIES ACT

1. JOL/IOD and the ESOP Centre contend that certain provisions of the Financial Services Act and the Companies Act present obstacles to the spread of ESOPs.

Financial Services Act

2. JOL/IOD are not specific when they refer to potential problems with the FSA, but the ESOP Centre suggest that an ESOP could become unlawful to operate if it constituted a "collective investment scheme" under Section 75 of that legislation. They add that it could fall foul of that Act if it has a trustee other than a sole corporate trustee who is within the group of the company whose shares are being used. And it would also be caught if it invested in anything other than the shares of the company, even in cash deposits at a bank.

3. DTI officials have made it clear that they do not accept the ESOP Centre's views on the effects of the legislation. It is by no means a foregone conclusion that an ESOP with internal trustees will be caught. If it opts for external trustees it will, and should, be caught. The arguments on holdings of cash are not accepted.

Companies Act

4. The ESOP proponents identify problems arising from Sections 151-155 of the Companies Act 1985 which prevent a public limited company from giving a guarantee in respect of an ESOP's external borrowings and from providing money to the ESOP to enable it to meet interest payments on its external borrowings. They complain that the route round

CHAPLIN 12/12

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FROM: JUDITH CHAPLIN
12th December 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Monck
Mr Burgner
Mr Culpin
Mrs Lomax
Mr Odling-Smee
Mr Gilhooly
Mr Call
Mr Tyrie

Mr Painter)
Mr Lewis) IR
Mr Farmer)
PS/IR

ESOPS

As I was at the IoD when it gave its support to proposals to encourage ESOPS, you will not be surprised to know that I hope some changes will be introduced.

2. I do not think changes in the tax treatment, even if they were extensive, would lead to a substantial increase in the number of ESOPS. Even without changes, I think there will be a continuing trickle of ESOPS established, and tax changes won't turn this into a flood.

3. However, ESOPS are a particularly appropriate way of encouraging employee share ownership in the smaller private company, and as these are relatively under-represented in employee share schemes, the encouragement of ESOPS should increase employee participation.

4. I would have thought the changes need to be relatively limited in scope - more a removal of restrictions than a substantial increase in tax relief. Ensuring that payments made by the company into its ESOPS are deductible for corporation tax purposes appears to be more a clarification than an actual change. I think there is a case, too,

for allowing capital gains tax roll-over relief for individuals who sell shares to the trustees of the ESOPS and reinvest the proceeds in other shares within a certain time. The sale is often at a substantially lower price than would have been obtained had the owner sold out to another company, and that they should face increased tax liability as well seems unfair. There are owners of private companies, albeit probably not many, who philanthropically want to hand these companies back to employees when they retire, but there is a limit to how much less they will accept for so doing. I don't, of course, know the technical difficulties associated with allowing this relief.

5. Mr Farmer suggests, in his paper (6th December), that there is little reason why the supporters of ESOPS should want the special tax charge on loans made by a close company to an ESOP trust to be removed since ESOPS would normally raise loans from external sources. As I understand it, the initial loan to establish the ESOP would be externally financed but small loans might be needed at various times, for example to buy shares in again, which would come from the company. Again, I don't know the extent of legislation which would be required to prevent abuse.

JC

MRS JUDITH CHAPLIN

FROM: A C S ALLAN
DATE: 12 December 1988

MR N WILLIAMS - IR

cc PS/Financial Secretary
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Neilson
Mrs Chaplin

Mr Painter - IR
Mr Lewis - IR
Mr Farmer - IR
PS/IR

Answer?

ESOPs ETC. (STARTERS 112, 113 AND 115)

The Chancellor would be grateful to know what the revalorised monetary limits for the items discussed in paragraph 62(i) and (ii) of your note of 6 December would be, taking the date when the present limits were first set as the base. The three items are the £1,250 lower limit and the £5,000 ceiling on FA 1978 All Employee Profit Sharing Schemes, and the £100 per month limit on the FA 1980 All Employee SAYE Share Option Schemes.

ACSA

A C S ALLAN

FST→
CH/EX
12/12.

CONFIDENTIAL

RS/12.12.1

FROM: FINANCIAL SECRETARY
DATE: 12 DECEMBER 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mrs Lomax
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Painter)
Mr Lewis) IR
Mr Farmer)

PS/IR

Ch/ See also Tyrie 12/12, + Chaplin 12/12
Neilson 9/12 serves as
an 'annotated agenda'!
12/12

ESOPs ETC (STARTERS 112, 113 AND 115)

I strongly favour doing something in this area.

My understanding of an ESOP is an employee benefit trust which purchases a large (30% +) block of shares in a company on behalf of its employees, and then distributes them to the employees under an approved Revenue scheme. The company in turn makes contributions to the trust which enable it to service and repay the borrowings taken out to finance the original purchase. I see the purpose of them as:

- increasing the spread of employee share ownership, particularly in the private, unquoted sector where existing employee share schemes have had little effect;

- spreading wealth by encouraging wealthy owner capitalists to sell shareholdings to their workforces;

- and thereby increasing the incentives available to workers and their identification with the company.

I am certainly no syndicalist; but I see room for this form of ownership and economic organisation. It is different from conventional employee share schemes in that the labour force will have a significant (and, in many cases, controlling) share in the company. And it has certainly aroused great interest, as the comments in the last 2 years' Finance Bill debates have shown. But I don't see it happening on a great scale without encouragement from the Government. The present tax consequences of selling shares to the workforce (notably the crystallisation of a CGT charge) are acting as a powerful disincentive.

However, I would not want to go as far down the ESOP road as the U.S. Many of the practices which occur there are not ones which we would wish to encourage here in the UK. And I would also want to set any ESOP measures firmly in the context of a package dealing with employee share schemes more generally. That suggests a rather cautious approach, aiming at encouragement and certainty rather than tax breaks. This is what the lobbies (ESOP Centre and JOL) themselves would like.

My shopping list for ESOPs would therefore be:-

- relaxation of the material interest provisions (Ms Fairfield's second variant);

- legislation confirming the deductibility for corporation tax purposes of contributions to an ESOP;

- CGT relief (the method to be decided) for disposals where more than 50% of the company's shares are sold to an ESOP;

- CGT roll-up in the trust so that employees can benefit from their individual annual exemptions;

I hope we will be able to devise a package along these lines. I believe it would go a long way to satisfying the demands of the ESOP lobbies, and that it would be quickly taken up and marketed by banks and other financial institutions.

On the existing employee share scheme legislation, I agree with the general thrust of Mr Williams' recommendations. But I would like to consider further the amount of the increases in the present limits.

R.C.M.J.

pp **NORMAN LAMONT**

AGT
→ CHEX
12/12

cst.rj/docs/12.12.2

CONFIDENTIAL

FROM: A G TYRIE

DATE: 12 December 1988

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Culpin
Mr Burgner
Mr Ilett
Mr Gilhooly
Mrs Chaplin
Mr Call

Mr Painter
Mr Lewis

ESOPs

Having spent a good deal of the last two years in meetings trying to work out how to make BES, PEPs and PRP work I approach yet another allegedly "supply side" tax relief with some scepticism. We don't want another flop even if we need a stocking filler for the budget.

2. We need to be clear why we might want an ESOPs. We do not want an ESOPs as a new form of pensions relief, nor as a form of defence against takeovers. These seem to be major reasons why they are popular in the States.

3. We might want ESOPs as a means of motivating employees. But do we have such a massive motivational problem? Business concentration is diminishing with the growth of small businesses, many of them created by employees who realise that they can do better than their bosses. A lot of slightly larger firms are being motivated by MBOs. Large companies have all employee schemes and PRPs available to them.

4. All in all, it seems to me that we did have a massive motivational problem in British industry ten years ago, before

privatisation, before we broke the power of the unions, and before other supply side reforms, including tax reductions. ESOPs might have been a clever way of avoiding confrontational union legislation. I am not sure we need it now. ESOPs would probably be no help in most of the areas where we still have a problem: parts of the public sector and the remaining nationalised industries. For the latter, privatisation will secure a substantial expansion in employee share ownership.

5. Judith and others are concerned that the smaller company is "under-represented" in employee share schemes. To the extent that there is a "gap" in the coverage of existing motivational schemes ESOPs might fill it.

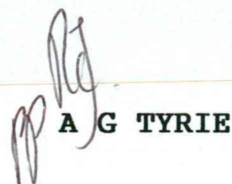
6. So even though I think the case for doing something is pretty dubious, it might be worthwhile exploring whether we could take some minimum steps to assist ESOPs, in particular to:

- Clarify CT treatment.

- Redress, or at least reduce the distortion created by the availability of rollover relief in the event of a takeover by another company but not in the event of an employee share takeover.

7. But before we can come to a view on this I think we should ask the Revenue to have a shot at setting out <u>in detail</u> exactly what <u>minimum</u> complications and constraints the Revenue would need to impose on "an employee benefits trust" that would be consistent with preventing abuse. Secondly, I wonder whether it is worthwhile doing further work to make absolutely sure that we cannot encourage ESOPs merely providing clarification in a "statement of practice" from the Revenue.

8. I am inclined to the view that, if we need an oversized lollipop for the budget, we would do better looking at PEPs rather than ESOPs.



A G TYRIE

CE

Employee share schemes

Your questions about revalorisation (Mr Williams' ppr.).

FA 78 scheme

Revalorisation would give a figure of £1800 or 10% subject to an £8000 ceiling.

(IR are recommending £2000, or 10% subject to a £6000 ceiling) Why?

FA 80 scheme

Revalorisation would give a figure of £130 a month

(IR want £150 a month).

[signature] 13/12

chex.ps/aa/58 **CONFIDENTIAL**

FROM: A C S ALLAN

DATE: 12 December 1988

MR N WILLIAMS - IR

cc PS/Financial Secretary
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Neilson
Mrs Chaplin

Mr Painter - IR
Mr Lewis - IR
Mr Farmer - IR
PS/IR

ESOPs ETC. (STARTERS 112, 113 AND 115)

The Chancellor would be grateful to know what the revalorised monetary limits for the items discussed in paragraph 62(i) and (ii) of your note of 6 December would be, taking the date when the present limits were first set as the base. The three items are the £1,250 lower limit and the £5,000 ceiling on FA 1978 All Employee Profit Sharing Schemes, and the £100 per month limit on the FA 1980 All Employee SAYE Share Option Schemes.

ACSA

A C S ALLAN

PS/FST → FARMER 13/12

Robert 1.13.12.88

FROM: R C M SATCHWELL
DATE: 13 December 1988

MR FARMER - IR

cc PS/Chancellor
Mr Gilhooly
Mr Ilett
Mr Neilson
Mr Barker
PS/IR

ESOPs

Malcolm Hurlston and David Reid of the ESOP Centre came in to see the Financial Secretary yesterday.

Mr Hurlston said that much had happened since he and the Financial Secretary had last met; support for ESOPs continued to grow. The ESOP Centre had also had discussions with the Unquoted Companies Group, and had found a large degree of common interest (only 2 or 3 of the UCG's members operated Revenue approved employee share schemes). However, the UCG were very concerned about a technical point covering the valuation of shares in private companies; if ESOPs led to regular valuations of the shares which in turn led (eventually) to an increase in IHT liability, then their attractions diminished. There was therefore a difference of emphasis between the UCG and the ESOP Centre.

