PO-CH/NL/0147

PART B

Part . B .

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 23/7/87.
Ends: 14/9/87.

PO -CH /NL/0147

PART B

Chancellor's (Lawson) Papers:

PROPOSALS FOR WIDER SHARE OWNERSHIP

Disposal Directions: 25 Years

[signature]

25/8/95.

PO -CH /NL/0147
PART B

MR 2/56

CONFIDENTIAL

FROM: A W KUCZYS
DATE: 23 July 1987

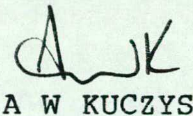
PS/FINANCIAL SECRETARY

cc: PS/CST
PS/PMG
PS/EST
Mr Monck
Mr D J L Moore
Mrs M E Brown
Miss Sinclair
Mr Bent
Mr Boote
Mr Cropper
Mr Isaac - IR
PS/IR

SHARE ISSUES: EMPLOYEE BENEFITS

The Chancellor has seen Mr Bent's minute of 22 July. He has asked:

> "Are not BP employees shareholders via an employee trust? And will they not thus get preference as existing shareholders?"



A W KUCZYS

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
23 JULY 1987

FINANCIAL SECRETARY

SHARE ISSUES: EMPLOYEE BENEFIT

1. I have sent you separately today a note on the next steps, following the decision at the Chancellor's meeting that we should plan to introduce a new extra-statutory concession to maintain (broadly) the effect of our present practice.

2. Quite separately, and following discussion with your Private Office, it may be helpful to let you have a response to the minute with Mr Bent sent you on this matter yesterday. If I may say so, it was particularly helpful to have a copy of that note because it appears that some of us may be at cross-purposes.

The legal position

3. As Mr Prescott reported to you in advance (his minute of 16 June) we found ourselves compelled to review our established practice in handling employees priority rights (pending the outcome of the review, we maintained our practice for the BAA flotation). In particular, our

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cc	Chancellor of the Exchequer	Mr Battishill
	Sir Peter Middleton	Mr Isaac
	Mr Cropper	Mr Lewis
		Mr Easton
		Mr Prescott
		Mr German
		PS/IR

practice had been questioned in the professional press, in the light of the experience of recent issues; and (against that background) the Treasury's advisers had asked us for authoritative guidance.

4. The statutory position, confirmed in our Solicitor's advice, was subsequently reported in Mr Prescott's and my minutes of 17 July. It is quite clear, and rests on the simple facts. An employee receives a taxable benefit if, only because he is an employee, he obtains shares of a value greater than the price he has paid for them, and in principle where he has obtained those shares only because of his priority rights as employee he receives the benefit as an employee. On this basis, employees in recent privatisation issues have, by virtue of their employment, received benefits which should strictly have been taxed, and which are not de minimis - up to £7,000 per head in the one issue, and (judging by press reports of the 'grey market' value) up to £1,800 a head in the more recent issue.

5. Any other points are strictly irrelevant - except insofar as they may

- either substantiate an argument that existing practice is a reasonable interpretation of the statutory position - rather than a (reasonable or unreasonable) concession from it;

- or help to explain why recent share issues have raised problems which we did not face previously.

Practice or concession?

6. As I said in my note of 17 July, we had previously sought to justify the existing practice, on the basis that the price at the "offer date" could - by and large - be taken as a reasonable approximation of the value at the "allotment

date". This was arguably always a generous interpretation, but one which we had up to now felt able to follow, without challenge from outside. However that may be, in the face of challenge, we were forced to conclude that this line of argument ceased to be plausible when viewed against premia of the size recorded in the annex to Mr Prescott's note. And it seemed to us, in addition, difficult to argue that the premia arose solely and 'adventitiously' from the buoyant rise in the bull market generally, as between the offer date and the allotment date, when the press were recording "grey market" estimates of premia of between 20 per cent and 30 per cent immediately following publication of its offer price. (For this purpose the quoted grey market price seemed necessarily to carry more weight than the views attributed in Mr Bent's quotations to a number of city interests before publication of the price, at a time when, one might expect them to be "talking their book").

The tender element

7. It is against that background that the tender element, in a flotation, presents the difficulty which I described.

8. As Mr Prescott explained in his note of the same date, the Courts have decided - and this is settled case law binding on us - that there is a benefit chargeable to tax if, in the context of a tender offer,

- employees are entitled to subscribe for shares at a fixed price and

- that price turns out to be less than the price at which the other shares are actually sold under the tender.

The motive - whether or not the company wishes to reward its employees - is (here as elsewhere) irrelevant. All that counts is the facts; the employees get shares at a lower price than outside investors.

9. As we understand it, the ratio of the decision is that, if in fact outside investors are prepared to and do pay more for the shares than the employees are required to pay, the employees must be presumed to have acquired shares at less than their market value - all the shares in question being valued at the time of allotment.

Other points

10. The other points in paragraph 8 of my note of 17 July are not central to the argument (that is why I introduced them as being "consistent with" the main points - rather than as conclusive in their own right).

11. I added them in an attempt to explain - to ourselves and to Ministers - how the underlying factual position could have changed, to the extent that we needed to reach conclusions on our present practice which we found (and which we knew Ministers would find) unwelcome. If the Treasury tells me that this explanation does not reflect their view of developments, then of course I accept that. But it does not affect one way or the other the taxability of the shares under law; and that is the problem before us.

A J G ISAAC

SHARE ISSUES: EMPLOYEE BENEFITS

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Again, riddled with errors of fact. Hence no grounds of misunderstanding X. Facts must be established first, before considering action, at mtg - must clear at mtg it.

FROM: A J G ISAAC
23 July 1987

ISAAC → FST 23/7

FINANCIAL SECRETARY

SHARE ISSUES: EMPLOYEE BENEFITS

note in separate folder on benefits in kind

not accurate - see note of meeting. You first said Isaac & FST should establish facts, & only if it were proved that any action was necessary should there be an ESC

1. My note and Mr Prescott's of 17 July about this were discussed at the Chancellor's meeting on Tuesday, and he asked whether the problem could be dealt with by administrative action - ie an Extra-statutory Concession - rather than by means of legislation. We now need to consider next steps. There is some urgency because of the impending BP disposal.

BACKGROUND

2. To recapitulate briefly, the problem concerns the proper tax treatment of the benefit derived by employees where they get a priority allocation when subscribing for an issue of shares in their company - and thus receive more shares than comparable members of the public - and at the time of allocation those shares command a premium over the offer price. Our practice hitherto has been normally not to seek a Schedule E charge on the grounds that because the employees were paying the same price for

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr D J L Moore
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Lewis
Mr Beighton
Mr Easton
Mr German
Mr Prescott (o/r)
Mr Peel
Miss Green
Mr Swann (SVD)
Mr Crabbe
PS/IR

the shares as everyone else they could be regarded as not having acquired the shares at undervalue. Implicit in this is the presumption that the offer price is a reasonable proxy for the true value of the shares at the point in time when they are actually allocated to the employees (which will always be some time after the offer price is announced).

3. We were, however, compelled to review that practice for a number of reasons, including Press and other comments concerning the apparently quite sizeable benefit to the employees in recent privatisations resulting from the combined effect of their priority allocations, and the substantial premiums on the shares over the offer price at the time of allocation. The problem is not, of course, exclusively one concerning privatisations - there have also been recent private sector share issues involving priority employee allocations and very substantial premiums).

4. In reviewing our practice we sought legal advice, and the advice from our Solicitor is clear beyond doubt. There is under the present law a taxable benefit to the employee if the price he pays for the relevant shares is less than the true value of those shares at the time that they are allocated to him. The "relevant" shares for this purpose are the extra shares he gets as a result of the priority allocation compared with the number allocated to a member of the public who subscribed for the same number of shares as that subscribed for by the employee.

5. In practice, for reasons explained in the earlier papers, things may be a little more complicated than this and the measure of any benefit will depend on all the facts in each particular case, including the basis of allocating shares to members of the public. And, even where there is a benefit, it might be possible in some cases to ignore this on de minimis grounds. Generally speaking, however, there will undoubtedly be a benefit that is taxable in principle, and one that it may not in practice be possible to ignore on de minimis grounds.

EXTRA-STATUTORY CONCESSION

6. The Chancellor asked us to consider whether there could be administrative action, rather than new legislation, to ensure that the benefit is not taxed in these circumstances. This would require a new, published extra-statutory concession.

7. We see no great difficulty in proceeding by way of ESC. Many of the circumstances which have made it sensible to ignore these liabilities in practice in the past - uncertainty as to the outcome, complexity of the calculation, large numbers of generally small liabilities - help to justify a new ESC. It is unhelpful that speculation in the press about these liabilities may link a new ESC specifically with privatisations because that would give it a political flavour inappropriate for an ESC. But we think it should be possible to meet any such comments by pointing to similar circumstances with private sector flotations.

8. In essence, the proposal in Mr Prescott's note is that exemption from a charge under Schedule E should apply where

- there is an offer of shares to the public, in which the employees will also receive a priority allocation, and

- at least 75% of the shares being issued are by way of an offer at a fixed price (as mentioned in the earlier papers this would deal with the problem of hybrid schemes where there is a partial tender element), and

- not more than [10%] of the shares are acquired by the employees at fixed prices under the priority allocation.

9. We shall need to do some further thinking with you about two aspects.

- Is 75% the right level at which to fix the minimum proportion of shares on offer at a fixed price? On the

one hand it is clear the concession can only apply if the offer is essentially a fixed price offer. On the other, we do not want to define the concession so tightly that some deserving cases - including perhaps some future privatisations - fall the wrong side of it.

- Should there be some cap on the amount of benefit an individual can obtain? This may not be easy to devise; but there could be difficulties in justifying a new ESC on the lines of paragraph 7 if the effect was to exempt from tax significant numbers of gains running into several thousands of pounds (as they have in the past).

10. The concession would be covered by the usual caveat that it applied only in "normal" circumstances, and not where an attempt was made to use it for purposes of tax avoidance.

