PO-CH/NL/0147
PART A

Part. A.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 1/10/86.
Ends: 22/7/87.

PO -CH /NL/0147

PART A

Chancellor's (Lawson) Papers:

PROPOSALS FOR WIDER SHARE OWNERSHIP

Disposal Directions: 25 Years

[signature]

25/8/95.

PO -CH /NL/0147
PART A

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 1 October 1986

CHANCELLOR

SECTION 303 ICTA

1. I am sorry to bother you with a small matter but I think you should be aware of it because of its potential implications.

2. Briefly, Mr Laurie Brennan, Chief Executive of New Bridge Street Consultants Ltd has been lobbying the Revenue for some months to change the way in which Section 303 ICTA 1970 is applied to approved all-employee or executive share schemes. Under present rules the employees of a close company cannot participate in these schemes if they have a "material interest" in the company, which is tested by very detailed rules. It is now apparent that for rather technical reasons these rules can be too restrictive.

3. The Revenue have some sympathy with Mr Brennan's point but Ministers were advised not to hurry through legislation in the 1986 Finance Act because of the complexities of the area. As a result, it appears that Mr Brennan has become impatient, and has taken the drastic step of converting BP into a close company and conferring a "material interest" on every BP employee thus making it illegal for the company to operate its existing share schemes. He has achieved this by buying one BP share and settling it in trust for the benefit of BP employees and shareholders. Mr Brennan believes that BP are not aware of this and we have not told them.

4. Mr Brennan's action is, of course, unacceptable. In particular, he appears to have chosen to single out BP since this is still partially under Government ownership, and, in a letter of 4 September., which you may have seen, he hints that

the risks to all companies "including the past and future privatised companies" are serious. We do not know whether he is contemplating action to turn a newly-privatised BGC into a close company and thus prevent the operation of its approved employee share schemes. The Revenue have informed Department of Energy officials of the outside possibility. Mr Brennan has also asked John Moore to lobby the Treasury on his behalf.

5. I have decided not to speak directly to Brennan at this stage but obviously we need a solution to this problem very quickly indeed. The Revenue are aware of the potential seriousness and hope to come up with a solution very soon.

G.H.

Approved by the FST and signed in his absence

FINANCIAL SECRETARY

MR 10/36

UNCLASSIFIED

FROM: A W KUCZYS
DATE: 6 January 1987

CHANCELLOR

EMPLOYEE SHARE SCHEMES

You asked what was the degree of overlap between employee share schemes and share option schemes - ie what proportion of firms with the latter also ran all-employee schemes. It turns out, surprisingly, that the Revenue do not at present have this information, although they are currently computerising their records which will make it possible to answer such questions quite easily. Meanwhile, it would be possible to mount a manual exercise to answer the question, but as you know resources in this bit of the Revenue are already stretched.

AWK

A W KUCZYS

This is v. unsatisfactory. [illegible] My impression was [illegible] [illegible] 1984 option schemes [illegible] companies [illegible] an all-employee scheme as well. Do the CBI know [illegible] members? [illegible]

Inland Revenue

Policy Division
Somerset House

FROM: D M GREEN
DATE: 10 March 1987

PS/CHANCELLOR OF THE EXCHEQUER

APPROVED EMPLOYEE SHARE SCHEMES : 1985-86

1. We supplied figures for the recent Nigel Forman PQ on the take-up in 1985-86 under the approved employee share schemes. But Ministers might also be interested in the trend, and figures for 1985-86 are repeated in the annex attached, together with figures for the earlier years.

2. Comparing 1985-86 with earlier years, there are no striking developments. There continues to be a steady but encouraging growth in the number of schemes and employees participating, and no sign of any fall in the overall trend. Although the figures for take-up in 1985-86 were lower than for 1984-85 in terms of both numbers of employees granted shares or options and the initial value of the shares involved, 1984-85 was an exceptional year, owing to the British Telecom flotation. In fact, if BT were omitted from 1984-85, the 1985-86 take-up would actually surpass every other year since the reliefs were introduced. This is true for both 1978 and 1980 schemes and in terms of both numbers of employees and the values involved.

---

c PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr McIntyre
Mr Neilson
Mr Cropper
Mr Isaac
Mr Lewis
Mr Beighton
Mr German
Mr Prescott
Ms Tyrrell
Miss Dougharty
Miss Green
PS/IR

3. Other points of interest

- during 1985-86, 181 all-employee schemes were approved, only 4 less than in the previous record year of 1984-85;

- we estimate that 1.5 million employees had benefited under all-employee schemes by the end of 1985-86. The figure takes account of our estimate that 50% of the cumulative total of employees will have benefited under more than one kind of scheme or in more than one year under the same scheme;

- the cumulative initial market value of the shares granted or made the subject of options under all-employee schemes increased during 1985-86 from £1.5bn at the start to £2bn by the close;

- the average initial values of shares granted or made the subject of options under all-employee schemes were higher in 1985-86 than in any previous year. The figure for FA 1978 schemes has passed £300 for the first time;

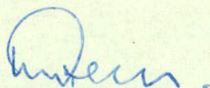
- for the FA 1980 savings-related share option schemes the steady growth in the number of employees prepared to commit their own savings is very encouraging. Participants from the first two years of operation of the reliefs will now be able to exercise their options, acquiring shares which will probably have doubled in value over the 5 year period;

- a recent article in the British Institute of Management's Employment Bulletin estimates that overall as many as 23% of a company's eligible employees are participating in its savings-related scheme. This has, however, to be treated with caution, as previous surveys have suggested much lower participation - 14% according to a report by Copeman Paterson last year and only 8% according to DE research in 1985;

- the FA 1984 discretionary scheme continues to be very successful. The estimated results for 1985-86 are very much in line with those for 1984-85;

- for 1986-87 we expect the trend to continue for all three schemes and for it to be another very impressive year in terms of numbers of employees and the value involved, especially as new major schemes - British Gas, British Airways and TSB-will be reflected.

4. I should mention that the information in the annex comes from confidential returns submitted to the Revenue after the end of the tax year - by the trustees in the case of FA 1978 profit sharing schemes and by the companies themselves in the case of FA 1980 and 1984 share option schemes. The estimates for 1985-86 are still far from firm at this stage, especially for FA 1978 schemes, because we have only recently received sufficient returns to offer even tentative figures. We are aiming to computerise the issuing of both returns and reminders this year, so we hope to be able to produce estimates for 1986-87 much more promptly.



D M GREEN

Encl.

ANNEX

1. FA 1978 ALL-EMPLOYEE PROFIT SHARING SCHEMES

Year	Schemes approved at end of year in question (cumulative totals)	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	£m 50	225,000	£ 220
1980-81	210	£m 67	350,000	£ 190
1981-82	278	£m 64	300,000	£ 210
1982-83	344	£m 73	285,000	£ 250
1983-84	392	£m 79	300,000	£ 275
1984-85	462	£m 170	580,000	£ 290
1985-86*	532	£m 140	400,000	£ 350
		£m 643	**	

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

Year	Schemes approved at end of year in question (cumulative totals)	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	£m 18	11,000	£1,710
1981-82	137	£m 151	89,000	£1,710
1982-83	215	£m 175	95,000	£1,850
1983-84	288	£m 185	105,000	£1,800
1984-85	403	£m 560	225,000	£2,300
1985-86*	514	£m 460	180,000	£2,400
		£m 1,549	**	

3. FA 1984 DISCRETIONARY SHARE OPTION SCHEMES

Year	Schemes approved at end of year in question (cumulative totals)	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	£m 800	50,000	£15,000
1985-86*	1453	£m 700	50,000	£15,000
		£m 1,500	**	

* 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. Allowing for an 'overlap' of about 50% where employees have benefited more than once or under more than one kind of scheme, the total number of employees who had been granted shares or options by the end of 1985-86 under FA 1978 and FA 1980 schemes was around 1.5 million.

MR 2/25

UNCLASSIFIED

FROM: A W KUCZYS
DATE: 12 March 1987

MISS GREEN - IR

cc: PS/CST
PS/FST
PS/EST
PS/MST
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr McIntyre
Mr Neilson
Mr Cropper
PS/IR

APPROVED EMPLOYEE SHARE SCHEMES: 1985-86

The Chancellor was grateful for your note of 10 March. He has commented that there is some interesting stuff here for use in the Budget Debate - not least that the cumulative initial market value of shares granted under all-employee schemes increased during 1985-86 from £1.5 billion to £2 billion.

Andrew
NB 'x'
T.

AWK

A W KUCZYS

3739/027

Ch/ As you heard from my end of a 'phone conversation just before NEDC, Mike Neilson wants one more go at this! Do you confirm your original conclusion against Venn Diagrams? AWK 1/4

FROM: M J NEILSON
DATE: 1 April 1987

PS/CHANCELLOR

cc: PS/FST
Mr Pickford

If Mr N wants to letter, I am content to let him have his V.D.

WIDER SHARE OWNERSHIP: VENN DIAGRAMS

Your minute of 31 March records the Chancellor's agreement that interlocking charts (venn diagrams) are a bit much for ordinary readers. Before finally rejecting these charts I thought it worth pointing out their advantages over pie charts for the current purpose. The information content of the Venn Diagrams is much higher than for the pie charts;

(i) It is not possible to derive from pie chart 1 how many people own shares in each company.

(ii) Everything other than individuals owning shares in only one company is lumped together in the pie charts under "other" - in the Venn diagram you can easily see the number of people owning shares in all three privatisations, or in any combination. At the press briefing on the survey, it was exactly this sort of information that the journalists were interested in.

(iii) Pie chart 2 gives the impression that privatisation holdings are lower than they actually are, since 3 million privatisation shareholders are hidden in the "multiple holdings" segment.

2. In my view the pie charts are positively confusing for these reasons.

3. On the question of whether the ordinary reader will understand them, Venn Diagrams are a standard part of modern maths courses, and are thus familiar to schoolchildren and students. The footnote on the chart should also help clarify any confusion.

[signature]

M J NEILSON

Inland Revenue

Policy Division
Somerset House

FROM: D M GREEN

DATE: 24 April 1987

PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

1. My minute of 15 January reported on the take-up of approved employee share schemes up to 31 December 1986. The attached Annex shows the position at 31 March 1987.

2. Of the 489 1984 schemes shown in table 4 as 'under consideration ' at the end of December, about three quarters had already received their preliminary examination by the Revenue. Of the 266 1984 applications over 12 months old and listed as 'deferred or dropped', correspondence between the Revenue and the applicants is still in fact continuing on about 150.

D M GREEN

c	
PS/Chief Secretary	Mr Lewis
PS/Financial Secretary	Mr Lawrance
PS/Economic Secretary	Mr Beighton
Mr Scholar	Mr German
Miss Sinclair	Mr Willmer
Mr Cropper	Mr Peel
Mr Lord	Mrs Eaton
Mr Neilson	Miss Dougharty
	Miss Green
	PS/IR

ANNEX

1. FA 1978 ALL-EMPLOYEE PROFIT SHARING SCHEMES : CUMULATIVE TOTALS

Date		Schemes submitted	Schemes deferred or dropped*	Schemes under consideration	Formally approved
Mar	1979	96			3
Sept		161			43
Mar	1980	228			117
Sept		277			161
Mar	1981	327			210
Sept		374			247
Mar	1982	400			278
Sept		443			310
Mar	1983	476	89	43	344
Sept		505	100	38	367
Mar	1984	552	107	53	392
Sept		591	109	49	433
Mar	1985	635	116	57	462
Sept		688	127	66	495
Mar	1986	733	135	66	532
Sept		778	141	53	584
Jan	1987	818	143	53	622
Feb		827	143	56	628
Mar		845	144	67	634

2. FA 1980 ALL-EMPLOYEE SAYE-RELATED SHARE OPTION SCHEMES : CUMULATIVE TOTALS

Date		Schemes submitted	Schemes deferred or dropped*	Schemes under consideration	Formally approved
Sept	1980	10			-
Mar	1981	82			22
Sept		142			89
Mar	1982	195			137
Sept		231			184
Mar	1983	267	12	40	215
Sept		308	17	36	255
Mar	1984	362	20	54	288
Sept		439	22	75	342
Mar	1985	516	27	86	403
Sept		573	43	61	469
Mar	1986	622	50	58	514
Sept		676	52	61	563
Jan	1987	709	54	56	599
Feb		719	51	57	611
Mar		728	56	54	618

* This column includes all cases submitted more than 12 months earlier not yet approved.

3. FA 1978 AND 1980 ALL-EMPLOYEE SCHEMES : YEARLY TOTALS

Year to	Schemes submitted	Schemes approved
March 1980	228	117
March 1981	181	115
March 1982	186	183
March 1983	148	144
March 1984	171	121
March 1985	237	185
March 1986	204	181
March 1987	218	206 — a record
	1,573	1,252

4. FA 1984 DISCRETIONARY SHARE OPTION SCHEMES : CUMULATIVE TOTALS

Date	Schemes submitted	Deferred or dropped*	Under consideration	Formally approved
Sept 1984	262	-	-	-
Mar 1985	1,125	7	916	202
Sept	1,649	58	701	890
Mar 1986	2,041	170	418	1,453
Sept	2,483	235	423	1,825
Jan 1987	2,778	258	440	2,080
Feb	2,855	253	456	2,146
Mar	2,959	266	489	2,204

* This column includes all cases submitted more than 12 months earlier not yet approved.

MR 2/56

UNCLASSIFIED

b/f with response (or s/s) [illegible]

FROM: A W KUCZYS

DATE: 27 April 1987

MISS GREEN - IR

cc: PS/CST
PS/FST
PS/EST
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Neilson
PS/IR

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

The Chancellor was grateful for your minute of 24 April.

2. He notes that a record number of all-employee schemes were approved in 1986/87.

3. He has asked whether we know (roughly) how many people are covered (a) by the 1¼ million all-employee schemes, and (b) by the 2¼ million 1984 schemes?

AWK

A W KUCZYS

RT8.88

UNCLASSIFIED

b/f with response (or s/s) (ω)

FROM: A W KUCZYS
DATE: 29 April 1987

MISS GREEN - INLAND REVENUE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Neilson
PS/IR

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

My note of 27 April. The figures of "1¼ million" and "2¼ million" should, of course, have read "1,250" and "2,200" respectively. Apologies.

AWK

A W KUCZYS

Inland Revenue

Policy Division
Somerset House

FROM: D M GREEN
DATE: 29 April 1987

PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

1. You ask in your minute of 27 April whether we know how many individuals are covered by the 1,252 all-employee schemes and 2,204 discretionary schemes approved at the end of 1986-87. ('Millions' in your note is a typing error for 'thousands'.)

2. I am afraid that we cannot at present offer any more up-to-date information than we gave in our minute of 10 March reporting on the position as at the end of 1985-86, ie an estimated 1.5 million employees have benefited under the schemes since 1978. We rely for our data on annual returns submitted to us after the end of the tax year, and it will be some time before we have sufficient returns to produce estimates for 1986-87.

3. We hope to computerise the issuing of returns and reminders this year, so that we should be able to produce these estimates much more promptly than in past years.

D M GREEN

G.T. MANAGEMENT PLC

8th Floor
8 Devonshire Square
London EC2M 4YJ

Telephone 01-283 2575
Telex 886100
Facsimile 01-626 6176

WTJG/gfrm

The Rt. Hon. Sir Keith Joseph Bt., C.H., M.P.,
63, Limerston Street,
London
SW10 OBL

1st May, 1987

Dear Keith.

At our recent meeting I promised that I would write to you on the subject of the attack on the investment trust industry which I believe has some important wider implications.

For over one hundred years the investment trust movement has provided one of the major repositories of savings in this country. It is, in my belief, in many respects the best collective medium of investment forthe long-term private investor since the individual investment trust constitutes a fixed pool of capital, not subject to expansion or shrinkage as with unit trusts, insurance company funds etc. This factor allows the manager to take the long view. He can afford to devote at least part of his portfolio to projects which may take several years to mature. The investment trusts have thus been one of the main sources of funds for venture capital, both for high technology companies and for such enterprises as the development of North Sea oil and, a recent example, the Channel Tunnel. This, I believe, has been a very important element in the work done by investment trusts, for which they are uniquely well suited.

In recent years, however, the investment trust movement has suffered from an erosion of support. The decline in the role of the individual stock holder and the growth of institutional funds and, in particular, the pension funds and insurance companies has led to a continuing decrease in the overall percentage of stocks held by individuals. This, sadly, has persisted despite the efforts of the government to reverse the trend.

According to the Bank of England returns, the private citizen has been a net seller of UK equities in each of the last three years. The effect of this trend has been felt acutely by investment trusts, whose shares have passed steadily from individual hands into those of the institutions. The experience of the Foreign & Colonial Investment Trust, the oldest and one of the largest (over £900 million) is illustrative. I attach a copy of their analysis of ordinary shareholders from which you will see that despite their strenuous and quite successful efforts to attract new individual shareholders, the overall percentage privately held continues to decline. I do not have general figures for the whole investment trust movement but my belief is that the F&C has had a more favourable experience than the average.

Our own recent experience gives an excellent example of what can happen if a major institutional investor takes hostile action. Since 1983 we have been managers of the United States Debenture Corporation, an investment trust with an asset value of about £300 million. Some weeks ago the Water Authorities Superannuation Fund, which had built up a holding of 12% of the equity, requisitioned a meeting to require the directors to "... consider the formulation of arrangements whether by means of unitisation or otherwise whereby the company ceases to continue as an investment trust and whereby the full underlying value of the investments and other assets of the Company be realised to the immediate benefit of the shareholders". This motion was approved by the shareholders owing to the support of most of the institutional investors but against the wishes of the vast majority of individual shareholders. The consequence is that the investment trust will cease to exist and much of the money will be returned to stock holders whether they like it or not. The benefit to the attacker derives from the fact that the USDC, in common with most investment trusts, sold at a substantial discount from its break-up value : on realisation, the discount is minimal.

Since a very large number of the remaining investment trusts have single institutional shareholders which own 10% or more of their equity they are clearly vulnerable to the same sort of procedure as that which has been suffered by the USDC. In fact, there must be very few investment trusts which can regard themselves as being wholly safe from attack and the strong probability is that there will be a continuation of the process of erosion. Although most institutions hesitate to launch an attack, few ofthem fail to join in the game if a trust is under fire : "Willing to wound, and yet afraid to strike".

One defensive measure which would enable investment trusts to have some protection would be to allow them to buy in their own shares. For instance, if in any one year they were to be allowed to buy in up to 10% of their equity, it is likely that discounts would narrow substantially. The Inland Revenue, however, has been adamant in its opposition to this move on the grounds that such a measure would amount to a distribution and should therefore be taxable.

The real problem, however, lies in the greater and greater domination of markets by the pension funds and insurance companies. Recent figures in the Bank of England returns show net flows into life assurance and pension funds running at a rate of over £18 billion a year whereas, as I have already said, private individuals have been net sellers. I believe that this is detrimental and even dangerous for the long term health of the economy. Recent statements by the Governor of the Bank of England and Mr David Walker about the short term nature of many investment decisions taken by instutitonal managers are all too true. Many portfolio managers receive direct incentives to achieve above average short term investment performance which leads them to take quick profits rather than seek long term gain. Furthermore, in the case of many of the large pension funds, the people responsible for their day to day management are inadequately supervised by their trustees, who are often men with little knowledge and experience of investment matters, and, at the same time, they themselves are in many cases people of limited ability and narrow vision. They see their responsibilities as being wholly to the beneficiaries of the funds they manage, to the exclusion of any other interests, such as those of shareholders and employees of the companies in which they invest.

What appears now to be almost entirely missing from the thinking of fund managers is the idea that ownership confers responsibilities and duties. It obviously would be wrong to subject managers to constraints on their ability to trade but in cases where they buy and sell major holdings in companies, the effects on those companies may be very grave. For large pension funds of nationalised industries and the like to be playing ducks and drakes with blocks of shares in this manner seems to me to be an abuse of power and of the trusteeship role under which they are supposedly governed.

Investment trusts have been particular victims of recent trends but my real concern is about the over-mighty institutions.

I am taking the liberty of sending a copy of this to Professor Brian Griffiths, whom I met at the IEA dinner.

Yours ever

Tom

W. T. J. Griffin

Analysis of Ordinary Shareholders

Percentage of Share Capital held by:

31 December	1982	1983	1984	1985	**1986**
Investment Companies	4.0	2.0	3.7	4.9	**5.2**
Insurance Companies	22.5	23.9	23.7	24.0	**23.1**
Other Companies	3.1	5.0	4.0	2.5	**2.3**
Pension Funds	29.7	26.4	26.6	27.6	**24.2**
Universities, Schools and other Corporate Bodies	7.0	7.5	8.2	4.6	**5.2**
Bank and Bank Nominee Companies	7.4	9.1	8.0	11.3	**15.8**
Individuals	26.3	26.1	25.8	25.1	**24.2**
Total	100.0	100.0	100.0	100.0	**100.0**

Number of Shareholders

31 December	1982	1983	1984	1985	**1986**
Investment Companies	34	26	26	32	**30**
Insurance Companies	53	53	56	62	**62**
Other Companies	178	216	183	107	**104**
Pension Funds	115	111	101	107	**92**
Universities, Schools and other Corporate Bodies	130	123	121	115	**126**
Bank and Bank Nominee Companies	243	223	228	222	**268**
Individuals	10,261	10,701	11,219	12,772	**13,832**
Total	11,014	11,453	11,934	13,417	**14,514**

Shareholder Categories

31 December 1986

Category	Number of Holders	Total Holdings Number	Total Holdings Percentage
1-1,000	1,780	949,347	0.2
1,001-5,000	5,340	15,826,201	3.0
5,001-10,000	3,468	25,346,657	4.8
10,001-100,000	3,599	85,790,374	16.3
100,001-500,000	211	49,818,192	9.5
500,001-1,000,000	39	27,674,824	5.3
1,000,001 and over	77	320,118,245	60.9
Total	14,514	525,523,840	100.0

RD11.23

FROM: MISS J L CAMP

DATE: 18 MAY 1987

MR D M GREEN

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

Thank you for your minute of 29 April the contents of which the Chancellor has seen and noted.

Janet Camp

MISS J L CAMP

LISCARTAN HOUSE
127 SLOANE STREET, LONDON SW1X 9BA
TELEPHONE 01-730 0811

From: The Rt.Hon. Sir Keith Joseph, Bt., C.H.

Vorss of Mr Gropper pss. [handwritten annotation]

The Rt.Hon. Nigel Lawson, M.P.,
Chancellor of the Exchequer.

22nd June 1987.

Dear Nigel,

On a recent occasion when we met, Tom Griffin of GT Management spoke to me about his worries concerning the tendency of institutional funds, and in particular pension funds and insurance companies, to absorb investment trusts - a tendency which he believes is damaging to the public interest.

I asked him to write to me explaining his views, and now enclose a self-explanatory letter from him with the enclosure to which he refers.

Would you perhaps be good enough to let me know whether you might be willing to take his views into account?

Yours ever,

Keith

RC6.72

UNCLASSIFIED

B/F

~~29/6~~
~~2/7~~
6/7

FROM: CATHY RYDING
DATE: 25 June 1987

MR CROPPER

LETTER FROM SIR KEITH JOSEPH

... I attach a letter the Chancellor has received from Sir Keith Joseph. The Chancellor would be grateful for your views.

CR

CATHY RYDING

LISCARTAN HOUSE
127 SLOANE STREET, LONDON SW1X 9BA
TELEPHONE 01-730 0811

From: The Rt.Hon. Sir Keith Joseph, Bt., C.H.