The Financial Secretary said that he was actively considering the issue of ESOPs. But he asked why the ESOP Centre wanted tax reliefs if ESOPs already existed. Mr Reid said that generous tax measures were not essential; what was more needed was encouragement and certainty in the tax treatment of ESOPs. That suggested relaxation of the material interest provisions; legislation to make payments to an ESOP clearly deductible for corporation tax purposes (a statement of practice would probably not be sufficient); and tax relief for the trust so that employees could take greater advantage of their individual annual CGT exemptions. However, CGT rollover relief was not a priority.

The Financial Secretary asked whether there should be a minimum holding to define an ESOP, say 30% of the company. Mr Reid said no; blocks of shares might need to built up over time, so a high initial hurdle might be prohibitive. What was more important was the leveraged nature of the trust, and the CT deductibility of the payments by the company, so that the employee obtained the rewards of share ownership without the risks (borne ultimately by the company).

The Financial Secretary asked what sort of legislative definition of an ESOP the ESOP Centre would recommend. Mr Reid said that he had not thought this through completely; but suggested that the FA78 all-employee share scheme legislation could be used as a precedent.

R.C.M.S.

R C M SATCHWELL
Private Secretary

MINUTES OF A MEETING HELD IN THE CHANCELLOR'S ROOM HM TREASURY, AT 4.30PM ON TUESDAY 13 DECEMBER 1988

Present: Chancellor of the Exchequer
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Matthews
Mr MacPherson
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr Beighton -IR
Mr Painter - IR
Mr Corlett - IR (Item 1)
Mr Kuczys - IR (Item 1)
Mr Lewis - IR (Item 2)
Mr Cayley - IR (Item 2)
Mr Farmer - IR (Item 2)
Mr Johns - IR (Item 3)
Mr Nield - IR (Item 3)
Mr Fawcett - IR (Item 3)

Item 1: Personal Equity Plans

Papers: Mr Gilhooly's annotated agenda of 9 December; Mrs Chaplin's note of 12 December; Mr Tyrie's note of 12 December; Financial Secretary's note of 6 December; Mr Kuczys/Walker note of 30 November; Mr Kuczys' note 16 November; Mrs Lomax/Mr Neilson note of 17 November.

Opening the discussion, the Chancellor said there was a range of possibilities for action: "Capital PEPs";some variant of the Barclayshare scheme; and some form of front end relief. There were also a number of proposals for simplifying the present arrangements for PEPs, which could be combined with any of these possibilities. Alternatively, no action could be taken. He had,

however, reached the conclusion that some positive changes should be made. But we would need to be confident that any such changes would have a real impact.

2. The Financial Secretary agreed that action should be taken. Which route to take would depend on how much we wished to adhere to the original objectives of the PEP Scheme. Capital PEPs, he thought, carried a lot of deadweight and would be difficult to defend. The Barclayshare approach also carried deadweight. His preferred approach would be to combine some form of front end relief with an increase in the unit trust/investment trust limit. These would encourage much greater marketing, both of existing schemes and of new schemes.

3. In discussion, the following points were made:

(i) Increasing the unit trust/investment trust limit would not help to encourage direct shareholdings. It might also sit oddly with front end relief, which would be designed to encourage direct holdings. On the other hand, increasing the unit trust/investment trust limit could be presented as directed specifically at the smaller investor;

(ii) the choice of route was crucially dependent on the objective. The Chancellor confirmed that this objective was to seek to redress the savings balance in the Budget by doing something to promote wider share ownership, rather than savings in general;

(iii) there were risks in using a tax route - front end relief - to encourage investment in equities in the face of market pressures in the opposite direction. It was doubtful, also, that there was a level of subsidy big enough to encourage PEPs yet small enough to avoid "round

tripping". An exit charge also carried considerable disadvantages;

(iv) relaxing the limits for unit trusts and investment trusts would diffuse the objectives of PEPs. The Barclayshare approach, on the other hand, was simple and mirrored a feature of the changes proposed for pensions (ie separating the limits for tax relief from the more general limits);

(v) a longer holding-in period might be considered in exchange for a relaxation of limits. But this could have a locking-in effect. Other variants could be to the amount of relief - full or partial - and the level of monetary limits. If the limit for tax relief were at a lower level than the monetary limit for investment in a PEP, however, this could have behavioural effects on the amount which potential investors would put into their PEPs;

(vi) the presentational implications of any changes would need to be considered carefully. For example, front end relief might sit oddly with the possible changes envisaged for life assurance;

(vii) the various approaches would appeal to different types of investors. Barclayshare, for example, would be more attractive to those with larger holdings. It was doubtful whether it would widen share ownership very much;

(viii) the present distinctions between discretionary PEPs, and non-discretionary PEPs should be borne in mind. Most PEP investors were in discretionary schemes. These were de facto small unit trusts. Consideration could be given

to designating only certain types of shareholding (eg UK, or EC equities) as eligible for inclusion in a PEP;

(ix) if the unit trust limits were raised, there was a possibility that direct investment in equities via PEPs could, to some extent, be driven out. However, this needed to be balanced against the market realities. Current market conditions were unfavourable to direct investment in equities; when conditions improved, there would be an incentive for PEP promoters to push direct investment more strongly.

4. Summing up, the Chancellor concluded that the following approach should be pursued. Existing PEPs should be retained. The limit for holding should be increased to £3,600 a year. Within that total, up to £2,400 could take the form of investment in unit or investment trusts. Eligible unit and investment trusts should be confined to those investing in UK equities (advice should be sought on how long this limit might last). New issues should be able to be put straight into a PEP; they should be set off against the direct equity holding if the full unit trust entitlement had been taken up. The various simplifications suggested in the papers should also be pursued, to the extent consistent with these other parts of the package. This was agreed.

Item 2: Employee share schemes/ESOPs

5. The Chancellor noted that increasing the existing limits on employee share schemes to £6,000 would help to slant relief towards the lower paid. It was agreed to raise the limit to £6,000.

6. The Financial Secretary said that an ESOP differed from a profit share scheme. It was, essentially, a scheme whereby

employees could be enabled to own a significant share of the business in which they worked. This share might, subsequently, be part of a controlling proportion of the shares. The arguments in favour of ESOPs were set out in the papers. He recognised that ESOPs in the United States had led to abuse - eg in their use as "poison pills" to prevent takeovers. He would not, therefore, wish to go as far as proposed by the JOL or the ESOPs Centre. At the minimum, he favoured action which did not require substantive changes to the present law: solving the material interest problem of JLP, and allowing deductibility from corporation tax for an ESOP. He also favoured, however, CGT roll-over relief for ESOPs.

7. The Chancellor agreed that it was sensible to make some changes here. These would assist, especially, the unquoted companies sector. Mr Painter noted that there would, however, be some difficulties with the proposals. In particular, allowing CGT roll-over relief might provide a route for proprietors to avoid tax charges on their capital gains, by cycling their shares through the trust.

8. In further discussion, the Chancellor said that he did not envisage any changes to ESOPs as part of a high profile attempt to alter the playing field. Instead, they would be intended merely to remove obstacles in the way of proprietors who wished already to move in this direction.

9. Summing up, the Chancellor said that action should be taken to solve the JLP material interest problem. The Revenue could discuss this in confidence with JLP to ensure that any action taken met the objective. Action should also be taken to make certain that payments made by companies in their ESOPs were deductible for corporation tax purposes. The statutory definition of the type of trust which would benefit should be drawn up in the simplest possible way. He also invited the Financial Secretary to examine, first, whether employees could be allowed to offer shares

a discount to the market price without triggering the provisions of benefits-in-kind tax legislation. Finally, he invited the Financial Secretary to consider further the possibilities for allowing CGT roll-over relief. A decision on this aspect would be taken at a later stage.

Item 3: Unit trusts

10. Following a brief discussion, it was agreed that the CT rate for unit trusts should be reduced to 25%. Unit trusts should also be given relief for their management expenses.

J M G TAYLOR
Private Secretary

19 December 1988

Distribution

HM Treasury
Those present

Inland Revenue
Mr Battishill
Mr Isaac
Mr Beighton
Mr Painter
Mr Corlett - Item 1 (only)
Mr Kuczys - Item 1 (only)
Mr Lewis - Item 2 (only)
Mr Cayley - Item 2 (only)
Mr Farmer - Item 2 (only)
Mr Johns - Item 3 (only)
Mr Nield - Item 3 (only)
Mr Fawcett - Item 3 (only)

Inland Revenue

BUDGET CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: J D FARMER
DATE: 19 December 1988

FINANCIAL SECRETARY

ESOPs (STARTER No 113)

1. We are now trying to put flesh on the bare bones of the proposals for tax reliefs for ESOPs previously discussed. It was agreed at the Chancellor's meeting on 13 December that these involve setting up a fourth type of statutory employee share scheme. Reliefs will be focused on the company and its existing shareholders rather than the employees. A central feature of the relief will be the definition of a qualifying ESOP trust, and in particular its powers to hold and dispose of shares.

2. It would be helpful to have an early opportunity to discuss with you some of the basic issues mentioned in your minute to the Chancellor of 12 December so that we can draw up a detailed scheme to meet the particular objectives you have in mind. This note briefly identifies the issues which need to be clarified or firmed up.

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c PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mrs Lomax
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Painter
Mr Isaac
Mr Lewis
Mr Pitts
Mr McGivern
Mr Elliott
Mr Cayley
Mr Creed
Mr Farmer
Mrs Majer
Mr N Williams
PS/IR

A minimum trust share acquisition

3. The requirement envisaged in your minute that the employee benefit trust (EBT) should have to acquire a large ("30%+") block of shares in the company is, as you know, not one sought by the ESOP lobbies. Asked in our questionnaire whether the EBT would have any minimum holding, the reply was "No". *The ESOP Centre confirmed this when they met you last week (Mr Satchwell's note of 13 December), explaining that blocks of shares might need to be built up over time, so a high initial hurdle might be prohibitive. Unless therefore a minimum acquisition requirement was set at a very low level - or could be satisfied over a significant space of time, which could mean serious practical difficulties in reopening tax assessments - such a requirement would probably be unwelcome to the ESOP lobbies. With any express tax easements or reliefs for ESOP made conditional on the operation of a statutorily defined EBT, they would suggest that additional - possibly complex - provisions aimed at ensuring a minimum EBT (or employee) interest were unnecessary.

4. The objective of a minimum EBT share acquisition would be to ensure that employees at some stage acquire shares through the medium of the trust which represent a significant (30%?) proportion of the company (though not necessarily amounting to employee control - assuming they acted together) If you see this as an important feature of the scheme there are several possible approaches depending on eg

*But JOL commented in answering the questionnaire that some tax reliefs might be limited to cases where the EBT and employees hold together a minimum percentage (say 26% or 51%).

- the point at which the requirement must be met;

- whether credit can be taken then, or at any other time, for shares already held by employees, or for shares they may have acquired, or received options over, which have or will be provided through the trust.

5. We have no particular 'feel' as to what the required percentage should be. The lobbies would look no doubt to something as low as possible.

A CGT Relief

6. Related to this first point is the third item in your list - "CGT relief (the method to be decided) for disposals where more than 50% of the company's shares are sold to an ESOP". A starting point here will presumably be that the same sort of measurement of satisfaction of such a test would operate as is contemplated for the minimum EBT acquisition. This might imply that the figure chosen should be the same (whether 30%, 50% or some other); but you may think a stiffer test should apply for the CGT relief, eg requiring that the EBT should have control. You would, we imagine, envisage that gifts of shares to the trust, as well as sales to the trust, might count towards the qualification?