BP

11. As we understand it, BP is entirely a fixed price offer, and the priority allocations for UK employees have not yet been fixed. An ESC on the lines envisaged would thus clear out of the way any difficulties for BP, subject to any cap on the extent of individual gains. As mentioned below, this needs further thought. But if we cannot get the terms of the new ESC finalised by the time decisions need to be made on BP, it would in our view be reasonable to apply the principle of the proposed ESC on an interim basis.

wrong

PUBLICATION

12. The fact that our practice has been under review is apparently widely known outside. This may cause uncertainty and speculation and it would obviously be desirable for the concession to be published as quickly as possible. This might

also help forestall queries that might otherwise arise concerning BP. If you are content to proceed in this way, we will prepare the text of an ESC and a draft Press Notice for your approval as soon as possible.

A J G ISAAC

3973/2

FROM: P J CROPPER
DATE: 24 July 1987

CHANCELLOR

PURCHASE OF OWN SHARES RELIEF

I refer to Sir Keith Joseph's letter of 22 June and subsequent exchanges.

2. Official advice has now been given. One is reminded that the derogation of 1982, enabling unquoted companies to buy in their own shares, was a selective enterprise measure.

3. It would be costly to extend the concession to other companies, but the official argument, set out in the attached papers, does not seem entirely confidently based on principle. Do you feel we should send Keith Joseph a variant of the standard reply or are you at all inclined to ask for a more comprehensive review before rejecting the idea?

P J CROPPER

If the proposal's not too comprehensive. I can see no argument in principle for the policy complained of: what would be the cost of changing it?

2. Cannot market forces solve [illegible] problem by buying back shares? [illegible]

Inland Revenue

Policy Division
Somerset House

FROM: D J HUFFER
DATE: 16 JULY 1987

cc Mr Beighton
Mr McGivern
Mr Reed
Mr Huffer
PS IR

MR P J CROPPER
SPECIAL ADVISER

PURCHASE OF OWN SHARES RELIEF

1. In your note of 3rd July you asked for comments on a correspondent's statement:

> "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."

2. This is presumably a reference to the fact that investment companies cannot take advantage of the purchase of own shares (POS) relief, introduced in Section 53 and Schedule 9 Finance Act 1982. This applies only to unquoted trading companies.

3. The attached copy of an extract from a Ministerial reply in 1986 conveniently sets out:

- The background to the relief,
- How it operates,
- Why it has not been extended to investment companies.

4. For the reasons set out in the letter there would seem to be no case for changing the approach on investment companies. Any such move would involve a fundamental departure from the principles which lay behind the introduction of the relief - and which are presumably still thought to be sound.

D.J. Huffer

D J HUFFER

It might be helpful if I explain the background. First, the 1981 Companies Act gave companies generally greater freedom, with certain safeguards, to buy back and then cancel their own shares. This was seen as a way of helping companies manage their affairs more flexibly and efficiently. Under normal tax rules, however, the amount paid by the company for its shares in excess of the original subscription price is treated like any other distribution out of profits. As such the company has to pay advance corporation tax on the "distribution element", and this is taxed as income (with a 30% tax credit attached) in the hands of the shareholder.

We recognised that in certain special kinds of situation there might be a case for more favourable tax treatment if companies were to get the full benefit of this new option. Section 53 of the 1982 Finance Act therefore provides an exception to the normal tax treatment, where an unquoted trading company purchases its own shares and certain qualifying conditions are satisfied. Then the company does not pay advance corporation tax, and, in the hands of the shareholder, the "distribution element" is not taxed as income but is, instead, subject to the Capital Gains Tax rules just as if the shares had been sold to a third party.

Mr is concerned that non-trading companies are excluded from the relief provided by Section 53. That is because the relief is deliberately narrowly targeted: we introduced it as part of a series of enterprise measures aimed specifically at encouraging small unquoted trading companies to improve their efficiency so that ultimately the economy benefits and more employment is generated. One of the fundamental purposes of the relief is to help such trading companies to buy back their shares where their trade might otherwise be adversely affected, for example, where the shares lack marketability or where the shareholders concerned are dissident or apathetic, or merely wish to exit the company but the only potential purchaser is a trade competitor.

We therefore decided to target the relief on those types of company for which we felt these particular problems would be most damaging. Thus, we decided that certain activities, which were essentially passive or financial in nature should be excluded, not because of bias against companies carrying on such activities, but because with limited resources available, we felt the relief had first to go where the need was greatest. In this respect I should emphasise that the relief is not available to all trading companies regardless, but only in very carefully defined circumstances where the purchase can be demonstrated to be of benefit to the trade.

An extension of the provisions, whether to non-trading companies or trading companies in circumstances outside the existing rules would involve considerable cost, and whilst we fully appreciate the role played by some non-trading companies, we do not feel that such cost would be sufficiently balanced by returns in terms of economic vitality and job creation.

I am sorry to have to send a reply that Mr   will find disappointing, but I hope I have at least shown why the provisions were constructed as they were.

JOHN MOORE

MR 2/63

UNCLASSIFIED

b/f with response [illegible]

FROM: A W KUCZYS
DATE: 27 July 1987

MR CROPPER

PURCHASE OF OWN SHARES RELIEF

The Chancellor has seen your minute of 24 July.

2. He would like to have a more comprehensive review before replying to Sir Keith Joseph - although not too comprehensive. He can see no argument in principle for the policy complained of: what would be the costs of changing it?

3. Cannot investment trusts solve their problem by buying each others' shares?

AWK

A W KUCZYS

psl/39A

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 27 July 1987

ACSA
PS/EST
27/7

PS/FINANCIAL SECRETARY

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

Mr Battishill - IR
Mr Isaac - IR
Mr Lewis - IR
Mr Prescott - IR

SHARE ISSUES: EMPLOYEE BENEFITS

The Chancellor has seen Mr Isaac's minute to the Financial Secretary of 23 July. He feels that there are again errors in the descriptions of what has happened and what the Government's policy is, and that while those remain there can be no question of rushing into drafting an Extra-Statutory Concession or press notice. As the Chancellor made clear at his meeting, the first step is to sort out the facts.

ACSA

A C S ALLAN

CONFIDENTIAL

Alex
Pps with you

HEYWOOD
↓
ISAAC
27/7

FROM: J J HEYWOOD
DATE: 27 July 1987

MR ISAAC IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mrs M E Brown
Mr Haigh
Ms Leahy
Mr Cropper
PS/IR

SHARE ISSUES: EMPLOYEE BENEFITS

1. The Financial Secretary discussed your minute of 23 July with you and others this morning. The discussion fell into two parts.

Does a Tax Charge Arise?

2. Your firm opinion was that under present law (and ignoring possible "de minimis" considerations) there is a taxable benefit to the employee if the price he pays for the relevant shares (ie. the "fixed offer price") turns out to be lower than the true value of those shares at the time of allocation (proxied, where there is a tender element, by the "tender price"). In this context, the "relevant shares" are the extra shares he gets as a result of the priority allocation arrangements.

3. The Financial Secretary was concerned that this missed the point that the Government never sought to sell shares to employees at below market value. Ex post it might happen that in a hybrid offer the tender price was higher than the fixed offer price. However, one could not say in advance that this

would happen. Therefore, he rejected your suggestion (paragraph 8, your minute of 17 July) that, at the time it is fixed, the offer price is not set at the maximum level which an outside investor might be expected to pay. You said that with hindsight you would not have raised this issue, because the Government's intention in setting the offer price was, in any event, strictly irrelevant to the question of whether a tax charge arose.

4. There was some discussion of whether the clawback arrangements proposed for a current privatisation issue implied that the Government was not exclusively concerned with maximising proceeds. You pointed out that if clawback were triggered this could on some (not unlikely) assumptions imply a willingness, on the Government's part, to increase the allocations of fixed-price investors at the expense of those applying in the tender. Insofar as the tender price were greater than the offer price then this suggested that the Government's intention was not exclusively to maximise proceeds.

5. The Financial Secretary asked Mrs Brown to prepare urgently a Treasury paper setting out the role of clawback. This should point out, inter alia, that:

(i) Clawback had been used for issues which were solely "fixed price".

(ii) Clawback could allow the Government to set a higher fixed price than would otherwise be the case.

6. The Financial Secretary wanted the Revenue's most senior Solicitor (Mr Miller) to read this Treasury paper before reaching a view on whether a tax charge does arise or not. He thought it was unsatisfactory that Ministers were being forced to review existing practice simply as a result of one Revenue Solicitor's advice (together with comment in a professional journal). He asked to see this advice and the article in the press which had given rise to the advice being sought.

A Possible Extra-Statutory Concession (ESC)

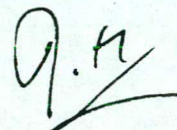
7. The Financial Secretary said that he was not convinced that a tax charge did arise. However, he thought it expedient to discuss, on a contingency basis, what form of ESC it might be necessary to introduce to ensure that any benefit would not be taxed in practice.

8. It was agreed that since a benefit could arise even if there were no tender element, it would not be sensible to frame the ESC in terms of a maximum proportion going out to tender. You suggested that another approach would be to exempt employees from a charge under Schedule E in a normal case where:

(i) there is an offer of shares to the public, in which the employees receive a priority allocation; and

(ii) not more than 10% of the shares available at the fixed price are offered to the employees under the priority allocation and these priority rights are available on broadly similar terms to all employees.

9. The Financial Secretary thought this was on the right lines but asked you to consider the details further with Treasury officials. He asked for separate advice on the possibility of a cap on the maximum gain which could be tax-free under the ESC, but his initial view was that this would probably be unnecessary.



JEREMY HEYWOOD
Private Secretary

047

P10/1

CONFIDENTIAL

Alex
Pps with you?

FROM: MRS M E BROWN
DATE: 27 JULY 1987

FINANCIAL SECRETARY

cc Chancellor
Sir P Middleton
Mr Monck
Miss Sinclair
Ms Leahy
Mr Haigh
Mr Cropper

SHARE ISSUES: EMPLOYEE BENEFITS

As requested at your meeting with Mr Isaac this morning, I attach a draft note, replying to the points which the Revenue have made about partial tenders. If you agree, I will send it to Mr Isaac directly.