Views of Mr Cropper pse.

The Rt.Hon. Nigel Lawson, M.P.,
Chancellor of the Exchequer.

22nd June 1987.

Dear Nigel,

On a recent occasion when we met, Tom Griffin of GT Management spoke to me about his worries concerning the tendency of institutional funds, and in particular pension funds and insurance companies, to absorb investment trusts - a tendency which he believes is damaging to the public interest.

I asked him to write to me explaining his views, and now enclose a self-explanatory letter from him with the enclosure to which he refers.

Would you perhaps be good enough to let me know whether you might be willing to take his views into account?

Yours ever,

Keith

G.T. MANAGEMENT PLC

8th Floor
8 Devonshire Square
London EC2M 4YJ

Telephone 01-283 2575
Telex 886100
Facsimile 01-626 6176

WTJG/gfrm

The Rt. Hon. Sir Keith Joseph Bt., C.H., M.P.,
63, Limerston Street,
London
SW10 OBL

1st May, 1987

Dear Keith.

At our recent meeting I promised that I would write to you on the subject of the attack on the investment trust industry which I believe has some important wider implications.

For over one hundred years the investment trust movement has provided one of the major repositories of savings in this country. It is, in my belief, in many respects the best collective medium of investment forthe long-term private investor since the individual investment trust constitutes a fixed pool of capital, not subject to expansion or shrinkage as with unit trusts, insurance company funds etc. This factor allows the manager to take the long view. He can afford to devote at least part of his portfolio to projects which may take several years to mature. The investment trusts have thus been one of the main sources of funds for venture capital, both for high technology companies and for such enterprises as the development of North Sea oil and, a recent example, the Channel Tunnel. This, I believe, has been a very important element in the work done by investment trusts, for which they are uniquely well suited.

In recent years, however, the investment trust movement has suffered from an erosion of support. The decline in the role of the individual stock holder and the growth of institutional funds and, in particular, the pension funds and insurance companies has led to a continuing decrease in the overall percentage of stocks held by individuals. This, sadly, has persisted despite the efforts of the government to reverse the trend.

According to the Bank of England returns, the private citizen has been a net seller of UK equities in each of the last three years. The effect of this trend has been felt acutely by investment trusts, whose shares have passed steadily from individual hands into those of the institutions. The experience of the Foreign & Colonial Investment Trust, the oldest and one of the largest (over £900 million) is illustrative. I attach a copy of their analysis of ordinary shareholders from which you will see that despite their strenuous and quite successful efforts to attract new individual shareholders, the overall percentage privately held continues to decline. I do not have general figures for the whole investment trust movement but my belief is that the F&C has had a more favourable experience than the average.

Our own recent experience gives an excellent example of what can happen if a major institutional investor takes hostile action. Since 1983 we have been managers of the United States Debenture Corporation, an investment trust with an asset value of about £300 million. Some weeks ago the Water Authorities Superannuation Fund, which had built up a holding of 12% of the equity, requisitioned a meeting to require the directors to "... consider the formulation of arrangements whether by means of unitisation or otherwise whereby the company ceases to continue as an investment trust and whereby the full underlying value of the investments and other assets of the Company be realised to the immediate benefit of the shareholders". This motion was approved by the shareholders owing to the support of most of the institutional investors but against the wishes of the vast majority of individual shareholders. The consequence is that the investment trust will cease to exist and much of the money will be returned to stock holders whether they like it or not. The benefit to the attacker derives from the fact that the USDC, in common with most investment trusts, sold at a substantial discount from its break-up value : on realisation, the discount is minimal.

Since a very large number of the remaining investment trusts have single institutional shareholders which own 10% or more of their equity they are clearly vulnerable to the same sort of procedure as that which has been suffered by the USDC. In fact, there must be very few investment trusts which can regard themselves as being wholly safe from attack and the strong probability is that there will be a continuation of the process of erosion. Although most institutions hesitate to launch an attack, few ofthem fail to join in the game if a trust is under fire : "Willing to wound, and yet afraid to strike".

One defensive measure which would enable investment trusts to have some protection would be to allow them to buy in their own shares. For instance, if in any one year they were to be allowed to buy in up to 10% of their equity, it is likely that discounts would narrow substantially. The Inland Revenue, however, has been adamant in its opposition to this move on the grounds that such a measure would amount to a distribution and should therefore be taxable.

The real problem, however, lies in the greater and greater domination of markets by the pension funds and insurance companies. Recent figures in the Bank of England returns show net flows into life assurance and pension funds running at a rate of over £18 billion a year whereas, as I have already said, private individuals have been net sellers. I believe that this is detrimental and even dangerous for the long term health of the economy. Recent statements by the Governor of the Bank of England and Mr David Walker about the short term nature of many investment decisions taken by instutitonal managers are all too true. Many portfolio managers receive direct incentives to achieve above average short term investment performance which leads them to take quick profits rather than seek long term gain. Furthermore, in the case of many of the large pension funds, the people responsible for their day to day management are inadequately supervised by their trustees, who are often men with little knowledge and experience of investment matters, and, at the same time, they themselves are in many cases people of limited ability and narrow vision. They see their responsibilities as being wholly to the beneficiaries of the funds they manage, to the exclusion of any other interests, such as those of shareholders and employees of the companies in which they invest.

What appears now to be almost entirely missing from the thinking of fund managers is the idea that ownership confers responsibilities and duties. It obviously would be wrong to subject managers to constraints on their ability to trade but in cases where they buy and sell major holdings in companies, the effects on those companies may be very grave. For large pension funds of nationalised industries and the like to be playing ducks and drakes with blocks of shares in this manner seems to me to be an abuse of power and of the trusteeship role under which they are supposedly governed.

Investment trusts have been particular victims of recent trends but my real concern is about the over-mighty institutions.

I am taking the liberty of sending a copy of this to Professor Brian Griffiths, whom I met at the IEA dinner.

Yours ever

Tom

W. T. J. Griffin

Analysis of Ordinary Shareholders

Percentage of Share Capital held by:

31 December	1982	1983	1984	1985	1986
Investment Companies	4.0	2.0	3.7	4.9	**5.2**
Insurance Companies	22.5	23.9	23.7	24.0	**23.1**
Other Companies	3.1	5.0	4.0	2.5	**2.3**
Pension Funds	29.7	26.4	26.6	27.6	**24.2**
Universities, Schools and other Corporate Bodies	7.0	7.5	8.2	4.6	**5.2**
Bank and Bank Nominee Companies	7.4	9.1	8.0	11.3	**15.8**
Individuals	26.3	26.1	25.8	25.1	**24.2**
Total	100.0	100.0	100.0	100.0	**100.0**

Number of Shareholders

31 December	1982	1983	1984	1985	1986
Investment Companies	34	26	26	32	**30**
Insurance Companies	53	53	56	62	**62**
Other Companies	178	216	183	107	**104**
Pension Funds	115	111	101	107	**92**
Universities, Schools and other Corporate Bodies	130	123	121	115	**126**
Bank and Bank Nominee Companies	243	223	228	222	**268**
Individuals	10,261	10,701	11,219	12,772	**13,832**
Total	11,014	11,453	11,934	13,417	**14,514**

Shareholder Categories

31 December 1986

Category	Number of Holders	Total Holdings Number	Total Holdings Percentage
1-1,000	1,780	949,347	0.2
1,001-5,000	5,340	15,826,201	3.0
5,001-10,000	3,468	25,346,657	4.8
10,001-100,000	3,599	85,790,374	16.3
100,001-500,000	211	49,818,192	9.5
500,001-1,000,000	39	27,674,824	5.3
1,000,001 and over	77	320,118,245	60.9
Total	14,514	525,523,840	100.0

3980/28

C/ Letter to issue?

OK M J. CR 3/7

FROM: P J CROPPER
DATE: 3 July 1987

CHANCELLOR

LETTER FROM SIR KEITH JOSEPH

I have asked for Inland Revenue advice on the narrow question whether anything could be done to make it easier for Investment Trusts to buy in their own shares. A draft holding reply to Keith Joseph is attached. On the broader issues:

1. **The Over-Mighty Institutions**. I think we all share Griffin's concern about the concentration of power in the hands of the big institutions. I am not so sure which side of the fence I would place investment trusts: for the purpose of PEPs we lumped them in with unit trusts. But for the sake of this argument I think we can accept Griffin's thesis that a share in an investment trust is not quite as impersonal and indirect an investment as a share in a pension fund portfolio.

In any case, we can certainly claim to have used the recent privatisation issues as an opportunity to create far more individual personal shareholders than anyone would have thought possible eight years ago.

Myself I am a little dubious about the validity of the argument that most modern fund managers "see their responsibilities as being wholly to the beneficiaries of the funds they manage, to the exclusion of any other interests, such as those of shareholders and employees of the companies in which they invest". If I buy shares in Foreign and Colonial Investment Trust I expect the management to maximise my return - not go around the place doing good. Even when it comes to the short term/long term argument, my inclination as an investor is to regard the long term as being a whole lot of short terms laid end to end. Perhaps I was corrupted by too long in the

City! I fear that one of the reasons why investment trust shares stand at a discount to asset value may be that their directors are too often thought of as gents.

2. **Why Investment Trust shares stand at a discount.** Apart from the not too serious point just made, I think we have to look mainly at Supply and Demand for an answer. Why will people pay more for a given basket of shares held directly, than they are prepared to pay for the same basket of shares held indirectly? Is it that the "skilled management" which they get when they buy an investment trust share is actually worth a negative amount of money? Is it that too many investment trust shares were issued before 1955 (when rising interest rates began to make it difficult to gear up an equity portfolio by issuing loan stock) and the surfeit has still not been absorbed? Is it that unit trusts have just as many advantages as investment trusts, plus the added advantage of being encashable at asset value?

I doubt very much whether enabling investment trusts to buy in their own shares would eliminate the discount to asset value. Just as likely, we would end up with most trusts becoming so small as to be unable to support the necessary costs of management, administration and compliance. But we will look at that when we have heard from the Revenue.

3. **Summary.** In short, one can well understand the angst of GT Management when the Water Authorities moved in to break up the US Debenture Corporation. But I am really not sure that we can do much for them. If more and more investment trust stock is passing into the hands of banks and bank nominee companies, en route to the breakers yard, that is the way things are.

Having said all this, and if you were to agree with me, would you want to make sympathetic noises to Keith Joseph, or give him the hard nosed truth? Or a judicious blend? I would have thought it might be better in the long run for Griffin

to get the truth, ie that HMG cannot suggest any way of strengthening his position against the predators, and he had better face up to the fact that investment trusts are not at present a growth industry.

P J CROPPER

DRAFT REPLY TO SIR KEITH JOSEPH

Thank you for letting me see Tom Griffin's interesting letter about the problems of the investment trust managers.

I have asked the Inland Revenue to look at the argument about allowing investment trusts to buy in their own shares, and will write again shortly on this specific point.

I will certainly take into account his concern that the favourable fiscal treatment of pension funds and life assurance companies is not in the public interest. Meanwhile,

P J C
3/7/87

RC2.4

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

6 July 1987

The Rt. Hon. Sir Keith Joseph Bt CH
Liscartan House
127 Sloane Street
LONDON
SW1X 9BA

Dear Keith

Thank you for letting me see Tom Griffin's interesting letter about the problems of the investment trust managers.

I will certainly take into account his considered view that the favourable fiscal treatment of pension funds and life assurance companies is not in the public interest. Meanwhile, I have asked the Inland Revenue to look at the argument about allowing investment trusts to buy in their own shares, and will write again shortly on this specific point.

Yours
Nigel

NIGEL LAWSON

Inland Revenue

Policy Division
Somerset House

FROM: D M GREEN

DATE: 6 July 1987

PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

1. My minute of 24 April reported on the take-up of approved employee share schemes up to 31 March 1987. The attached Annex shows the position at 30 June 1987.

2. Of the 559 1984 schemes shown in table 4 as 'under consideration ' at the end of June, around seven eighths had already received their preliminary examination by the Revenue. Of the 273 1984 applications over 12 months old and listed as 'deferred or dropped', correspondence between the Revenue and the applicants is still in fact continuing on over 140.

D M GREEN

c PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Lord
Mr Neilson
Mr Lewis
Mr Lawrance
Mr Beighton
Mr German
Mr Willmer
Mr Peel
Mrs Eaton
Miss Dougharty
Miss Green
PS/IR

ANNEX A

1. FA 1978 ALL-EMPLOYEE PROFIT SHARING SCHEMES : CUMULATIVE TOTALS

Date	Schemes submitted	Schemes deferred or dropped*	Schemes under consideration	Formally approved
March 1979	96			3
Sept	161			43
March 1980	228			117
Sept	277			161
March 1981	327			210
Sept	374			247
March 1982	400			278
Sept	443			310
March 1983	476	89	43	344
Sept	505	100	38	367
March 1984	552	107	53	392
Sept	591	109	49	433
March 1985	635	116	57	462
Sept	688	127	66	495
March 1986	733	135	66	532
Sept	778	141	53	584
March 1987	845	144	67	634
April 1987	860	145	74	641
May	867	146	76	645
June	887	147	74	666

2. FA 1980 ALL-EMPLOYEE SAYE-RELATED SHARE OPTION SCHEMES : CUMULATIVE TOTALS

Date	Schemes submitted	Schemes deferred or dropped*	Schemes under consideration	Formally approved
Sept 1980	10			-
March 1981	82			22
Sept	142			89
March 1982	195			137
Sept	231			184
March 1983	267	12	40	215
Sept	308	17	36	255
March 1984	362	20	54	288
Sept	439	22	75	342
March 1985	516	27	86	403
Sept	573	43	61	469
March 1986	622	50	58	514
Sept	676	52	61	563
March 1987	728	56	54	618
April 1987	741	57	60	624
May	754	60	59	635
June	762	58	57	647

* This column includes all cases submitted more than 12 months earlier not yet approved.

3. FA 1978 AND 1980 ALL-EMPLOYEE SCHEMES : YEARLY TOTALS

Year to	Schemes submitted	Schemes approved
June 1979	131	29
June 1980	122	117
June 1981	225	130
June 1982	157	187
June 1983	143	128
June 1984	197	125
June 1985	227	207
June 1986	201	180
June 1987	246	210
	1,649	1,313

4. FA 1984 DISCRETIONARY SHARE OPTION SCHEMES : CUMULATIVE TOTALS

Date	Schemes submitted	Deferred or dropped*	Under consideration	Formally approved
Sept 1984	262	-	-	-
March 1985	1,125	7	916	202
Sept	1,649	58	701	890
March 1986	2,041	170	418	1,453
Sept	2,483	235	423	1,825
March 1987	2,959	266	489	2,204
April 1987	3,061	271	534	2,256
May	3,139	264	557	2,318
June	3,229	273	559	2,397

* This column includes all cases submitted more than 12 months earlier not yet approved.

RT4.88 UNCLASSIFIED

b/f with response

FROM: A W KUCZYS
DATE: 13 July 1987

MISS GREEN - INLAND REVENUE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Neilson
Miss Simpson
Mr Cropper
Mr Tyrie
PS/IR

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

The Chancellor was most grateful for your minute of 6 July (not copied to Miss Simpson).

2. He assumes the latest figures - some 1300 all employees schemes and 2,400 share option schemes - will feature in the TWEB. Please could Miss Simpson confirm this?

A W KUCZYS

Inland Revenue

Policy Division
Somerset House

FROM: M PRESCOTT
DATE: 16 JUNE 1987

1. MR LEWIS

2. FINANCIAL SECRETARY

PRIVATISATION OF BRITISH AIRPORTS AUTHORITY (BAA): TAX TREATMENT OF EMPLOYEE SHARES

1. A problem has arisen concerning a possible liability to income tax that may be incurred by the BAA employees in respect of certain of the shares they acquire under the proposed privatisation. The matter needs to be resolved urgently - the "Pathfinder" for the offer has to be finalised by Thursday night.

BACKGROUND

2. In previous privatisations in recent years, the flotation was solely by way of an offer for sale at a fixed price, whereas in the case of BAA up to 25% will be by way of tender. The fixed offer price will be the same as the minimum tender price, and in addition to a free offer of shares - which need not concern us here - the employees will get

(a) a matching offer of 2 free shares for every one share purchased at the fixed offer for sale price (subject to a limit), and

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cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Mr Monck
Mr D J L Moore
Mr Colman
Miss Sinclair
Mr Isaac
Mr Lewis
Mr Beighton
Mr Easton
Mr German
Mr Reed
Mr Prescott
Mr Peel
Miss Green
PS/IR

(b) priority in the fixed offer of up to £10,000 worth of shares (at the fixed offer for sale price). The priority offer is subject to a maximum of 5% of the offered shares.

The key question is whether in these circumstances the fixed offer for sale price could be regarded as the true value of the shares at the time of acquisition. If it was less than the true value, the employees would in that capacity have received shares at undervalue and under the normal rules of Schedule E that undervalue would be taxable as income.

3. It is common when floating a company by a <u>tender offer</u> to allow the employees to apply for shares at a price fixed before the outcome of tendering is known, perhaps at the minimum tendering price. The striking price would normally be higher, and so the employees will acquire their shares for a lower price than members of the public. It is well established case law, confirmed by a decision of the House of Lords, that there is Schedule E liability on any such difference between an amount reflecting the (higher) striking price paid by the public and the (lower) price actually paid by the employees.

4. It is also usual when floating a company by <u>a fixed price offer</u> to reserve for the employees a proportion of the available shares for which they can apply at the same price as members of the public. Since the employees acquire their shares at the same price as members of the public, it has long been Inland Revenue practice not to seek a Schedule E charge.

5. However, this practice evolved at a time when substantial over-subscription was rare, and so the fact that the employees were able to buy more shares than members of the public was not all that significant. But recent flotations have shown that the benefit of a priority allocation can be very valuable indeed, and it can be argued that these windfall profits in the case of a fixed price offer are - and should be - chargeable under Schedule E in the same way as shares acquired at

undervalue in the case of a tender offer. (On the other hand, it cannot be assumed that the bull market will last for ever or that stags will always make a profit). Indeed, the Revenue's practice hitherto of not seeking a charge is now beginning to be questioned by informed commentators.

6. The problem is brought into sharper relief in the BAA case because this will be a hybrid scheme, involving an offer by tender as well as a fixed price offer (and a substantial element of pre-placing at the fixed price less the commission). As a result, and on the assumption that the offer as a whole is over-subscribed, the employees will in effect be able to buy at the fixed offer price quantities of shares which members of the public could only obtain under the tender offer at a higher price; or as priority applicants at, in effect, a lower one. The advice from our Solicitor is that the Courts might well hold that, in these circumstances and on the authority of the case law mentioned above, the employees had indeed received a benefit taxable as an emolument under Schedule E. (Quantification of the charge itself would then, broadly, depend on the difference between the "market value" of the shares on acquisition - having regard amongst other things to the prices offered in the tender - and the price paid for them).

COMMENT

7. Having reviewed the matter carefully, we believe that on balance we would be justified in not seeking a charge in the BAA case, having regard also to the fact that we are now at a very advanced stage of the timetable. That, by definition, resolves the problem so far as BAA is concerned.

8. The main reason for this is that though there will be a partial tender element, this will still be primarily a fixed price offer (at least 75%) and our practice hitherto in respect of such offers has not been to seek a charge. Moreover, the tender element does not of itself change in any way the

benefits received by the employees by comparison with a more conventional fixed-price flotation. Furthermore, while - as indicated below and in the light of our Solicitor's advice - we obviously do need to review our practice for the future, it would be unreasonable to do so without first having given a fair degree of advance warning.

9. As I say, however, we clearly do now need to review our practice for the future. We need to look particularly at the position where the flotation involves a partial tender offer, but also at the position with fixed price offers especially as regards those that are structured from the very outset to give the employees not just a priority allocation, but also a sizeable premium benefit. We shall of course report to you further on this, in due course.

M. Prescott

M PRESCOTT

CONFIDENTIAL

FROM: Ms P M LEAHY
DATE: 16 JULY 1987

1. MR D J L MOORE

2. FINANCIAL SECRETARY

cc: Chancellor
Chief Secretary
Paymaster-General
Economic Secretary
Sir Peter.Middleton
Mr F E R Butler
Mr Monck
Mrs M E Brown
Mr Lyne
Ms Sinclair
Mr Bent
Ms Huleatt-James
Mr S B Johnson
Mr Cropper
Mr Prescott) - IR.
Mr J Reed)

LEAHY to FST 16/7

BP SALE:
SPECIAL PROVISION FOR EMPLOYEES

This submission asks for your agreement to our proposed approach to provision for BP employees in the sale.

Background

2. In previous Government secondary sales employees have received priority in allocation but not free shares, matching shares etc. In the last BP sale employees were entitled to priority in allocation for up to 250 shares (worth about £1,000 at the minimum tender price). In the 1985 Britoil and Cable & Wireless sales UK employees were given priority in allocation for shares worth about £25,000.

BP's Proposals

3. BP proposed that all employees (including overseas employees) who are also shareholders should receive priority in allocation for up to 1,000 shares at the UK fixed price. Officials see no problems in this principle for overseas employees (subject to BP sorting out the overseas securities law problems). But we will want to consider putting an overall limit on the number of shares available for priority

allocation. We also think it is premature to go firm now on the number of shares for which they receive priority. (It would be unfortunate if American shareholders were getting 1000 shares and our UK Sids had to be cut back to much less [NL]).

4. We do however see problems with the principle for UK employees as the Government's policy is to encourage and extend employee shareownership in the UK. BP explained that they have given their employees every encouragement already to own BP shares and about 75% of them already do so. They did not believe the other 25% could ever be persuaded. Officials are not convinced. Our marketing campaign is designed to encourage people who have never owned shares before to apply and it would be surprising if this did not affect some BP employees at least. We have therefore said at official level that we would prefer all UK employees to be given priority in allocation.

5. As you are aware there is however a possible tax problem as Inland Revenue concluded just before the BAA sale that priority allocation to employees solely because they were employees could probably be considered a taxable benefit. We understand that Inland Revenue are about to submit to you on this matter bearing in mind the implications for the BP sale and other Government share sales.

6. Sir Peter Walters has said he would very much like to be able to say that overseas employee shareholders were to be given priority in allocation when he is in the US next week and talking to Standard Oil employees. Tactically in the overall context of the sale it would be helpful to be able to let him do so. However it would not be practicable to announce priority for overseas employees without saying anything about provision for UK employees. BP have now said that if a full assurance cannot be given yet, it would be helpful to Sir Peter Walters if he could say in the US that although it was too early to have settled decisions on special provisions for employees he thinks it likely that priority in allocation will be given to overseas employee shareholders.

Conclusion

7. We would be grateful for confirmation that you are content for:

(i) overseas employee shareholders to be given priority in allocation;

(ii) all UK employees to be given priority provided the tax problems can be sorted out;

(iii) that we should tell BP **before the weekend** that Sir Peter Walters can say what provisions for overseas employees he expects to be made in the sale next week when he is in the US.