Method of share distribution

7. Your minute to the Chancellor spoke of an EBT distributing shares to employees under an approved Revenue scheme. Is the intention that distribution could be made only in this way?

8. The ESOP lobbies are interested in a variety of different distribution methods, including sale at market value or at a discount. Some see buy-outs being assisted by ESOPs. Some may well envisage circumstances in which faster

distribution is sought than is possible under approved schemes (given present and even next year's limits on individual acquisition; and given, too, the 3 and 5 year waiting period before approved scheme options can be exercised with tax reliefs). More generally, limiting distribution to the approved scheme route might be seen as providing little real assistance to unquoted companies which find approved schemes difficult or unattractive at present, and for which ESOPs are seen as providing the answer. Except perhaps for bodies like the Wider Share Ownership Council and the Industrial Participation Association, therefore, few might regard such a limited distribution route as meeting their objectives for ESOPs.

9. On the other hand, distribution confined to the approved scheme route would go some way to ensuring that any special tax reliefs or easements for ESOPs actually served the purposes of the Government's employee share acquisition policy (as underlying the present approved scheme legislation) - particularly if such distributions had to be made through all-employee schemes and within fixed time limits (this would assume that distributions were made on similar terms to all employees). To enjoy their tax reliefs, employees would in effect have to retain their shares (or share options) for some years before disposing of them, so ensuring lasting involvement and incentive; and only those employees could participate who did not have a material interest already in the company (under the new, relaxed but still effective test). Such an approach might enable a somewhat simpler and less stringent definition of the EBT to be adopted.

10. A decision on this is an essential starting point for consideration of the definition of an ESOP trust. It is for consideration how far the interest of unquoted companies might be met by some half-way house, eg a requirement that a minimum proportion of the trust's shares should go out to employees through an approved scheme or schemes.

Time limits for distribution

11. You have indicated in earlier comments that you would want to see an EBT's shares pass into individual employees' hands within a short period. The legislation would also be simpler if this period were not too long. But ESOPs - particularly if they hold a large tranche of shares - usually entail a longish time scale because shares are not distributed to employees until they have been fully paid for out of the company's earnings relating to those shares.

CGT relief for the EBT

12. A point which we need to be clear about relates - not to the question of a CGT relief of some sort for owners selling shares to the trust (which we will look to in subsequent advice) - but to the last proposal in your 12 December note, viz "CGT roll-up in the trust so that employees can benefit from their individual annual exemptions". This appears to reflect Mr Reid's answer to you, recorded in Mr Satchwell's note of 13 December.

13. This point was unclear to us, but we now understand from further conversations with Mr Reid that what he intended was a similar facility for ESOP trusts as currently applies to 1978 approved scheme trusts - that the trust's own income and capital gains from shares held before appropriation are relieved from additional rate income tax and CGT. The point is one which we will consider in subsequent advice (but CGT relief would sit oddly with trust distributions by <u>sale</u>; and it could be complicated and costly if large gains could accrue CGT-free during long periods of EBT share retention).

Conclusion

15. In approaching the question of the definition of an ESOP trust (on which any special tax easements or reliefs would be conditional), we need first to focus the answers to

the first four points discussed above and their rationale. So it would be particularly helpful to be able to discuss these questions with you.

J D FARMER

Robert 04.03.1.89

BUDGET CONFIDENTIAL

FROM: R C M SATCHWELL
DATE: 4 January 1988

MR LEWIS - IR

cc
PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Farmer)
Mrs Majer) IR
PS/IR

STARTER 113: ESOPs

The Financial Secretary yesterday discussed Mr Farmer's minute of 19 December with you and others. The following points were agreed:-

- there should be no minimum shareholding in a company by an employee benefit trust in order for payments by the company to the trust to be deductible for corporation tax purposes. But there would need to be a minimum holding if the seller of the shares to the trust wished to receive CGT rollover relief. The Financial Secretary favoured 50% for this (ie. the seller would have to surrender control); though 30% (a substantial block) might be an acceptable fallback. You are providing further advice on the choice of percentage;

- distributions from the trust to employees would not have to be under an approved Revenue scheme. One option might be a requirement that 50% of the distributions had to be by way of approved all-employee schemes, another would be to have no limit, but a requirement for shares to be offered on "similar terms" to all employees, together with (possibly) rules providing for minimum holding periods. You agreed to do further work on this, and in particular the interaction with buyouts and other acquisitions of large holdings;

- the Financial Secretary would like as small a period as possible for distributing shares from the trust to employees;

- CGT/IT relief for the trust depended in part on decisions on this time limit. The tighter the limit, the more reasonable it would be to have such a relief;

- provisions might be needed to ensure the independence of the trustees - otherwise they might act in the interests of the company rather than those of the employees. One option would be to require a majority of the trustees to be genuinely independent (ie had no material interest in the company, and were not a director of the company). A more severe safeguard would be to require the trustees to obtain voting instructions from employees. But this might prove too administratively complex.

The Financial Secretary would also be grateful for advice on whether employers should be allowed to offer shares at a discount to the market price without triggering a benefits-in-kind charge (see para 9 of the minutes of the Chancellor's meeting of 13 December).

R.C.M.S.

R C M SATCHWELL
Private Secretary

Inland Revenue

Personal Tax Division
Somerset House

FROM: N WILLIAMS
DATE: 24 January 1989

PS/CHANCELLOR OF THE EXCHEQUER

APPROVED EMPLOYEE SHARE SCHEMES 1987/88

1. My submission of 6 December (Review of Employee Share Schemes (Starter No 112)) included some preliminary figures on scheme operation for 1987/88. These showed a continuation of the encouraging trends of recent years. The figures now shown in the Annex very much support those early indications. Indeed, in a number of respects 1987/88 was a record year, particularly in respect of employees participating in, and the value of shares appropriated and shares made the subject of options under, the all-employee schemes.

Number of schemes approved:

2. The Annex does not indicate any significant decline in the rate at which schemes of any of the three kinds are being approved (nor is there any such sign in the numbers of applications for approval).

3. The figures for 1987/88 do not of course take account of any subsequent reaction from either the Stock Market crash or the Budget tax changes last year. As noted in my earlier submission, however, most commentators now seem to have come to the conclusion that significant advantages

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c PS/Chief Secretary
PS/Financial Secretary
Mr Odling Smee
Mr Culpin
Mr Bent
Mr Neilson
Mr Flanagan
Mrs Chaplin
Mr Painter
Mr Lewis
Mr Bush
Mr Creed
Mr Farmer
Mr Fletcher
Mrs Majer
Miss Dougharty
Mr Willmer
Mr N Williams
PS/TR

remain in having approved schemes, and in general terms the number of schemes being submitted for approval has remained at a fairly constant level. (The latest take-up figures as at the end of December 1988 are contained in the separate note accompanying this annual report.)

4. We also commented, in my submission of 6 December, on the number of approved schemes now known to have ceased operation. Our latest estimates of these figures are 37, 108 and 149 respectively for the FA 1978, FA 1980 and FA 1984 schemes.

5. Some further work has been done to seek to identify those companies which have cancelled a scheme but have a second scheme of the same type now approved. (In other words to see to what extent we may have been 'double counting' schemes in the past.)

6. This has proved to be a rare occurrence. In only ten cases had companies done this. In the majority of instances where schemes have ceased, therefore, companies are not ending one scheme in order to re-establish one of the same type at a later date. The result is that the approval figures which we report periodically relate to total numbers approved, without adjustment to take account of double counting, but they somewhat overstate the total numbers of 'live' approvals. We do not however suggest altering further future publicity to report 'live' scheme numbers rather than total approvals, because this would imply that 'live' schemes are active (whereas no employer with an approved scheme is obliged actually to operate it, or to operate it with any particular frequency).

Number of employees benefiting:

7. By the end of the year to March 1987 we estimated that over 1.5 million employees had benefited under the all-employee schemes. Since then 1987/88 has proved to be

the most successful year ever in so far as the number of employees participating in all-employee schemes is concerned. Almost 1 million employees received shares or were granted options over shares in 1987/88.

8. As a result of some further work on the basis of the returns received for 1987/88 and for earlier years, we estimate that, of this 1 million total, there were between 150,000 and 200,000 new employee participants during 1987/88 (about half of this number is due to four large companies making allocations under profit-sharing schemes for the first time).

9. On the basis of these figures we feel able to advise that by the end of the year to March 1988, some 1.75 million employees had benefited under the all-employee schemes, and it is now reasonable to state that over 1.75 million have benefited.

Value of shares appropriated/options granted:

10. The cumulative initial market value of shares granted or made the subject of options under the all-employee schemes showed a particularly large increase during the course of 1987/88 rising by nearly £1,200 million from just under £3 billion to over £4 billion by the close of the year.

11. By comparison with 1986/87 the average level of appropriations/options granted both rose, with the profit-sharing scheme figure showing a large increase for the second successive year. The figures remained well within existing limits, however.

Conclusion:

12. These figures serve to confirm our preliminary views that in many respects 1987/88 was the most successful year

ever so far as operation of the approved schemes was concerned. The changes that Ministers have recently agreed should provide further impetus.

13. The main points of interest are summarised below (the figures in the annex come from confidential returns submitted to the Revenue after the end of the tax year by the trustees in the case of the FA 1978 profit-sharing schemes and by the companies themselves in the case of FA 1980 and FA 1984 share option schemes. Figures for the two option schemes can now be regarded as near-final. Only 70% of profit-sharing schemes have, however, been reported and these figures must therefore remain provisional):

<u>All-employee schemes (FA 1978 profit-sharing schemes and FA 1980 SAYE-related share option schemes)</u>:

* 193 schemes were approved during 1987/88, the second highest total for a year to March.

* The initial market value of shares granted or made the subject of options was a record £1,190 million, taking the cumulative figure to over £4 billion.

* Nearly 1 million employees received shares or were granted options - a record for any one year. Of these, up to 200,000 were benefiting for the first time.

* 1.75 million employees are estimated to have benefited under the schemes by the end of 1987/88.

<u>FA 1978 profit-sharing schemes</u>:

* Over 100 schemes were approved for the second successive year.

* The average initial market value of shares granted was over £500 for the first time, representing a substantial increase on the 1986/87 figure of just over £400 (itself a record).

* 600,000 employees were allocated shares during the year - the highest number recorded in any one year of scheme operation.

FA 1980 SAYE-related share option schemes

* The number of employees to whom options were granted was a record at 380,000 representing an increase of 100,000 over the 1986/87 figure (itself a record).

* Additional information on the return forms indicates that the number of employees exercising options was 45,000 and that they paid some £60 million to do so. These are lower than the 1986/87 figures of 60,000 and £70 million respectively, but this may not be surprising in view of the fall in the value of share prices midway through the tax year.

FA 1984 discretionary share option schemes

* The number of employees granted options was a record 85,000, compared with 50,000 in each of the first three years of schemes' operation.

* The average value of options granted fell slightly to £21,000. (This figure is well below the current statutory limit of 4 times salary or £100,000 if greater.)

14. The key figures from this annual report have been added to the quarterly report which accompanies this note and will continue to appear in successive quarterly reports until the next annual report is available.

N. Williams

N WILLIAMS
Encl.