2. We are considering the points raised at the meeting about the terms of any extra-statutory concession: ie whether there should be a cap on the size of allocation to any one employee, and the maximum percentage of the total offer which should be available for potential allocations to employees.

Mary Brown

MRS M E BROWN

ENC

BROWN
FST
27/7

CONDFIDENTIAL

SHARE ISSUES: EMPLOYEE BENEFITS

The Inland Revenue's argument that priority allocations for employees in share issues are taxable rests on two main points:

(i) The premia which have been seen on share issues in both the public and private sectors;

(ii) partial tenders, which are said to add weight to the argument that shares allocated in a fixed offer are priced below their "true value".

2. On the first point, Mr Bent's minute of 22 July explained that in privatisation issues there has been no intention to generate a large premium (contrary to the suggestion in Mr Isaac's minute of 17 July).

3. On tenders, the following points should be noted:

(i) tenders are subject to risk. They reflect market movements in the period after the fixed offer is priced. Such movement may be either up or down. It is perfectly conceivable that the tender price might be less than the fixed offer price. There is nothing to change our view that the fixed offer price reflects our best judgment at the time of the price the market will bear.

(ii) Clawback is a well-tried mechanism in privatisation issues: it is not a special feature of tender offers. It is intended to allocate the maximum number of shares to retail purchasers, and to create a perception of potential scarcity amongst institutional and overseas investors. As such, it is crucial to the dynamics of a major international offering. The clawback provisions in the

BAA and proposed BP tenders have been designed for exactly the same purposes. Clawback certainly demonstrates the Government's commitment to wider share ownership. It does <u>not</u> undermine our view that the fixed price is the best judgment that can be made at the time of what the market will bear.

(iii) Privatisation sales are planned on the basis that clawback will occur: for BP, we expect that the tender element will be 37.5%, although it will be set pre-clawback at 50%. It is arguable that a larger tender element, without the perception of scarcity engendered by clawback, would result in less keen a tender price. In other words, clawback is not necessarily detrimental to proceeds overall.

H M Treasury
27 July 1987

CONFIDENTIAL

From: SIR PETER MIDDLETON
Date: 28 July 1987

PMP

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Monck
Mr Moore
Mr Scholar
Mrs Brown
Miss Sinclair
Mr Haigh
Ms Leahy
Mr Cropper

PS/IR
Mr Isaac - IR

Ch
(papers in FST material folder)
AA

SHARE ISSUES: EMPLOYEE BENEFIT

May I make two suggestions.

2. First, paragraph 4 of Mr Isaac's minute of 23 July makes it clear that the only question at issue is whether an employee obtains shares of a value greater than he has paid for them. I therefore share the conclusion recorded in paragraph 3 of your meeting of 27 July.

3. The question of whether the Government underpriced this or other classes of share is irrelevant. In my view it should cease to be discussed in this context. But as it has been, I should record my view, as Accounting Officer, that so far as BP is concerned I am satisfied that the arrangements will achieve the best price given the Government's clearly stated privatisation objectives.

PEM
↓
FST
28/7

4. Second, could our professional advisers be advised not to "challenge" the Revenue without first giving thought to the pattern of events which will be set in train.

PEM

P E MIDDLETON

3361/01

CONFIDENTIAL

FROM: N M DAWSON
DATE: 28 July 1987

MRS M E BROWN

cc PS/Chancellor
Sir P Middleton
Mr Monck
Miss Sinclair
Ms Leahy
Mr Haigh
Mr Cropper

SHARE ISSUES: EMPLOYEE BENEFITS

1. The Financial Secretary has seen your draft reply to the Inland Revenue on partial tenders.

2. The Financial Secretary agrees with the reply. Could you send it on to Mr Isaac please.

NIGEL DAWSON
Diary Secretary

3973/7

CONFIDENTIAL

Pps / plaine

FROM: P J CROPPER
DATE: 28 July 1987

CHANCELLOR

cc Financial Secretary
Sir P Middleton
Mr Battishill
Mr Isaac
Mr Lewis
Mr Easton
Mr Prescott
Mr German
PS/IR

SHARE ISSUES: EMPLOYEE BENEFIT

Does it help to look at the vexed question of employees' preferential allotments this-wise:

2. Everybody knows that, if you want to sell a large number of shares in a given company, you have to accept a lower price. Similarly if you want to buy a large number you have to pay a higher price. In my day it used to be expressed in the form of a jobber's quote like this:

ICI:	323 - 327 in 5,000
	322 - 328 in 10,000
	320 - 330 in 25,000
	315 - 335 in 100,000
	above that by negotiation.

3. A fortiori, if you wanted to sell all the shares in a company you would have to offer them at a significant undervalue. In other words at the initial flotation of a company you expect the price at the start of dealings to open at a level where individual sellers will be able to take a profit. By symmetry, if everybody wanted to sell on the first day of dealings you might expect the emergent price to be at an undervalue similar to that used at the flotation itself.

CROPPER
↓
CH/X
28/7

4. Thus it is in the nature of things, that when all the shares of a company are offered for sale, they have to be priced at a discount. In short, "this is the only way the issue will go".

5. Turning next to the position of the employees, they will probably want to apply for a very modest proportion of the shares on offer - otherwise they would have organised a management buy-out. So it cannot be said that their applications are more than very marginally necessary to the success of the offer. In other words the offer of preferentially large allotments to the employees is not essential to the success of the offer: more likely it is judged as a goodwill gesture conducive to the loyalty of staff, to the subsequent success of the business etc. And it is a useful means of spreading wider ownership: an opportunity too good to be passed up, in the case of privatisation.

6. It seems to me indisputable that the employees are getting a benefit which should, unless otherwise ordained, be taxed. If the man in the street only gets 100 shares on an application for 2,500 shares, and the employee gets 2,500 shares on an application for 2,500 shares; and if the opening premium is 40p; then that employee is getting a benefit of 2,400 x 40p, or £960. I argue this without reference to hybrid fixed price/tender arrangements.

7. Should he have to pay tax on that £960, or not? I certainly think he should pay tax if the profit comes out at some big figure like £5,000 or more. I am not sure that it is something we should bother with below about £1,500. So there are grounds for a de minimis approach, or an upper limit.

8. If, however, we wanted to relieve all such benefits from taxation, I think we could bring in several arguments:

1. Capital Gains Tax is already liable on a realised gain. The fact that most employees' gains in the year concerned will total less than £6,600 is by the way. That is simply the way CGT works: the liability is there, but it happens to be nil. Really big gains on employees share allotments would be caught if realised.

2. Uncertainty. The employees of Morgan Grenfell, who bought shares at the flotation at 500p and saw them down to 365p would be justified in arguing that the sort of profits we are talking about can only be safely counted after they have happened. But then they would not have been liable to tax in any case - unless they had held on for the present recovery of the MG price to 530p. By which time the distinction between the employee's allotment and the man in the street's allotment might appear slightly academic.

3. A-symmetry. I think it is true to say that a Morgan Grenfell employee, selling his allotment at 365p, would not have been given an income tax loss. He would, of course, have been able to clock up a CGT loss. So it is, on income tax account, a case of heads Inland Revenue wins, tails taxpayer loses.

9. Against this, one should perhaps compare the restrictive limits on individual allotments under the 1978 etc Profit Sharing schemes, with the open ended profit if we went for total exemption in the case of allotments in new issues.

P J CROPPER

4119/026

RESTRICTED

FROM: P M LEAHY

DATE: 28 July 1987

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Moore (or)
Mrs M E Brown
Mr Lyne (or)
Mr Bent (or)
Ms Pelham
Mr S B Johnson
Mr Cropper

BP SALE: PREFERENCE FOR EMPLOYEES/PENSIONERS

You and the Chancellor asked whether BP employee/shareholders would obtain priority through the rights issue.

2. The answer is yes but not on average for many shares. The rights element of the issue is likely to be 1 share for every 12 already held. The average employee shareholding is about 500 shares so the average employee shareholder would obtain priority for about 40 shares. BP are proposing priority in allocation for up to 1000 shares for employee shareholders.

3. As I mentioned at yesterday's meeting BP have indicated that if we insist on giving priority in allocation to all UK employees (about 30,000 in total) they might well want all BP employees worldwide also to have priority (about 130,000). The potential problem of extending priority to all overseas employees is that it might lead to overseas employees obtaining priority over UK retail investors. We could however try to set the amount of preference at a level that would avoid this. We would be grateful for your views.

4. BP have now said they would also like BP pensioners to receive priority in allocation. Pensioners have been given priority in allocation in a number of Government sales including BAA the most recent one. Officials see no problem in allowing pensioners priority in this offer. But again we would be grateful for your views.

P M LEAHY

I see no case for giving preference for BP employees, no case for ditto to BP pensioners, & precious little for ditto for BP UK employees, who already hold BP shares far above the average. And what do we get in return for all this?

AWK 29/7

ps3/42K

RESTRICTED

FROM: A W KUCZYS
DATE: 29 July 1987

28

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr D J L Moore
Mrs M E Brown
Mr Lyne Ms Leahy
Ms Pelham
Mr S Johnson
Mr Cropper

BP SALE: PREFERENCE FOR EMPLOYEES/PENSIONERS

The Chancellor has seen Ms Leahy's minute of 28 July. He does not like what is proposed at all. We must not let BP take us for a ride. The Chancellor recalls (and Ms Pelham confirms) that we resisted worldwide employees in the 1985 Cable & Wireless sale. The Chancellor sees no case for giving priority to BP overseas employees, no case for BP pensioners, and precious little for BP UK employees (who already hold BP shares for the most part). And what do we get from BP in return for all this?

AWK

A W KUCZYS

Ch

Reading Miller's advice below made me realise that what we have here is a third-party benefit in kind: the owner of the shares (HMG) is conferring a benefit on the employees; it's not the employer who is.

I'm not sure this makes any difference: the ESC drafted by the Revenue never refers to 'employers', but it highlights why this//

feels so odd.