P M LEAHY

[Updated to 16/7/87]

REVIEW OF SECTION 79 FA 1972

RESPONSES TO CONSULTATIVE DOCUMENT

SUMMARY OF MAIN POINTS

GENERAL

Welcome decision to review S.79	General
Hope/assume further consultative document, with draft clauses, will be published.	NBS Consultants Ltd Clement Keys Neville Russell CACA

BROAD ATTITUDES TO S.79

Ideally should be scrapped altogether (hostile tax regime, discouraging employee share ownership, no longer appropriate); failing that, radical review.	Stoy Hayward NBS Consultants Ltd Neville Russell BVCA
Explicitly accept need for some anti-avoidance provisions in this area, but strong reservations about scope/complexity etc of present S.79.	Pannell Kerr CIMA IOT Clement Keys ICAEW CACA IPM Law Society Save and Prosper CBI

ALTERNATIVE APPROACHES NOT MENTIONED IN CONSULTATIVE DOCUMENT

Replace S.79 with charge on whole of market value at time of acquisition, but with charge abated on a sliding scale where shares held for longer than minimum holding period applicable to approved schemes.	Stoy Hayward
Charge income tax on gain in all cases at special rate, say 45%; or else charge half gain to income tax and half to CGT; or charge CGT rather than IT where shares held for at least say 10 years.	ICAEW
Other anti-avoidance legislation, especially S.460 ICTA, might form basis of any provisions to counter objectionable devices.	Neville Russell

[illegible]SSIBILITY OF MOTIVE/CLEARANCE PROCEDURE

Opposed

Motive test would be unsatisfactory/ capricious/uncertain.	Gunson Law Soc. of Scotland
Any anti-avoidance provisions must be certain, not based on Revenue discretion.	Stoy Hayward CIMA
Motive test would be unworkable.	ICAS
Motive test undesirable; though formal advance clearance procedure might help reduce uncertainty for companies.	Ernst Whinney
Motive test would involve administrative difficulties for Revenue and taxpayer; if Revenue given wider discretion, taxpayer loses protection of having clear, statutory guidelines as to liability.	BBA

Qualified Support

Wrong to reject motive test purely on grounds of operational difficulties/ compliance cost. Might be preferable if only alternative involved catching innocent cases as well. Might be necessary to deal with subsidiaries' problem.	IOT CACA
Motive test may be needed to identify transactions leading to "artificial" growth in value.	Clement Keys
Motive test, with clearance procedure, might be used to deal with value shifting in case of special classes of shares in <u>parent</u> company (but not in case of subsidiaries, where this approach would not work). Publication of guidelines by Revenue would help reduce uncertainty for taxpayers.	ICAEW
Despite practical problems/compliance costs of motive test, should be possible for individuals to appeal against assessments "on grounds that transaction was not motivated by avoidance".	CBI
Anti-avoidance function of S.79 might be achieved by adopting <u>Ramsay</u> formula, enabling Revenue to ignore certain transactions.	Gunson

ALTERNATIVE BASIS OF CHARGE

General

- Wrong to tax "genuine" and not just "artificial" growth in value.	General

Immediate tax charge for restricted shares

Outside subsidiary situation, replace (perhaps at employee's election) growth in value charge with a charge at time of acquisition on difference between value of shares without restrictions and amount paid;	NBS Consultants Ltd Clement Keys Ernst Whinney Pinsent ICAEW ICAS IPM CACA BBA Law Society CBI BVCA
- with facility to defer payment or to pay by instalments	IOT Clement Keys Ernst Whinney ICAS Law Soc. of Scotland
- with "top-slicing" relief for payment of such a charge	IOT Clement Keys Ernst Whinney CBI
Means should also be found of valuing "geared" shares (ie those with preferential rights).	NBS Consultants Ltd Ernst Whinney Law Society
No point in allowing election for immediate tax charge: would merely duplicate S.181 ICTA and S.67 FA 76.	Stoy Hayward

VALUE SHIFTING AFTER ACQUISITION IN CASE OF SPECIAL CLASSES OF SHARES

Base any income tax charge on comparison between respective growths in value of employee and non-employee held shares - perhaps on basis of certificate from accountant.	NBS Consultants Ltd
Tax should be charged in respect of restrictions only if these are actually lifted and such lifting affects share price.	IPM
Perhaps tackle by something on lines of value shifting provisions in CGT legislation; tax should be charged only where value increases due to "specific	Law Society

[illegible]ions" affecting rights of shares or intended to increase value disproportionately.

GROWTH IN VALUE CHARGE AT 7-YEAR POINT

7-year period for charging tax should be reduced.	IOT Clement Keys
Wrong to charge tax at 7-year point unless shares actually sold.	ICAEW
Where charge arises other than on actual disposal of shares, employee should be able to elect to pay by instalments.	CBI

SUBSIDIARIES

General

Shares of subsidiary companies should be exempt from S.79 [no specific suggestions as to how this might be achieved].	Linskell Turnbull Dolton CACA CBI Law Soc. of Scotland
Legislation ought to be targeted on cases involving actual abuse.	IOT Ernst Whinney
Illogical that S.79 does not provide specific exemptions in case of subsidiaries of quoted parents (cf approved scheme legislation).	NBS Consultants Ltd Ernst Whinney
Anti-avoidance provisions should be framed so that tax only charged where "specific actions" intended to increase value of shares disproportionately.	Law Society

Specific proposals

S.79 not to apply where all major subsidiaries in the group offer shares to employees and where agreed basis of valuation is used consistently each year (alternatively allow use of shares of unquoted subsidiaries in approved schemes with above safeguards, or where at least 25% of parent's shares held by quoted companies).	Rothschild
Extend the "majority"/"control" tests so that Revenue could "look through" shareholdings of subsidiary, in deciding which were "available shares" (cf FA 1972 provisions for apportionment of income of close company).	Stoy Hayward

S.79 not to apply where (a) employee-acquired shares subject to same dividend and winding-up rights as those held by parent (b) employees not members of/related to the family controlling parent (c) percentage of shares acquired by employees not more than say 25%.	Pannell Kerr
S.79 not to apply where full-time employees acquire fully paid shares (perhaps subject to pre-emption restrictions) and where (a) subsidiary has only 1 class of ordinary shares (b) employee holds shares for say 2 years and (c) does not receive more than market value at disposal.	Pinsent
S.79 not to apply where shares unrestricted and company is sole trading subsidiary of pure holding company.	Buzzacott
Adopt "broad brush" approach eg S.79 not to apply where (a) subsidiary has not been party to intra-group transactions and none of its costs borne by another member of group and, (b) auditors certify subsidiary has traded on arm's length basis each year.	ICAEW
S.79 to apply only where shares restricted, or where company was an unquoted subsidiary of unquoted parent.	ICAS
Exempt acquisitions in companies incorporated to carry on new business, providing not owned as to more than 75% by existing companies; and where employees (along with other parties investing) acquire controlling stake from parent (S.79 to continue to apply where minority stake acquired and company remains subsidiary of parent).	BBA
Exempt acquisitions where the individual's "entrepreneurial talents" are essential to operation of the subsidiary.	IPM
S.79 not to apply where effective management and control of subsidiary exercised by own board rather than parent, where reasonably active market in its shares, and where valuation formula agreed with Revenue.	Save and Prosper

NAGEMENT BUY-OUTS

Complex, awkward structures have to be adopted to avoid charge; preferable to remove buy-outs altogether from ambit of S.79.	Stoy Hayward IOT CACA Ernst Whinney
S.79(1) not to apply where shares acquired through buy-out by an employee qua entrepreneur.	ICAEW
Gearing techniques, so that executives receive accelerated growth in value, should be encouraged for political reasons.	NBS Consultants Ltd
Income tax should not be charged where value of employees' shares rises due to terms on which institutions' shares acquired; "marriage of expertise and finance bound to create value by itself".	ICAS
Revenue should issue Statement of Practice about how S.79 applies to buy-outs involving "Newco".	IOT
Present rules applying to buy-outs should be relaxed.	CBI

"CAPACITY" TEST

S.79 not to apply where employees acquire shares in "entrepreneurial role".	IOT CACA
If basis of charge not amended so as to catch only "artificial" growth in value, S.79(1) should be amended to exclude cases where shares acquired by promoters/entrepreneurs.	Clement Keys
Amend S.79(1) to exclude genuine promoters/entrepreneurs, perhaps by rewording capacity test to read "wholly or mainly because he is an employee".	ICAS
Revenue should operate clearance procedure as to whether individual acquires shares qua entrepreneur.	CBI
S.79(1) should be amended to exclude all share acquisitions in company incorporated to carry on new business (other than "75% subsidiaries" of existing companies).	BBA

[illegible]ght to be proper definition of "founder", to embrace all those with entrepreneurial role, including in subsidiaries.	IPM
Revenue's view of what is within S.79(1) "exceedingly restrictive".	Neville Russell
Revenue should issue Statement of Practice explaining how S.79(1) is applied.	IOT Clement Keys Pinsent

DEALING WITH ABUSE OF "MOMENT IN TIME" LOOPHOLE (CONSULTATIVE DOCUMENT, PARAGRAPH 18)

No case for imposing 2-year or other "quarantine period" for purposes of S.79(2)(c) exemption tests; might inhibit commercial policy of company and cause uncertainty.	Stoy Hayward CBI
"Quarantine period" would add to uncertainty, complexity; query whether extent of abuse would justify it.	IOT
No case for any "quarantine period".	Clement Keys ICAEW
Imposing "quarantine period" would worsen problems in certain cases, eg where there are minor restrictions not materially affecting share value.	ICAS
2 year "quarantine period" would be better approach to "moment in time" problem than alternative proposed in Consultative Document (ie targeting on particular types of arrangement).	Law Soc. of Scotland
Meaning of "immediately after" in S.79(2)(c) tests should be clarified, so that clear whether Revenue would invoke Ramsay doctrine where matters temporarily arranged so as to secure exemption.	Pinsent

MISCELLANEOUS

S.79(7) charge might be subsumed in FA 1976 legislation.	NBS Consultants Ltd Ernst Whinney
S.79 should contain de minimis rule for small growths in value.	Pinsent
Ought to be formal clearance procedure at local level for S.79 matters.	IOT

[Updated to 16/7/87]

REVIEW OF S.79 FA 1972: RESPONSES TO CONSULTATIVE DOCUMENT

1. H H Linskell Esq
2. David Gunson Esq (Company Director, Hong Kong)
3. Hunting Gate Group Ltd
4. N M Rothschild & Sons Ltd
5. N T Dolton Esq (Director, Sawards Advertising Ltd)
6. Stoy Hayward (Accountants)
7. Pannell Kerr Forster (Chartered Accountants)
8. Chartered Institute of Management Accountants
9. New Bridge Street Consultants Ltd
10. Institute of Taxation
11. Clement Keys & Co (Birmingham District ICAEW)
12. Ernst & Whinney (Chartered Accountants)
13. Pinsent & Co (Solicitors)
14. Buzzacott & Co (Accountants)
15. ICAEW
16. ICAS

15\. Neville Russell (Accountants)

18. Institute of Personnel Management
19. Chartered Association of Certified Accountants
20. British Bankers' Association
21. Law Society
22. Save and Prosper Group Ltd
23. CBI
24. Law Society of Scotland
25. British Venture Capital Association

REVIEW OF SECTION 79 FINANCE ACT 1972 - NOTE BY THE INFORMAL WORKING GROUP ASSISTING WITH THE REVIEW

INTRODUCTION

1. The review into the scope for simplifying and improving S.79, consistent with its underlying purpose, was undertaken by the Inland Revenue with the assistance of a small informal group of outside practitioners who have expertise in this area. A list of members of the Group is attached. The emphasis was on informality, with the practitioners participating in an essentially private and personal capacity.

2. The Group agreed that it should try to produce some agreed analysis of the problems and the possible options for dealing with them, taking account also of the formal responses to the Consultative Document, in the light of which the Revenue would be better placed to advise Ministers on any possible changes. This note summarises the Group's discussions and consideration of the issues. The Group felt that a note on these lines was more appropriate than a formal report with recommendations. While the Note reflects the views of the Group as a whole there were inevitably differences in emphasis between members on particular points.

SUMMARY

3. The Group concluded that the need for provisions to deter abuse in this area remained, and that the provisions should continue to apply as at present in all cases where shares were acquired by employees in that capacity and outside an approved scheme. However, while the present, "special benefits" charge in S.79(7) could be left as it was, there was a strong case for replacing the main - growth in value - charge altogether with a much more narrowly target charge. The Group developed two alternative proposals to this end and considered a number of related matters. The Group also agreed that the present

provisions could cause genuine difficulties where the shares were those in a subsidiary company, but that any solution needed to include adequate safeguards against the extra opportunities for abuse that also existed in such cases. The aim should be to help subsidiaries that were essentially "stand alone" and whose transactions with other group companies were on an arm's length basis. The Group developed a possible solution on these lines, based on self certification by companies with supporting auditor's reports.

UNDERLYING PURPOSE OF THE PROVISIONS

4. Section 79 brings in to income tax certain benefits relating to shares acquired by employees in that capacity and outside an approved scheme. The main - growth in value - charge applies to employee-acquired shares whose value is capable of being artificially manipulated to the benefit of the employees, either because the shares are subject to certain restrictions or because they are of a class that is not widely available other than to the employees. A second charge applies to various other special benefits which employee shareholders might receive from the company in respect of their shares, and which for various reasons would not otherwise be within the normal charge to income tax. In both cases, S.79 is founded on the view that these benefits are in reality part of the emoluments of the individual's office or employment, akin to his other remuneration, and that they should be taxed as income accordingly.

5. The Group agreed that some form of anti-avoidance provision in this area clearly was necessary. Without this, there would undoubtedly be considerable scope for employers to pass to their employees what in reality was remuneration, free of income tax, using these kinds of special or restricted shares. Most of the formal responses to the Consultative Document had also accepted this, implicitly if not explicitly.

6. It was true that S.79 had originally been introduced at the same time as the 1972 code for "approved share incentive schemes" and that code had subsequently been repealed. But the Group considered that too much significance should not be attached to this; the fact was that though S.79 stood alongside the approved schemes, it was independent of them and remained necessary in its own right.

7. It was also true that S.79 had been introduced at time when the rates of income tax were higher than they were now and when, therefore, there was a greater incentive to try to convert income to capital using this kind of scheme. The fact remained, however, that there was still a substantial differential between the rates of tax on income and on capital gain - having regard also to effective and not just to nominal rates. On the other hand, if there was further significant lowering in the rates of income tax then, of course, the need for anti-avoidance provisions would be reduced accordingly.

8. It was also noted that there had since 1972 been a significant and widely supported change in philosophy concerning the desirability of encouraging employee share ownership generally, as evidenced by introduction of the Finance Act 1978, 1980 and 1984 approved schemes. Some people - including one or two representations - had suggested that because of this the very need for anti-avoidance provisions in this area could be looked at in a new light, possibly with a view to dispensing with them altogether.

9. The Group concluded, however, that there was no inconsistency between the desire to encourage wider employee share ownership and the introduction of the approved schemes on the one hand, and the retention of S.79 or something like it on the other. Section 79 was concerned with particular kinds of abuse involving shares acquired by employees outside the approved schemes, and to a large extent the kind of shares involved would be mutually exclusive anyway - for example, shares in an approved scheme could not be subject to the kind

of restrictions that S.79 was concerned with. Clearly, however, the increased importance now attached to encouraging employee share ownership provided another good reason for reviewing S.79 thoroughly, with a view to ensuring that it was targeted as narrowly as possible on cases involving obvious and blatant abuse.

Target of provisions

10. It was agreed that the underlying purpose of S.79 was to counter particular kinds of abuse, and that the aim should be to target the provisions as specifically as possible on those abuses. As presently drafted, S.79 attempted to do this by means of objective rules and tests that had the advantage - in itself an important one - of providing certainty as to whether or not the provisions applied in a particular case. But this and the complexity of devices that might be adopted in practice by those determined to abuse the system had - perhaps inevitably - resulted in provisions that were very complex, and an important aim of the review was to examine the scope for simplifying the provisions as far as possible. Another important drawback of S.79 in its present form - particularly as regards the growth in value charge - was that it could also catch bona fide share acquisitions not involving abuse, and be fairly draconian in its effect - eg cases where the shares were subject to restrictions that in practice had an insignificant effect on the value, but where as a result of the restriction all of the subsequent growth in value was chargeable to income tax in the hands of the employee.

11. The starting point was, therefore, to focus on the abuse with which the provisions were intended to deal. It was agreed that, in essence, this involved the use of employee-acquired shares as a vehicle for passing to the employee shareholders benefits that were not available to other shareholders as well - ie such that the employee shares grew in value by significantly more than the value of the company's

shares generally. Specifically, it involved artificially boosting the value of the employee shares either by

- subjecting them to restrictions of a kind that could be used to manipulate their value,

- or by using employee shares of a special class such that their value could be enhanced by the granting of special or preferential rights

- or by "value shifting" in other ways, where the employee shares were those in a subsidiary company.

12. The Group also agreed that there was a strong case on presentational grounds for enacting completely new legislation when introducing whatever changes were agreed as a result of the review, rather than attempting to introduce those changes by amending S.79 itself yet again. Though the end result might be the same, it would look more like a clean sweep if completely new free standing provisions were enacted; this might also help people to understand the changes more readily.

MOTIVE OR MAIN PURPOSE TEST

13. As mentioned in the Consultative Document, one suggestion that is sometimes made is that S.79 might be replaced altogether with provisions specifically designed to operate only in cases motivated by avoidance or abuse. Instead of the present objective rules and tests, therefore, there would be a subjective motive or main purpose test designed in some way to distinguish "artificial" growth in value of the employee shares from "normal" growth, with only the former being taxed as income.

14. In line with many of the responses to the Consultative Document, the Group concluded that such an approach would in practice be largely unworkable and/or ineffective as a safeguard against abuse. The test would, for example, have to

apply to the company issuing the shares but that of itself could make the question of motive virtually impossible to answer in those cases where the issuing company was not the employing company. A further difficulty concerned the action or event in respect of which the motive test would be applied. In practice it would have to apply to the issue of the shares themselves, and not at any other point - eg when restrictions attaching to the shares were lifted or when value was added - because it would nearly always be possible for a company to produce "commercial" reasons for its actions apparently unconnected with any desire to benefit the employee shareholders. But companies that were able to satisfy the motive test when the shares were issued - easy enough in itself - would then be entirely free subsequently to manipulate the value of the shares to the benefit of the employees, and the Section would have become totally ineffective in preventing this.

15. The Group also agreed that the difficulties would be even greater where the shares were those in a subsidiary company, and value was being shifted into that company from the parent company or from other companies in the group. There were almost limitless ways in which value could - quite legitimately - be shifted between companies in the same group, and it simply would not be practicable to test the motive - and whose motive anyway? - of all transactions between the company and other companies in its group in order to identify any "artificial" growth in value in the employee shares in the subsidiary.

16. Finally, it was also noted that such an approach could involve substantial additional resource costs for the Revenue. For individual companies too, the compliance cost could well be quite heavy.

ALTERNATIVE TO PRESENT GROWTH IN VALUE CHARGE

17. The main effect of S.79 is to apply an income tax charge on the whole of the growth in value of the shares (or interest

in shares) concerned, either 7 years from the date of their first acquisition or, if earlier, when they are disposed of or the restrictions in question are removed. However, one possible alternative approach - at least as regards restricted shares - would be to replace the growth in value charge with a charge at the time of acquisition of the shares, based on the difference between the value of the shares without restrictions and the amount actually paid for them by the employee. There was support for this kind of approach in many of the responses to the Consultative Document.

18. Such an "initial charge" would not, however, be capable of dealing with

- employee shares of a special class which have some new or enhanced right or benefit attached to them after acquisition (under S.79 at present, the "majority" and "control" tests would be unlikely to be satisfied in respect of such shares, so that the growth in value charge would apply. On the other hand, there is already a post-acquisition "special benefits" charge in S.79(7) but this is aimed mainly at bonus issues and is rarely triggered in practice)

- employee shares in a subsidiary company that were not subject to restrictions or of a special class, but where there was "value shifting" from the parent to the subsidiary and, thereby, into the employee shares.

Separate provisions would, therefore, still be needed to deal with these two cases.

19. A number of arguments were adduced by the Group in support of replacing the growth in value charge with an initial charge for shares subject to any of the proscribed restrictions at the time of acquisition. These were

(a) It would be more equitable than the present growth in value charge in those cases where the restriction had an insignificant effect on value. Under S.79 at present, the mere fact that the shares were subject to any of the proscribed restrictions was sufficient to bring them into the growth in value charge.

(b) The present growth in value charge was unfair anyway because it applied to the whole of the growth in value, and not just to that part of it associated with any manipulation of the restrictions.

(c) Arguably, restrictions of a kind that did have a significant effect on value were often "suspect" anyway, and it was reasonable therefore that there should be a charge on that "hidden" component in the value of the shares at the time of acquisition.

20. The Group recognised, however, that a major disadvantage with an initial charge was that it "presumed guilt" in the sense that the offending restriction might not subsequently be lifted or otherwise varied to shift value into the employee shares. So the employee might be taxed on a benefit he did not receive. Whatever its present weaknesses, this particular objection could not be directed at S.79 in its present from - though S.79 was open to the different but equally strong objection that it attacked the whole of the subsequent growth in value even if none of it was due to manipulation of the restrictions. (Another, related, disadvantage was that the charge would crystallise at a point when the employee had not, at least not yet, received any value out of which he could meet it - though this particular point was perhaps less conclusive bearing in mind that there were many other instances in the tax code where this could happen.)

21. One possible counter argument might be that the initial charge would be in the nature of a payment for an option to

acquire shares, with payment of the charge now relieving them from further charge to income tax for any enhancement of value resulting from subsequent lifting etc of the restrictions. Viewed in this way, it would be no more reasonable for the employee to seek repayment of the charge if the restrictions were not in the event lifted etc than it would for an option holder to seek reimbursement for the cost of an option because the value of the relevant shares did not in the event rise sufficiently to make exercise worthwhile. On the other hand, it would no doubt be pointed out that, by the same analogy, S.196 ICTA 1970 had been introduced precisely because in the case of options it was considered right to tax gains at the time the option was exercised, not when it was granted.

22. Whatever the counter arguments, however, the Group accepted that this objection would inevitably lead to pressure for arrangements for deferring or repaying the charge in certain circumstances. Indeed this had already been suggested in a number of representations.

23. The Group noted that such a facility would largely defeat the object of the initial charge. It would also mean more complexity in the provisions, and would give rise to some very real operational and related difficulties. (It would for example be very difficult to apply in cases where the shares were subject to more than one restriction, only some of which were subsequently removed or varied.) A more fundamental criticism would be that it was perverse and operationally inefficient to raise a charge and then waive or repay it if the benefit did not in the event arise, rather than simply to raise a charge only if and when a benefit did arise.

24. Because of these difficulties, and because even with an "initial charge" a separate charge would still be needed anyway for cases where new or enhanced rights were attached to the shares after acquisition, the Group examined the possibility of dispensing with the initial charge and of having just the one charge at the time of any relevant

post-acquisition changes. That is to say, there would simply be a single charge to income tax if and when there was actually an increase in the value of the shares as a result of the removal or variation of a proscribed restriction, or the attachment of a new right - the charge to apply at the time that the restriction was removed or the right attached. There would be no time limit, but the present "majority" test for exemption would be adapted in an appropriate form so that there would be no charge if the majority of shares affected were held by other than the employees and/or an associated company of the company concerned.

25. The charge itself would then simply be based on any excess of the value of the shares immediately after the restriction was removed or the right was added over the value immediately prior to the change in rights or restrictions. This would need to be framed in such a way that it also applied where the value of the employee shares was increased indirectly - ie by subjecting the non-employee shares to some new restriction or loss of rights.

26. The Group agreed that conceptually this solution appeared to be the correct one, above all because it would focus the provisions narrowly and directly on the specific target intended - there would be a charge only if, when and to the extent that a benefit actually arose. And, a regime comprising only a post-acquisition charge would on the face of it be simpler, and more straightforward than one that included an initial charge - with all its attendant difficulties - as well.