ANNEX

1. FA 1978 ALL-EMPLOYEE PROFIT SHARING SCHEMES

Year	Schemes approved at end of year in question: Cumulative	In year	Total initial value of shares allocated during year	Number of employees to whom shares allocated during year	Average initial market value of shares per employee
1979-80	117	117	£m 50	225,000	£ 220
1980-81	210	93	£m 67	350,000	£ 190
1981-82	278	68	£m 64	300,000	£ 210
1982-83	344	66	£m 73	285,000	£ 250
1983-84	392	48	£m 79	300,000	£ 275
1984-85	462	70	£m 170	580,000	£ 290
1985-86	532	70	£m 120	360,000	£ 330
1986-87	634	102	£m 240	570,000	£ 420
1987-88	737	103	£m 310*	600,000*	£ 510
			£m1,170	**	

2. FA 1980 ALL-EMPLOYEE SAVINGS-RELATED SHARE OPTION SCHEMES

Year	Schemes approved at end of year in question: Cumulative	In year	Total initial value of shares over which options granted during year	Number of employees to whom options granted during year	Average initial value per employee of shares over which options granted
1980-81	22	22	£m 18	11,000	£1,600
1981-82	137	115	£m 151	89,000	£1,700
1982-83	215	78	£m 175	95,000	£1,800
1983-84	288	73	£m 185	105,000	£1,800
1984-85	403	115	£m 560	225,000	£2,500
1985-86	514	111	£m 460	200,000	£2,300
1986-87	618	104	£m 500	280,000	£1,800
1987-88	708	90	£m 880	380,000	£2,300
			£m 2,950	**	

3. FA 1984 DISCRETIONARY SHARE OPTION SCHEMES

Year	Schemes approved at end of year in question: Cumulative	In year	Total initial value of shares over which options granted during year	Number of employees to whom options granted during year	Average initial value per employee of shares over which options granted
1984-85	220	220	£m 800	50,000	£16,000
1985-86	1,453	1,233	£m 750	50,000	£15,000
1986-87	2,204	751	£m 1,100	50,000	£22,000
1987-88	2,949	745	£m 1,750	85,000	£21,000
			£m 4,400		

* Estimates on the basis of incomplete returns.

** The number of employees cannot be cumulated because the same employee may be allocated shares/granted options in successive years. The total number of employees who had been granted shares or options by the end of 1987-88 under FA 1978 and FA 1980 schemes is estimated at about 1.75 million.

Inland Revenue

Personal Tax Division
Somerset House

Mr Monks:
Some of these (or Sobes) 85 or used in Budget speech.

FROM: N WILLIAMS
DATE: 24 January 1989

PS/CHANCELLOR

APPROVED EMPLOYEE SHARE SCHEMES : TAKE-UP

1. The Annex shows the take-up of approved schemes as at the end of December 1988.

2. Although there is still evidence of a decline in the 12 month total of all-employee scheme approvals by comparison with the previous year, to December 1987, this is now less marked than it was when we last reported on scheme approvals in my note of 26 October. In general schemes are still being sub mitted for approval at a respectable rate.

3. The key figures at the foot of the Annex have been updated to reflect the information contained in my note of today reporting on scheme operation in the year to March 1988.

behind

N. Williams

N WILLIAMS

Encl.

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c PS/Chief Secretary
PS/Financial Secretary
Mr Odling Smee
Mr Culpin
Mr Bent
Mr Neilson
Mr Flanagan
Mrs Chaplin
Mr Painter
Mr Lewis
Mr Bush
Mr Creed
Mr Farmer
Mr Fletcher
Mrs Majer
Miss Dougharty
Mr Willmer
Mr N Williams
PS/IR

The number of approved employee share schemes which had received formal approval by 31 December 1988 was as follows:

FA 1978 All-Employee Profit Sharing Schemes	780
FA 1980 All-Employee SAYE-Related Share Option Schemes	787
Combined total of all-employee schemes	1,567
FA 1984 Discretionary Share Option Schemes	3,617

FA 1978 and FA 1980 All-Employee Schemes:

Combined Yearly Totals:

Year to	Schemes Approved
December 1979	78
" 1980	113
" 1981	190
" 1982	143
" 1983	123
" 1984	169
" 1985	193
" 1986	192
" 1987	203
" 1988	163
	1,567

FA 1984 Discretionary Share Option Schemes:

Yearly Totals

Year to	Schemes Approved
December 1984	32
" 1985	1,178
" 1986	824
" 1987	733
" 1988	850
	3,617

Key figures from latest annual report of scheme operation (year to March 1988)

* By the end of March 1988 about 1.75 million employees had benefited under approved all-employee schemes.

* By the same date the cumulative initial market value of shares granted or made the subject of options under approved all-employee schemes was over £4 billion.

* During 1987/88 some 85,000 employees were granted options under FA 1984 discretionary share option schemes with an average initial value of shares per employee of £21,000.

(The next annual report on scheme operation for the year 1988/89 will be available by about the end of the year.)

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FROM: J M G TAYLOR
DATE: 25 January 1989

MR N WILLIAMS - IR

cc PS/Chief Secretary
PS/Financial Secretary
Mr Odling-Smee
Mr Culpin
Mr Bent
Mr Neilson
Mr Flanagan
Mrs Chaplin

Mr Painter - IR
Mr Lewis - IR
Mr Bush - IR
PS/IR

APPROVED EMPLOYEE SHARE SCHEMES: TAKE-UP

The Chancellor was most grateful for your note of 24 January.

2. He has commented that some of this material, and that in your separate minute of 24 January on 1987-88 as a whole - for which he was also grateful, should be used in the Budget speech. He was interested to see, for example, that 1987-88 has proved to be the most successful year ever as far as the number of employees participating in all employee schemes is concerned. He was also interested to see that over 1 million employees received shares or were granted options over shares in 1987-88.

3. He has asked what we know of 1988-89 to date. I should be grateful for advice.

J M G TAYLOR

Inland Revenue

Personal Tax Division
Somerset House

FROM: N WILLIAMS
DATE: 31 January 1989

PS/CHANCELLOR (Mr Taylor)

APPROVED EMPLOYEE SHARE SCHEMES : TAKE-UP

1. Your minute of 25 January asked for advice on the take-up of approved schemes for 1988/89 to date.

2. Figures indicating the value of shares appropriated and options granted under the approved schemes are derived from annual returns submitted to the Inland Revenue after the end of the tax year. Consequently, figures for the year 1988/89 will start to become available later this year and we should be in a position to report to Ministers on scheme operation for 1988/89 by about the end of this year.

3. The only comparison we can therefore supply at this stage between 1988/89 and earlier years concerns the number of schemes submitted for approval and formally approved.

4. The figures below cover the period from April to December:

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c PS/Chief Secretary
PS/Financial Secretary
Mr Odling Smee
Mr Culpin
Mr Bent
Mr Neilson
Mr Flanagan
Mrs Chaplin

Mr Painter
Mr Lewis
Mr Bush
Mr Creed
Mr Farmer
Mr Fletcher
Mrs Majer
Miss Dougharty
Mr Willmer
Mr N Williams
PS/IR

All-employee schemes (FA 1978 profit-sharing and FA 1980 SAYE-related share option)	Schemes submitted	Schemes approved
1986	153	155
1987	187	152
1988	133	122

Discretionary schemes (FA 1984 share option)		
1986	651	571
1987	945	569
1988	623	568

These figures bear out the comments made in the last two quarterly reports on take-up (the most recent being my note of 24 January) to the effect that there is some evidence of a decline in submissions of all-employee schemes but that this is not a dramatic decline.

5. The number of FA 1984 schemes being submitted for approval has returned, approximately, to the 1986 level, reflecting the abnormally high 1987 figure, due possibly to the substantial rises in share price levels occurring for most of that year.

6. As the annual report on scheme operation for 1987/88 (my note of 24 January) showed, the approved schemes continue to be successful and, so far as we can tell from the levels of scheme submissions and approvals, there is cause for continued optimism about operation of the schemes in 1988/89.

N. Williams

N WILLIAMS

Susan 01.03.2.89

pup

MEETING HELD IN THE FINANCIAL SECRETARY'S ROOM ON THURSDAY 2ND FEBRUARY 1989 AT 11.30AM

Those Present: The Financial Secretary
Mr S Prior-Palmer) Credit Suisse First Boston Ltd
Mr S Hester)

Mr N Ilett
Mr A Sharples

THE APPLICATION OF PRE-EMPTIVE RIGHTS IN THE UK

The Financial Secretary explained he was keen to discuss this matter further and to clarify the main arguments for and against pre-emptive rights. He noted that there was a strong lobby against changing the present position. He emphasised that his main interest was to extend wider share ownership; but he was also convinced there was a general cost of capital issue.

Mr Hester said he believed that pre-emption rights were an obstacle to wider share ownership. When new issues are made there is an opportunity to market shares to a wider public - as UK privatisation issues have shown. It is much more difficult to attract wide interest in the secondary market (and brokers get lower commission on secondary market sales than on new issues). Pre-emption rights blocked this marketing opportunity in the UK and so hampered the development of a retail market. He explained that there was an extensive retail brokerage system in both the US and Japan which had helped to widen share ownership in both countries.

Mr Ilett pointed out that there were other reasons why the retail equity market in the US and Japan was more developed than in the UK. In Japan, for instance, salesmen (usually young women) sell shares "on the doorstep" but within a tight regulatory framework. In the UK such cold calling is not permitted. In the US, Mr Ilett said, there was generally a lot more wealth available to invest in the equity market than in the UK where wealth was tied up in institutional savings, housing and pensions.

The Financial Secretary asked why the UK system demands that rights issues be priced at a discount.

Mr Prior-Palmer explained that this was because of the '21 day rule' imposed by the Stock Exchange to allow shareholders enough time to decide whether to take up their allocation of shares under a rights issue. Over time there may be major changes in market conditions and therefore the shares are offered at a discount to ensure the attractiveness of the issue and cover against uncertainty. He felt that the present system was highly monopolistic as it ensured that long-standing core shareholders had a strong influence over the issue of new equity.

Mr Prior-Palmer highlighted the US experience on pre-emptive rights. He explained that in the US, companies can waive pre-emptive rights and virtually all US companies do this.

Mr Hester pointed out that as a consequence there was no fixed underwriting period and new issues were not priced at a discount. This means that new equity capital is cheaper for US companies than it would be under UK arrangements.

The Financial Secretary pointed out that pre-emption rights did at least offer the shareholders some protection against directors issuing new shares and selling them to outsiders at a discount.

Mr Hester countered by explaining that in the US, shareholders have legal redress if they believe that a share issue has damaged their interests. As a result in the US the new shares were generally priced fractionally above the market price in order to cover commission costs and guard against the risk of suit by aggrieved shareholders.

The Financial Secretary said there would have to be complex provisions in company law if a similar redress was to be given in the UK.

The Financial Secretary then asked for views on the "cost of capital" argument.
Mr Prior Palmer said that pre-emption rights brought an immediate gain to shareholders who could take up their rights at a discount

below market value. However this gain was offset by transactions costs particularly for small shareholders.

Moreover, companies were forced to pay more for new capital then would be the case without pre-emption rights (because such rights put an artificial restriction on the potential market for new shares). As a result, marginal projects which might be funded from new capital in US might be shelved in the UK, causing long term damage to UK companies. Pre-emption rights effectively caused a distribution from the company to shareholders at the time of an issue, and this restricted frequency with which offers could be made.

Mr Hester said that there was an institutional prejudice against any forms of issue other than ordinary shares which meant that UK companies have a very limited flexibility if they want to raise capital in forms attractive to other major international companies such as warrants/convertible issues.