AA

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: P LEWIS
EXTN: 6371
DATE: 29 JULY 1987

1. MR ISAAC
2. FINANCIAL SECRETARY

SHARE ISSUES: EMPLOYEE PRIORITY SHARES

1. I attach copies of the following papers which you asked for at your meeting on Monday.

- Mr Easton's opinion of 16 June 1987 (Mr Easton is a very experienced Grade 3/Under Secretary Solicitor who has worked for many years on Schedule E problems)

- An opinion of 29 July 1987 by Mr Miller, the Solicitor of Inland Revenue

- A copy of the 1986 article from Tax and Law which, so far as we know, has triggered off the current interest in the tax position of employees receiving priority shares.

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cc PS/Chancellor	Mr Battishill
PS/Chief Secretary	Mr Isaac
PS/Paymaster General	Mr Miller
PS/Economic Secretary	Mr Beighton
Mr Scholar	Mr Easton
Mr Monck	Mr Lewis
Mr D J L Moore	Mr German
Miss Sinclair	Mr Prescott (o/r)
Mrs Brown	Mr Peel
Ms Leahy	Miss Green (o/r)
Mr Haigh	Mr Swann (SVD)
Miss Wheldon (T/Sol)	Miss McFarlane
Mr Cropper	Mr Crabb
	Mr Ellis
	PS/IR

2. I also attach a summary of the case of Tyrer v Smart in which you were interested which deals with the tax position of employees under a tender offer.

3. We have also sought the views of our Shares Valuation Division on the extent to which employees are given priority rights in private sector flotations; and whether priority rights could give rise to a loss (on which we explained there would be no tax relief under the Schedule E rules). The short answer is that they think it is fairly common for employees to be given priority rights in private sector flotations, and that it is highly unlikely that they will lead to a loss. (As we explained at your meeting, one would expect any such losses to be rare and comparatively small since they presuppose that the offer is over-subscribed - so that the employee gets some benefit from his priority allocation - and yet that the shares are worth less than the offer price at the date of allotment).

The way forward

(Discussed with Mr Miller)

4. The conclusion we draw from rereading Mr Easton's opinion, and considering Mr Miller's, is that there is a clear tax charge in law on the employee in the circumstances we have been discussing. We therefore need to proceed with the extra statutory concession which - on a contingency basis - we discussed towards the end of your meeting.

5. What follows has been discussed with and seen in draft (hurriedly) by the Treasury. You may feel that another discussion would be helpful.

6. I attach a draft Press Release announcing an ESC. We feel there would be advantage in issuing this soon. There will almost certainly be some press interest in the tax position of employees when the BP sale is announced, given the press comments made on BAA. It would be helpful, therefore, to have an authoritative statement on the record

to which our Press Office can refer. The announcement of the ESC is likely to be seen as less directly connected with BP if it is made in advance of the BP announcement, rather than about the same time or shortly afterwards. On the other hand, to issue it immediately would risk having it linked with BAA, and thus receive more attention than we want. The first BP publicity is due about 20 August. This suggests that somewhere about 10 August might be the optimum date.

7. There are two main points to note on the substance of the ESC (the text is at the end of the draft Press Release).

<u>Mixed Tender/Fixed Price Offer</u>

8. First, as Mr Isaac suggested at your meeting, we have developed - and linked - the two conditions Mr Prescott floated in his minute of 16 July 1987, namely that at least 75% of the offer should be a fixed price, and that employee priority should not apply to more than 10% of the shares on offer. Thus we have drafted in terms of the ESC applying where the employee priority shares amount to 10% or less of the shares which are subject to a fixed price offer. This avoids any requirement as to the minimum proportion of the total offer which has to be by way of fixed price issue - indeed the whole ESC does not have to mention tenders as such. It does, of course, mean that the proportion of the total shares which can be given to employees falls as any tender element in the offer increases. But, even at 50%, employees could still be given 5% of the total number of shares on offer.

9. One other point on this aspect. On the BP offer the actual proportion of shares allocated by tender will not be known until after applications are in because the tender allocation may be reduced if the fixed price offer is over-subscribed. We have therefore drafted the 10% rule in the ESC by reference to the shares allotted rather than offered since the offer may not give a firm figure.

Limit on relief to any individual

10. The second point is whether or not there should be some "cap" on the maximum amount an individual can gain from the ESC. As we have mentioned, some BT employees had gains of over £7000 on the BT flotation; and once we have drawn attention to, and officially blessed, this form of tax-free benefit we can expect employers to make increasing use of it and, in some cases, to push it to its limits. You may feel therefore that there is a case for putting some limit on the tax-free benefit which can be obtained.

11. There is a further important consideration now that Ministers have decided to proceed by way of ESC rather than legislation. With legislation, Ministers can change the tax system in whatever way they choose, subject to being able to get the legislation through the House. But an ESC is made by the Board under their "care and management" powers, and must therefore be capable of justification, certainly to NAO/PAC and possibly to the Courts, on "good management" and "administrative common sense" grounds. These considerations are clear enough to see in relation to, for example, the great mass of relatively small liabilities arising from a large privatisation. But it is more difficult to see any plausible administrative reason for the Board to disregard flotation profits running well into four figures.

12. If there is to be such a limit on the relief available under the ESC, certainty for the investor points to linking it to the amount he undertakes to subscribe, rather than the gain he makes calculated by reference to the market value on allotment day.

13. The amount of any limit is entirely a matter of judgement. In the draft we have suggested, purely as an illustration, a total subscription payable of £5,000. In relation to some large recent privatisations (for example BT) that would have exempted gains of about £1000. But in

the private sector many gains would have been less and - particularly outside of a bull market - a limit at this level is probably broadly defensible on "care and management" grounds.

14. But any cap at about this level would have meant, if it had applied in the past, that some employees of recently privatised concerns would have been liable to tax on their gains and, in the context of privatisation policy, the Treasury's strong preference would be to have no limit on the ESC. For example, the maximum employee priority subscription to BT was £26,000, and to BA £31,000; and some 20,000 out of 90,000 British Gas employees subscribed more than £5000.

15. We doubt if there is any solution to this dilemma in a significantly higher limit. That would merely point up that the ESC could be exceptionally generous, and still not leave a completely free hand on privatisations.

"Free" and "Matching" shares

16. Nothing in this note affects the free and matching shares which are often offered to employees on privatisations. These are tax free because they are channelled through approved employee share schemes.

Questions for decision

The questions for decision are

- are you content with the approach to mixed tender/fixed price offers (paras 8 & 9)?

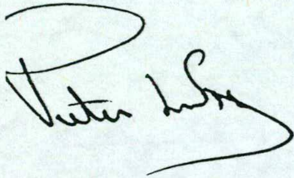
- should we include a "cap" on the maximum relief an individual can obtain under the concession (paras 10 & 11)?

- if so, do you agree it should be based on the full subscription the employee undertakes to pay (para 12)?

- at what level should it be set (paras 13-15)?

- are you otherwise generally content for the draft Press Release and ESC to issue?

- should it be issued on 10 August?



P LEWIS

FROM: J F EASTON
SOLICITORS OFFICE
EXT: 7262

DATE: 16 JUNE 1987

cc Mr Prescott
Mr German
Mr Peel
Mrs Eaton
Mr Reed

Miss Green

BRITISH AIRPORTS AUTHORITY FLOTATION

I think that, for present purposes, the essential features of the flotation will be that some shares will be offered at a fixed price and some on tender (the tender prices being expected to exceed the fixed price which will be the minimum tender price); but employees are to be given priority in application for fixed price shares and are likely to be allotted fixed price shares in numbers substantially greater than a member of the public is likely to be able to obtain.

I understand the immediate question at issue to be the tax position under S.181 of a BAA employee who obtains fixed price shares pursuant to this arrangement.

I think the authorities show that where an employee, in return for acting as or being an employee and for no other reason, is enabled to acquire shares at a cost less than the true value of those shares at the time of the acquisition, the difference between the cost and the true value at the time of the acquisition is an emolument of his employment and assessable as such (Weight v Salmon, Tyrer v Smart, Hanblett v Godfrey).

I suspect part of our problems in this area have been problems of valuation. Where all shares have been fixed price we have taken the true value on acquisition as the fixed price and where public shares have been on tender we have taken the true value as the striking price but this seems to me a matter of convenience and by no means necessarily correct. In Tyrer v Smart the Special Commissioners did not take the striking price.

Suppose a BAA employee acquires 1,000 shares at fixed price in the flotation because of his priority but the maximum a member of the public can in the result acquire at fixed price is 200 shares, I would think (and this would, in my view, be a question of fact) Commissioners could reasonably come to the conclusion that the employee obtained 800 shares in return for being an employee and for no other reason, and he would then be assessable on the difference between what he paid for those 800 shares and their true value at the time of acquisition.

Where a flotation is entirely fixed-price, and without any tender element, but employees are allowed larger allotments, I think the same principle would apply. Insofar as the employees acquired shares in return for being employees and for no other reason, they would be assessable on the differences. Insofar as their allocations exceed those that members of the public could receive I think they acquire them in return for being employees and for no other reason.

J F Easton

J F EASTON

FROM: R K MILLER
Solicitor's Office
DATE: 30 July 1987
EXTN: 6645

Mr A J G Isaac

SHARE ISSUES: EMPLOYEE BENEFITS

I am asked to consider whether liability to income tax under Schedule E arises in connection with the issue of shares to employees upon preferential terms as part of an offer to the public, for example upon flotation of companies.

The operation of the stag market may well ensure that a real benefit accrues to those employees given priority and other rights who decide that they will take up the offer and have the money to enable them to do so. The benefit can be substantial and greatly exceed the advantages obtainable by a member of the public who responds to the share offer.

The test to be applied to determine whether that benefit is taxable is well established. "It is whether the benefit represents a reward or return for the employee's services, whether past, current or future, or whether it was bestowed upon him for some other reason." - per Lord Diplock in Tyrer v Smart 52 TC 533 at p.556. He there explains that in looking to solve this question whether the benefit comes to the employee as employee - because to be taxable as an emolument it has in the statutory words to be from the employment - the purpose of the employer in granting the benefit to the employee is an important factor in determining whether it is properly to be regarded as a reward or return for the employee's services. Where the employer's motives in conferring the benefit may be mixed one looks to first what was his dominant purpose. But this is not to be confused with the question whether the employer intended the advantage, whatever it was, to be as beneficial as it turned out to be. That is not relevant in considering this first question, namely the capacity in which the employee received his benefit and whether it can truly be said to arise from his employment.