27. The Group also agreed, however, that there were certain other considerations that needed to be weighed carefully.

28. First, it was noted that one desirable effect of an "initial charge" might be to discourage employers from using restrictions in the first place, in which case there was a danger that a regime in which there was only a

post-acquisition charge might tend actually to <u>encourage</u> the use of restrictions - ie compared to a regime in which there was an initial charge as well. It was difficult to say whether or to what extent any such behavioural effects might occur, but this would clearly be an unwelcome result if it happened on any scale. The Group accepted, however, that the difference in this respect between a post-acquisition charge only and a post-acquisition charge plus an initial charge was probably of far less significance than the difference between either and the present growth in value charge which they would replace. Nor - because of the post-acquisition charge - would there be any advantage in resorting to restrictions which it was intended should subsequently be lifted etc so as to enhance the value of the shares; though this would not of course apply to restrictions imposed for purposes other than "value shifting". Finally, this particular advantage of an initial charge would largely disappear anyway if in the event it was felt necessary to concede a facility for deferring/repaying the charge.

29. Second, there might on the face of it be some operational advantage with an initial charge compared to a post-acquisition charge particularly in cases where the shares were subject to more than one restriction, and where those restrictions were subsequently lifted one at a time. With an initial charge they could all be valued and "charged" in one go, at the outset. A similar problem could arise with certain performance-related rights where achievement by the company of eg successive performance levels would trigger successive post-acquisition charges. On the other hand, this ignored the complications that would arise if there was a deferral/ repayment facility. Moreover, while there might be a post-acquisition charge in more than one year, this would only happen if the individual was in fact receiving more than one lot of benefits as a result of successive manipulation of rights and restrictions. And, the need to value the effect of such post-acquisition charges separately could in practice be reduced in a number of ways, including perhaps by an

arrangement for grouping all changes in the relevant period (year of assessment or perhaps even longer) and applying the post-acquisition charge only once to combined effect of the changes in that period.

30. Third, there might equally with a post-acquisition charge be pressure to allow repayment of tax in some cases - eg where the enhancement in value resulting from the change in rights etc was not realised in any subsequent sale. However, it might be easier to resist such arguments here than in the case of the initial charge because with the post-acquisition charge a benefit - enhancement in share value - would undoubtedly have arisen at the time of the charge, even though it might not subsequently be realised, whereas in the case of the initial charge the benefit at that stage would be only a potential one which might never arise.

31. Finally, while both the present growth in value charge and an initial charge would automatically encompass the benefit and any acquisition of the shares at undervalue, which would otherwise fall to be charged under normal Schedule E rules, this would not happen with a post-acquisition charge which would be concerned only with post-acquisition changes. With a post-acquisition charge, therefore, there would be the added need to ensure that no Schedule E liability at the time of acquisition was overlooked.

<u>The proscribed restrictions</u>

32. The present S.79 growth in value charge applies if, immediately after acquisition, the shares acquired by employees in that capacity are subject to certain restrictions. There are three categories of proscribed restrictions: those not attaching to all shares of the same class, those ceasing or liable to cease at some time after the acquisition of the shares, and those depending on the shares being or ceasing to be held by directors or employees of any body corporate (other than such restrictions imposed by a

company's Articles of Association). All of these restrictions are of a kind that could be used directly or indirectly artificially to shift value into the the employee shares.

33. There are also certain "deemed" restrictions for this purpose. Broadly, this covers any restriction flowing from any contract, agreement, arrangement or condition that would restrict the employee's freedom to dispose of the shares or to exercise any rights attaching to them, or that would result in any disadvantage to him in the event of disposal or exercise. There is an exception to this which applies where the restriction is imposed as a condition of a loan that is not a "related" loan - broadly, one to the employee or a connected person by the company employing him or some connected company or person.

34. Such restrictions do not normally affect the value of the shares themselves. But they still need to be taken into account because they do affect the value of the shares to the particular individual concerned and, therefore, the value that is relevant for Schedule E purposes in determining whether the individual acquired the shares at undervalue. If such restrictions were ignored for purposes of the growth in value charge, it would be easy enough to circumvent the charge altogether; employers would simply use this kind of restriction to manipulate the value of the shares to the employee concerned, rather than using restrictions that attach directly to the shares themselves.

35. One other exempted category of "deemed" restriction concerns pre-emption rights. Broadly, the exemption here covers a requirement in any contract, agreement, arrangement or condition that the shares be sold, when the employee ceases employment with the company in question, to a person nominated in accordance with the contract etc at a price not exceeding the market value.

36. The Group agreed that the present three categories of proscribed restriction would need to be retained under the proposed new regime and that it would continue to be necessary to take account of the "deemed" restrictions as well as those attaching directly to the shares themselves. However,

(a) it would help if the Revenue were to publish some guidance on the kinds of restriction that were and were not covered by the legislation.

(b) it needed to be made clear (in the legislation itself, or perhaps in a Statement of Practice) that by "restriction ceasing or liable to cease" was meant not any restriction that was merely capable of ceasing (this was far too wide ranging, and would cover practically every conceivable restrictions), but restrictions that were designed or intended to cease.

(c) the deemed restrictions as they applied to related loans might be refined slightly, to make it clear that restrictions attaching to the loans that were of a normal commercial nature were excluded.

(d) similarly, it might be possible to limit slightly the scope of the charge in respect of certain kinds of pre-emption agreement outside Articles of Association.

VALUATION

37. The Group agreed that it would be necessary under the proposed new regime to have an agreed yardstick for valuation purposes that was used consistently throughout. However, valuation on the normal CGT basis, assuming an open market and a potential vendor, would not be appropriate in the case of restrictions that were personal to the individual concerned. The Group agreed, therefore, that as with "deemed"

restrictions the basis used for S.181 purposes would be more appropriate - ie the "pecuniary worth" of the shares to the individual concerned.

INTEREST IN SHARES

38. The Group agreed in principle that, as at present, the new regime would need to cover an interest in shares. This should apply where the interest was specific and not merely that of a potential beneficiary in a discretionary trust. The details would need to be considered further but, broadly speaking, the charge should apply on any enhancement in the value of the interest due to the lifting of restrictions etc or to any increase in the size of interest.

SUBSIDIARIES

39. As noted in the Consultative Document, a particular concern with S.79 is the difficulties that can arise where the shares concerned are those in a subsidiary company. In such cases, and even if the shares are not subject to any of the proscribed restrictions, the employees will - by definition - not be able to qualify for exemption under the "control" test. Nor often in practice will they be able to satisfy the "majority" test - ie where, apart from the employee shares, the subsidiary is a company wholly owned by another company with no other outside shareholders. Generally speaking, therefore, S.79 will normally apply to catch shares in a subsidiary company acquired by its employees outside an approved scheme - even if there is no abuse. This will also be so even where the company has a quoted parent and where, therefore, its shares might otherwise be used under an approved scheme.

40. In consideration of this issue the Group agreed that

(a) there did appear to be a genuine problem here for groups in which it was desired to "incentivise" the

employees and directors of a subsidiary company by allowing them to acquire shares in that company, and not eg the parent. This was likely to be particularly important in the case of "stand alone" subsidiaries whose trading and other activities were largely independent of other companies in the same group.

(b) at the same time, there was considerable scope for abuse, in the form of value shifting, where the shares were those in a subsidiary and it was therefore necessary to retain adequate safeguards against this. The potential for abuse and the need for safeguards seemed also to have been accepted in most of the responses to the Consultative Document, implicitly if not explicitly.

41. The Group began by considering two broad alternative approaches, both of which on analysis it felt forced to reject.

42. The first of these would involve confining any exemption to "stand alone" subsidiaries, strictly defined. This would be justified on the grounds that the scope for value shifting would by definition be less in the case of a subsidiary whose activities were largely independent of those of its parent and other companies in the same group. And, this was just the kind of subsidiary where it would make sense to incentivise the directors and employees by giving them shares in that company, rather than in the parent company.

43. However, this approach depended on being able to construct sufficiently comprehensive tests and rules of what constituted a "stand alone" subsidiary so as to encompass all of the ways in which value might in practice be passed to a subsidiary from its parent or other group companies. But in practice there was an almost limitless number of ways - all in themselves quite legitimate - in which value could be shifted,

and so undoubtedly very complex legislation would be needed in order to ensure that only genuinely "stand alone" companies benefited. There would for example need to be many detailed rules and tests about the maximum permitted proportion of the company's output and its inputs that could go to and come from other group companies, the pricing of any asset transfers from other group companies, and of head office charges, and so on.

44. Nor would it be sufficient for all of these tests to be satisfied only for a particular moment in time. They would need to be satisfied continuously while the shares in question were held by the employees, or at least for a period of say 7 years consistent with S.79 at present. Also, the greater the complexity and comprehensiveness of the tests that had to be satisfied, the greater would be the resource cost to the Revenue - and probably the companies as well - in monitoring adherence to those tests.

45. The Group therefore concluded that this approach had to be rejected.

46. In theory, an alternative approach would be confine the charge to any artificial growth in value of the employee shares in the subsidiary. This would obviously involve being able to identify the "artificial" growth in value, and that in turn would require some test of motive or main purpose as regards the action of the parent and other group companies viz-a-viz the subsidiary, perhaps supported by provisions of the kind in S.485 ICTA 1970 (sales of goods between connected persons at an undervalue), or S.280 ICTA 1970 (transfers of assets within a group at an undervalue giving rise to an artificial loss for a group company).

47. The Group concluded, however, that such an approach was simply not practicable, because it would in effect involve looking into the motives underlying virtually every transaction between the subsidiary and all other group companies in order to try to determine the effect of each

transaction on the value of the employee shares, and whether the transaction had been undertaken wholly or mainly as a means indirectly of rewarding the directors or employees of the subsidiary for their services. And, even if a particular transaction did involve value shifting to the subsidiary - eg disposal of an asset to it at substantially undervalue - the companies concerned might still be able to demonstrate that there were also genuinely commercial reasons for the transaction.

48. Nor, more specifically, would provisions modelled on those in S.485 ICTA or S.280 ICTA be effective. For example, S.485 was concerned with value shifting in the form of transfer pricing, but there were many other ways in which value could be shifted between companies. Similarly, a S.280-type approach would require the Revenue to look back at all transactions between the subsidiary and group companies over many years, and would be a virtually endless exercise - this would of course impose an enormous administrative burden for the Revenue and the companies alike.

Possible way forward on subsidiaries

49. Against this background, the Group then considered a sort of midway, pragmatic solution that would avoid the difficulties with either of the approaches mentioned earlier, while still giving reasonable - albeit not complete - protection against abuse.

50. The proposal as developed by the Group was as follows. The growth in value charge would remain in a modified form for shares in a subsidiary. But there would be exemption where

- the directors of the ultimate group parent company produced each year a statement to the effect, broadly, that the basis of the operations of the subsidiary company followed accounting policies consistently applied, and that there had been no

change in trading activity or material contracts such that there had been an "appreciatory transaction" relative to the rest of the group [for this purpose, appreciatory transactions would be defined as those that were other than at arm's length prices and whose effect had been to increase the value of the company as a whole by more than say, 5%]; and

- that statement had been the subject of review and report by the company's auditors.

For so long as the required statements and reports were forthcoming, and the Inspector had no reason to challenge them, there would be no charge. The charge would, however, be triggered in any year for which these were not available. The charge itself would then apply to the whole of the growth in value of the shares over a specified period up to the year in question. This period should not be more than 7 years, as at present. It could perhaps be shorter than this, but as a deterrent against abuse it should not be less than 5 years.

51. The Group also agreed that while, for reasons previously discussed, it was not possible to construct a watertight definition of a "stand alone" company, it was still desirable to try to confine the scope of the exemption to such companies. It should, for example, be possible to devise a fairly general formula to the effect that the company also had to be one whose trade, operations, transactions etc were wholly or mainly independent of other group companies, and to include this as another of the points to be reported on explicitly by the auditors in their report.

52. It was agreed that in principle the charge ought not to be triggered if there had been an appreciatory, value shifting transaction, but the company was prepared to reverse that transaction (or the effect of it) and did so within a limited period. In practice, however, there would be difficulties

with such a facility eg where the employee had sold the shares before remedial action had been taken. More generally, an appreciatory transaction in this context by definition would be one involving value shifting and the Group agreed it was difficult to conceive a situation where this could happen inadvertently - ie without the companies concerned knowing from the outset that the transaction would involve value shifting and that this in turn would have consequences under S.79.

53. Various other points on subsidiaries were also noted, as follows

(a) It was for consideration whether the proposed additional route to exemption should be confined to cases where the employee/director works wholly or mainly for the subsidiary company in question, and for no other group company. This would be consistent with the idea of wanting to incentivise those individuals whose commitment etc was to a particular subsidiary, rather than to the group as a whole. On the other hand such a restriction might be difficult to frame and monitor in practice unless it took the form of saying that the individual should work entirely for the subsidiary and no other group company - but that might be considered too restrictive.

(b) A parent company could also shift value into the (minority) employee-held shares by deliberately increasing dividends paid on the subsidiary's shares irrespective of whether the company's profits had also increased. In theory this could happen at present but in practice it was not a problem because most subsidiaries were in effect outside the present S.79 exemptions anyway. The Group agreed, however, that it was not clear whether in practice companies would resort to this kind of device, and that there

were certain checks on their ability to do this anyway. Action at this stage did not therefore seem necessary; but the position would need watching in case, as a result of having let in subsidiaries to a greater extent than is now possible, serious signs of abuse did begin to emerge.

(c) It was also noted that there could be a benefit in cases where the employee shares were acquired shortly before a company was disposed of outside the group (or floated in the case of a "singleton" company), bearing in mind that this would normally involve not only a boost in the value of the company's shares generally, but also a disproportionate increase in the value of any minority holding - including the employee shares. One way of dealing with this would be to have a charge on the increase in value unless the shares had been acquired and held for some minimum period - say 2 years - prior to the disposal or flotation. The Group agreed, however, that the introduction of such a restriction was probably not justifiable, because the opportunities for securing such benefit would in practice be very limited, and because other shareholders who also had a minority holding would get this benefit as well so it would not be specific to the employees.

AMBIT OF THE PROVISIONS: "CAPACITY" IN WHICH SHARES ACQUIRED

54. Section 79 at present applies to a person who "acquires shares in a body corporate in pursuance of a right conferred on him or an opportunity offered to him as a director or employee of that or any other body corporate, and not in pursuance of an offer to the public". A director or employee for this purpose includes someone who is to become a director or employee, and S.79 liability also attaches to shares

acquired after cessation of employment if those shares were nevertheless obtained by reason of the former office or employment.

55. In many cases it will be obvious enough that the individual concerned has acquired the shares as an employee and that he is, therefore, rightly within the ambit of the provisions. In certain other cases, it will be equally clear that though the individual has become a director or employee of the company concerned, he nevertheless acquired the shares in some other capacity. A particular example would be where the individuals concerned incorporate an existing business of theirs and they obtain shares in the company in return for the market value of the assets of that business that they have vested in the new company.

56. However, it has been suggested - including in a number of representations - that in certain circumstances individuals who are (or who become) an employee or director of a company can nevertheless also be regarded as having acquired the shares in an essentially proprietorial or entrepreneurial role, and that in such cases S.79 should not apply at all. As a particular example of this general proposition, it is also suggested that shares acquired by employees in the course of a management buy-out of their company should similarly be excluded from the ambit of S.79 altogether.

General

57. The Group noted that the arguments in support of these propositions were hard to pin down, but in essence seemed to rest on the view that in certain cases it was possible to regard the shares as having been acquired by the individual mainly in the capacity of a proprietor/entrepreneur/investor rather than in the capacity of director/employee.

58. The Group concluded, however, that it was in practice extremely difficult to draw this kind of distinction and,

therefore, that there appeared to be no really convincing reason why S.79 should cease to apply solely because the shares were acquired by the individual not only as an employee or director, but in one of these other capacities as well. By definition, anyone who acquired shares did so partly as an entrepreneur (ie by investing his own risk capital in the company) and, by virtue of being a shareholder, as a part proprietor. But that of itself did not seem sufficient reason for exempting such shares from S.79 - and indeed the logical conclusion of this line of reasoning was that S.79 should be dispensed with altogether. The fact that the employees acquired the shares in some other capacity as well as that of employee was not sufficient justification for giving privileged tax treatment to the employees in respect of benefits which they got - and which other shareholders in the company did not - as a result of manipulation of special restrictions etc attaching to their shares and not others.

59. Moreover, this was tantamount to saying that the employee who acquired the shares in that capacity should get privileged treatment, vis-a-vis any special enhancement in the value of his shares, compared to the employee who similarly invested in his own company - but in "normal" shares and as a member of the public - and who instead received a performance-related salary chargeable to income tax in the normal way. These two cases were essentially the same and it would clearly be inequitable to treat the former more favourably than the latter.

<u>Employee/management buy-outs</u>

60. The Group noted that the argument for exemption here seemed to rest on the view that in an employee/management buy-out there were quite distinctive characteristics in relation to risk, proprietorial initiative and the nature of the incentive compared to "normal" employee shares incentive; and that the actions of the managers in obtaining the necessary financial backing, committing their personal

resources etc all bore the hallmarks of entrepreneurs even though the individuals concerned were also or would become employees/directors of the company.

61. Again, however, the Group felt that this did not provide sufficient justification for saying that it should therefore be possible to use the employee shares as a vehicle for passing special benefits to the employees and not other shareholders. It was difficult to avoid the conclusion in such circumstances that the benefits were coming to the individual in his capacity as an employee rather than in any other capacity.

62. Nor in practice was it always possible to draw distinctions anyway. For example, while it was true that in a buy-out the employees were acquiring a stake as "entrepreneurs" and as "part-proprietors" of their own company, that was true also where the employees were acquiring only a minority interest. Nor was "control" necessarily a distinguishing factor bearing in mind that in some buy-outs the employees might not - at least initially - acquire a controlling interest in the company anyway.

63. The Group also noted that buy-outs often in practice seemed to involve precisely the kind of performance- related share incentive at which S.79 was directed. This might in part be due to the fact that S.79 did not at present operate anyway in the majority of buy-outs. It was important to note, however, that arrangements of this kind were not a necessary or essential feature of the buy-out itself - in practice they were usually agreed to by the financing institutions simply because of competitive pressures.

64. The Group agreed, therefore, that the ambit of the provisions should remain essentially the same as at present, with no special exemptions for shares acquired in the context of an employee/management buy-out or other instances where the shares were similarly acquired partly in an entrepreneurial/

proprietorial capacity. It was important to note, however, that there was no reason why buy-outs as such should be adversely affected under the proposed new regime - the charge would only apply if the shares themselves were subject to restrictions etc and these or the other terms were varied in such a way as to confer special benefits on the employee shareholders. Moreover, the present regime sometimes made it necessary to structure the buy-out in a particular and perhaps not ideal way simply in order to avoid inadvertently bringing the shares within the ambit of the growth in value charge; the suggested new regime would help reduce that kind of difficulty.

65. The Group also agreed, however, that it would be helpful if the Revenue published some guidance with illustrative examples of those cases it regarded as being within or outside the scope of the provisions. It was also agreed that the precise wording of the present legislation might be improved to remove certain slight ambiguities.

OTHER MATTERS

66. The Group also considered numerous more detailed and technical points that were raised in representations and elsewhere. It was noted that a number of these points would fall away if the substantive changes considered by the Group were adopted, and that other would need to be dealt with as appropriate and on the basis agreed.

REVIEW OF S.79 FA 1972

Informal Working Group

Mr Brian Armitage
Investors in Industry plc

Miss Susan M Ball
Linklaters & Paines

Mr Tony Wakeford
J Warwick Hardy Ltd

Mr Roger White
Peat Marwick McLintock

For the Revenue:

Michael Prescott Dorothy Green Andrew Ellis	)	Policy Division
Robert Peel Pauline Eaton	)	Technical Division
Michael Swann	-	Shares Valuation Division

SECRET

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

FROM: A J G ISAAC
DATE: 16 JULY 1987

Financial Secretary

UNAPPROVED EMPLOYEE SHARES: REVIEW OF SECTION 79 FINANCE ACT 1972

1. I attach a report by Mr Prescott on the outcome of the informal consultation exercise set in hand on Budget Day.

2. I do not wish to comment in detail on Mr Prescott's report which is, I hope, self explanatory. As you will see, his working group have identified several changes which could be made to Section 79 which, while broadly maintaining the effectiveness of this anti-avoidance provision which there is general agreement remains necessary, should go some way towards meeting the current criticisms of it.

3. I should, however, like to comment briefly on the possible interaction between the proposals on Section 79 and the wider reform of personal taxation which Ministers are considering (hence the much more restricted circulation of this covering note) in relation to the future handling of this review.

4. Essentially, Section 79 is concerned with preventing the conversion of income into capital gains. If income and gains were in future to be charged at (broadly) the same tax rates, the question would inevitably arise how far Section 79 and similar anti-avoidance provisions were any longer necessary. We shall be

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cc Chancellor
Chief Secretary
Mr Scholar

Chairman
Mr Isaac
Mr Beighton
Mr Lewis
PS/IR

sending the Chancellor a preliminary note on this shortly, following the discussion of my note of 22 June on Tax Reform - removing shelters and anti-avoidance provisions.

5. As we see it, while the large annual exempt slice of gains remains - and there are other advantages within the capital gains field such as indexation relief - there will remain an incentive to convert income into capital gains. If that is Ministers' view also - and clearly the judgement can only be preliminary at this stage, depending among other things on exactly how the personal tax package turns out - there need be (at worst) no embarrassment in announcing in the Budget a package of reforms to Section 79 at the same time as announcing plans for more closely aligning the taxation of income and gains.

6. I am not sure that we need to prejudge, at this stage,

(a) the question of substance, whether the incentive for income/capital conversion will be reduced to the point where the existing safeguards against avoidance here can be reduced or even removed altogether; and

(b) the question of timing, whether any initiative in this direction should be a starter for 1988 Finance Bill, or for subsequent years in the light of experience (as I say in my note on the wider aspects, there are issues here of Budget Security, and resources).

On balance, the best course at this stage seems to be to press on, as Mr Prescott recommends, with a further round of consultation in the Autumn based on draft clauses. This expectation has already been set up in the consultative document issued at the time of the Budget.

7. In short, our advice is that the Section 79 exercise should proceed, at least for the time being, independently of wider personal tax reform. It may be, however, that the prospect of

reform will in the event justify accepting risks (for example, the relaxation which Mr Prescott proposes in the treatment of shares issued by certain subsidiaries of unquoted companies) which have not been judged acceptable previously.

A J G ISAAC

Inland Revenue

Policy Division
Somerset House

FROM: M PRESCOTT
DATE: 17 JULY 1987

See also separate note - not to all.

1. MR ISAAC

2. FINANCIAL SECRETARY

UNAPPROVED EMPLOYEE SHARES: REVIEW OF SECTION 79, FINANCE ACT 1972

1. You will recall that the purpose of this review - announced on Budget Day - was to explore the scope for simplifying and improving the wide ranging anti-avoidance provisions in Section 79, consistent with their underlying purpose. A Consultative Document was published and representations were invited in the normal way. More unusually, however, the review was undertaken with the assistance of a small informal group of outside practitioners who have expertise in this area.

2. The first part of the review is now complete - formal responses to the Consultative Document have been analysed carefully, and the Working Group has completed its deliberations. A note summarising the Group's discussions and conclusions is attached, together with a second note summarising the responses to the Consultative Document.