The Financial Secretary noted that Credit Suisse obviously have a strong interest in removing pre-emption rights; but he wondered if there were many "unbiased" institutions who also supported their cause.

Mr Prior-Palmer explained that a number of companies were interested but were not prepared to admit openly their support for abolition as it could damage relations with key institutional shareholders and hurt their company if they wished to embark on a rights issue in the near future. The CBI was likely to be very cautious on the issue.

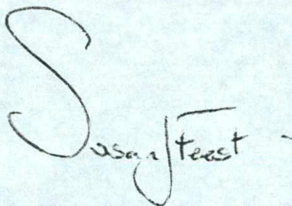
He also felt some of the overseas securities houses and regionally based brokers would support a change. The UK merchant banks would be restricted by the views of their stock broking interests.

The Financial Secretary said he was keen to develop an abolition lobby who would be prepared to go public. He asked Mr Prior Palmer to encourage such public support - in particular he felt it was important to maintain press interest in the subject.

On the European experience Mr Hester said that some countries were more liberal than the UK on disapplying pre-emption rights and some countries less so. He left a memo on this subject.

In conclusion, the Financial Secretary asked Mr Prior-Palmer and Mr Hester for their comments on the way forward.

Mr Hestor said that little could be done by changing UK company law given the constraints of European law. The most effective change would be to persuade the Investor Protection Committees to relax their guidelines to allow companies to issue new shares each year worth up to 20% of the existing equity capital without pre-emption rights being exercised. Where longer issues were made only that portion which exceeded the 20% ceiling would be subject to pre-emption rights.



SUSAN FEEST

cc

PS/Chancellor
Mr Monck
Mr Odling-Smee
Mr Ilett
Mr Neilson
Mr Sharples
Mr Farmer-IR

fim2.cd/neilson/min33 BUDGET CONFIDENTIAL

FROM: M J NEILSON

DATE: 3 February 1989

1. **MR SCHOLAR**

2. **FINANCIAL SECRETARY**

Mr Neilson's two-tier proposal seems to me well worth considering (para 5)

MCS 3/2

cc: Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgewick
Mr Odling-Smee
Mr Riley
Mr Ilett
Mr Macpherson
Miss J Simpson
Mr Matthews
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR
Mr Lewis IR
Mr G Bush IR
PS/IR

ESOPS

We have been involved in discussions with the Inland Revenue on the shape of the ESOPs provisions. We have a number of comments on the shape of the package as whole.

2. It is clear that the package being produced is somewhat different from that which the ESOPs lobbyists would ideally wish. But that is because we think some requirements are necessary to focus on the right target area. It is very difficult to establish rules aimed at achieving Ministers' objectives for genuine employee share ownership without creating such complexity that firms simply will not participate. In terms of Ministers' objectives, we clearly need rules to ensure that trustees are independent, that

only employees may benefit, and that distributions of shares should be, overwhelmingly, on similar terms to all employees. And we must prevent the most obvious forms of avoidance. But to go beyond that, particularly for ESOPs which only aim to benefit from the CT relief, runs the risk of restricting take-up.

3. Though it is clearly not possible to stamp out all abuse, the basic rules of the Employee Benefit Trust should deal with many of the more obvious forms. Selling a controlling shareholding to another proprietor through an ESOP to gain CGT relief (Mr Lewis's paragraph 31) would be prevented by the similar terms provision. The material interest test should reduce the scope for recycling shares directly to the owners. But evasion cannot be prevented. Overall, it must be likely that the main rules outlined above will substantially limit the potential costs of abuse.

4. There are three reliefs under discussion:

- Corporation Tax Relief on company contributions to the EBT.

- CGT relief for substantial sales of shares to an EBT.

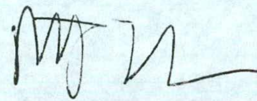
- CGT and additional income tax relief within the EBT.

5. The CT relief, in most cases, merely provides clarification of tax treatment, rather than additional relief. Many firms will wish to benefit only from the CT relief. The other two reliefs and particularly CGT relief are more generous, and owners might reasonably expect to go through more hoops in order to benefit from them. This suggests that a two tier approach is appropriate - the bare minimum of rules for EBTs benefiting only from CT relief; more complex, additional, anti-avoidance provisions if the more generous reliefs are to be given.

6. If you want a CGT relief the key question is what the minimum proportion of the company's shares that must be transferred into the EBT should be. The conflicting considerations are that family companies, by and large, would be reluctant to surrender control,

and that an attractive tax relief should only be provided if employees receive sufficient shares to be able to exercise some influence. The first consideration suggests that a 50% requirement would be so rigorous that take up would be negligible. The compromise area is perhaps between 25% and 50%. With a 25% holding the EBT will have some influence, since it can block changes to the articles of association, and other measures requiring a special resolution. A threshold of 25% or 30% is perhaps a reasonable balance between these conflicting considerations.

7. Tax relief within the EBT is the proposal that will most directly benefit employees, and parallel the arrangements under the 1978 scheme. The argument in favour is that most of the beneficiary employees will be basic rate taxpayers well inside the CGT threshold, so the tax treatment of the vehicle reflects their position, along the lines of unit trusts. The argument against is that shares may be held for a long period in the EBT, and substantial gains/income may be involved.

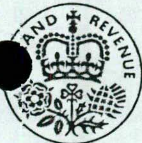


M J NEILSON

ESOP'S

PAINTER → FST 2/2

BUDGET CONFIDENTIAL



Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: T J PAINTER

DATE: 2 FEBRUARY 1989

FINANCIAL SECRETARY

ESOPs

I am sorry that we have not been able to get to you earlier our further note on the more detailed options for ESOPs.

2. We are, I hope, as aware as anyone of the pressures of the timetable and of the overriding need to put Ministers in a

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr Macpherson
Miss J Simpson
Mr Gilhooly
Mr Ilett
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Pitts
Mr McGivern
Mr Farmer
Mr Cayley
Mr Reed
Mr Elliott
Mr Stewart
Mr Thompson
Mr Creed
Mrs Majer
PS/IR
Mr Bush.

position to take firm decisions and then to instruct Counsel. But as I forecast at the Chancellor's meeting on 13 December the issues we are grappling with are difficult. Tax relief in this field, particularly CGT relief, is potentially wide open to abuse. The total amount of revenue at stake may not be large though in individual cases it will be. And the fundamental point is that to the extent that the relief is abused it fails to hit the policy target. Thinking through even the main possibilities and keeping them in perspective (we have not been looking over-zealously for trouble and certainly not for an illusory perfection by way of answers) is difficult and time consuming. The main job has fallen on a handful of people who are already over-stretched, in some cases seriously, on the Bill and their other work.

3. Perhaps I could underline one or two points which are discussed in Mr Lewis's note or have been touched on in earlier discussions.

The prime objective is to encourage the dispersal of shares to employees of unquoted, particularly family, companies where participation in the existing employee share schemes has so far been disappointing. That is to be achieved by putting more weight on tax relief to the proprietors of the company, first by way of more certain, but also extended, corporation tax deductibility for contributions to an employee benefit trust and second, possibly, by relieving existing shareholders of all or some of the capital gains tax liability on shares disposed of into the trust.

4. Legislation to clarify and extend CT deductibility would need to spell out the detailed requirements for a qualifying trust, include some specific anti-avoidance provisions and would almost certainly need to be buttressed by a general (and therefore of course controversial) anti-avoidance provision against abusive "arrangements". I hesitate to suggest that any path through the ESOPs minefield is relatively straightforward.

it would be difficult enough and complicated enough. But we would be traversing relatively familiar territory.

5. The essential requirement would be to ensure that the trustees were, at least formally, independent of the company; that shares had to be passed out of the trust to employees within a fixed, and preferably as short as possible, timescale; and that there were no "arrangements" for passing them back into the hands of the proprietors. The starting point could be the rules for the 1978 scheme.

6. The rules would need to be tight and detailed and the ESOPs lobbies would no doubt run the familiar argument that "the Revenue" were stifling a good idea with their obsession with avoidance and that the benefit of the greater certainty and availability of CT relief was too limited. But as we noted in our earlier submission, it is what they have said they most want and they have not unanimously pressed for more on the tax front.

7. CGT relief for proprietors' gains would put much more strain on the integrity of the new regime and Mr Lewis spells out some of the possibilities for abuse which would need to be blocked off.

8. The difference in vulnerability between CT and CGT relief is arguably largely a difference of degree but our judgment is that it is a substantial difference. At a very rough guess, the legislation might be, say, two pages longer than for CT alone. But the more important point is that, as we are finding, it is very much more difficult to think through the ways of exploiting the system (and thereby defeating the policy objective) and of countering them without at the same time putting unacceptable constraints on the trust.

9. You have taken the view that any CGT relief would be conditional on the transfer of a substantial, possibly controlling, stake in the company to the trust.

10. It was recognised at the Chancellor's earlier meeting that to require the existing owners of a family company to divest themselves of control of the company (it is axiomatic that they divest themselves of control of the specific shares put into the trust) would go against the grain of the UCG's overriding objective for tax which is to buttress the retention of control in the family down the generations. The incentive effect of a CGT exemption with that requirement would be likely to be marginal. The margin might be important and useful but those with an interest would be pretty certain to caricature the limited effects of the new incentive as a 'failure', keeping the pressure on for a more relaxed regime, targeting their attack on the control - or substantial - holding requirements specifically and the "Revenue's restrictions" more generally. And those who were not necessarily looking for avoidance opportunities would complain that the mere complexity would choke off the uninitiated from a basically simple idea.

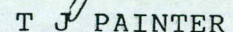
11. The scope for abuse does not turn on whether there is a requirement that the proprietors should divest themselves of control. The basic problem with reliefs for ESOPs in the 'family' company field, where there will often be a small number of proprietors and employees and the possibility of close connections between them and the trustees, is that whatever the formal requirements for distinctions between company, trustees and employees there will always be scope for informal agreements to take, and possibly share, the tax relief with no real change in ownership: the EBT can be used as a conduit.

12. No legislation can be devised to deal with that anywhere near completely. The best that can be done is to make the formal requirements sufficiently detailed to render artificial transactions as difficult as possible and so prevent a level of abuse which would make a nonsense of the scheme. And that is a ready-made basis for allegations of undue complexity.

13. The question is, I suggest, whether the complicated game of introducing CGT relief is worth the candle - at least this year

and perhaps until there is more practical experience of ESOP trusts including the risk that they could detract from the existing very successful and more direct share incentive schemes. My own advice remains that if Ministers confirm the intention to legislate this year there is a strong case for restricting legislation to CT deductibility. It would, as I have said, be criticised as inadequate and over-complex. But it would meet the basic case the lobbies have put forward and could, if you felt it appropriate, be accompanied by undertakings to monitor experience and continue consultations with the relevant interests.

15. Even then there must be a serious risk that we could not meet the Chancellor's objective of getting this, as a 'policy' initiative in the Bill as published. Our present judgment is that that would scarcely be possible with the CGT add-on but might for CT deductibility alone. But I must emphasise that we would need to be further down the track on detailed instructions, and discussion with Parliamentary Counsel, before we could give firmer advice on timing. We would, obviously, do our best.



T J PAINTER

BUDGET CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXT: 6371
DATE: 2 FEBRUARY 1989

FINANCIAL SECRETARY

ESOPS

1. At Monday's Overview meeting the Chancellor asked for work on ESOPs to be carried forward urgently, and we promised you a note this week. Accordingly, in this note I have tried to draw together the main threads of the detailed work which Mr Farmer (in my Division), Mr Cayley (Capital and Valuation Division), Messrs Elliott and Reed (Business Tax Division) and Mr Stewart (Savings and Investment Division) have been doing.