HMG is not the employer

The recent decision of the Court of Appeal in respect of the payment made to a civil servant at G.C.H.Q., Hamblett v Godfrey [1987] 1 WLR 357 shows that the fact that a payment was not paid as remuneration in return for the employee's services does not mean that it was not an assessable emolument arising from her employment in the sense of being received by her "in return for acting as or being an employee".

In my opinion one has to look at the offer made to the employee as a whole. It seems to me that from the point of view of the employer's purpose in the sense I have explained, it would be both unrealistic and wrong to seek to differentiate parts of a package the whole of which is calculated to induce an employee to take an interest in the shape of a share holding in his employer. Such packages commonly include free shares, some free shares matching shares for which he has to pay, better terms as regards the price he has to pay and priority in that he is assured of a greater number of shares if the issue is over subscribed than would be allocated to a member of the public. But all these advantages which may be in the package are directed to the same end.

The size of the benefit which actually results is not strictly relevant in deciding as a matter of principle whether there is tax liability. Of course conscious under pricing is a factor to be taken into account in considering the employer's purpose. But if advantages are bestowed upon an employee in return for acting as or being an employee it simply increases the amount of the taxable emolument if those advantages turn out to be greater than the employer contemplated. If an employer in order to reward an employee transfers to him property which the employer believes to be worth £x but the market value of which at that time turns out to be twice £x, the employee is taxable upon the latter figure.

This is all based on the employer giving employee a benefit

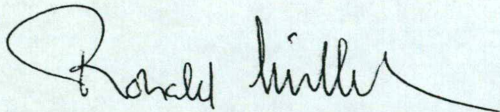
Although the purpose of the employer in any particular case must be a question of fact - in Tyrer v Smart Lord Diplock accepted that different Commissioners might have come to a different conclusion of fact as to the company's purposes - I find it difficult to envisage that in the sort of share offers which I am asked to consider they will not ordinarily be seen as a reward, perhaps for past services in that there may be a minimum service qualification but more particularly future services, and accordingly made to him "in return for acting as or being an employee". The G.C.H.Q. case has shown that at the end of the day whether a benefit was so conferred is the real test. Where, as in the case of these share offers, the invitation is made to all employees in a large organisation (subject perhaps to a minimum service qualification) and is quite independent of any particular individual's circumstances but to encourage them all to take a share in the company and to identify with its future, the natural conclusion, in my opinion, would be that the benefits resulting from the share offer were conferred in return for acting as or being an employee.

may be

The benefit accrues to the employee when his offer for the shares is accepted and shares are allocated to him. The benefit thus has to be valued at that date. In response to an invitation by the company he makes an offer to subscribe for shares which the company accepts. It is at that point, and not before, that he receives the perquisite - Weight v Salmon 19 TC 1974. That the benefit had to be

valued at the date when the shares were allotted was common ground in Tyrer v Smart.

Before finishing this opinion I had and considered the supplementary note on share premia and partial tenders enclosed with Mrs Brown's letter to you of 28 July. For the reasons which I have tried to explain the arguments that priority allocations for employees give rise to liability under Schedule E do not rest upon the presence of any intention consciously to pitch the price at below what might be considered the "true value".



Law and Tax Review, Vol. 3 No. 3, 1986

RELEVANT SECTION SIDE-LINED

LAW&TAX ANALYSIS

Tax consequences of employee priority on a flotation (with particular reference to the British Telecom flotation)

David Cohen, of Nicholson, Graham and Jones

Introduction

Flotations on the London Stock Exchange almost invariably give preferential application rights to the employees of the company being floated. The usual practice will be for a percentage of the shares being offered to be reserved for employee applications but at the same price and otherwise on the same terms as for members of the public. Occasionally, employees will be given the added inducement of a discounted offer price. The tax position, as currently interpreted and applied by the Inland Revenue, appears to be that employees who pay the full price—even if they receive a priority allotment—will pay no tax on acquisition of the shares and will thereafter be treated just like any other shareholder ie will suffer no tax disadvantage as a result of being an employee. The only difference for employees who pay a discounted price is that they will be liable to Schedule E income tax on the value of the discount.

This is an area of tax law which has recently been the subject of Governmental and Parliamentary scrutiny as a result of the high priority given by this Government to both privatisation and employee share ownership. These twin policy aims lay behind the campaign to maximise employee participation in the flotation of British Telecom. A major concern was that there should be no technical tax traps to deter BT employees from becoming shareholders or to trip them up afterwards. BT offered its employees priority applications at the public offer price and also a separate offer at a 10% discount for those who remained employees at the time of the final instalment. The evident aim was to ensure that the tax consequences of participating in these offers were as set out in the first paragraph of this article.

It is understood that it was for this specific reason that the Government introduced Section 41, Finance Act 1984. (Speaking shortly after the flotation, BT's Personnel Director, Mr Michael Bett, said of Section 41: 'Special legislation was enacted—a concession now available to all companies.')

This article assesses the rationale of Section 41 and explores two other categories of potential tax charge which have apparently been either ignored or overlooked by the Government and, until now, the Inland Revenue.

Section 41, Finance Act 1984

Section 41 introduces a new subs (1A) to s 79, Finance Act 1972. Section 79 creates two potential income tax charges for employee shareholders but we are primarily concerned with the charge on the growth in value of employees' shares under s 79(4).

By s 79(1), s 79 only applies where a director or employee acquires shares in a company pursuant to an opportunity conferred on him as a director or employee of that or any other company and not *'in pursuance of an offer to the public'*.

The precise scope of this latter phrase is far from clear. It obviously does cover a situation where employees are no more favourably treated in any respect than members of the public, and so s 79 will be excluded. But what if the employees are entitled to preferentially large allotments of shares, although on no better terms than the public? The Revenue's answer is that, in practice, they will still treat such shares as having been acquired 'in pursuance of an offer to the public' and therefore outside s 79 (leaflet IR16 para 3.8(c)).

However, the Revenue practice has never extended to cases where employees acquired their shares more cheaply than general applicants. Any price differential would mean that two separate offers were in existence—one to the employees and the other to the public. Ergo, the employees were acquiring shares under their own offer and not 'in pursuance of an offer to the public'.

BT and the Government wished to protect BT employees who took up shares under the discount offer from a possible growth-in-value charge under s 79. It was for this purpose that s 41 was enacted. The effect of s 41 is that if an employee or director acquires shares under a discount offer he will still be treated as acquiring them pursuant to an offer to the public provided the following conditions are satisfied:

(*a*) the discount offer is made in conjunction with the main offer to the public; and

(*b*) the two offers are of the same class of shares and on the same terms apart from the price difference; and

(*c*) the employees and directors are chargeable to Schedule E income tax on the amount of the discount; and

(*d*) of the combined total of shares acquired under both offers at least 75% are acquired under the main offer.

The practical significance of this new exemption needs to be put into perspective. The main threat posed by s 79 is the growth-in-value charge under s 79(4) and this will anyway be excluded if the conditions in s 79(2)(*c*)(i) or (ii) are satisfied. In each case one condition is that the shares being acquired are not subject to 'restrictions' as defined in s 79(2A) viz restrictions not attaching to all shares of the same class (s 79(2A)(*a*)), restrictions ceasing or liable to cease at some time after acquisition (s 79(2A)(*b*)), or restrictions depending on the shares being or ceasing to be held by directors or employees of any body corporate (s 79(2A)(*c*)). Where employee shares are subject to special restrictions within s 79(2A)(*a*) and (*b*) they will presumably not have been issued on the same terms as the public offer shares and therefore one of the conditions of s 79(1A) may not have been met. Where they are issued subject to a discount which is lost if the holder of the shares ceases employment before the final instalment date then they would seem to be subject to a s 79(2A)(*c*) type restriction. Section 79(1A) may however operate to exclude liability under s 79. This was the rationale behind the passing of s 79(1A) on the BT flotation.

It may be that the shares being offered to employees are not subject to any restrictions at all but relief under s 79(2)(*c*) is nevertheless denied because of non-fulfilment of the other conditions in (*c*)(i) and (*c*)(ii). The requirement is that immediately after the acquisition under s 79(1) a majority of the available shares of the same class either were acquired otherwise than under s 79(1) or were acquired by employees or directors who were thereby able to control the company. Shares in a company are 'available' if they are not held by or for the benefit of an associated company of that company.

Example
A Ltd is owned as to 75% by B Ltd and as to 25% by directors and employees whose acquisitions were within s 79(1).

A Ltd's shares are now to be floated on the Stock Market, and the flotation will entail the sale of a 20% shareholding by B Ltd. 90% of this (ie 18% of A Ltd) is to be offered to the public and the remaining 10% (2% of A Ltd) to the employees of A Ltd. The employees are to be offered a discounted price but otherwise identical terms to the public.

(*a*) Prima facie, the acquisition of shares by the employees is within s 79(1) because they are not acquiring pursuant to the public offer.

(*b*) s 79(2)(*c*)(i) will not apply because:

available shares (not held by B Ltd) = 45%
shares acquired pursuant to s 79(1) = 27%

Therefore a majority of available shares were acquired under s 79(1).

(*c*) s 79(2)(*c*)(ii) will not apply because the employees do not have control of A Ltd.

(*d*) However, s 79(1A) will apply and therefore the employees will be treated as being outside s 79(1).

Section 79(1A) may also serve a purpose because s 79(2)(*c*) disapplies s 79(4) but not s 79(7) which imposes an income tax charge on special benefits received by s 79(1) shareholders. Since s 79(1A) takes employees completely outside s 79(1) it will give them immunity from s 79(7). However, it is understood that s 79(7) is rarely invoked by the Revenue and it is unlikely that the facts which would give rise to a potential s 79(7) charge could occur in a quoted company.