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cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr Scholar
Mrs Lomax
Mr Moore
Miss Sinclair
Mr Cropper
Mr Jenkins (OPC)

Mr Isaac
Mr Beighton
Mr Lewis
Mr Lawrance
Mr Prescott
Mr German
Mr Peel
Mr Swann (SVD)
Miss Green
Mrs Eaton
Mr Ellis
PS/IR

3. This note sets out our recommendations, which are for major recasting and simplification of the present provisions. We also recommend publication - in the autumn - of a further Consultative Document with draft Clauses incorporating the proposed changes, with a view to legislation in the 1988 Finance Bill. It would obviously help us and Parliamentary Counsel in getting ahead with this work if Ministers were able to reach a decision before the Summer break on whether they wish to proceed to this next stage.

BACKGROUND

4. Section 79 is an important anti-avoidance provision. It brings into income tax certain benefits relating to shares acquired by employees and directors in that capacity (ie and not as ordinary investors), and outside an approved scheme.

5. The main, growth in value, charge applies to employee-acquired shares whose value is capable of being artificially manipulated, to the benefit of the employees, either because the shares are subject to certain kinds of restriction or because they are of a class that is not widely available other than to the employees. The charge - to income tax - is on the whole of the growth in value of the shares and arises 7 years after the date of acquisition or, if earlier, when the shares are disposed of or the restrictions are lifted. There are certain exemptions. In particular, the charge does not apply where, immediately after acquisition, the shares are not subject to any of the proscribed restrictions and, very broadly, either

- the majority of shares of the same class, excluding those held by an associated company of the company concerned, were acquired other than by the employees and directors in that capacity (the "majority" test) or

- the majority of shares of the same class (again excluding any held by an associated company) were acquired by the employees or directors in that capacity and who as holders of those shares were able to control the company (the "employee-control" test).

These two tests are a pragmatic attempt at excluding cases where the scope for abuse is likely to be limited. For example, the majority test is likely to deter companies whose real aim is to confer special benefits on the employees because of the greater cost of having to give similar benefits to other shareholders with shares of the same class. Similarly, if the employees have majority control there is unlikely to be any advantage in shifting value from one share held by an employee to another such share.

6. A second charge applies to various other special benefits which employee shareholders might receive from the company in respect of their shares, and which for various reasons would not otherwise be within the normal charge to income tax. A particular example is bonus shares that might otherwise be issued to the employees but not to other shareholders.

7. In the case of both charges, Section 79 is founded on the view that these benefits are in reality part of the emoluments of the individual's office or employment, in essence no different from his other remuneration, and that they should be taxed as income accordingly.

8. The provisions were introduced in 1972 to counter a variety of such arrangements whose use was becoming widespread, with the prospect of very considerable tax avoidance. The original provisions were subsequently extended on a number of occasions to counter various more sophisticated devices that emerged from time to time.

9. As noted in the Consultative Document, however, the Section has - particularly in recent years - become a source of

criticism and complaint. Almost all of these criticisms concern the growth in value charge and the fact that it applies to the whole of the growth in value of the shares over the period in question, including any "normal" growth reflecting the company's underlying performance; and, moreover, that this applies even if the offending restriction which caused Section 79 to bite had no significant impact on the value of the shares, or where - in the case of unrestricted shares - it was not possible to satisfy the majority or control test but there was nevertheless no artificial pumping of value into the employee shares.

10. The provisions are frequently also criticised for their length and complexity, though this is to some extent inevitable given the complexity of devices that might be adopted in practice by those determined to abuse the system. In addition, however, the Section attempts to counter the abuse by means of objective rules and tests that have the advantage - in itself an important one - of providing certainty as to whether the Section applies in a particular case, but that again inevitably adds to the complexity.

RESPONSES TO THE CONSULTATIVE DOCUMENT - GENERAL

11. We have had 25 responses, including those from most of the main representative bodies as well as from the leading practitioners in this area. These were all concerned almost exclusively with the growth in value charge.

12. The decision to review Section 79 was universally welcomed in the responses, as was the setting up of the informal Working Group. A number of respondents also expressed the hope that there would be a further Consultative Document, with draft Clauses, once Ministers had reached decisions on the review.

13. In almost all the responses the need for some kind of anti-avoidance provision in this area was accepted, implicitly if not explicitly, albeit with strong reservations about

Section 79 in its present form. It was also generally accepted that the shares of a subsidiary company were a special problem, because of the considerable additional scope for abuse - by artificially shifting value into the subsidiary - that existed in such circumstances, even if the shares were not restricted or of a special class.

14. One general possibility mooted in the Consultative Document was that of replacing the present objective rules and tests in Section 79 with provisions specifically designed to operate only in cases that were motivated by avoidance or abuse. The Consultative Document noted, however, that even if this was practicable, provisions based on such a motive or main purpose test would - in the very nature of such tests - be more subjective, and less certain and clear-cut than the present provisions.

15. Not all respondents commented on this aspect explicitly. Nevertheless, views on this were usually implicit and, overall, there was a clear consensus in favour of sticking with an objective approach, based on rules and tests that were certain and clear-cut. Some respondents also recognised that though motive/purpose tests were used elsewhere in the tax code, they would for a variety of reasons be largely unworkable anyway in the particular circumstances of unapproved employee share schemes. This latter conclusion was also firmly endorsed by the Working Group - see paragraphs 13 to 16 of the Note of its discussions.

GROUP'S ANALYSIS

16. As you know, the four outside practitioners on the Group were selected not only because they were senior people with directly relevant expertise in this area, but also on the basis that we wanted someone from each of the main "constituencies" with an ongoing interest in S.79. Their participation obviously adds weight to the Group's conclusions.

17. Because the practitioners were participating on an informal and personal basis, the Group decided it would not be appropriate for it to produce a formal report with recommendations as such. It has nevertheless produced what amounts to much the same thing - agreed analysis of the problems with conclusions on how best to tackle them, as summarised in the note attached. The Group has worked pretty intensively - six fairly lengthy meetings in two months - on the basis of papers prepared by the Revenue and the practitioners, and thorough analysis of the formal responses to the Consultative Document.

Underlying purpose of provisions

18. As you will see (paragraphs 4 to 12 of the Note) the Group agreed that there was undoubtedly potential for abuse here, involving the use of shares acquired by employees outside an approved scheme as a vehicle for passing to the employees benefits that were not available to other shareholders as well - such that the employee shares grew in value by significantly more than the company's shares generally. Specifically, this might involve artificially boosting the value of the employee shares either by

- subjecting them to restrictions of a kind that could be used to manipulate their value,

- or by using employee shares of a special class such that their value could be enhanced by the granting of special preferential rights,

- or by "value shifting" in other ways, where the employee shares were those in a subsidiary company.

19. The Group agreed that for so long as a substantial differential existed between effective rates of tax on income and on capital gains, the incentive to convert income to capital using this kind of scheme would continue and so,

therefore, would the need for anti-avoidance provisions to deter this. As I say, this was also accepted implicitly or explicitly in virtually all of the representations. Nor did the Group see any inconsistency between the desire to encourage wider employee share ownership and the introduction of the approved schemes on the one hand, and the retention of Section 79 or something like it on the other. These provisions were concerned with particular kinds of abuse involving shares acquired by employees outside the approved schemes, and to a large extent the kind of shares involved would be mutually exclusive anyway.

Alternative to growth in value charge

20. As noted, the main criticism of the present growth in value charge is that it applies to the whole of the growth in value of the shares in question, not just to any "artificial" growth resulting from manipulation of restrictions etc. The Group agreed, therefore, that subsidiaries apart (where, as explained later, special problems exist and different solutions are needed) the growth in value charge should be replaced altogether with a much more narrowly targeted charge.

21. The Group identified two alternative approaches. Under the first of these, there would be an initial charge to income tax at the time of acquisition of the shares, based on the difference between the value of the shares ignoring the effect of any restrictions attaching to them and the price paid for them by the employees. But there would also need to be a second charge to deal with cases where value was shifted into the employee shares by attaching a new or enhanced right to them sometime after acquisition. This post-acquisition charge would apply to the increase in the value of the employee shares resulting from the new or enhanced right.

22. The second option would be to dispense with an initial charge, and have just the one - post-acquisition - charge to income tax if and when there was an increase in the value of

the shares after acquisition as a result either of the lifting or variation of a proscribed restriction, or the attaching of some new or enhanced right, the charge to apply at the time that the restriction was removed or the right attached. Again, the charge would be based on the difference between the market value of the shares immediately before and after the change.

23. In both cases, the post-acquisition charge would not apply if the majority of the shares affected by the enhancement of value in question were held by other than the employees and/or an associated company of the company concerned. This adaptation of the existing majority test would serve to restrict the charge to cases where the employee shares were being injected with value but others were not. The provisions for the post-acquisition charge would also need to be framed so as to apply where the value of the employee shares was being increased indirectly - ie by subjecting the non-employee shares to some new restriction or loss of rights.

24. The pros and cons of these two alternatives are set out in paragraphs 17 to 31 of the Group's Report. As you will see, there are a number of considerations that need to be weighed carefully, and the choice is not clear cut. The Practitioners were themselves divided and the Group was not, therefore, able to come down firmly in favour of one option or the other.

25. As you will see, the Group did agree that conceptually the second option - a post-acquisition charge only - was the correct one. A major drawback of an initial charge is that it could result in the employee being taxed on a benefit that he did not receive - ie if, in the event, the "offending" restriction was not subsequently lifted or varied. A post-acquisition charge by itself avoids these difficulties. It would focus the provisions narrowly and specifically on the target intended - ie there would be a charge only if, when and to the extent that a benefit reflecting special features of the employee shares actually arose.

26. On the other hand, one potentially desirably effect of an initial charge is that it might discourage people from resorting to the use of restrictions in the first place, and some of the Practitioners on the Group were particularly concerned that if there was only a post-acquisition charge this might actually encourage the use of restrictions - ie compared to a regime in which there was an initial charge as well or, a fortiori, to the present much harsher regime. The reasons why this might happen are not entirely clear, especially as there would be no advantage in applying restrictions with the intention subsequently of lifting them etc so as to shift value into the employee shares, because a post-acquisition charge would still arise. The worry, however, seems to be partly that restrictions generally are "suspect" and should be positively discouraged by the tax system; and partly that ingenious tax planners might find ways of attaching a large bundle of restrictions, each on its own having an insignificant effect on share value, which could then be lifted one by one such that value was shifted into the shares over a period of time but without there being a big enough shift at any one time to trigger the post-acquisition charge.

27. An important point relevant to the choice between these two options is the judgment whether with an initial charge there would also have to be a facility for deferring/repaying tax if in the event the restrictions were not lifted etc and no value was shifted into the employee shares. The Group as a whole was agreed that such a facility would largely defeat the point of an initial charge, including any effect it might have in discouraging the use of restrictions in the first place. As I say, this is a matter of judgment but we ourselves are much less sanguine than some of the Practitioners about the prospects of being able to resist the inevitable pressure that there would be for such a facility. And, if a facility was conceded, there would then also be the more fundamental criticism that it was perverse and operationally inefficient to devise a system for raising a charge and then waiving or repaying it if the benefit did not subsequently arise, rather

than - which would be the case with a post-acquisition charge on its own - simply raising the charge only if and when it does actually arise.

28. This is something that you will obviously want to consider carefully. Our own feeling is that on balance a post-acquisition charge on its own, without an initial charge, would be the better option. This is mainly because it is conceptually the right answer, focusing the provisions specifically on the target intended, but also because of our doubts whether in practice it would be possible to have an initial charge without a tax deferral/repayment facility. We accept that there would be a risk of encouraging more use of restrictions than otherwise, though as the Group itself noted the difference in this respect between an initial charge plus post-acquisition charge and a post-acquisition charge on its own would be much less significant anyway than the difference between either and the growth in value charge which they would be replacing. And, it might be possible to counter the "slow drip" problem (paragraph 26 above) by some kind of arrangement for applying the charge to the combined effect of a number of such changes over specified periods.

"Restrictions"

29. There are three kinds of proscribed restriction*, all of which could be used directly or indirectly artificially to shift value into the employee shares. The Group agreed that all of these would need to be retained - a point which also seems to have been accepted implicitly if not explicitly in the representations. It would also be necessary to continue to

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*Those not attaching to all shares of the same class; those ceasing or liable to cease at some time after the acquisition of the shares; and those depending on the shares being or ceasing to be held by directors or employees of any body corporate (other than such restrictions imposed by a company's Articles of Association).

take account of certain "restrictions" that attach to the individual concerned, rather than directly to the shares themselves. If such restrictions were ignored, it would be easy enough to circumvent the charge altogether.

30. There might, however, be certain minor changes to help simplify and limit the scope of the present definition. The Group also agreed that it would be of considerable help if the Revenue were at some stage to publish guidance on the kinds of restriction that were or were not covered by the legislation.

Subsidiaries

31. Section 79 in its present form causes particular concern where employes acquire shares in a subsidiary company. Even if the shares are not subject to any of the proscribed restrictions, the employees will not - by definition - be able to qualify for exemption under the "employee control" test mentioned at paragraph 5 above; nor usually will they meet the alternative "majority" test. Generally speaking, therefore, Section 79 is likely to catch shares in a subsidiary even if there is no abuse or where the company has a quoted parent and where, therefore, its shares might otherwise be used under an approved scheme.

32. An important aim of the review, therefore, was to find a solution to the subsidiary's problem, and it was particularly helpful to have on the Working Group a practitioner (Mr Wakeford) nominated by the Unquoted Companies Group. There were also many representations on this aspect in the responses to the Consultative Document.

33. The Group concluded that there did appear to be a genuine problem here for groups where it was desired to "incentivise" the employees and directors of a subsidiary by allowing them to acquire shares in that company, rather than eg in the parent. This was likely to be particularly relevant in the case of "stand alone" subsidiaries whose trading and other activities

were largely independent of other companies in the same group. At the same time, however, the Group agreed that shares acquired in a subsidiary offered considerable additional scope for abuse - even if the shares were not subject to restrictions or of a special class - because of the numerous ways (eg transfer pricing, transferring assets at undervalue, etc) that value could be shifted to a subsidiary and, therefore, into a minority holding of employee shares.

34. While relaxation of the present rules is desirable, therefore, it is also necessary to retain adequate safeguards against abuse. The extra scope for abuse, and the need to safeguard against it, was also recognised in most of the responses to the Consultative Document.

35. The Group examined a number of possibilities, some which it felt forced to reject. One possibility would be to confine exemption to "stand alone" subsidiaries, strictly defined. But because there is an almost limitless number of - legitimate - ways in which value can be shifted between companies of the same group, very detailed and extensive rules, tests and definitions would be needed to ensure that only genuinely "stand alone" companies benefited. And there would be considerable resource costs for the Revenue - and probably for companies as well - in monitoring adherence to such tests. A second alternative would be to confine the charge to any artificial growth in value of the employee shares in the subsidiary, but the Group concluded that such an approach was simply not practicable because it would involve having to examine the motives underlying virtually every transaction between the subsidiary and other group companies.

36. As you will see (paragraphs 49-53 of the Note), therefore, the Group tried to develop a sort of midway, pragmatic solution that would avoid the difficulties with either of the above approaches while at the same time still giving reasonable - albeit not complete - protection against abuse.

37. Under this proposal, there would, as with the suggestion for other shares, be a need to tax any increase in value from changes in restrictions or rights attaching to the shares. As noted, however, value could still be shifted into the shares in other ways in the case of a subsidiary, and so a further set of rules would be needed to deal with this possibility. In essence, this would involve retaining a growth in value charge but with a let-out where

- the directors of the ultimate group parent company certified that the basis of the operation of the subsidiary company followed accounting policies consistently applied, and that for the year in question there had been no change in trading activity or material contracts such that there had been an "appreciatory transaction" relative to the rest of the group; and

- that statement was supported by a report from the company's auditors and

- (in an attempt still to target as much as possible on "stand alone" subsidiaries) the auditors confirmed in their report that the company was, in effect, one whose trade, operations, transactions etc were wholly or mainly independent of other group companies.

38. For so long as the required director's statements/ auditor's reports were forthcoming, and the Inspector saw no reason to challenge them, there would be no charge. The charge would, however, be triggered in any year for which these were not available and would then apply to the whole of the growth in value of the shares over a specified period up to the year in question. This period should not be more than 7 years - as at present. It could perhaps be shortened, but as a deterrent against abuse should not be less than 5 years.

39. As a further safeguard, the exemption for shares in a subsidiary might be confined to cases where the individual concerned was an employee or director of the subsidiary only and works for no other group company. This would be consistent with the idea of wanting to incentivise those individuals whose commitment etc is to the particular subsidiary, rather than to the group as a whole. It might be appropriate for example to adopt the "whole time" requirement (at least 25 hours a week) that applies for the approved schemes.

40. This proposal would represent a significant relaxation on the present regime which, in practice, operates to catch virtually any case involving shares in a subsidiary. So far as we can tell it would meet many of the more general points in representations, and Mr Wakeford is confident that it would be acceptable to organisations such as the Unquoted Companies Group who have the closest interest in this matter.

41. At the same time, however, it has to be recognised that the proposal would have some rough edges. For example, the provisions might still operate at the margin to catch cases where there was no real abuse but where the conditions for exemption could not be satisfied eg because the company was not largely "stand alone". On the other hand, directors' statements and auditor's reports of the kind described - and of course the precise terms of these would need working up in much more detail when it came to drafting the legislation - would be far from watertight, and so would probably act as a safeguard only against more obvious and blatant forms of abuse. These certificates and reports may also (as for PRP) be criticised as an "unnecessary" compliance burden for companies; but they are of course inescapable since they are of the essence in relation to the proposed relaxation.

Ambit of the provisions

42. As noted earlier, the provisions at present apply to shares acquired by employees and directors in that capacity but

it has been suggested - including in a number of the representations - that in certain circumstances individuals who are (or who become) an employee or director of the company can nevertheless also be regarded as having acquired the shares in an essentially proprietorial or entrepreneurial role, and that in such cases Section 79 should not apply. A particular example of this general proposition is shares acquired by employees in the course of a management or employee buy-out of their company.

43. As you will see, the Group saw no reason for change here either generally, or specifically in relation to management buy-outs. In either case, this boils down to saying that there is no obvious reason why shares whose value is artificially enhanced by manipulation of restrictions attaching to them etc should get privileged treatment merely because the shares were acquired by the individual not only as an employee or director, but in some other capacity as well or in the context of a management buy-out. Apart from anything else, this would clearly be inequitable vis a vis the employee who similarly invests in his own company - but in "normal" shares and as a member of the public - and who receives a performance-related salary that is chargeable to income tax in the normal way.

44. Nevertheless this something of a grey area and it clearly would be desirable, as agreed by the Group and suggested in some representations, for the Revenue to publish some guidance on the sorts of case that were considered to be either within or outside the ambit of the provisions.

45. There seems no reason why the proposed changes should adversely affect buy-outs as such - indeed they should help in that it is sometimes necessary to structure a buy-out in a particular and perhaps less than ideal way simply to avoid inadvertently being caught by the present growth in value charge. On the other hand it has to be recognised that buy-outs often in practice involve precisely the kind of performance related restriction that these provisions are aimed

at. It is important to note however that such restrictions are not essential to buy-outs as such.

RESOURCE IMPLICATIONS

46. We anticipate that the proposed post-acquisition charge would involve some additional resource cost compared with the existing S.79 procedures. However, we do not expect the amount to be significant though we cannot form any estimate until the procedures have been worked in more detail. In theory there would be rather more occasions of charge than at present, (ie whenever a benefit arose as a result of varying the restrictions or rights) so that there might also be a need for advice more often on share valuations. In practice, however, we would issue guidance on this to Districts and so reduce referrals to our Shares Valuation Division in cases where the effect of variation on share values was small and so could be ignored on de minimis grounds. (The resource cost would be greater if there was also an initial charge with a deferral/repayment facility). The proposal concerning subsidiaries would have a minimal additional resource cost compared with the present regime.

TIMING OF PROPOSED CHANGES

47. The details of this have still to be sorted out. However, the new provisions - initial charge and/or post-acquisition charge - would obviously apply to shares acquired after the start date. More problematic is the question whether shares acquired earlier and which are now within the ambit of the growth in value charge should become liable instead to the new, and generally speaking, much lower post-acquisition charge. There would be no real objection to this in cases where there had so far been no "artificial" growth in value of the shares but in practice we would have no way of being able to separate sheep from goats.

RECOMMENDATIONS AND NEXT STEPS

48. Clearly, there are many aspects of these proposals that need working up carefully in more detail. At this stage, however, what we seek is your

- agreement to the broad outline of the provisions that we are recommending should replace Section 79 in its present form, and

- authority to instruct Parliamentary Counsel on preparation of the draft Clauses, with a view to publication by the late autumn and enactment in the 1988 Finance Bill. Although we have had invaluable benefit from the advice of the Working Group, we envisage that the draft Clauses should be published on a fairly "green" basis because it seems possible that both the proposals themselves and the details may attract a fair amount of comment. We would of course report back to you before publication not only with a draft document and Press Release but also on any further points of substance which arose during the course of drafting the new provisions.

49. On substance, our main recommendations are as follows

(a) The present "special benefit" charge in Section 79(7) should be retained (see paragraph 6 above), but the main - growth in value - charge should be replaced altogether by a new more narrowly targeted charge. Though the considerations concerning an initial charge need to be weighed carefully, the better option is probably that of having only a single, post-acquisition, charge that would apply on any increase in the value of the shares resulting from the removal or variation of a proscribed restriction, or from the attachment of a new right, the charge to apply at the time that the restriction is removed or the right attached. (See paragraphs 20-28 above).

(b) For this purpose, the present three categories of "proscribed" restriction would be retained, as would the "deemed" restrictions. (Paragraphs 29 and 30).

(c) The growth in value charge should be retained, in modified form, for shares in a subsidiary company but with a let-out for "stand alone" companies and/or companies where there have been no appreciatory transactions, based on certification in an appropriate form by the directors of the group parent company with supporting reports from the subsidiary's auditors. (Paragraphs 31-41 above).

(d) The ambit of the provisions should remain essentially the same as at present, with no special exemption merely because the shares whose value is manipulated are acquired by the employees in some other capacity as well - eg in the context of a management buy-out. (Paragraphs 42-45 above).

50. The Working Group also saw considerable merit in incorporating these changes in a completely new free standing provision, rather than seeking to introduce them by amending Section 79 itself. This is largely a matter of presentation but one to which the Practitioners on the Group in particular attached importance. Though the result may be identical, a new, free standing provision would look more like a clean sweep and might also make it easier for people to understand the changes. We have already mentioned this informally to Parliamentary Counsel and he would be prepared to try tackling the drafting in this way.

51. We also propose - if you agree - to continue to consult the Practitioners if and when necessary in working up detailed proposals in the draft Clauses. They have all indicated that they would be prepared to go on helping in whatever way they can, subject of course to other demands on their time.

52. Finally, we have not as yet had meetings with any of the representative bodies or other respondents to the Consultative Document to discuss their representations in detail. This is largely because the responses contained no real surprises, and as indicated there is a fair amount of support in representations for the kind of changes which the Working Group itself has been considering and which we are now recommending. But it might well be helpful to meet some of them once draft Clauses had been published.

M. Prescott

M PRESCOTT

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC

17 JULY 1987

FINANCIAL SECRETARY

SHARE ISSUES: EMPLOYEE BENEFITS

1. You may like to discuss with us and the official Treasury the difficult issues raised in the attached note.

2. As you know, we have been compelled, amongst other things by press and other comment, to review the proper tax treatment, where employees enjoy a priority right to subscribe for shares in a share issue, and those shares command a significant premium.