2. This is pre-eminently a field in which the precise details of what can be done - and the implications of doing it - if tax relief is to be available are important. I am afraid therefore that we shall still need to put further, detailed, issues to you over the next few weeks. But given the pressure of time, it would be very helpful to have your views on the main issues now.

3. Although a good deal of detailed work on this subject has already been put in by the policy and technical experts concerned, we have all found it a particularly difficult subject to get into close focus. This stems mainly from the range of objectives of the ESOPs movement, and the need to consider the implications of the wide variety of developments which may occur during the life of an ESOP. Trying to mesh these factors in with the Government's policy objectives in this field, and the need to identify at least the more obvious possibilities of abuse, means that the picture is inevitably complicated, and we may not even now have identified all the important issues.

Structure of note

4. The note is structured as follows

- comparison between FA 1978 schemes and ESOPs;
- main features of an ESOP trust qualifying for tax relief;
- corporation tax relief for payments to a qualifying ESOP trust
- treatment of an ESOPs own income and capital gains
- CGT relief for proprietors disposing of shares to a qualifying ESOP trust
- Exchequer costs, Revenue staff costs, compliance
- Possible ESOP packages
- Questions for decision.

Comparison between FA 1978 schemes and ESOPs

5. Under a Finance Act 1978 scheme, a trust is set up by the company to distribute shares to employees. Corporation tax relief is given to the company on payments it makes to the trustees to enable them to acquire shares. Shares may come either from purchases in the market or from a new issue. Provided the trustees appropriate the shares to employees within a maximum of 18 months, they are not liable to CGT on any gains arising on the shares pending appropriation, or to additional rate income tax on any dividends they receive.

6. Employees with a material interest (over 25%) in the company are excluded; and all shares must be distributed to accepting employees on "similar terms" (this does not preclude variations to take account of the level of pay or length of service). The shares are a free gift to the employees. Provided they leave

their shares in the trust for 5 years there is no income tax charge on their value. The maximum shares which can be distributed to any individual in any year will be increased in the Budget to £2,000 (or 10% of salary up to £6,000).

7. Essentially, therefore, the FA 1978 schemes envisage

- relatively small amounts of shares going to employees free and exempt from income tax

- the shares being bought with funds provided by the company

- the trustees exercising a limited function which is essentially appropriation to employees within a short time scale rather than the holding of shares for substantial periods.

8. As they seem to be conceived at present, ESOPs differ in a number of important respects

- they would usually be concerned with holding a significantly larger proportion of the company's equity, in some cases becoming the majority shareholder. They could thus be a vehicle for employee buy-outs.

- the ESOP would often be financed with borrowed money, rather than by means of outright gifts from the company. It must repay interest and capital from contributions from the company, and from its own income (if any) from the shares acquired, before it can distribute shares to employees.

- the trustees could be holding the shares over a much longer period than the FA 1978 trusts. This links to the more substantial nature of the holdings, which

amight take some time to build up, and which might be acquired with borrowed money which would take time to repay

- distribution to employees might be by sale at open market value, or at a discounted price (with the benefit subject to income tax), or through an approved scheme (providing income tax exemption).

9. So far as tax reliefs are concerned, ESOPs are not seeking new relief for employees (who would thus be liable to income tax on the benefit of free or cheap shares). Their main concern is with CT relief for contributions from the company to the trust and - going beyond any share scheme reliefs at present - CGT relief for proprietors selling their shares to an ESOP.

Definition of an ESOP trust

10. The keystone of new reliefs for company contributions to the trust and proprietors supplying shares to the trust would be the definition of the ESOP trust itself.

11. The main objectives of the rules relating to the trust itself would be

- to ensure that the majority of the trustees are completely independent of the company and the previous or current majority shareholders, so that they properly represent the interests of the employees rather than the employer

- to ensure that shares are acquired and passed on to the employees themselves within a reasonable period so that there is full employee share ownership, and no

possibility of a self-perpetuating trust which, though nominally for the benefit of employees, effectively controls the company independently

- to ensure that all or most shares are distributed to employees on a "fair" basis, and that they are not passed to "favourite sons" or recycled straight back to the original proprietors.

12. Some, or all, of these conditions may be unwelcome to the ESOPs movement since they would prefer flexibility in most things. Another factor which needs to be kept in mind in specifying the qualifying ESOP trust are the opportunities for avoidance - discussed below. Rules which ensure that ESOPs are a vehicle for genuine employee share ownership may also serve in themselves to reduce the opportunities for abuse. New tax reliefs must specify the conditions on which they are available, and these conditions need to reflect the Government's policy objectives - which may not always be entirely in line with the objectives of particular ESOPs supporters.

13. To meet these objectives, we suggest that there might be 5 broad groups of requirements for a qualifying ESOP trust.

a. Independence of trustees

The provisions would require the majority of the trustees to be independent of the company and its owner or previous owners.

b. Beneficiaries

All the employees and directors of the company and any subsidiaries would need to be included among the beneficiaries (with some exclusions, or permitted exclusions, for people on the fringes eg part-timers, casuals, temporaries, people employed for less than a year etc). People who had a material interest in the company - with the limit set at perhaps 5% - would be excluded, as would people connected with them. We

would have to ensure that this test operated at all the relevant times eg when shares were sold into the ESOP as well as when they were distributed; and that the "old" proprietors were not able to take themselves outside this test at the relevant times simply because their shares had, for the time being, gone into the ESOP.

c. <u>Purpose and operation of the trust</u>

The purpose of the trust would be to provide shares or an interest in shares to the beneficiaries as defined above, and to that end it would be able to acquire manage and distribute shares to beneficiaries. Since the central concept is one of employee shareholding, we assume that tax relief should not be available (or would be withdrawn) if either shares were distributed or sold to people who were not beneficiaries <u>or</u> beneficiaries were given benefits in other forms eg cash.

It would be necessary to prevent a trust set up with qualifying purposes getting tax relief if it diversified into other activities. It would therefore, not be able to invest in other assets (other than necessary cash balances etc) and its powers would be limited to those essential for, or incidental to, its purpose of providing shares for employees. While they held the shares the trustees would have to vote them in the employees' interests.

d. <u>Distribution of shares</u>

Given what would be serious scope for diverting the benefit of tax reliefs to outsiders (non-beneficiaries) we envisage that the trust would have to dispose of the shares it acquired only to beneficiaries or those who would promptly pass them to beneficiaries ie the trustees of a Finance Act 1978 scheme. To the extent it did otherwise, there would be a clawback of

tax relief. Any sales to non-beneficiaries which were made should be at open market value to ensure that the employee beneficiaries were not disadvantaged.

On the distribution of shares to beneficiaries, there are two important issues to be decided. First, should all the shares be required to be distributed to all beneficiaries on "similar terms", or only a high proportion of them - say 80%. The first would accord with the pure milk of employee share ownership and would itself be an additional safeguard against avoidance and "round tripping" by the original proprietors. But the ESOPs lobbies have been cautious in specifying a high all-employee "similar terms" requirement because they would like, for example, to be able to give special rewards to senior management.

Second is the question of the terms on which the shares are distributed. Again, the pure milk of employee share ownership might suggest that they should be free, as in the case of FA 1978 schemes, since in practice any required payment discriminates against lower paid employees and those with no capital resources. But this would prevent the use of share option schemes (eg FA 1980), as a means of distributing shares to employees and would mean ESOPs which qualified for tax relief could not be used for employee buy-outs. Having some contribution towards the value of the shares would enable the ESOP trust to distribute the shares earlier where borrowings still remained to be paid off.

e. Time limit on distributions

There clearly needs to be some time limit within which the shares must be got into the hands of the employees themselves if there is to be real employee share ownership and if the trust is not to become an on-going shareholder perhaps, in practice, remote from

employees. The question here is the need to balance such considerations with the time reasonably needed by the ESOP to acquire shares, perhaps in various batches, and to pay off money it has borrowed to finance its acquisitions. (It will not be able to distribute shares until it had paid off the corresponding borrowings). The appropriate period here might be somewhere in the range 6 to 10 years.

Whatever period Ministers choose there will, no doubt, be pressure to extend it. That points, perhaps, to starting at the low end of the range. Another, important, consideration is certainty and administration. It seems appropriate to make all the ESOP reliefs turn not just on a declaration of good intent at the time a particular relief is being given, but on the ESOP actually being operated in accordance with the statutory rules over a period so that the policy objectives for which relief is being given are actually met. On that approach it follows that a relief, even if provisionally given, could not be said to be finally due until the ESOP trust had been operated for a specified period - say 6 years, the usual tax time limit - in accordance with the rules. The "claw-back" provisions would clearly need to be able to operate however long the interval between relief being given and the ESOP rules being broken.

14. One other important question is whether, as a condition for the tax reliefs, an ESOP trust should have to be "approved" by the Revenue, in the same way as with the 1978, 1980 and 1984 share and share option schemes.

15. Given the existing practice in this field, and the fact that ESOP reliefs will be "conditional" for a considerable period, as explained above, we would expect there to be considerable pressure from companies and their advisers for the "comfort" of having Revenue approval, either under a formal scheme or some kind of informal clearance procedure. Although the numbers may -

at least initially - be relatively small, the work involved on each case could be considerable and on occasions it could be extremely urgent, for example, when an employee buy-out is being set up (if ESOPs can be used for that purpose ie it is not a condition that shares are distributed free).

16. A system of that kind would impose a further unwelcome burden on resources at Inspector level which are already over-stretched. An alternative approach, therefore, might be to put the responsibility for deciding whether it qualified on the company/ESOP, (we could of course aim to provide guidance notes as soon as possible, after the legislation, and help with genuine points of difficulty while the legislation was unfamiliar). But recent experience with PRP has not been encouraging for the "hands off" approach. And a disadvantage of this approach is that it would probably make it more difficult to curb the use of ESOPs for avoidance purposes. We shall need to let you have further advice on this point.

Corporation tax relief

17. Subject to the general question of avoidance possibilities (discussed below), there is no intrinsic difficulty in giving corporation tax relief for contributions a company makes to a qualifying trust set up to acquire its shares and distribute them to its employees provided, of course, that there is a clear assurance from the outset that most or all of the shares will be distributed to employees, on an all-employee basis, within a reasonable period. As mentioned in earlier papers, that relief would already be due in many cases. But a statutory relief would not only provide certainty - meeting the ESOP lobbies' principal demand - but would also represent an important extension of relief in certain circumstances (in particular to the employee buy-out, where normally it would not now be due). A combination of a new CT relief, and a new CGT relief for proprietors would provide a considerable stimulus to employee buy-outs - and make it the more important to ensure that qualifying ESOPs could only be used as Ministers intend.

Treatment of ESOP trust's own income and capital gains

18. Exempting a qualifying ESOP trust's own income from additional rate income tax and its gains from capital gains tax would follow the treatment of Finance Act 1978 scheme trusts. To the extent that such an exemption reduced its own tax liabilities it would increase the funds available for the repayment of borrowings and enable shares to be distributed to employees earlier than might otherwise be possible.