Finally on this subject, it is interesting to note that althought the s 79 reporting requirements do not apply to acquisitions made 'in pursuance of an offer to the public' they do apply to acquisitions deemed by s 79(1A) to be so made. This is the result of s 41(2) Finance Act 1984 which provides that s 79(1A) is to be disregarded for the purpose of para 3 of Part VII of Sched 12 to the Finance Act 1972.

Schedule E—s 181, ICTA 1970

It is clearly established that a director or employee who, by virtue of his office or employment, acquires shares for less than maket value, will be subject to a Schedule E income tax charge on the amount of the discount. Note that one of the conditions for the exclusion of discount offers from s 79, FA 1972 is that the discount should be taxable in this way. A fortiori, free shares received by a director or employee will be fully taxed under Schedule E.

However, where employees are given priority on a flotation but pay the same price as the public there seems never to have been any suggestion that a Schedule E charge might arise. The only question to have been raised—before being answered in the negative by the Revenue—was whether priority applications fell within s 79(1).

There is something rather surprising about the unchallenged assumption of no immediate Schedule E charge. Let us revert to the BT flotation. Due to the heavy oversubscription of the issue, members of the public were allocated a maximum of 800 shares each. BT employees were given priority allocations of up to 20,000 shares each. At the start of dealing the shares traded at a premium of 40p over the issue price. Hence, a BT employee who had received a maximum allocation would have made a gain of approximately £8,000. Without employee privilege—or multiple applications—he could not have made more than £320. It is surely at least arguable that the extra profit of £7,680 was a Schedule E emolument.

Of course, the mere size of the gain on the BT flotation is irrelevant but the case is a striking illustration of the sort of benefit which priority applications can produce when an issue is underpriced and as a result is heavily oversubscribed so that all but employee applications have to be drastically scaled down.

Why did the Government not deem it necessary to protect BT employees from an immediate Schedule E charge and why has there been no subsequent suggestion that their windfall profits should be taxed?

The accepted view appears to be that a Schedule E charge cannot arise on a fixed price offer for sale where the employees are given no discount but that it could arise on an offer by tender where the employees are invited to subscribe at the minimum tender price and the public at the (higher) striking price. That a Schedule E charge may be imposed in the latter case is confirmed by a decision of the House of Lords. The failure to adopt the same approach to fixed price offers appears to be based on fallacious reasoning.

The House of Lords case is *Tyrer* v *Smart* [1979] STC 34 which arose out of the flotation of the Rentokil Group. Shares were reserved for directors and employees at the minimum tender price of £1. The striking price was £1.25. The first day dealing price was £1.37½. It was common ground that the employees became entitled to their shares on the day on which the allotment letters were posted—the day before dealings commenced—and that on that day the share value was £1.20. Tyrer, who was allocated 5,000 shares, was assessed to income tax on £1,000 being the difference between the value of the shares on the day on which he became entitled to them and the price he paid for them.

In *Tyrer* v *Smart* the arguments centred on the Company's motives for giving its employees priority allotments. If the main motive was to encourage identification with the Group then tax would be avoided. In fact, the finding of fact of the Special Commissioners, which the House of Lords felt unable to overturn, was that the Company gave employees priority as a reward for services. It was accepted that if this was the purpose of the priority then Schedule E tax was properly chargeable.

The one apparently significant difference between *Tyrer* v *Smart* and a fixed price offer such as BT, is that in *Tyrer* v *Smart* the employees paid less than the public while in BT they paid the same price. To put this difference into perspective consider the share prices of Rentokil and BT at various stages. (The BT day-before-dealing price is the approximate price at which unofficial dealings took place in the over-the-counter 'grey' market.)

	(A) Issue price to Employees	(B) Issue price to Public	(C) Price on day before dealing when employees became entitled	(D) First dealing price
Rentokil	£1	£1.25	£1.20	£1.37½
BT (partly paid	50p	50p	70p	90p

The difference between the two cases is that with Rentokil (B) exceeded (A) while with BT (A) and (B) were the same. However, Mr Tyrer of Rentokil was taxed on (C) minus (A) and (B) was immaterial. The (C) minus (A) calculation would also have thrown up a substantial gain for BT employees and it is very difficult to see why the mere fact that (B) and (A) are the same should exempt this gain from being taxed. Put less algebraically the mere fact that members of the public netted the same large premium per share on BT as did BT employees should not afford income tax immunity to the employees who, as a result of being employees, were able to achieve that premium on a far larger number of shares.

Section 67 Finance Act 1976

Subsections (1)–(6) of s 67, FA 1976 apply whenever a director or higher-paid employee or a connected person acquires shares in a company and:

> 'the shares are acquired at an under-value in pursuance of a rights or opportunity available by reason of the employment.' (s 67(1)(*b*))

Section 67(2) gives 'at an under-value' an extended meaning to include not only the acquisition of shares at a discount but also any element of deferred payment even for shares acquired at market value.

In broad terms, the modus operandi of s 67(1)–(6) is that the director or higher-paid employee is treated as being in receipt of an interest-free loan from his employer to the extent of the under-payment for so long as and to the extent that such under-payment continues. This notional loan is then taxed as a beneficial loan under s 66, FA 1976 to the extent that the under-payment for the shares is not otherwise charged to tax as an emolument.

It has been a feature of recent privatisation issues that the shares have been offered in partly-paid form with the balance of the subscription price being paid by way of subsequent instalments. For example, in the British Telecom issue the offer price was £1.30 but only 50p was payable on application with the remaining 80p being payable in instalments over the following 17 months. In the case of BT—and of all other relevant privatisations—this part-payment facility was made available to employees and non-employees alike on precisely the same terms.

Prima facie, it would appear that the directors and higher-paid employees of BT acquired their shares 'at an under-value'. The only contrary argument would be based on the fact that there were no fully-paid BT shares in issue at the time of the flotation. Since 'an under-value' is defined by s 67(2) as existing when the amount subscribed is less than the market value of fully paid shares of the same class it could conceivably be argued that where there are no such shares there is no under-value. However, the better view would appear to be that there is nothing to prevent the value of hypothetical fully-paid shares from being ascertained.

Since it is also apparent that the benefit of under-payment would not be charged to tax as an emolument, otherwise than under s 67 the only remaining question to be resolved before the application of s 67 is established is whether 'the shares are acquired at an under-value in pursuance of a right or opportunity available by reason of the employment' (s 67(1)(*b*)).

Assuming that the shares are acquired at an under-value, are they also acquired in pursuance of a right or opportunity available by reason of the employment? This wording is very similar to that contained in s 79(1), FA 1972. Section 79(1) does, however, contain an exclusion where the right or opportunity is available 'in pursuance of an offer to the public' whereas s 67(1)(*b*) has no such exclusion. Hence, the exclusion of 'pink form' priority offers from s 79(1)—as a result of Revenue acceptance that such offers are in pursuance of a public offer—would presumably not hold true for s 67(1).

A fortiori with discount offers which are within s 79(1) and are only treated as being outside because of s 79(1A) (which has no counterpart in s 67).

There remains one ambiguity in the wording of s 67(1)(*b*). What must the employee obtain in pursuance of a right or opportunity available by reason of the employment? Is it sufficient that he obtains 'shares' and that those shares are acquired at an under-value? Or must not only the shares but also the right to acquire them at an under-value be available by reason of the employment? If the former then the case for s 67 appears to be made out; if the latter, then it founders on the fact that the right to pay an under-value was not a specific employee right.

Such opinion as has been expressed on the subject appears to favour the former view ('Share Incentive Schemes—A detailed review of the legislation' by S. Ball para 6-2). Certainly, there can be no doubt about the application of s 67(1) to a discount offer, since the discount element is made available to the employees by reason of their employment. The value of the discount will be taxed as an emolument under Schedule E and will therefore avoid being taxed again under s 67(1). But where, as in the case of BT, a discount offer is combined with part payment, the unpaid part of the issue price will not be otherwise taxed and would appear to fall squarely within s 67(1).

The Inland Revenue view now appears to be that s 67 is theoretically applicable to both priority and discount offers. However, the Revenue say that in practice they will not invoke s 67 where the part-payment terms for employees are the same as for members of the public generally.

Conclusion

Although s 41, FA 1984 has made discount offers safe from s 79 FA 1972, there remains the possibility that priority offers could in the future be attacked under Schedule E with the additional threat of s 67 FA 1976 where the public offer is partly-paid. In the meantime, a priority application in a popular flotation must rank alongside Approved Share Options as an employee's best chance of deriving a substantial income-tax free sum from his employment.

HIGH COURT OF JUSTICE (CHANCERY DIVISION)—28 AND
29 JUNE AND 23 JULY 1976

COURT OF APPEAL—29 AND 30 NOVEMBER
AND 1 DECEMBER 1977

HOUSE OF LORDS—6 AND 7 NOVEMBER AND 13 DECEMBER 1978

Tyrer *v.* Smart (H.M. Inspector of Taxes)(1)

Income tax, Schedule E—Public flotation of company—Offer for sale of shares by tender—Right of employee to take up shares at minimum price rather than "striking" price—Whether advantage an emolument—Value of advantage.

The parent company of a group, of which the Appellant's direct employer was a member, decided in 1969 to become a public quoted company and to offer its shares by tender. In such cases the public is invited to tender for shares at or over a "minimum price" fixed by the offerer; when the tenders are in, a price is struck which is near the average of the tenders but is also designed to promote an active market; those who have tendered at or above this price are allotted shares at the "striking price". In the present case, 10 per cent. of the shares in issue were reserved for employees within the group with a qualifying period of service for subscription at the minimum price, namely 20*s.* per share, and the employee could choose the number of shares for which he wished to apply. After tender, the striking price was fixed at 25*s.* and the public's and employees' applications were formally accepted on 17 March 1969. Dealings started on 18 March 1969 and on that day the price of the shares varied between 26*s.* and 27*s.* 6*d.* This was against the trend of the market, which had fallen between the date when the striking price was fixed and 17 March. The Appellant, having purchased 5,000 shares at 20*s.* each, appealed to the Special Commissioners against an additional assessment to income tax under Schedule E raised on the basis that the Appellant's price advantage as compared with members of the public was an emolument accruing to him from his employment. Before the Commissioners expert evidence was adduced to the effect that on 17 March the value of the Appellant's shares was between 23*s.* and 24*s.* The Appellant contended before the Commissioners (i) that there was no taxable emolument because his financial advantage had arisen from market forces rather than from his employment; (ii) alternatively, that the value of any emolument was the difference between the minimum price and market value (23*s.* to 24*s.*) on 17 March. On behalf of the Crown it was contended (i) that the right to acquire shares at a special price given to the Appellant by his employer was an emolument from his office or employment, and (ii) that such emolument was 5*s.* per share, being the difference between what an employee (buying at the minimum price) and a member of the public (buying at the striking price) had to pay for the same shares on 17 March 1969. The Special Commissioners decided that the Appellant had received a taxable emolument which they valued at 4*s.* per share. Both parties demanded Cases (but the Crown's cross-appeal on the valuation point was not pursued in the High Court).