3. Our Solicitor's advice is absolutely clear. Under the present law there is a taxable benefit to the employee, if the price which he pays for the relevant shares (those shares which he receives by virtue of his priority rights) is less than the true value of those shares; and as a matter of law that "true value" must be determined at the point in time when those shares are allotted to him.

4. Up to now, our practice has been normally not to seek a Schedule E charge, where the employee pays the same price for his

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cc		
	PS/Chancellor	Mr Isaac
	PS/Chief Secretary	Mr Lewis
	PS/Paymaster General	Mr Beighton
	PS/Economic Secretary	Mr Easton
	Mr Monck	Mr German
	Mr D J L Moore	Mr Reed
	Miss Sinclair	Mr Prescott
	Mr Cropper	Mr Peel
		Miss Green
		PS/IR

ISAAC to FST 17/7

shares (under his priority rights) as that paid by outside investors. In effect, we have been prepared to treat the "offer price" as a reasonable proxy for the market price at the point in time (perhaps a few days or a week or so later) when the shares are allotted to him. In justifying this practice, we have relied on the (I would hope generally reasonable) presumption that a private sector company and its market advisers will fix the "offer price" of a share issue at something approaching the maximum level which they can reasonably expect outside investors to pay (having reasonable regard to the risks inherent in a market share issue and the need to maintain a "good market" for the company's shares thereafter). To put it another way, the company's shareholders will not normally want to give away to outside investors a part of their company for nothing, or for less than its fair market value.

5. On the whole, I think that this has up to now been a reasonable - and reasonably beneficent - interpretation of the statutory position. But I have to accept that, in the case of some recent share issues, it has stretched the proper interpretation of the law to its limit - and it may be beyond it.

6. However that may be, with the benefit of hindsight, we have now to recognise that the success of the recent privatisation issues has created something of a new position - and the present problem.

7. In this context, my main concern is not with the apparent belief by some people that small private investors will always make a profit from new share issues, and stags are invulnerable. Certainly, that fashion has contributed to the (in this context troublesomely) large premiums on certain recent private sector share issues - Laura Ashley and Tie Rack. However, valuation is not an exact science. And, sooner or later, life will burst that bubble, like others before it.

8. The problems, for tax purposes, come from a combination of features of the recent privatisation issues themselves: the

consistently very large premiums which recent issues have commanded; the fact that large premiums have been expected in the market, and widely forecast in the press, even at the time when the "offer price" has been fixed; and the fact that all this is itself consistent with the terms of the issues themselves, with preference for small investors and sharp scaling down of larger investors, suggesting that the terms may not have been fixed exclusively with a view to fixing the "offer price" at the maximum level which an outsider investor might be expected to pay. Taken together, it has become unrealistic - and commentators have increasingly said it is unrealistic - to claim that the "offer price" in these issues is (in law) the true value of those shares at the time when they are allocated.

9. The recent BAA issue represents the most extreme case yet. The tender element in that offer carries the clearest possible inference that the fixed price does not represent a genuine view of the true value of the shares, at the price that they may be expected to trade in the market.

10. Against that background, we need to consider the way forward, with you and the Treasury.

- Must we, however reluctantly, enforce the statutory tax charge, in the light of the clear legal advice we have received, and the facts of individual share issues? Should this apply to both private sector and public sector issues - subject of course to the normal commonsense tolerances for the uncertainties of the valuer's art?

- Or do you wish to legislate, effectively to validate existing practice? If so, again, should legislation extend to private and public sector issues alike? Given that legislation would need to have some statutory rules, which of the options discussed in Mr Prescott's note do you wish to adopt?

11. As you know, there is some urgency to decide the way forward both because of the press speculation and the need to get the arrangements for future privatisations settled.

A J G ISAAC

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: M PRESCOTT
DATE: 16 JULY 1987

1. MR ISAAC

2. FINANCIAL SECRETARY

TAX TREATMENT OF PRIORITY EMPLOYEE SHARES IN COMPANY FLOTATION

1. In my note of 16 June about the BAA privatisation, I said that in view of advice from our Solicitor we needed urgently to review our practice for the future concerning the tax treatment of the benefit derived by employees from a priority allocation in a sale of shares in their company. This is of particular relevance to the privatisation programme, but the issues involved apply also to private sector flotations. With disposal of the Government's remaining shareholding in BP scheduled for the autumn - and some speculation in the press arising out of the BAA flotation that Ministers are reviewing the position - the matter needs to be resolved as quickly as possible.

2. This note sets out the problem and examines the options. You may find it helpful to have a discussion with us and the official Treasury to decide the best way forward.

BACKGROUND

3. Under Schedule E, an employee is assessable to income tax on all the emoluments from the employment. The term

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PRESCOTT to FST 17/7

"emolument" is very wide, and is defined to include all "salaries, fees, wages, perquisites and profits whatsoever".

4. It is well established law that if an employee is able in that capacity to acquire shares outside an approved scheme at a cost less than their true value, the difference between the cost and the true value at the time of acquisition is taxable as an emolument of his employment. This is clearly right in principle - such benefits are akin to other remuneration and they should be taxed accordingly.

5. It is also well established case law that there is liability where a company is floated by a tender offer and the employees are able - because they are employees - to acquire shares at a lower price than members of the public. Thus, if employees are allowed to apply for shares at a price set before the outcome of the tendering is known which is lower than the eventual striking price, they will be liable to tax on an amount reflecting the difference.

6. We assume in what follows that Ministers would not wish to disturb these general principles. Certainly, they seem to be fairly widely accepted, and so far as we aware no one is seeking seriously to challenge them.

Fixed price offers

7. It is common when floating a company by a fixed price offer to reserve for the employees some shares for which they can apply at the same price as members of the public. If the offer is over-subscribed the priority allocation may be of value to the employee. The first, and most important question for consideration, therefore, is whether even though the employees pay the same price for the shares as the public, they nevertheless derive a benefit from the priority allocation that is chargeable under Schedule E.

8. Our published practice hitherto has been not to seek a Schedule E charge in such cases. This has been mainly on the

grounds that because the employees were paying the same price for the shares as everyone else, they could not be regarded as having acquired the shares at undervalue. As explained in my previous note, however, this practice evolved at the time when substantial over-subscription was rare, and when, therefore, the fact that the employees were able to buy more shares than members of the public was not all that significant anyway. But more recent flotations - including certain privatisations - have shown that the benefit of a priority allocation can be very valuable if the offer is heavily over-subscribed and from the outset the value of the shares is at a premium over the offer price. The table attached gives the outcome of some recent share issues.

9. We are now advised that such a benefit is almost certainly chargeable under Schedule E, though of course we could only be certain about this if the point was tested in the Courts. As I mentioned in my previous note, it is perhaps also significant that our present practice is beginning to be questioned by informed commentators.

Hybrid schemes

10. You will recall that an additional feature of the BAA flotation is that it is a hybrid scheme, involving an offer by tender as well as a fixed price offer with priority for the employees in the latter. If the offer as a whole is over-subscribed, employees will thus be able to buy at the fixed offer price quantities of shares which members of the public could only obtain under the tender offer at a higher price.

11. As you know, we felt able to justify not seeking a charge in the BAA case, mainly because it would still be primarily a fixed price offer (at least 75%) and our practice hitherto in respect of fixed price offers has not been to seek a charge. In any event, it would clearly have been wrong to change our practice in advance of considered legal advice and a review of the whole field. But we do now need to review our practice

urgently for future flotations. Even if there was not a problem concerning fixed price offers, a hybrid scheme in which, say, the tender/fixed offer proportions of the BAA case were reversed would look much more like a straightforward tender scheme of the kind in which the employee would almost certainly be held by the Courts to be getting a benefit taxable as an emolument. So we need to look at both hybrid and fixed price offers.

FIXED PRICE OFFERS - MEASURE OF THE BENEFIT

12. It is necessary to consider carefully what precisely is the nature and the measure of the benefit of a priority allocation in a fixed price offer. This will depend on the facts in each particular case.

13. It is incontrovertible that if the employees - and they alone - are given the right to a priority allocation, that right is acquired by them in their capacity as employees. But this of itself will not necessarily confer a benefit of any value - if the offer is not over-subscribed, so that every member of the public gets the number of shares he applies for, the priority right will in the event be of no monetary value to the employees. A priority allocation will, therefore, only confer a benefit of value to employees if

- the offer is over-subscribed, such that a non-employee who applies for the same number of shares as the employee in question will have his offer scaled down so that he gets fewer shares than the employee, and

- the shares are at a "premium" from the outset - ie from the date of allocation - so that their "market value" at time of acquisition exceeds the price actually paid for them.

The measure of the benefit would then be the number of extra shares that the employee gets compared to the non-employee who

applies for the same number, multiplied by the difference between the value of the shares at the time of allocation and the price paid.

14. Whether the benefit is large or small will then depend on the facts. In the BT case, for example, the employees were given priority allocations of up to 20,000 shares, members of the public were allocated a maximum of 800, and the premium at the start of trading was 40p. For each of the 135 employees who applied for the full amount, therefore, the benefit of the priority allocation was £7,680. On the other hand, for the 23,000 or so employees who applied for 400 shares or less there was no benefit at all because members of the public who applied for that number were also allocated the full amount. By contrast, in the Rolls Royce case there was scaling down for applications from the public even for as little as 400 shares so the priority allocation conferred a benefit on the employee in this case even at that level - though of course the size of the benefit would still be quite small at that level.

15. The basis of allocation may also be relevant. There are two ways to determine allocation when an offer is over-subscribed - by scaling down or by ballot. (In practice, balloting usually requires scaling down first). Where scaling down is employed, it should in principle always be possible to determine the measure of the benefit to each employee concerned, provided that the public applications are scaled down on a uniform basis.

16. However, the position will be far less certain if scaling down of the public applications is not on a uniform basis. The situation could then arise where the employee in question applies for and is allocated, say, 500 shares; and where one member of the public also applies for and is allocated 500 shares but a second member of the public applies for 500 and is allocated only, say, 400. In that event it would be difficult to say whether or not the employee had got a benefit from the priority allocation - it would depend on which of the two members of the public he was compared with. Though in practice

this kind of discrimination between applicants may be rare, there is nothing in company law or eg the Stock Exchange rules to prevent it.

17. The allocation may, alternatively, be on the basis of a ballot, perhaps also with some scaling down so as to give all applicants an equal chance in the ballot. It could also in this case be very difficult to say whether or not the priority allocation represented a benefit to the employee concerned - would a member of the public applying for the same number of shares have been successful or not in the ballot?

PRIVATE SECTOR FLOTATIONS AND PRIVATISATIONS

18. As explained above (paragraph 8) we have in practice not sought liability on fixed price flotations partly because the employees pay the same price for their shares as members of the public. But - as paragraph 13 explains - that in itself is not sufficient to prevent a benefit arising if the shares immediately go to a large premium. Implicit in our previous practice, therefore, has been the assumption that the "offer price" was broadly equivalent to the value of the shares at the date they were acquired by the employee. It is necessary to review that assumption to see how far it continues to be sustainable in present circumstances.

19. The justification for our practice hitherto has to rely, for better or worse, on the assumption that the "offer price" is essentially equivalent to the best estimate of the directors and their advisers of the current market value of the shares being offered. At the margin they may, of course, wish to adjust that price, for example to take into account possible adverse movements in the market between the date of its announcement and the date dealings can begin; and more generally to ensure that there is a reasonably firm market in the new shares. But, subject to considerations of that kind, it is not in the interests of the owners of the business to sell it cheaply. So (the argument runs) it is reasonable to

regard the "offer price" as being equivalent to the market price at the time it is fixed.

20. When the shares first begin to be traded - usually a few days at least after they are allocated - a premium or discount to the offer price may emerge. This will reflect a whole range of matters affecting market sentiment since the "offer price" was fixed; it may perhaps also indicate that the directors' judgement of the market value of the company's shares was sometimes too sanguine and sometime too pessimistic. While some issues have gone to premiums, and some to discounts, there are a good many which start off within a relatively few percentage points of the offer price, even in the particularly strong bull market of this year (see table attached).

21. It is against this background that our practice has been - at least where there is no reason to suppose that any special factors have influenced the setting of the "offer price" - to say that, taking one case with another, and recognising as the share valuation experts do that valuation is very far from being an exact science, the "offer price" is likely broadly to reflect the value of the shares at the time they are acquired by the employee, and that therefore we should continue not to seek a Schedule E liability in such cases.

22. This "broad brush" assumption was coming into question anyway because of the spectacular premiums recorded in some recent private sector flotations. And the legal advice we have now received would also in any event have raised a question whether it could still be maintained.

23. We fear that the recent privatisation issues have taken the issue beyond serious doubt. We are, of course, not privy to all the circumstances which are taken into account in fixing the "offer price" in such cases. However, it seems reasonably clear, both from the outcome and the way the issues are structured, that - as one would expect - the Government has other objectives in mind beyond achieving the best possible price for the shares being marketed which will be the objective

of the private sector flotation. In particular, offers are structured so that small investors generally get a marked degree of preference in line with the Government's wider share ownership objectives. This contributes to larger investors not getting all the shares they want, and coming into the market early, helping to push the shares to a premium. In the BAA case it could be also argued that the very existence of the tender element implies that the fixed price is below the "expected" market value because otherwise there would be no incentive to tender at a higher price. In any event, the outcome of recent privatisations has been confident predictions of a higher "market price" as soon as the offer price has been announced. In these circumstances the legal advice that we have received points inescapably to the conclusion that the employees who enjoy priority rights are gaining a significant benefit as employees, which is chargeable to tax and which (subject to the usual de minimis rules) we have no justification for not seeking to tax.

24. On this analysis there seem to be four possible courses

- To arrange the terms of future privatisations in such a way that the potential benefits to employees are limited to amounts which are sufficiently small to enable us to disregard any potential tax liability as de minimis. If you were attracted to this possibility we would need to explore whether it is feasible with the official Treasury.

- To collect any Schedule E tax due in accordance with the normal rules on privatisations and on comparable private sector flotations where the benefits are not de minimis.

- To introduce a general statutory exemption for employees' flotation profits.

- To introduce an exemption for employees' privatisation profits only.

25. The rest of this note looks at the last three options.

APPLY SCHEDULE E IN NORMAL WAY

26. The main argument for this would be that the employees were in truth receiving a benefit from the priority offer that was not insubstantial (because we would be ignoring de minimis amounts) and that clearly derived from the employment and no other source as evidenced by the fact that the employees got it and non-employees did not. As a matter of policy, therefore, and consistently with the general rules for charging employment income, such benefits should be taxed along with all the employee's other emoluments from the employment.

27 One possible counter-argument might be that because under approved shares schemes employees can already get the benefit of shares for nothing, or at undervalue, free of income tax there should in principle be no objection to their getting the benefit of a priority allocation - in effect an acquisition of shares at undervalue on terms specially favourable to the employees - free of tax as well. However, this does not compare like with like. By definition, relief under the approved schemes is only available where all of the conditions for approval are satisfied. In the case of an FA 1978 approved scheme, for example, the shares must be held for at least 5 years before full relief is available, and under all three approved schemes there are limits on the size of benefit per employee.

28 Another possible objection is that the charge would arise whether or not a gain had been realised (ie where the employee does not dispose of the shares immediately after acquisition), or which may be larger than any later realised gain if prices subsequently fell. Again, however, these considerations are not conclusive - there are examples elsewhere in the tax system where liability arises even though no gain from which to meet it has actually been realised at the time. But this would no doubt make it difficult for employees to understand the reasons

for this charge; and in some cases it would encourage earlier sales to produce funds for meeting the liability.

29 If this option was adopted, it would be necessary to publicise the change in Revenue practice and it could of course apply only to future issues. As noted, the charge in any particular case could not be quantified in advance - it could only be ascertained after the event. It might, however, be possible to publish some guidance in fairly broad terms about the basis on which the quantum of any charge would be determined. This might include guidance on what would normally be taken as the date of valuation for this purpose, the method of valuation and the determination of the "relevant" shares - broadly, the excess of the number of shares the employee in question received over the number a member of the public would have received, had they both applied for the same number.

30. There would of course be resource implications for the Revenue in having to tax such benefits, subject to the usual de minimis rules - ie a commonsense allowance for the familar valuation uncertainties and the usual £75 assessing tolerance. We have not attempted any quantification so far.

STATUTORY EXEMPTION

31. The disadvantages of seeking a tax charge - especially in the context of the Government's privatisation programme - are self-evident. The alternative would be to introduce legislation exempting any benefit arising to employees from a priority allocation in a fixed price offer.

32. We assume that Ministers would want any exemption to apply across the board, so as to include private sector flotations as well as privatisations. (As noted, our present practice concerning private sctor flotations could come under challenge). If a statutory exception were to be introduced there would be no justification for confining it to privatisations, and to attempt to do so would no doubt be criticised as putting public sector employees in a privileged

position. If legislation is to be introduced it would be far better to put the private sector cases on a firm statutory footing also.

33. It would also be necessary to deal with the problem of hybrid schemes, all the more so because exemption for any benefit in the case of fixed offer schemes would provide an incentive to dress up hybrid schemes as much as possible to look like fixed offer schemes. Though we should need to work out proposals in much more detail, very broadly a solution might be to provide that where

- the majority (say at least 75%) of the shares being issued were by way of an offer at a fixed price, and

  not more than a fairly small proportion (say 10%*) of the shares were acquired by the employees at fixed prices under the priority allocation

then there would be no benefit assessable under Schedule E etc in respect of the shares acquired by the employee under the fixed price offer. (Technically, the desired result might be achieved by deeming the fixed prices paid by the employee to be "market value" for all purposes under S.186 ICTA, S.67 Finance Act 1976 (the benefits in kind legislation) and - so as to ensure that there was not a gap in CGT treatment - under S.29(a) CGTA 1969). As you will see, this approach would allow exemption in respect of the fixed price offer even where there was a minority tender component in the offer as a whole. But any preferential treatment to the employees under the tender offer itself would continue to be taxable under Schedule E as at present.

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*The limit in Stock Exchange rules. Current Treasury guidelines for privatisations set a limit of 5%.

34. If exemption were to apply without limit or qualification there could be some large tax free gains, and the rules for flotations might seem inconsistent with the (tightly drawn) rules for share schemes. It would be for consideration whether

(a) as with the approved schemes, there should be a cap on the total benefit per employee or at least on the value of shares that might be acquired by an employee under such a scheme. Though it might not happen often, the benefit in a particular case could be very substantial and this condition would ensure that in such cases a charge did still apply; and/or

(b) the shares should to qualify for exemption should be held by the employee for a minimum period - eg 3/5 years as with the approved schemes. On the face of it this might have some attractions if the context of wider share ownership; on the other hand it could create operational difficulties because of the need to monitor what the employee did with the shares he owned outright, and to raise what in effect would be a deferred charge if in the event he disposed of them before the end of the minimum period.

CONCLUSION

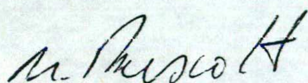
35. Though this is not an issue we ourselves would have sought to raise, our present practice regarding the treatment of employee priority offers is be open to challenge, and privatisation issues have inescapably brought the matter to a head. This would not matter in cases where the benefits are small enough to be ignored on de minimis grounds or where the method of scaling down applications from the public is such that it may be possible to argue there is no benefit to the employees at all. But where, as with recent privatisations, there has from the outset been a sizeable premium over the offer price, our advice is that it is inconsistent with the law to ignore the resulting benefit to the employees that arises in such circumstances from the priority allocation. These

difficulties could be exacerbated where - as in the BAA case - there is also a partial tender element.

36. One option may be to structure privatisations so that the gains to employees are kept within a size which can reasonably be ignored for taxation purposes.

37. Another option would be to modify our practice on privatisations - and any comparable private sector flotations - and in future seek a Schedule E charge where the amounts involved are other than de minimis. We assume, however, that Ministers would regard this option as unattractive. It would be bound to discourage some employees from participating in future privatisations, and many employees would be likely to find the reason for, and basis of, the charge itself difficult to understand. It would encourage early disposals. And, even with a de minimis limit there could be quite large numbers of what were nevertheless relatively quite small liabilities.

38. The alternative, therefore, would be legislation to exempt the benefit altogether in defined circumstances, on the lines outlined above. If that is to be the solution the details would need to be worked up as quickly as possible because they will probably need to be announced (because of forthcoming privatisations) well in advance of the next Finance Bill.



M PRESCOTT

THE FAMILY

NEW ISSUES JANUARY-MARCH 1987

Company	Dealings began	Issue price	First day close	Premium %
Paribas Fr Invest Trust...	19/1	100p	101p	+ 1
Viking Packaging	22/1	130p	168p	+29
British Airways‡	11/2	*65p	109p	+68
Dale	18/2	110p	126p	+15
Sanders and Sydney†	19/2	100p	129p	+29
Hewetson†	23/2	70p	84p	+20
Prism Leisure†	24/2	120p	130p	+ 8
Sinclair Goldsmith	26/2	125p	136p	+ 9
Forward†	26/2	125p	136p	+ 9
Capital Radio‡	27/2	105p	131p	+25
Hobsons Publishing	2/3	250p	325p	+30
JSB Electrical†	2/3	115p	141p	+23
Barbour Index	3/3	215p	305p	+42
RCO	3/3	95p	98p	+ 3
John D. Wood†	4/3	144p	188p	+31
G. W. Thornton†	9/3	135p	175p	+30
Regina Health†	9/3	20p	32p	+60
Scandinavian Bank‡	11/3	210p	243p	+16
Misys†	12/3	95p	134p	+41
Wilson Bowden‡	12/3	130p	138p	+ 6
Renaissance	16/3	100p	100p	—
Admiral Computing	17/3	150p	180p	+20
Perpetual	19/3	180p	191p	+ 6
Mallett	25/3	120p	206p	+72
Castle Communications† .	26/3	200p	218p	+ 9
Burford†	30/3	80p	160p	+100
Reliance Security	30/3	140p	180p	+29
Airtours	31/3	180p	200p	+11

* Partly paid. † USM. ‡ Offer for sale.

	Dealings began	Issue price	First day close	Premium (discount) %
Amersham International	25.02.82	142	193	36
Britoil	23.11.82	215	81	(62)
British Telecom	03.12.84	50 (pp)	93	86
British Gas	08.12.86	50 (pp)	62½	25
British Airways	11.02.87	65 (pp)	109	68
Rolls Royce	20.05.87	85 (pp)	143	68
Sock Shop	14.05.87	125	257	106
Wellcome	14.02.86	120	160	33
Virgin Group	21.11.86	140	140	-

pp - part paid

HEYWOOD 17/7

4374/024

CONFIDENTIAL

28

FROM: J J HEYWOOD

DATE: 17 July 1987

Ms LEAHY

cc: Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Moore
Mrs M E Brown
Mr Lyne
Ms Sinclair
Mr Bent
Ms Huleatt-James
Mr S B Johnson
Mr Cropper
Mr Isaac - IR
Mr Prescott - IR
Mr J Reed - IR
PS/IR

BP SALE: SPECIAL PROVISION FOR EMPLOYEES

The Financial Secretary has read your minute of 16 July.

2. The Financial Secretary is content for Sir Peter Walters to say in general terms that overseas employee shareholders are likely to be given some form of priority in allocation, when Sir Peter is in the US next week.

3. As to UK employees, the Financial Secretary agrees with you that, provided the tax problem can be sorted out, all UK employees and not just employee-shareholders should be given priority.