19. As against that, this has not generally featured high in the list of requests for ESOP reliefs. A CGT exemption would be unnecessary, or of little value, to the extent that it was a requirement that shares were distributed to beneficiaries free or at a substantial discount to their market value. But if ESOP trusts were able to sell shares on at full value, and were exempt from CGT, there is little doubt that people would try to make use of them purely as tax shelters for large gains accrued while the trust held the shares, if the rules for qualifying ESOP trusts left any discretion in the distribution of shares.

20. An exemption from additional rate income tax (which is charged on discretionary and accumulation trusts) would be difficult to justify except as a special concession to favour ESOPs, and would make it more difficult to resist claims for similar exemption for other types of trust - eg heritage maintenance funds, children's trusts, disaster funds. (The reason for exempting 1978 scheme trusts was that the shares had to be appropriated to employees within a very short time; so they were held on 'discretionary' trust only very temporarily). In any case if the trust income is distributed to beneficiaries, they will get credit for the additional rate tax. Exemption from additional rate could also encourage people to use ESOPs to shelter dividends from higher rate tax.

CGT relief for proprietors disposing of shares to a qualifying ESOP trust

21. Ministers have indicated that any relief would be conditional on a substantial stake in the company being transferred to the ESOP.

22. Two possible figures have been mentioned - 30% and 50%. 50% would involve the transfer of control.

23. In the United States the test is 30%; but there is no particular logic behind it as it was a compromise between much higher and much lower figures which had been proposed. ESOP supporters are bound to want a lower figure, both because it would be an easier test to meet and because many are likely to be reluctant to surrender control.

24. But there are also strong arguments for the higher figure. On the one hand, it could be argued that a substantial relief, like this one, should only be given where proprietors are prepared to give a very substantial commitment to employees by transferring at least 50% of the shares. And if control is not surrendered there is a much greater question mark over the extent to which employees will in reality participate to any significant extent in either the running or the profits of the company. As the UGC have noted, where there is a minority employee shareholding, the employees and the proprietors are likely to take different views about the desirability of the value of the shares increasing.

25. In looking at either test, we assume that Ministers would want to look at the amount of the shareholding transferred within some specific period to the ESOP rather than on the much narrower basis that relief would only be due if a particular shareholder's holding exceeding 30% or 50% were put into the ESOP.

26. The CGT relief could be either an exemption, in full or in part, or a deferral. There are strong arguments against deferral which would, in practice, take the form of a roll-over relief. The sort of roll-over the ESOP lobbies have suggested - into quoted shares - is really outside the normal type of case in which roll-over relief is given where the gain on one asset is rolled over into the purchase of another asset of the same type, or, in the case of shares, there is an exchange of one share for another (paper for paper), with no cash passing. A relief which took the form of a roll-over would add to existing pressures for

the extension of such reliefs; it would be more complicated to operate; and it would be far more complicated if relief had to be recovered if the ESOP trust subsequently broke the rules.

27. For all these reasons, an outright exemption, whether total or partial, seems preferable, if you decide on a CGT relief for proprietors.

Avoidance

28. As you will know from other reliefs affecting family companies - for example IHT relief, BES, purchase of own shares - there is inevitably scope for widespread abuse unless the reliefs can be very tightly drawn. Such rules - I have already indicated some in outlining the main conditions for relief - always make for complexity and reduce the attractiveness of the original, simple, idea. The combination of CT relief for a company for money it provides for the purchase of its own shares, a specially set up trust - with or without its own special tax reliefs - and CGT relief for the owners of the company to sell their shares into the trust is precisely the sort of combination which, experience suggests, is likely to be especially vulnerable to avoidance possibilities. Some could involve routing transactions which have nothing to do with employee share schemes through an ESOPs arrangement.

29. We have already identified some avoidance arrangements which it would be essential to guard against. I mention some of them briefly below. But, given the heavy commitments of all those involved, we certainly could not be sure that we have already identified all the possibilities, or that we could do so in time for the Finance Bill. There would be more time to consider this aspect if the introduction of legislation were delayed until Committee Stage.

30. First, there would clearly be a need for a rule which withdrew any CGT relief given to the proprietors if the ESOP sold the shares back to them or to people connected with them. Otherwise the proprietors could simply sell their shares to the ESOP, get their CGT Relief, and then buy their shares back.

Using the ESOP as a temporary holding vehicle, they could effectively arrange to take some of their gains out of tax.

31. Second, an ESOP might be used for getting tax relief for a sale which would in any event have taken place. If a controlling share holding in a company were to be sold to another proprietor, CGT relief could be gained simply by routing the sale through an ESOP. (That would be prevented - if the ESOP complied with the rules - if 80% or more of ESOP distributions had to go to all employees, on similar terms, excluding employees having a material interest. But there is clearly some scope for using this device so long as ESOPs can distribute <u>any</u> shares other than on "similar terms" etc).

32. A third situation Ministers would need to consider would be where there were genuine arms length employees but there were "arrangements" whereby it was understood that they would sell their shares back either to the original proprietors or to connected persons. The result of such an arrangement would be to leave the proprietors essentially where they were before, or with their shares transferred to other family members they wished to hold them, with the value of the tax reliefs on the way being divided between themselves and the employees. The small company environment is clearly one in which there could be particular problems of this kind - and so far we have not envisaged any rules which would limit the employee's right of disposal of his shares if they reached him through the proper operation of an ESOP.

33. If Ministers decided that the gains of an ESOP trust should not themselves be exempt, there might need to be a rule to prevent a de facto exemption being arranged through the transfer of shares (free) to a 1978 scheme, for onward transmission to the employees (a common arrangement). In relation to unquoted trading companies there would be no liability on the ESOP under the new gifts rules; the gain would be exempt in the 1978 trust; and not chargeable on the employee since his base cost would be the market valuation at the date the shares were appropriated to him. This difficulty could be avoided if ESOPs were only able to

transfer free shares direct to employees, because they would be liable to income tax on the market value of the shares at the date of acquisition.

34. We have already worked into the conditions for an ESOP noted above some features designed to make more difficult or less attractive some of the avoidance possibilities. But it seems fairly clear that this is an avoidance minefield. A lot more work is needed to identify further possibilities, and how they might be countered. At the moment we can see no satisfactory solution to the problem in paragraph 31.

Exchequer costs, Revenue staff costs and compliance

35. Leaving aside the avoidance possibilities, we would not expect a relief of this kind to have, in the early years at least, a very significant Exchequer cost. On the CT side, relief would often be available under the present provisions. So far as CGT is concerned, we would expect the extra cost to be more considerable, but it would probably relate to a large extent to transactions which would not otherwise have taken place.

36. An ESOPs relief of this kind would be complicated - and it would become more so with anti-avoidance provisions. To that extent it would add marginally to Revenue staff costs but - subject to further consideration when there is a more worked out scheme - they are likely to be small because at least initially the number of cases should not be large. Staff costs would increase with an approval mechanism.

37. As is invariably the way with reliefs of this kind, there would be an addition to the complexity of the tax code. That would bring criticism even in the context of a new relief because employers would have to tailor their schemes to meet the conditions (and some would be unable or unwilling to do so).

Length of legislation

38. At the moment we can do no better than the estimate of 5+ pages given at the Overview.

Possible components of an ESOP package

39. A new relief which incorporated corporation tax and CGT relief for proprietors should be seen as a substantial encouragement to ESOPs (to add to the "material interest test" relaxation already agreed).

40. But there are substantial difficulties with the CGT relief for proprietors. It you decided to drop that from the package, it would probably seem over-elaborate if it did no more than confirm (in most cases) CT deductability. In that case, we would need to consider whether a simpler definition of a qualifying ESOP would be sufficient.

41. A third possibility if you felt that CT deductability alone was insufficient would be including an income tax and CGT relief for income and gains within the ESOP trust. But as already indicated, that looks unattractive in many ways, and we would need to do further work on it because it could reintroduce some of the complications of the proprietor's relief for CGT.

Question for decision

42. The Chancellor has said that he definitely wants to include an ESOPs provision in the Budget, if possible with the CGT relief for proprietors. There are clearly various "second line" issues on which we shall need to report to you again. But it would be helpful if we could have your guidance on the main structural issues raised in this note.

43. Are you content with the outline of the qualifying ESOPs definition?

i. Must all shares be distributed to all accepting employees, on "similar terms". If not, what proportion?

ii. Should all shares be distributed free to employees (either direct or through an approved all-employee share scheme)?

iii. What should be the time limit for distributing shares to employees?

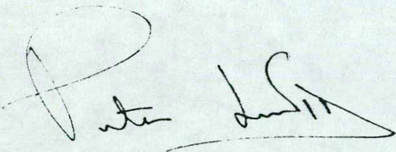
44. Do you agree that CT relief should be given, including in the case of employee buy-outs where relief would not be available at present?

45. Should a CGT relief for proprietors be given? If so

i. Do you see it as a requirement that - within some specified period - at least 50% of the shares should go to the ESOP to qualify for relief?

ii. Should it be a full or partial exemption, not a roll-over (deferral)? If a partial exemption, how much?

45. Do you agree there should not be relief for the ESOPs own income (additional rate) and capital gains?



P LEWIS

Inland Revenue

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Personal Tax Division
Somerset House

Given existing commitments, it is difficult to see time being available for working this up for this year's Bill. But if you see attractions in it, we could look at it in more detail as a starter for next year.

FROM: J D FARMER
DATE: 3 February 1989

1. MR LEWIS

2. FINANCIAL SECRETARY

EMPLOYEE PURCHASE OF SHARES AT A DISCOUNT

1. Mr Satchwell's note of 4 January (Starter No 113 : ESOPs) asked for advice on whether employers should be allowed to offer shares at a discount to the market price without triggering a benefits-in-kind charge. This matter had been raised at the Chancellor's meeting on 13 December at which papers relating to employee share schemes and ESOPs were discussed.

2. The suggestion is a tax relief for the benefit enjoyed by an employee who acquires from his employer shares in the company for which he works at a discount to their market value. We understand the objective to be a potentially

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c PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Painter
Mr Lewis
Mr Farmer
Mr Creed
Mrs Majer
Mr Fletcher
Mr N Williams
PS/IR

effective and yet straightforward method of achieving increased employee involvement in companies.

3. We have examined this matter separately from our urgent and continuing work on ESOPs, because whereas the latter is concerned essentially with tax easements for companies and owners who make shares available for employees, a discount relief would be for employees. A discount relief has wider implications, therefore, and its relevance is by no means confined to ESOPs.

Background

4. Present legislation generally makes employees liable to income tax on any benefit that they may receive as employees, thus if their employment enables them to acquire shares at a price lower than their value at the time of acquisition they are liable to tax on the difference.

Previous consideration of employee discount taxation

5. During their consideration of the taxation of employee benefits arising from public offers, Ministers decided that, subject to certain conditions, employees should be exempt from tax on any benefit they derive from being able to subscribe for more shares than the public (employee priority). Legislation was accordingly included to that effect in last year's Finance Act. Ministers have since also decided that this year's Finance Bill should contain further provisions extending the terms of the exemption.

6. In this context they have confirmed, however, that employee discount should remain taxable and this was stated in Press Releases relating to the employee priority exemption (the last of which, announcing the changes to appear in this year's Finance Bill, was issued on 11 October). To move now to relieve the income tax charge on employee discount would thus appear a reversal of recently confirmed policy.