The Chancery Division, allowing the Appellant's appeal and discharging the assessment, held (1) that the benefit accruing to the Appellant of 3*s.* to 4*s.* per share was not an emolument from his employment for the following reasons: (*a*) the benefit was an isolated one with no past history; (*b*) every eligible employee had the same opportunity of benefiting; (*c*) the purpose of the company was to encourage employees to identify with, and become shareholders in, the parent company; (*d*) the opportunity to apply for shares was not represented to the employees as being of financial advantage to them; and (*e*) the Appellant had no particular confidence that the value of the shares would exceed the minimum price of 20*s.*; (2) accordingly, that the benefit to the Appellant, while it would not have arisen but for his employment, was the result of his venturing his own money and his judgment of the market and the Special Commissioners' decision was not one to which they could reasonably come on the facts.

The Court of Appeal, dismissing the appeal, held that the Judge's conclusion that the Special Commissioners' decision was not one to which they could reasonably come was correct.

The House of Lords, unanimously allowing the Crown's appeal and restoring the determination of the Commissioners, held that (i) there was a clear finding by the Commissioners that the offer to the Appellant was made as a reward for past and more particularly for future services and so was made to him in return for acting as or being an employee; (ii) that finding was one of fact to which the Commissioners were entitled to come; (iii) the Court of Appeal and Brightman J. had wrongly held that the only reasonable conclusion contradicted the Special Commissioners' determination. *Edwards* v. *Bairstow* 36 TC 207; [1956] AC 14 applied.

DRAFT

INLAND REVENUE Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01–438 6692 OR 6706

[3X] [10 August 1987]

PUBLIC OFFERS OF SHARES: EMPLOYEE PRIORITY SHARES

With the approval of Treasury Ministers, the Inland Revenue have today issued a new Extra-Statutory Concession. It provides that, where certain conditions are met, there will be no Income Tax charge on the benefit an employee may obtain from any priority given to employees in the allotment of shares in a public offer of shares.

Notes for Editors

1. The full text of the concession is given below.

2. Directors or employees may be allowed a priority allocation of shares when an offer of shares is made to the public. Under the rules relating to the taxation of employment income, a benefit arises where, as a result of such preferential treatment, an employee receives more shares than he would have done had he subscribed as a ordinary member of the public and the value of the shares at the date they are allotted to him exceeds the issue price which he paid.

3. In the past the Revenue has not generally sought to assess such benefits. This practice has recently been reviewed, and this Extra Statutory Concession sets out the approach the Revenue will adopt in future to the benefit an employee may derive from taking up priority shares in a public share offer.

4. The concession applies to offers which are made wholly or partly at a fixed price. The employee will be exempt from Income Tax on any benefit he derives from a priority allocation of shares provided the following conditions are met

- First, the priority allocation of shares given to directors and employees must not exceed 10% of the total shares allotted at a fixed price in the share offer; and directors and employees must be offered priority on similar terms so that no one person or group is picked out for particularly favourable treatment.

- Second, the total subscription the director or employee undertakes to pay for the full issue price of the shares for which he subscribes must not exceed [£5000]. This limits the amount of the gain which can be received tax-free in this way. The limit is based on the amount the employee undertakes to subscribe to allow the employee to know for certain whether or not the concession will apply at the time he subscribes for the shares.

- Third, the director or employee accepts that the issue price is the price at which he acquired the shares for any capital gains tax computation on a subsequent disposal.]

5. The concession has no application to any free shares an employee receives, at the time of a public offer, through an employee share scheme approved under the provisions of Finance Act 1978; or to any shares an employee subscribes for on the same terms as an ordinary member of the public. There is no question of any income tax liability arising in relation to such shares.

6. Extra statutory tax concessions are relaxations which give the taxpayer a reduction in tax liability to which he is not entitled under the strict letter of the law. Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation or to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter. In a particular case there may be special circumstances which will require to be taken into account in considering the application of the concession. A concession will not be given in any case where an attempt is made to use it for tax avoidance.

7. The new concession applies to any public offer of shares made on or after [10 August]. It will be included in the Inland Revenue booklet on concessions (IRI) when it is next reprinted.

PUBLIC OFFERS OF SHARES: EMPLOYEE PRIORITY SHARES

Where on an offer of shares to the public, directors or employees are entitled to a priority allocation of shares, liability under Schedule E may arise on the benefit obtained where:-

(a) they receive more shares than they would have received had they subscribed as ordinary members of the public, and

(b) the value of the shares on allotment exceeds the issue price.

In practice such liabilities are disregarded when all of the following conditions are met:-

i. The priority allocation of shares to directors and employees does not exceed 10% of the total shares allotted at a fixed price in the flotation or rights issue

ii. The priority shares are offered on similar terms to all directors and employees

iii. The total amount which the director or employee undertakes to pay for the full issue price of the shares for which he subscribes does not exceed [£5000].

iv. The director or employee treats the issue price of the shares as the value of the consideration given in acquiring them for capital gains tax purposes.

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cc PS/Chancellor
PS/CST
PS/PMG
PS/EST
Mr Scholar
Mr Monck
Mr D. Moore
Miss Sinclair
Mrs Brown
Ms Leahy
Mr Haigh
Mr Cropper

Please attach as last page of Mr P. Lewis' minute to the FST dated 29 July about Share issues: Employee Priority shares.

psl/46A

SECRET AND PERSONAL

Pup

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

29 July 1987

John Footman Esq
PS/Governor
Bank of England
Threadneedle Street
LONDON EC2

Dear John,

DRINKS WITH THE CHANCELLOR: TUESDAY, 28 JULY

This is to record the main points raised at drinks last night.

Kuwait Investment Office

The Chancellor noted that the activities of the KIO seemed to be increasingly embarrassing. The Governor said he was not satisfied that the KIO deserved to be afforded the privilege of using Bank of England Nominees, which was primarily designed for Royal Families etc; the KIO was clearly a money-making business. The options seemed to be to withdraw completely the KIO's right to use Bank of England Nominees, or to prevent them using it to build up more than a 1 per cent holding in any one company. The FCO were concerned about complete withdrawal but would probably accept a 1 per cent rule. DTI did not like the 1 per cent rule and were sheltering behind proposals for a comprehensive review, which seemed to be an excuse to do nothing. The Chancellor thought that, on the face of it, complete withdrawal seemed the most attractive option, with the 1 per cent option a second best.

Standard Chartered

The Governor reported that Mr Y K Pao and Mr Holmes a Court both (separately) wished to increase their stakes in Standard Chartered as a prelude for going for full control. They had been told that the Bank would start the usual procedures for deciding whether they were "fit and proper", but would not be able to give a final ruling until after the Bank's investigation into share dealing in Standard Chartered was complete; that would not be before October. The Governor thought it would probably be difficult to turn either down on "fit and proper" grounds, though neither had banking experience.

The Chancellor noted that there were reciprocity problems in both cases. For Mr Holmes a Court there was the clear issue of whether

we should take a stand against Australian takeovers. For Mr Y K Pao the position was slightly different: it seemed unacceptable that the Hong Kong authorities could successfully block the Midland/HKSB proposal, but that we should acquiesce in letting effective control of Standard Chartered move to Hong Kong. He would be grateful if the Governor could keep him in close touch with development on Standard Chartered; there would no doubt need to a further discussion in the autumn.

Royal Bank of Scotland

The Governor noted that the KIO had behaved very badly in this case. They had effectively announced that they were ready to dispose of their 14.7 per cent shareholding, but in a way that had prompted large gyrations in the share price. An investigation into this had been launched.

Hill Samuel

The Governor said he thought the UBS bid was a useful solution. Providing terms were agreed, UBS were likely to seek 100 per cent control, but might settle for 60 per cent if necessary.

Morgan Grenfell

The Governor noted that Mr Holmes a Court, operating through Dewey Warren, had bought a stake in Morgan Grenfell from the KIO. He had assured the Bank that this was strictly an investment holding.

Mercantile House

The Governor noted that B&C had bid for Mercantile House. This seemed a good solution: they would retain the fund management arm, but would sell off Alexander, Laing and Cruickshank to Credit Lyonnaise. It was better to get such firms into a safe home (even if foreign) rather than leaving them "in play".

Clydesdale

The Chancellor noted that the Midland announcement had gone well, helped by the unpopularity of Midland in Scotland. The issue of whether or not to refer to the MMC was a matter for Lord Young. The Chancellor's own position was fairly relaxed: if there was a reference, he thought it would be likely to go through. On balance, he shared the Bank's view that a reference was not necessary. The Governor noted that an Edinburgh investment adviser had approached the Bank indicating he had plans to put together a consortium of Scottish businessmen to bid for Clydesdale; but it seemed unlikely that they would have appropriate resources to make a success of this.

Stock Exchange settlement problems

The Chancellor noted that the position seemed to be getting worse. He thought the banks must put more resources into their Registrars' Departments as a matter of urgency. The Governor noted that

NatWest in particular had already been doing this, though more needed to be done. He thought the main trouble was in the back-offices of stockbrokers: Sir Nicholas Goodison was already putting considerable pressure on the firms involved; and the Bank had taken action with Stock Exchange money brokers. The Chancellor said he felt it was essential to keep up every means of pressure on this, so that the problem could be sorted out before the BP sale. The Governor noted that it would help reduce settlement problems if it was possible to avoid having overlapping periods when two different privatisation stocks were trading in allotment letter form. The Chancellor said he would look into this.