CONFIDENTIAL

4. One further point; the Financial Secretary has asked whether employee-shareholders will, in any event, have a priority allocation via the rights component of the issue?

5. The Financial Secretary will probably hold a small meeting early next week to consider the tax aspects of priority allocations (the minutes of today from Messrs Isaac and Prescott).

see separate folder

J.H.

JEREMY HEYWOOD
Private Secretary

ps3/10K

CONFIDENTIAL

FROM: A W KUCZYS
DATE: 20 July 1987

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr D J L Moore
Miss Sinclair
Mr Cropper

SHARE ISSUES: EMPLOYEE BENEFITS

The Chancellor has seen Mr Isaac's minute of 17 July, covering Mr Prescott's of 16 July. He strongly disagrees with Mr Isaac's paragraph 8 - the main premise on which the whole argument is based. Whatever some commentators may say, it is simply a matter of assertainable fact that at the time the BAA price was fixed large premiums were not forecast by the press; and this goes for most if not all previous privatisation offers. Mr Isaac's paragraph 9 is similarly flawed.

2. The Chancellor suggests that the Treasury should put forward a brisk counter-paper, explaining the facts of life, and providing relevant quotes from the press at the time - not subsequently. This should dispose of the matter, without any need for a meeting. Neither of the courses of action in Mr Isaac's paragraph 10 is either necessary or desirable.

A W KUCZYS

EXTRACT FROM MINUTES OF MEETING ON 21 JULY

Share issues: Employees benefits

20. The Chancellor said that he thought the Revenue views on this were based on a misunderstanding of the facts. There was no question that privatisation issues had been deliberately under-priced at the time the price was set; the premiums which had emerged at the time of allocation reflected the particular circumstances of a strong bull market. Mr Isaac said that the Board's legal advice was that, strictly, if the price at allocation was higher than the price paid by employees then there was a taxable benefit. The Revenue had not thought it was sensible to enforce that and had not sought any charge on gains arising solely from market movements between price-setting and allocation; but the consistent premiums which had emerged had raised doubts about whether the price set was the true market value at the time. The Chancellor said he did not believe there was any evidence in the way of contemporary press or market comment to suggest that the prices for recent privatisation issues had been pitched below what the market were expecting; at the time the price had been fixed, no-one had expected such substantial premiums to emerge. He asked Mr Isaac to examine with the Financial Secretary the facts surrounding recent issues and reconsider his advice. If any action was still necessary, he was sure that it would have to be via an extra statutory concession.

BF

Ch

See papers below (sorry not shown to you before). IR now preparing draft clauses, with plans for publication end October (not to be revealed yet)

AA

Thanks. As M-1 says, we still clearly need to reconsider X on date consultn.

4375/06

FROM: J J HEYWOOD
DATE: 22 July 1987

MR PRESCOTT IR

cc PS/Chancellor
Mr Monck
Mr Scholar
Mrs Lomax
Mr Haigh
Mr Cropper
Mr Jenkins OPC
Mr Isaac IR
Mr Lewis IR
PS/IR

REVIEW OF SECTION 79

1. The Financial Secretary was most grateful for your submission of 17 July and its attachments. He is very pleased that this review has been carried out with such efficiency and expertise.

2. Your paragraphs 48-52 summarised your recommendations:

(i) Financial Secretary agrees with the broad outline of the provisions your recommend.

(ii) He has given authority for you to instruct Parliamentary Counsel on the preparation of draft clauses with a view to publication by late autumn and enactment in 1988.

(iii) The Financial Secretary agrees that the "special benefit" charge in Section 79(7) should be retained, but the main - "growth in value" - charge should be replaced with a single, post-acquisition, charge, on the lines you recommend.

(iv) He agrees that the present three categories of "proscribed" restrictions and the "deemed" restrictions should be retained.

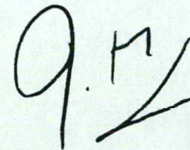
(v) The Financial Secretary agrees with your proposals on subsidiary companies.

(vi) The Financial Secretary agrees that there should be no special exemptions in the context of management or employee buyouts.

(vii) He thinks we should repeal Section 79 and introduce a new free-standing provision.

(viii) The Financial Secretary is content for you to continue to consult the Practitioners if and when necessary in working up detailed proposals on the draft clauses, and is content for you to meet the representative bodies if and when you might find this useful.

3. The Chancellor and the Financial Secretary are due to lunch with the UCG on 15 October.



JEREMY HEYWOOD
Private Secretary

CONFIDENTIAL

1. MRS M E BROWN 22/7.

2. FINANCIAL SECRETARY

From: R M BENT

Date: 22 July 1987

cc PS/Chancellor
PS/CST
PS/PMG
PS/EST
Mr Monck
Mr Moore
Miss Sinclair
Mr Boote
Mr Cropper
PS/IR
Mr Isaac (IR)

Ch
Not as forceful as it might have been.
AA

Ch/ Relevant to BP meeting — see 'X' (para. 9)

Are we sure BP employees are advantaged vis a vis shareholders? And will they not get preference as shareholders?

BENT to FST 22/7

SHARE ISSUES: EMPLOYEE BENEFITS

In the light of the partial tender for BAA, Mr Isaac's (Inland Revenue) submission of 17 July casts doubt on the policy of treating the offer price as a reasonable proxy for the aftermarket dealing price.

2. It has to be recognised that a modest discount is always built into a conventional fixed price offer to encourage investors to buy stock in the offer rather than wait for the aftermarket. The need for such a discount is crucially important in the case of a secondary share sale where investors have to be persuaded to take a chance on the allocation of stock under the offer rather than simply purchase direct from existing shareholders in the market. But I understand that Inland Revenue has traditionally accepted this practice as constituting a fair offer price. As Inland Revenue note, the discount is kept modest by the natural wish of existing shareholders not to give away to outside investors a part of their company for less than its market value.

3. Whatever the outcome in some recent privatisations, there was no intention when the offer was priced to have a large premium: nor was there any general expectation in the press that there

would be large premia. I attach press clippings on or about the impact days for the British Airways and Rolls-Royce privatisations. Admittedly, the fixed price set for BA was seen as marginally less keen than that for RR, but the latter was very tight indeed. Had the market not moved on during the offer period the RR underwriters would no doubt have been increasingly nervous as lists day approached. The pre-impact day press clippings for BAA also suggest that the fixed price of 245p was at the upper end of City expectations.

4. On the basis that the fixed price is normally fair, it follows that the preferential allocation of shares to employees at this price should not constitute a taxable benefit.

5. The key question is how, if at all, this balance is upset by the introduction of a partial tender.

6. We in PE do not agree with the Inland Revenue comment that the BAA partial tender mechanism carries the clearest possible inference that the fixed price does not represent a genuine view of the true value of the shares. We continue to believe that the fixed price is fair in the market circumstances in which it is set. The partial tender mechanism does not alter this view. The key point here is that tenders are submitted later than the date on which the fixed price is set. The market may move in that period - either up or down. In the 8 working days between the pricing of the BAA fixed price offer, and the closing date for the submission of tender bids (lists day), the FT All Share Index rose 5 per cent. Tenders are thus a means of capturing upward movement in the price - but they also carry the risk that the price will fall.

7. It is important to note that the whole of the offer is underwritten at the fixed price. This is because there is no prospect of persuading the underwriters to underwrite the tender element at the higher price that might be obtained should the market drift up, not down, during the offer period.

8. On the closing day of the offer, of course, investors will assess for themselves the prevailing market conditions, and enter their tender bids accordingly. By the time these bids are known, however, employees will already have had to decide whether or not to take up their preferential allocation, just as if this were a normal fixed price offer. Only subsequent to lists day will it emerge that in the conditions prevailing on lists day the tender shares could either be sold at or above the fixed price, or could not be sold at all. This will belatedly provide a second genuine view of the fair value of the shares according to the different circumstances prevailing on lists day. While there will be a tendancy for the tender price to be higher than the fixed price in a bull market, share prices go down as well as up, and stock can be left with the underwriters. Thus, the second genuine view may or may not be more favourable than the first: and it emerges after the employees have decided whether or not to make preferential application.

X 9. We do now need an urgent decision on whether employees will be able to have preferential application rights in the BP offer. As you know, it is intended that the UK retail investors, and all BP shareholders (so far as their rights are concerned), will be able to subscribe at a fixed price, which will be set at ~~a~~ some discount to the prevailing market price. Any preferential allocation to employees would also be at this fixed UK retail price. There will, however, be an international tender mechanism open to overseas professional investors (via national syndicates) and the UK institutions. The same points made in paragraphs 6,7 and 8 above would apply here. Tenders would be submitted after the fixed price was set (we hope, but have no certainty, that these may result in a tighter discount, or even no discount at all on the tender element). Employees would not know the results of the tender by the time their offer closed. And the whole offer would be underwritten at the fixed price, reflecting uncertainties about market movements above that level.

R M Bent

PE2.

WEDNESDAY, JANUARY 28, 1987

FINANCIAL TIMES

BA price aimed at UK investors

BY RICHARD TOMKINS

THE GOVERNMENT has decided on a cautious approach to the flotation of British Airways by putting a price of 125p on the airline's shares, instead of the 130p which was seen as the most likely alternative.

The pricing appears to be an eleventh-hour attempt to stimulate interest in the issue among UK investors. So far only 500,000 people have applied for prospectuses, compared with 7m at the same stage of the British Gas flotation.

In another attempt to attract attention, BA staged an elaborate publicity stunt on the Thames in London last night, with laser beams illuminating a 50 ft floating globe displaying the airline's route network as Concorde made a low-level fly-past.

Overseas interest in the flotation is strong, particularly in the US, but the Government's advisers fear this enthusiasm will collapse if the issue proves unpopular in the UK.

With 720.2m shares being sold, the airline's value at the issue price will be just over £900m. The gross dividend yield will be 6.8 per cent and the shares will be sold on 6.3 times forecast earnings per share.

The minimum number of shares which can be applied for is 400, but payments will be in two instalments — 65p a share now and the other 60p in August.

About 20 per cent of the shares are to be sold overseas, through public offerings in the US and Canada and private placings in Japan and Switzerland.

Another 45 per cent of the issue will be preplaced with UK institutions while 10 per cent will be available on special terms to BA employees.

That leaves only 25 per cent of the issue for the UK public. But if this part of the offer is subscribed at least three times, 20 per cent of the overseas and institutions' shares would be clawed back into the UK public offering.

Continued on Back Page
Lex Back Page

The triggering of the clawback is seen as the benchmark against which overseas investors will judge the success of the domestic offering. It could therefore prove to be the key to the success of the issue as a whole.

Mr David Bucks of Hill Samuel, the merchant bank sponsoring the flotation, said yesterday he was confident the clawback would be triggered at an issue price of 12[illegible]. He added: "At 130p, I think it would have been very much less certain."

The British public's low-key response to the flotation reflects the Government's decision to direct the issue towards experienced investors, although some critics believe this has been taken too far.

THE TIMES

Tim Bishop

Lord King at yesterday's presentation: strong foreign demand predicted

Daily Mail

'Would you please tighten your belts and reach for your chequebooks ...'

LEX

FINANCIAL TIMES

Airlines

Frightening the market with macho talk of putting British Airways out on a 130p price tag seems to have worked a treat. Underwriters who demurred at taking all that they were offered have seen 125p and are reported to be queueing up for more. If the London equity market holds its present course, next week may bring some complaints from Whitehall that the issue was not priced, after all, to bring in the full £1bn; but that is the trouble with fixed-price issues.

Since BA will certainly prove a minority taste with the individual shareholders, some generosity of pricing was inevitable. But the gulf between a flotation price and the premium obtainable for a strategic stake is illustrated by yesterday's deal between Swire and the Chinese Government: the £172m that was paid for 12.5 per cent of Cathay Pacific capitalises that smaller airline at the best part of £1.4bn.

THE TIMES WEDNESDAY, JANUARY 28, 1987

TEMPUS

Sid will be welcomed aboard BA flight 125

The small share buyer will be more than welcome on the share register of British Airways, the chairman, Lord King, said yesterday, despite the government health warnings.

Just to ram home the point, Fanfare for the Common Man was the music that heralded yesterday's gala unveiling of the final details of the flotation.

The 125p offer price, giving a forecast price/earnings ratio of 6.3 on actual tax and 9.5 assuming 35 per cent tax, appears to place BA in the bargain basement of world airline stocks, despite an expected fall in profits from £195 million to £145 million in the year to end March. (One broker not associated with the issue predicts £151 million).

Those who want the industry represented in their portfolios, a weighting towards BA would now appear to make the most sense.

Given the different valuations on markets, price/earnings ratios are probably not the best guide to BA's place on the scoreboard. Cash flow multiples are probably a more realistic guide, according to some of that growing band of British airline analysts.

On this basis, BA is offered at 2.4 times cash flow. Those European airlines which it most closely resembles, although all airlines have distinct personalities, are considerably more expensive. KLM comes at 3.1 times, Lufthansa at 3.3 and Swissair at 5.3.

A look at the Americans shows why US institutions are likely to be enthusiastic. They are paying up to ten times cash flow for local airlines, and are getting little or no yield. BA offers 6.8 per cent from what is a blue chip stock.

Whether it will pay individuals to stag the issue is not clear. Analysts predict a 10 per cent premium, but also forecast that the size of foreign demand will mean substantial scaling down of applications, even if clawback clauses are triggered.

For the longer term holder, Lord King's judgement that it is BA that is most in step with the stock market, not British Gas or Telecom is right. BA is in a volatile and competitive business. The management is good, but often it has to be reactive. Which is why the yield fairly sums up the risks.

THE GUARDIAN

Floating into the skies

The Government's announcement that British Airways is to be sold off for £900 million marks the denouement of a much delayed privatisation, but not the end of the argument. The companies which now make up BA were nationalised in 1939 (by a Conservative government) to form BOAC. The company was one of the earliest candidates for privatisation when Mrs Thatcher came to power. It was announced in July, 1979, but a succession of obstacles including the international airline recession and litigation from Laker Airways, have kept it stuck on the runway.

The privatisation of BA will continue to be controversial for several reasons. First, the pristine purpose of privatisation was to introduce more competitive pressures. Yet BA is being privatised with its monopoly status virtually untouched. Sure, it is in very fierce competition with other international airlines, but then it always has been. BA will retain a dominant 50 per cent of all airline passengers on domestic UK routes and a near monopoly of international flights from Heathrow by domestic airlines. The Government firmly rejected proposals by the Civil Aviation Authority and much of the civil industry to reduce this dominance. Even such white knights of competition as Nicholas Ridley and John Moore recoiled from forcing BA to dispose of more routes. Obviously if they had done that BA wouldn't have raised nearly as much money for the Treasury to recycle as tax cuts, which is what this exercise is all about.

If a monopoly, whether gas, telephone or electricity is making monopoly profits in the public domain then that is tolerable, because the excess return accrues to the taxpayer. But once a company is fully privatised there is surely no excuse not to increase competition and bring prices down to the consumer. If BA can't stand the heat, it should in logic vacate the kitchen.

The second controversy is whether BA's recent improvement is a success story to be claimed by the public or private sectors. British Airways is the biggest international airline in the world. Not bad for a nationalised concern. Since the nadir of 1981-2, profits have recovered to around £200 million (despite a post-Libyan dip to £145 million this year.) This is pretty profitable by world standards, though not much of a return on its £3 billion sales. Productivity has improved by 40 per cent since 1981-2. The Government, rather cheekily, has been claiming this as a success of privatisation for some years even though the deed has yet to be done. In fact the "necessary measures" were being taken when the Government's appointee, Lord King, became chairman in late 1981. He undoubtedly accelerated the pace of change and can justly claim much of the credit. But surely, all this is down to management not ownership. The Government might as well claim that the recent revival of the Post Office is due to the fact that, although it has never been officially stated, there is a possibility that it will be a privatisation candidate after the next election.

The third aim of privatisation is to widen share ownership. But even here the Government hasn't summoned up the courage of its convictions. The minimum amount of shares which can be purchased is £500 (far more than British Gas and the TSBs). The reason? Although BA will remain a nonopoly it is still a highly risky investment vulnerable to higher interest payments, the price of oil and the whims of tourists. The Government doesn't want popular capitalism to come too close to real risk taking, especially during the run up to an election. Sid might get the wrong idea.

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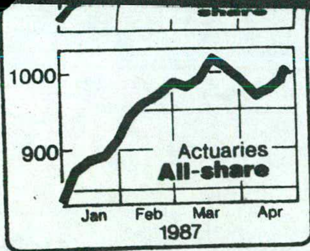

although it closed above January lows. The FT-SE 100 index finished 14.9 down at 1,986.6, the FT Ordinary index finished 15.7 down at 1,565.2 and the FT Actuaries All-Share index fell 0.7 per cent to 994.81. Page 41; World Stock Markets, Page 40

HILLARDS, Yorkshire-based supermarket group, rejected an increased bid of £203.3m from Tesco, national supermarket chain. Page 26; Lex, Back Page

BANK FOR International Settlements reported dramatic growth in international lending last year, boosted by a surge in inter-bank loans, especially in Japan. Page 37

US COMMERCE Secretary, Malcolm Baldrige, urged Hong Kong to take a leading role in promoting free trade in Asia. Page 6

US JUSTICE Department dropped its recommendation that the seven regional Bell telephone companies be authorised to compete in the long-distance telephone market against their former parent, AT&T. Page 6

WEST GERMANY'S federal budget deficit is expected to expand next year to DM 28bn (£9.43bn) from the DM 22.3bn set for this year, because of tax cuts due to take effect in January. Page 3

CHINA is likely to be given a seat on the Asian Development Bank's board of directors, while the Soviet Union is expected to make its first application for membership. Page 5

ICL: A consortium led by ICL, biggest UK-owned computer group, won a Royal Air Force contract worth up to £100m, and vital to Nato. Page 8

CAPITAL TAXIPHONES, a small private company, has won the franchise to instal public telephones in most of central London's black cabs. Page 7

BOEING, world's biggest aircraft maker, reported a 20 per cent fall in first-quarter net earnings to $118m (£71m), and partly attributed this to research and development costs. Page 32

INCHCAPE, diversified group, recorded an 86 per cent increase in pre-tax profits to £86.1m last year and increased its dividend for the first time since 1980. Page 26; Lex, Back

Divers then recovered four more bodies from the ferry, bringing the total of those known to have died when it capsized to 182. About 20 bodies are believed to be still on board.

Mr Steel told the inquiry in an opening statement that it was clear no attempt had been made to close the Herald's bow doors before it left Zeebrugge, and it was "highly probable" that this led to the capsize.

failed to carry out his duty.

"Although he was nominally responsible for closing the doors, there was no system where he was the only person responsible. It was common for others to close them," he said.

Mr Steel said Captain Lewry had reported four months before the tragedy a tendency for the ship to sail trimmed down by the bow—one of the

deck, improved drainage to dispose of water once it entered the ship; and separation of passenger and commercial vehicles.

The inquiry continues today when barristers representing the owners and insurers of the ship are expected to make opening statements.

Zeebrugge inquiry details, Page 8

Rolls-Royce's likely value £1.36bn with 170p shares

BY RICHARD TOMKINS

SHARES IN Rolls-Royce, the state-owned aeroengine maker, are expected to be priced at 170p when details of the Government's offer for sale are unveiled this morning. The price is at the mid-point of the 160p to 180p range predicted at the weekend by the Government's advisers but higher than the 150p to 160p forecast by City analysts. It would value the company at £1.36bn.

The Government has apparently decided to opt for a fairly full price because it does not want to be accused of selling assets on the cheap in preliminaries to the general election.

It can afford to risk a low-key public response because it is confident it has conducted a successful behind-the-scenes marketing campaign for the issue with institutional investors.

The share price will be payable in two equal instalments, 85p on application and 85p in September. The smallest allowable application will be for 400 shares, so the minimum initial investment will be £340.

Dividend payments will be fixed at a level which provides an historic gross yield of 4.1 per cent.

The advisers to the issue are confident the shares will rise to at least 200p on a fully paid basis when dealings begin. A 30p premium would represent a gain of 35 per cent on the partly-paid price, much smaller than the premiums seen on other recent privatisation issues.

The figure was decided at meetings between the advisers to Rolls-Royce and the Government yesterday afternoon. It took full account of the fall in world stock market indices. It is unlikely to have been changed overnight.

About 801.5m shares will be offered for sale. Of these, 60 per cent will be placed with institutional investors, leaving the remaining 40 per cent for employees and the general public.

If the public part of the offer is more than twice subscribed a clawback provision will raise the public portion to 50 per cent at the expense of the institutions' allocation.

More than 500,000 people have asked the Rolls-Royce share-information office to send prospectuses. This is about the same number as at the same stage of the British Airways flotation.

The prospectus for the flotation will come out on Thursday. The offer will close on Thursday May 7. Stock market dealings will begin on Tuesday May 19.

Lex, Back Page

Waldheim barred from the US

BY LIONEL BARBER IN WASHINGTON

DR KURT WALDHEIM, the Austrian President and former United Nations Secretary General, has been barred as a private citizen from entry into the US because of his alleged links to German army atrocities during the Second World War.

This is the first time that any country has decided sufficient evidence exists that Dr Waldheim took part in Nazi war crimes against Yugoslav partisans.

Austria recalled its Washington Ambassador immediately after the ban was announced by the US Justice Department. Mr Alois Mock, the Austrian Foreign Minister, said the ban caused "Austria deep dismay and is categorically rejected."

Dr Waldheim said last night he was disappointed by the US decision, which he claimed violated the principle that a man is innocent unless proven guilty.

President Reagan told Austria's Ambassador at the good relations between the two countries should not be affected by the US decision.

The New York-based World Jewish Congress said that Mr Ed Meese head of the Justice Department, had taken a courageous decision.

Dr Waldheim, who made much of his international experience during the Austrian presidential campaign last year, has been internationally isolated since his election and has so far not made any official visits abroad.

The decision to bar Dr Waldheim follows an investigation by the Justice Department's Office of Special Investigations (OSI), which recently submitted a 200-page memorandum containing new information on Dr Waldheim's wartime role in the Balkans in 1942.

Under the order, Dr Waldheim will be placed on a "watch list" which prohibits entry into the US to certain foreign nationals.

diplomatic immunity, Dr Waldheim could technically enter the US and avoid the legal provisions being enforced against him. However, diplomatic protocol dictates he would first need an invitation from the US President, a move seen as highly unlikely.

Since the first disclosures in the course of the Austrian presidential campaign of his wartime role, Dr Waldheim has repeatedly denied that he was involved in Nazi atrocities against Jews and others.

However, an investigation led by the World Jewish Congress claimed that Dr Waldheim served as an intelligence officer in the German Army in the Balkans for much of the period between 1942-45. Dr Waldheim was on the headquarters staff of Army Group E, whose troops slaughtered thousands of suspected underground partisans and deported tens of thousands of Jews from Greece to Nazi death camps.

anxious for signals
e president will act
y to restore confidence
dollar, Mr Reagan gave
of a shift in policy.

White House again re-
o rhetoric to defend the
repeating its view that
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could be counterproduc-

speech to the US
r of Commerce, Mr
stuck to his confronta-
tance towards Congress
question of tackling the
budget deficit, an issue
s crucial to restoring
ace in economic policy-

ing Capitol Hill for the
deficit, he called on
ss to "get control of
spending," rejected sug-
s from Democratic con-
en for higher taxes, and,
ng to an old refrain,
Congress to give him the
to veto individual spend-
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the House of Repre-
ves due to vote this week
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David Blunkett, president
Local Government Infor-
n Unit, said yesterday
Ir Clarke's measures were
ng more than election
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ical reaction, Page 12;
spendeding needed,

come. Assuming the smooth passage of CSR's offer for the 50.1 per cent of Monier that Redland does not own, that, at least, should be in the bag. Indeed such a joint venture may turn out to be rather more than second-best to Redland's original plan of buying up the outstanding shares itself. CSR will be ambitious partners and will take Redland into several new areas such as cement and plaster-board; the Monier joint venture may be the first of many.