Approved Employee Share Schemes (ESS)

7. If the employer wishes, employees can in effect already obtain shares at a discount through the existing approved schemes. They can do so by way of matching FA 1978 profit-sharing scheme offers (where an employee buys one share and gets one free), and also through the discount of up to 10% (shortly to be increased to 20%) on the share price at which options may be offered to employees under FA 1980 SAYE-related share option schemes. The approved FA 1980 and 1984 share option schemes effectively offer a further and substantial 'discount' in that at the time the employee exercises an option and acquires the shares he does so at the price at which the option was granted, which is likely to be considerably below the price of the shares at the time of exercise (otherwise, of course, he would not exercise). There is no liability to income tax at that point, although a liability to CGT does arise when the shares are eventually sold.

8. The existing approved scheme legislation therefore already provides employers with a wide choice of methods for getting shares into employees' hands on an income tax-relieved basis. Free shares, cheap shares and the prospect of cheap shares later can all be, and are provided.

Restrictions needed to make relief on discount effective

9. The various reliefs available through participation in the approved ESS depend on the schemes and their participants observing the statutory conditions. These conditions include a variety of requirements as to, for instance, the employees who may or must participate (eg all-employee rules), the terms on which they participate (eg "similar terms"), the limits on individual participation, and the length of time for which shares or options over shares must be held. They all seek to ensure adequate service of the policy objectives underlying the

valuable tax reliefs provided - eg improved industrial relations through real employee participation, wider employee share ownership, incentives to better employee performance, all over a reasonably long period.

10. A specific new tax relief for the benefit arising from employee discount could prove costly and achieve little save widespread avoidance of the taxation of employment income, unless conditions similar to these were imposed. It would on the face of it be possible, for instance, for a company to sell shares to one or a favoured few directors or employees at a 99% discount, and for the fortunate recipients then to sell these shares and realise their profit tax-free as quickly as the CGT annual exemption permitted. £5,000 a year tax-free income from employment would be a valuable opportunity.

11. A short cut to a sensibly limited new tax relief for employee discount, if one was needed, might appear to be by way of FA 1978 matching offers, referred to in paragraph 7 above; and we now examine this briefly.

'Matching' scheme offers

12. The clear aim of the profit-sharing scheme legislation is that employees receive shares free from the employer. The legislation states that "the scheme must not contain features which are neither essential nor reasonably incidental to the purpose of providing employees and directors with benefits in the nature of interests in shares".

13. In the context of the BP share sale in 1979 it was admitted that these conditions could be regarded as met where a matching share arrangement was employed. Since then a number of companies have adopted this approach, which appears certainly to be well-known, though in order to ensure compliance with the provision quoted each case has to

be carefully considered on its individual merits. Some fairly extreme proposals, involving conditions on the issue of free shares quite unrelated to share issues, have had to be rejected.

14. There would be clear dangers in going too far down the 'matching share' route. Making the appropriation of one free share conditional on subscription for one or two others is not a long step from making it conditional on subscription for five or ten, or conditional on subscription for preference shares or loan stock, or on a variety of other conditions (such as undertakings to sell the free share back to the company's owners). Such conditions, however far reaching or limited, can hardly be consistent with a scheme aimed at the free allocation of shares to employees, with all of them being able to participate on similar terms. Nor, as explained above, does it seem necessary for a company to go down this route, since, if it is anxious to engage the employee's interest in more tangible ways than giving him free shares outright, it can instead under the present Government's own 1980 and 1984 share option schemes, require some payment by the employee for the shares he obtains.

15. Be that as it may, we would expect any substantial development of the "free and matching" facility in the operation of FA 1978 schemes, in the interest of extending effective tax exemption for employee discount, to lead to a decline in the numbers of employees actually taking up share offers made to them.

16. Looking at participation rates in privatisations where there has been both a free and a matching offer, we note that the free offer was in most instances taken up by well over 90% of eligible employees, while the matching offer was taken up by as little as 38% of eligible employees in one case, and in most cases the participation rate is around 80%. This too is in situations where the offer has been <u>two</u>

free shares for one contributed. In other cases employers could well only offer shares on a one for one basis. If employers were to offer only matching arrangements instead of offers of free shares a 15% reduction in participation levels could mean, on the basis of the 1987/88 figures, nearly 100,000 fewer employees being granted shares under profit-sharing schemes in any one year.

17. This could conceivably be offset if more employers were to take up FA 1978 schemes as a result of any special publicity for the facility open to them of offering matching schemes to their employees and not having to give all (or any?) of the shares free.

18. Action is of course already proposed in the Budget on ESOPs. These will enable share distributions to be made to employees from the employee benefit trust either by sale, gift or through an approved scheme. In the latter case employers already would be able to use the matching share facility in operating their 1978 scheme. But any increased publicity for this facility, or any deliberate relaxation of the conditions on which it may be used, would seem very likely to encourage demands at least from the ESOP quarter for a more overt and free-standing tax relief for employee discount as such. This would then take us back into the objections of principle discussed in paragraphs 10 to 14 above.

Conclusion

19. An express new relief allowing employees to acquire shares at a discount to the market price without triggering an income tax charge on the benefit that arises would be a substantial step, reversing recent indications that the Government would maintain taxation of this benefit. For any arrangement centred on a tax-free discount to be effective in terms of the Government's ESS policy, conditions would have to be imposed similar to those in the existing all-employee schemes.

20. While the facility to establish matching share arrangements or otherwise effectively to offer employees shares at a discount already exists, and employers already make use of it, it is at present limited by close association with the existing approved scheme legislation. We are aware of no demand for any more generous 'discount' relief; and if this was offered - whether by a free standing concession or by relaxing the conditions on which free, 1978 scheme shares may be offered, we consider there would be a real risk of weakening the take-up of approved schemes and/or reducing the numbers of employees accepting offers of free shares.

21. We could look further at the various possibilities for a more positive encouragement of employee discount offers through tax relief if you wished, but at first sight our view is that some significant legislative changes might be involved.

J D FARMER

Inland Revenue

BUDGET CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: N WILLIAMS
DATE: 3 February 1989

FINANCIAL SECRETARY

APPROVED ALL-EMPLOYEE SAYE-RELATED SHARE OPTION SCHEMES : INCREASE IN MONTHLY SAVINGS LIMIT

1. You agreed (Mr Satchwell's minute of 20 December) with the recommendation in my submission of 6 December (Starter No 112 : Review of Employee Shares Schemes) that the maximum monthly savings limit for participants in the FA 1980 all-employee SAYE-related share option scheme should be increased from the present limit of £100 to £150.

This note seeks a decision on how this increase is to be implemented.

Background

2. On the one previous occasion when the limit was increased, a clause was included in the (1984 Finance) Bill setting out what the increase was to be. The increase was to be made 'effective on or after the appointed day' ie the day appointed by Treasury Order. This Order was made shortly after the Finance Bill received Royal Assent and the new limit came into force on 1 September 1984.

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c PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Odling Smee
Mr Peretz
Mr Culpin
Miss Anderson
Mr Neilson
Miss Hay
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)
Mr Painter
Mr Lewis
Mr Bush
Mr Creed
Mr Farmer
Mr Fletcher
Mrs Majer
Mr Streeter
Mr N Williams
PS/IR

3. The same Finance Bill Clause also provided, however, for future variations in the limit to be effected by way of Treasury Order. Since there is some relationship between the levels of the limit and the rate of return on the savings contracts, Ministers felt that it would be convenient if the limits were capable of being altered at the same time as savings rates were altered, and at a time when no primary legislation was current.

4. There exists therefore, a choice of means by which an increase in the scheme limit can be implemented.

Possible options

5. We anticipate that the Chancellor will want to announce the increase in his Budget Speech, since it will fit in well alongside the other measures being taken in the employee share ownership field. Subsequent to this announcement the alternative routes available are as follows:

i. a Clause could be included in the Finance Bill setting out the new limit. This would essentially be an enabling provision since a Commencement Order would still be needed to enable the DNS and building societies to operate the new savings contract limit. The setting of the precise date upon which the limit could become effective would have to wait until it is known when the Finance Bill will become law. Assuming a similar pattern was followed to that adopted in 1984, new contracts incorporating the new limits could be issued from 1 September, giving the necessary 21 day interval for the laying of a Commencement Order between the Finance Bill receiving Royal Assent and the starting date;

ii. a Treasury Order setting out the new limit could be laid (eg after the Budget), under the Negative

Resolution procedure (it would be subject to annulment within 40 days after it had been laid). In order to give the DNS and building societies a chance to reprint, or perhaps to draw up a new prospectus, and companies an opportunity to make arrangements for the operation of the new limit a period of some three months between the date of announcement of the new limit and the date from which new contracts could be issued would be desirable. This would point to the further (Commencement) Order being laid in June with the increased limits coming into effect from 1 July.

Comment

6. In practice, most companies participating in approved schemes will grant options to their employees only once a year, following on the shareholders' approval at the company's AGM. There might therefore be some criticism if an announcement that the limits are being increased is made in the Budget and employees are unable to be granted options and start saving at the new higher levels until September. It clearly seems desirable to make the new limit effective as soon as possible, but only as soon as is practicable given the arrangements that have to be made by the DNS and building societies before they can operate the limit at the new level.

7. Having taken the power in 1984 to make alterations to the scheme limits, so that they could come into force more quickly if necessary, by way of Treasury Order, Ministers may feel that this is an appropriate occasion on which to make use of that power. It would enable the increased limit to be operated earlier than if the primary legislative route were followed (1 July as opposed to 1 September).

8. Against this must be set the possibility of criticism on the grounds that Ministers were using secondary

legislation at a time when there was plainly the opportunity of using primary legislation instead.

9. An increase in the statutory limit, from 10% to 20% on the share price discount at which options may be offered to employees participating in FA 1980 schemes is also to be included in the Finance Bill.

10. Before participants can take advantage of the increased monthly savings limit and before companies are able to grant options with the benefit of the higher discount limit it will be necessary in the majority of cases for the scheme rules to be amended. Although this should not be a complicated process it will involve companies in submitting the amendments for approval by our Specialist Division. It will inevitably take a little while therefore before companies are in a position to operate the new limits.

11. Good administration, for employers in particular, would suggest that effective implementation of the two changes should occur at about the same time. This points towards a start date of 1 September for the increase in the monthly savings limit.

Symmetry with change in FA 1978 profit-sharing scheme limit?

12. When this limit was last increased in 1983 the new limit was made effective for allocations of shares on or after 6 April 1983. We think that this precedent could be followed this year and the increase made effective for allocations of shares on or after 6 April 1989.

13. Given that this scheme is based on a year-by-year measurement of appropriations, compared with the FA 1980 scheme monthly savings limit, and that changes in the rules of existing approved schemes of the 1978 kind are unlikely to be necessary, there seems no particular awkwardness in having a different effective date for this particular change.

Conclusion and recommendation

14. Proceeding via the Treasury Order route, would be of benefit to participants in the approved schemes by enabling them to save at the higher permitted levels earlier than would be the case if the Finance Bill route were adopted.

15. However, a period of only two months is involved and there are a number of arguments against adopting that course.

16. An effective date of 1 September, achieved by following the Finance Bill route, would sit better as regards the time from which companies will be able to make use of the facility to offer options at higher discount levels. Use of the Finance Bill route would also avoid any possible criticism of the Government for following a secondary legislative route when a primary one was available.

17. We would be grateful to know, therefore, whether you are content that the increase in the FA 1980 SAYE share option scheme monthly savings limit should follow the Finance Bill route outlined in paragraph 5(i) above, enabling larger options to be granted and their associated saving contracts to be started, from 1 September?

N. Williams

N WILLIAMS