The price of A$3.50 a share which values Redland's holding

those earnings will not dilute Tesco shareholders. This is in part a testament to the efficiencies of merging the two operations, which suggests that Tesco has even been a bit cheese-paring with its final offer, which is based not so much on the true value of Hillards to Tesco, but on the level at which Tesco thinks institutional fidelity will crack.

There is a theory that the institutions no longer like to reveal such disloyalty publicly, and so are more inclined to sell in the market than accept an offer. But with disclosure

pective p/e of under 13 does not look over-optimistic.

Rolls-Royce

The Government's confidence in Rolls-Royce (as in the markets) is considerable, to go by the 170p flotation price. Only Rolls' heritage of losses, now coming through as a low tax charge, disguises the implicit premium over British Aerospace, and the rather stiff down payment on the shares (50 per cent) offers surprisingly little leverage to the opportunistic investor.

ADVERTISEMENT

UPDATE

A Bulletin about New Business from Northern Engineering Industries plc

Steam Generator Test a success at Rihand

The first 500MW steam generator at the Rihand power station in India has successfully completed its hydraulic test.

NEI Power Projects Ltd. is building the £350m power station under a contract signed in 1982, and most of the equipment is being supplied by NEI companies. The two 500MW steam generators are being supplied by NEI International Combustion Ltd, of Derby.

For the hydraulic test the steam generator was subjected to a water pressure of two tonnes per square inch – equivalent to one-and-a-half times the maximum working pressure.

The successful completion of this test means NEI is on schedule for steam generator commissioning and steam raising in the next few months.

Inverters for British Rail

The Industrial Controls unit of NEI Electronics Ltd has won a £1.3m order from British Rail Engineering Ltd for static inverters.

These inverters use microprocessor controls and solid state electronics to provide and control power for air-conditioning, ventilation fans, water heating and battery charging.

They will be used in a fleet of electric multiple units which are being built for British Rail by BREL.

Switchgear for CEGB

Reyrolle Power Switchgear has won an order worth £1m from the CEGB for

Switched on in Singapore

The first of three NEI Parsons 250MW turbine generators has now been completed at the new Pulau Seraya power station in Singapore.

The machine supplied full load to Singapore's electrical supply system recently; the second machine is on programme to produce power during the summer; and the third machine will be working by the end of the year.

The three turbine generators, together with condensing and feedheating plant, are being supplied under a £70m contract which also covers other items of power station plant, including two 25MW standby gas turbine generators.

This contract was won in 1983 in the face of tough international competition from Japanese, European and American firms. Winning it was a major breakthrough for NEI Parsons into the Singapore market which had been dominated by the Japanese since 1962.

NEI Parsons is currently also supplying a further five turbine generators for export: one 350MW machine for Brazil and four 320MW machines for Iraq.

Our photograph shows the first 250MW machine installed in the turbine hall at Pulau Seraya.

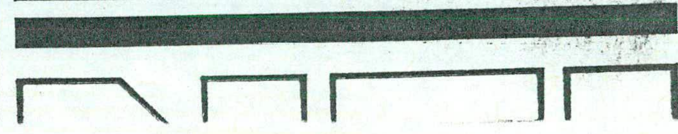
£3m Bridge Order for British Rail

Horseley Bridge, a business unit of NEI Thompson Ltd., has won an order to manufacture and assemble a large single span truss railway bridge designed by British Rail. The total contract is worth more than £3m.

The bridge will carry the main Manchester to Sheffield railway line, and will span the M66 and two feeder roads North of Manchester. The single span of 125 metres is of box chord construction, with trusses and decking for two main lines.

Horseley Bridge will fabricate all the steelwork at its Tipton factory. Sections will then be transported to site for assembly. When completed the bridge will weigh more than 2000 tonnes and will be put into place over a 72 hour possession period.

Work has already started at Tipton on the fabrication sections and civil works are proceeding on site. Main fabrication is scheduled for completion by January 1988 with site completion by March 1988.



TIMES

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TELEVISION 45

Mark Pepper

High hopes, high price: Secretary of State Paul Channon (left) with Sir Francis Tombs of Rolls-Royce yesterday

Rolls-Royce share price of 170p sets minimum stake at £680

By Alexandra Jackson

...s in Rolls-Royce, the ...tional aero-engines ...will cost 170p when the ...pany returns to the stock ...et next month after an ...ce of 16 years. It is the ... company to be pri... by the Government ...1979.

...year to December 31, ... whose chairman ... made ... profits of £120 million ...rnover of £1.8 billion. On ...o forma basis, assuming ...benefit of the issue ...ghout the period, pretax ...ts would have been £148 ...ion.

...yment will be in two ...l instalments of 85p – ...payable on application, the other on September 23. The minimum application of 400 shares will cost £680. The Government is not aiming to attract the small investor.

Certain institutional investors are being given preferential allocation of 60 per cent of the shares although if the issue is more than two times oversubscribed this will be reduced to 50 per cent.

The price is about 10p higher than City commentators had expected and, according to one, leaves little room for manoeuvre if market conditions change between now and the first day of dealings, scheduled for May 19.

The Government will subscribe for a golden share which will ensure that Rolls-Royce cannot pass out of British control. The proportion of foreign owned shares will be limited to 15 per cent of the whole.

Mr Paul Channon, Secretary of State for Trade and Industry, said yesterday that the usual precautions were being taken to detect multiple applications.

At the time of the launch of the pathfinder prospectus earlier this month, the sponsors of the issue received 250,000 inquiries. By yesterday, when the price was announced, the level of inquiries had more than doubled to 550,000.

Mr Ian Wild, analyst at Barclays de Zoete Wedd, the stockbroker, believes that Rolls-Royce has considerable long-term potential but he is lukewarm about the pricing. "There is nothing to get enthusiastic about at this time," he said.

The full prospectus will be published on April 30 and application forms will be available thereafter. Applications must be submitted by 10am on May 7.

According to Samuel Montagu, the merchant bank acting as financial advisers to the Goverment, the costs of the issue are lower by a considerable margin than for any other privatization.

At the issue price, the shares stand on an historic pro forma price/earnings ratio of 10.2 times.

Parliament, page 4
Comment, page 25

Frosty US awaits Nakasone

From Bailey Morris and Michael Binyon, Washington

...Yasuhiro Nakasone, the ...nese Prime Minister, ar...s in Washington today for ...e visit he has described as ... most important of his ...ical career.

...e will find the atmosphere ...omising, in spite of Presi... Reagan calling Repub... leaders to the White ...se yesterday in an attempt ...ead off trade reform that ...nsiders dangerously prot...nist.

...ch foes of the omnibus ... legislation that would ...ire the President to take ...datory action against na... enjoying large trade deficit is with Japan. More important, there is a widespread perception in the United States that Japan has not played by the rules in closing its markets to Western goods.

There is little that Mr Nakasone can pull out of the hat this week to change these perceptions. The measures he will propose to head off a trade war after the US imposition of punitive tariffs against Japan are regarded as more of the same.

"I am heartsick that Japan has not been more forthcoming. Their stubborness will not help me on the floor of the US House," said Mr Dan Rostenkowski, the chairman of the powerful House Ways and Means Committee.

Representative Bob Michel ...

BP raises Standard share offer

By David Young
Energy Correspondent

BP has responded to opposition from small shareholders of Standard Oil of Ohio by increasing its offer to buy the outstanding shares in the company it does not already own.

It has raised its bid from $70 a share to $71.50 – a move which will increase the total offer from $7.4 billion (£4.48 billion) to $7.56 billion and...

City Editor
Neil Collins

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TEL: 01-353 4242.

Field day in silver, gold and platinum

LONDON silver shot up 85p an ounce yesterday 653.6p—a three and a half year high—on the back of a weaker dollar. It closed off the the top at 617p, still 48.50p higher.

Gold followed silver rising $11.60 on the morning fix to $476.60 an ounce, the highest level for more than four years.

The price subsequently slipped as the dollar rallied closing at $472, a rise of $7.

The plummeting dollar and fears about inflation accelerated the move to transfer money into tangible assets like gold, dealers said.

Platinum strengthened in line with silver and gold and closed near the day's highs at $639.50 an ounce compared with Friday's $627.50.

Inchcape leaps

INCHCAPE, the international services and marketing group, yesterday pleased the stock market with an 86p.c. rise in pre-tax profits from £46.2 million to £86.1 million in 1986 and, with a final of 13.85p a share payable on July 1, a 16p.c. rise in the total dividend, the first increase since 1980.

Questor on page 23 looks at these results and full year figures from John Menzies and Farnell Electronics.

Arrow payout

A £420,000 compensation payment was made last year by Britannia Arrow, the investment group where Michael Newman was replaced as chief executive by Lord Stevens after its merger with Lord Stevens' MIM company.

Oil stronger

OIL prices began to strengthen yesterday as it was disclosed that Saudi Arabia increased output this month by more than a million barrels a day to slightly above its official quota level.

Prices for North Sea Brent Oil for delivery next month were 15 cents higher than Friday's level at

Rolls-Royce at 170p gives £1.36bn price tag to issue

By Roland Gribben

ROLLS-ROYCE shares are to be offered for sale at 170p each, valuing the Government's latest privatisation stock at £1.36 billion.

The decision, made yesterday, surprised many analysts and observers who felt the price was being pitched too high in a nervous market. "They have been brave and gone right to the limit" said one analyst.

Payment for the shares will follow other privatisation patterns with a two-part system. There will be an 85p down payment with the balance being paid later in the year.

Analysts were trimming their expectations of the premium as details began to trickle out. "At 160p I would expect the shares to go to £2 on a fully-paid basis. At 170p, the premium will be probably 20p" said Ian Wild of Barclays de Zoete Wedd.

But at James Capel, brokers to the issue, the feeling is that the shares should quickly show a 30p premium with a rush of foreign investors, particularly from Japan, adding to the momentum.

Ministers accepted the pricing recommendation from their advisers, headed by merchant bankers Samuel Montagu, but rejected another on the trigger point for clawing back shares from institutions to the public.

Advisers advocated that clawback should be triggered if applications from the public reach three times the allocated level. The Government, with its eye on the price and conscious of criticism that the stock has been marketed as an institutional investment rather than a share for "Sid", decided to reduce the level to two times subscribed.

Therefore, initially, 60 p.c. of the 800 million shares on offer will be allotted to the institutions and 40 p.c. to the public, with provision for a 10 p.c. clawback to produce a 50-50 balance. The minimum application of 400 shares will involve an outlay of £680 on a fully-paid basis or £340 initially.

The Government and its advisers have taken British Aerospace as the yardstick for determining the pricing parameters, breaking out of the 120p-130p bracket set by the earlier privatisation offers.

The higher price may limit the premium but will be financially and politically helpful for the Government in countering Opposition charges that state assets are being offered too cheaply and sold too quickly by ordinary investors now looking more for a profit rather than becoming part of a wider share-owning democracy.

An estimated 500,000 ordinary investors have indicated they will apply for shares, but with a late advertising blitz the figure could be considerably higher.

Tokyo takes a hiding from crumbling dollar

By Anne Segall in London and Kimiko Barber in Tokyo

THE DOLLAR continued to crumble on the exchanges yesterday, falling to new lows against the yen and Swiss franc as mounting fears over the inflationary outlook in America encouraged international investors to dump the dollar.

The pound benefited, rising by more than a cent to $1.6655, its best level for four and a half years, with dealers reporting Bank of England intervention to stop it going even higher.

The slide in the dollar began in Far Eastern markets overnight as Japanese securities houses and large trading firms started offloading the United States currency through their offices in Sydney.

Renewed attempts by the Bank of Japan to halt the

nese stock market reacted with its biggest single day fall in history.

The Nikkei Dow Jones index plunged 831.32 points to 23,072.41 after losing 102.64 points on Saturday. The previous record fall of 637.33 points took place on September 16 last year.

Hardest hit were financial stocks such as banks and securities houses, while export-orientated issues—cars and light electricals—were surprisingly resilient.

The Japanese market boom has been fed in recent months by the excess liquidity of Japanese companies which have been investing in each others' shares rather than in new plant because of the impact of a high yen on trading prospects.

Wickins rules out Harvard board post

DAVID Wickins, chairman of British Car Auction Group, will not be lining up alongside Tom Wilmot as joint chairman of Harvard Securities, the licensed share dealers.

Tom Vallance, Harvard's company secretary, admitted Mr Wilmot's comments linking Mr Wicking with the job were "entirely wishful thinking by Mr Wilmot."

He said Harvard welcomed BCA as a shareholder and said it was looking for someone to take on part of Mr Wilmot's workload. "Mr Wilmot thought someone buying a sizeable stake may have been interested in taking up such a position," he added.

Mr Wickins yesterday confirmed BCA had acquired a 4.9 p.c. stake but said he did not own any Harvard shares person-

SUNDAY TIMES

CITY Tempted to squeeze BAA juice

VIEWPOINT by IVAN FALLON

IT IS privatisation time again, and the government and its City advisers are in danger of getting carried away by the euphoria. All last week I could detect a growing inclination, which I hope they will resist, to flog BAA to the public for every last penny they think they can get away with. One ministerial friend has accused me of pushing for too low a price for previous privatisation issues, and mentions British Airways in particular where the price has certainly taken off.

Maybe I have, but my riposte is that in the BA issue in particular the government itself was trying to talk the small investor out of it, and it was only because of commentators such as me that the public did flock to it — and made a very good profit.

If the government gets too greedy over BAA, it could get a rude shock. Most of the people I have talked to reckon the shares are worth around 210-220p. The two leading brokers on the issue, Phillips & Drew and Kitcat & Aitken, are in that ball park — P&D goes for 220p, Kitcat for 210p. Generally, last week's papers were in the same area.

I have a suspicion however that the Treasury wants more. It has seen the extraordinary rush of interest into other issues, and been embarrassed by the way the shares have often roared up afterwards, indicating the issues were underpriced and they have lost potential revenues for the government coffers. One can almost hear them saying to themselves "Why not take advantage of the frothy atmosphere? Let's get as much as we can." At the end of the week word was percolating out from County NatWest, handling the issue for the government, that a much better price would be 250p, which would raise £1.3 billion, or even 280p, which would raise £1.4 billion.

There were, the word went, special factors not in the prospectus: the roadshows, where chairman Sir Norman Payne and his groupies have gone armed with films around the country, have gone very well. Gatwick is doing much better than anyone imagined. Traffic is going through the roof at Heathrow. At 210p the shares would be a giveaway, and even at 250p they would be cheap.

But let us do some simple sums here. The market is now selling at 16 times historic earnings. BAA's earnings in its last financial year were 16p a share, so on that basis the shares should sell at 256p. But allowing for a discount in order to create some sort of decent aftermarket, we should knock 10% off. So, say, 230p. But there are better companies than BAA selling at lower ratings than that. BAA's growth record suggests it should sell at several points below the average rating. It is a monopoly, but is heavily regulated. It also needs to spend money in order to get money back — some £850m over the next five years, and it must be remembered this comes on stream in huge chunks, with the commissioning of a new terminal (or even airport, in the case of Stansted).

Given these problems the right p-e in this market, to get 500m shares away and create a satisfactory aftermarket, should be around 13 — which gives us a price of 208p. On that basis, I'll settle for 210p, and 220p at a stretch. But no more than that.

About half the issue will be offered at this all-important fixed price. The rest will go to the institutions at the same price, but with the now automatic feature of the "super clawback", whereby some of these shares will be "clawed back" to satisfy extra demand from the small investor. These are the shares that will be offered on a tender basis, which means the investor applies at or above the fixed price and the shares go to the highest bidders.

The fixed price will be announced on July 8 and applications close on July 16. In between those dates I will give you my views on what price to tender at. It is an issue which could be a good one for the small investor.

Sunday, June 28, 1987

THE INDEPENDENT

BAA float still on runway

22

With only three days to go before the price for BAA shares is announced, public response has not been enthusiastic. Lorna Bourke reports.

THE Government cannot be too happy with the level of interest in British Airports Authority, which is about to be floated in a complicated two tier offer-for-sale comprising a fixed price and tender offer.

The number of people who have registered with the BAA share information office is just over 1 million, compared with 3 million who registered for TSB prospectuses and 7.5 million who registered for British Gas at approximately the same stage in the flotation.

Keith Payne, of Charles Barker, the firm handling the public relations for the BAA flotation, said: "Those two privatisatons are not directly comparable because TSB and British Gas were able to drum up support by direct mailing customers.

"British Airways and Rolls Royce, for example, had 612,000 and 696,000 people respectively, registered so BAA we think is doing well," he said.

Both these privatisations were around £1 billion — roughly comparable in size with the BAA issue.

Next Wednesday, 8 July, is impact day when the price of the fixed-price offer is to be announced. And if interest remains at a relatively low level, the Government may be obliged to fix the BAA share price below the predicted 210p to 220p, to drum up interest.

Part of the problem is that the offer-for-sale is complicated. Three quarters of the 500 million shares to be sold will be at the fixed price, yet to be announced. The other 25 per cent is a tender offer — but a tender with a nasty twist which the brokers do not like.

Anyone bidding for shares in the tender auction, who is successful will have to pay the price bid — not the more usual "striking" price. (This is the lower price at which all successful applications are fulfilled.)

This will act as a major deterrent to would-be investors. Brokers see this as the thin end of the wedge.

With other privatisations in the pipeline — BP, the water authorities, and the electricity industry — they see the BAA tender as creating a precedent, and a means of raising as much as possible for the Government, leaving little or nothing for the brokers, their clients and the speculators.

The stags may still have a flutter, but the institutions who might well be long-term holders of BAA will probably find it more advantageous to wait and see at what price the shares settle when dealings start on 28 July, and buy in the market.

"The issue is too complicated and the advertising does not make it clear that this is an offer-for-sale which the public should take up," commented a rival of Charles Barker and JWT, which is handling the BAA advertising campaign.

This view is inevitably biased but is shared by many of the brokers.

A row is rumoured to be brewing over the pricing of the issue which will be considerably more difficult to judge, given the onset of the holiday period and the likelihood of somewhat weaker markets than in the pre-election stock market euphoria when Rolls Royce and British Airways were sold off.

This could be good news for potential investors since the price may be lower than otherwise, providing healthy profits for the stags, to ensure that the issue is not a flop.

Stockbroker Phillips and Drew reckons that when dealings in the shares start on 28 July, the price will settle at around 240p per share. If the fixed price offer is at 220p this does not leave enough to attract the speculators in any numbers.

After dealing costs of a minimum of 1.5 per cent, a profit of less than 10 per cent does not look very attractive.

Those involved in the issue however, claim that dealings are much more likely to start at about 270p — but here again, they are hardly unbiased.

All of which points to the possibility of a lower offer price than 220p. This is good news since BAA should be a long-term hold, enjoying as it does a monopoly as UK airport operator and rising revenues from increased air traffic, passengers and duty-free sales.

So if you want to register your interest and ensure that a prospectus is sent, ring 01 200 1000, or write to the BAA Share Information Office, PO Box 181, Liverpool, L70 1AA.

Saturday July 4 1987

3

FINANCIAL TIMES

Over 1m register for BAA prospectus

8

By Richard Tomkins

THE IMMINENT flotation of BAA, the state-owned airports group, appears to be creating strong interest among investors in spite of the relative complexity of the offer arrangements.

With another week to go before the launch of the prospectus, the number of people registering with BAA's share information office passed the 1m mark yesterday. That compares with less than 700,000 each for the Rolls-Royce and British Airways flotation when their share information offices closed.

There had been concern in some quarters that the unusual structure of the offer, under which part of the shares will be offered at a fixed price and part through a tender, would prove off-putting to investors. Yesterday's figures suggest that those fears could prove unfounded.

Meanwhile the debate over the pricing of the offer rumbles on with the Government's advisers apparently at loggerheads with independent analysts and BAA itself.

The County NatWest, the merchant bank advising the Government, and County Securities, the bank's broking arm, continue to suggest that the shares warrant a rating above the market average, suggesting a price well above the 250p mark.

However Phillips & Drew, a stockbroker not connected with the flotation, yesterday joined other independent brokers in suggesting that an offer price in the range of 210p to 220p would be more appropriate, giving BAA a market capitalisation of 1.05bn to £1.1bn.

"In view of the highly regulated nature of BAA and the political worries on duty free sales, we believe BAA's price should be set at a discount to the market price/earnings ratio, despite its good growth potential," Phillips & Drew said.

Freedom according to the rules, Page 6

Daily Telegraph

Rising hackles over pricing for BAA

13

By Roland Gribben

DIFFERENCES between the City, the government and its advisers over the pricing of British Airport Authority shares continued yesterday with analysts continuing to argue that the issue is in danger of being overpriced

But County Natwest, the government advisers, denied suggestions that a higher than predicted price had produced a public "turn off", said the number of applications for information about the latest privatisation stock had topped the million mark and was well above the levels recorded for British Airways and Rolls-Royce at the comparable stage.

The wide rift over pricing - the difference between the two sides is between 40p-50p - produced a flurry of behind the scenes activities yesterday with suggestions that analysts and the company were engaged in serving vested interests by "talking down" the price.

BAA strongly denied the charge. The indications are that after what is regarded as a successful series of road shows around the country and presentations this week to institutions and underwriters there is strong support for a price in the 250p-260p range and enough enthusiasm to pitch the tender element of the issue in the 20pc-25pc range, close to the maximum level.

Analysts maintain that on a past and prospective performance rating there is nothing in BAA to justify a price above the 210p-220p level. One said: "Pricing the issue at 250p would be ludicrous. The government obviously want the most out of it with a high fixed price and the tender but they are being unrealistic."

Alan Kelsey of stockbrokers Kitcat Aitken maintained that with a high capital spending programme and interest and tax charges to take into account BAA is likely to be lagging behind the market. Richard Hannay of Phillips and Drew argued that with the company's growth in pre-tax profits below the market average the case for an offer price above 210p was weak.

County Natwest argued that the brokers case was too pessimistic and that other arguments about the risk to duty free business and the controls over the regulatory regime had been exaggerated.

Advisers attached to the "road show" presentations said there had been an enthusiastic response. "The main point made was to ensure there were sufficient application forms available to avoid the problems encountered with Rolls-Royce. There was talk of bidding up to 300p in the tender," said one. The price will be officially announced on Wednesday.

THE TIMES

Whitehall insists rush for BAA continues

25

By Ray Heath

The inclusion of the tender element in the sale of BAA shares has not put off small investors, according to sources close to the Government, which is selling its holding in the airports management group. Inquiries for details of the issue have risen from 500,000, before the pathfinder prospectus was published, to more than 1 million, they said yesterday.

It was feared that the added complication of a tender might have deterred some unsophisticated investors.

Yesterday, it became clear that the Government is determined to price the issue well above the level suggested by many analysts, arguing that they do not reflect investor opinion.

Suggestions that the fixed price should be about 220p were well out, said an official. A figure of 270p was closer to officials' estimates of the correct price. While that might reflect their expectations of the levels of bids for the 25 per cent of the issue open to tender, it would still suggest a fixed price much in excess of analysts' calculations.

The Government's advisers feelfund managers and small investors are prepared to pay a full price which reflects current market multiples for industrial companies.

6/4