Convergence

The Governor reported that at the last Basle Meeting the G10 Governors had given the Cooke Committee a remit to meet in September and report in October; they were expected to reach agreement on minimum capital ratios. If necessary the initial minima might be set rather lower than otherwise desirable, but with the possibility of their being raised subsequently. He thought the prospects for a solution by the end of the year were reasonably good.

Between September and November the Bank would have bilateral discussions with the US, and trilateral discussions with the US and Japanese. He hoped it would be possible to get agreement with them, even if it was not possible to bring in all the others. The Chancellor commented that there would be considerable difficulties if we again took an initiative which did not include our EC partners. He would be grateful if the Governor could make sure this point was fully considered, and discuss it further with him if it looked likely that problems might emerge.

The Chancellor asked what the prospects were for agreement with the Japanese. The Governor noted that there were considerable problems over the valuation of unrealised equity profits. He thought that there might need to be a transitional period to cover this. But the Japanese themselves were concerned about this problem, and in any case would not be keen to be isolated. We also had levers to put pressure on them, for example by saying we would slow down the issue of licences if agreement could not be reached.

Provisioning

The Chancellor asked how discussions with the Revenue were going. The Governor said that progress was satisfactory, subject to some minor points of detail; for example, the Revenue did not like using "political stability" as a measure.

Yours
Alex

A C S ALLAN

2200/25

CONFIDENTIAL

FROM: MRS M E BROWN
DATE: 30 JULY 1987

FINANCIAL SECRETARY

cc Chancellor
Mr Scholar
Mr Moore-or
Miss Sinclair
Ms Leahy
Mr Bent-or
Mr Haigh
Ms Pelham
Mr Cropper

EMPLOYEE PRIORITY SHARES

Mr Lewis's minute of 29 July proposes a cap on the amount which an individual employee may be allocated under a priority arrangement. He suggests a figure of £5,000.

2. In the BP sale, this would probably cause us no problems. BP themselves have suggested a £5,000 maximum. However, an extra-statutory concession will apply to all future privatisations. In past primary sales the maximum employee allocations have been much higher: eg 20,000 shares (£26,000) in BT; 25,000 shares (£31,250) in BA. Allocations of this size (though small in number) did, of course, lead to very large profits, and you may take the view that this is not desirable in future. On the other hand, there may be occasions (electricity?) when we need to foster employee support in every possible way. There may also be sales where it is particularly appropriate to have a large proportion of employee shareholders.

3. In the British Gas sale, more than 20,000 of the total 90,000 employees applied for - and were allocated - more than £5,000 shares in the priority offer.

4. I agree with Mr Lewis that it would not look good to specify a high cap in the ESC. I would therefore prefer to omit it altogether, and rely simply on the overall limit on

employee allocations: ie 10 per cent of the total fixed price offer.

Mary Brown

MRS M E BROWN

3361/33

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 31 July 1987

CHANCELLOR

TAXATION OF BENEFITS IN KIND: EMPLOYEE SHARES

1. I have been considering Mr Lewis' submission of 29 July and Mr Miller's legal advice which arrived yesterday. I have also seen Sir Peter Middleton's advice (28 July) and Peter Cropper's note (28 July).

2. I personally am still not convinced by the arguments. However that seems to be a solitary view. I am no lawyer and those who are seem adamant.

3. The key argument made is that the Government's intention in setting the fixed price which employees pay is wholly irrelevant to the question of whether there is a tax liability. Whatever we in the Treasury think of all this, it is clear that the Revenue and their legal advisers are not going to give way.

4. We are very short of time. In these circumstances I see no alternative but to press ahead with the ESC. I believe that the ESC suggested by the Revenue is acceptable - and, in particular, that a "cap" of £5000 will be necessary. The Treasury are opposed to a cap and we have to recognise that some people in the future may face tax charges. However, Tony Battishill would find it very difficult, I think, to defend an ESC before the PAC, which allowed the Board to disregard gains of thousands of pounds.

5. I have not copied this to anyone else. If you agree I shall minute out as below.

NL

NORMAN LAMONT

3361/32

FROM: J J HEYWOOD
DATE: 31 July 1987

MR LEWIS IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr D J L Moore
Mr Scholar
Miss Sinclair
Mrs M E Brown
Ms Leahy
Mr Haigh
Miss Wheldon T.Sol
Mr Cropper
PS/IR

PS/FST
↓
Mr Lewis
31/7

SHARE ISSUES: EMPLOYEE PRIORITY SHARES

1. The Financial Secretary has read your submission of 29 July and its attachments.

2. He is content with what you proposed, including the idea of a cap of £5000.

JJH

JEREMY HEYWOOD
Private Secretary

BANK OF ENGLAND
LONDON EC2R 8AH

31 July 1987

PUP

Alex Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
London
SW1

Dear Alex

The Governor asked me to make two corrections to your record of what he said to the Chancellor on 28 July. On convergence, a report is required by November and will include agreement on the definition of capital as well as capital ratios. On provisioning, the Governor thinks that "satisfactory subject to points that were rather more than detail" would better sum-up his report on progress with the Revenue.

Maybe what he should have said, but not what he did say!

Yours

John

J R E Footman
Private Secretary
to the Governor

CH/EXCHEQUER
REC. 31 JUL 1987
ACTION
COPIES TO

PH1/22

CONFIDENTIAL

BP 6/8

FROM: A C S ALLAN
DATE: 3 AUGUST 1987

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Mr Monck
Mr D J L Moore
Mr Scholar
Miss Sinclair
Mrs Brown
Ms Leahy
Mr Cropper
Mr Battishill IR
Mr Isaac IR
Mr Lewis IR
Mr Prescott IR
PS/IR

ACSA
↓
PS/FST
3/8

SHARE ISSUES: EMPLOYEE PRIORITY SHARES

The Chancellor has seen Mr Isaac's minute to the Financial Secretary of 29 July, attaching a copy of the advice from Mr Miller, the Solicitor of the Inland Revenue.

2. He has studied Mr Miller's opinion carefully. He notes that it refers throughout to the "employer" conferring a benefit on the employee. For the BP sale, it is perfectly clear that HMG is not the employer; what we have in the BP case is a "third party benefit". This distinguishes it from the GCHQ case, where the Government was the employer. Nor in the case of the BP sale does the benefit represent "a reward or return for the employee's services, whether past, current or future" (to quote Lord Diplock); it is bestowed "for some other reason" - because the Government believes that employee shareholdings are per se a good thing.

3. The Chancellor would be grateful if the Revene could consider again whether a taxable benefit arises in the case of the BP sale. If not, the urgency disappears, and the Chancellor would wish to have a further meeting in the autumn to discuss the issue of

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primary flotations. If the Revenue confirm their present advice, the Chancellor would wish to consider further how to proceed.

ACSA

A C S ALLAN

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Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
5 August 1987

ISAAC → G/X 5/8

PS/CHANCELLOR OF THE EXCHEQUER

SHARE ISSUES - EMPLOYEE PRIORITY SHARES

1. As arranged, I attach a copy of the further opinion which I have had today from the Board's Solicitor.

2. As you will see, I have to report that the Solicitor remains of the opinion that the benefits in a case of this kind would be taxable.

3. We remain, of course, entirely at the Chancellor's disposal if there is any aspect of this he would like to discuss with us.

Ch
Shall I now seek advice from PE on dropping employee share preferences from BP offer?
AA

A J G ISAAC

cc Sir Peter Middleton
Mr Monck
Mr D J L Moore
Mr Scholar
Mr Cropper

Mr Battishill
Mr Isaac
Mr Miller
PS/IR

Inland Revenue

R K Miller The Solicitor

Solicitor's Office
Somerset House
London WC2R 1LB

Telephone 01-438 6645

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5 August 1987

Mr Isaac

SHARE ISSUES - EMPLOYEE PRIORITY SHARES

The Chancellor has asked for the Revenue to look again at whether a taxable benefit could arise in relation to the proposed sale of BP shares. I do not have details of the proposals but, as I understand it, the shares which will be offered to the public and employees will all be shares sold by the Government and not new shares to be subscribed.

My advice was given in the context of shares being offered by the employer because I understood that it was sought in relation to preferential terms for employees as a question of general application where shares are being offered to the public. Further where, as in Tyrer v Smart, the shares on offer and to be allocated to employees consist of both existing shares sold by the principal shareholder and new shares offered by the employer, there is commonly an identity of purpose.

The Chancellor has suggested that in the case of the BP offer, because the Government is not the employer and the Government's reasons for conferring a benefit upon the employees are because it believes that employee shareholdings are per se a good thing, such a benefit is not an emolument from the employment and so not taxable.

It is of course true that in the GCHQ case the Government was the employer and the money came from its pocket. But this does not affect the principle. Benefits to employees from third parties can be taxable as emoluments of the employment - a familiar example is the restaurant tip. The test is the same, namely whether the benefit came to him for acting as or being an employee. The words used by Lord Diplock and other judges to explain what is meant by emoluments from an office or employment are not definitions to be treated as if they were substitutes for the statutory words. They are attempts to illustrate what distinguishes those benefits which an employee receives which are emoluments from his employment and those which are not. Where the provider is not the employer it may be easier to find that the benefit was not a taxable emolument, but this is a question

(if the will is there)

of fact and degree with a total outsider at one end of the scale and someone closely connected with the employer at the other.

Accepting entirely that the Government's motives are that it believes employee shareholdings to be in itself a good thing, it still, it seems to me, means that the intention is that employees should have whatever benefits there may be in being given priority for no other reason than that they are employees. It is not just that if anyone is not an employee he gets no chance of the preferential terms: the whole point of giving those terms is to provide the employee as employee with an advantage which is wholly connected with and affecting his employment. Employee shareholdings are a good thing because of their beneficial effect upon the employment. On that footing, in my opinion, upon the present state of the authorities the benefits would be taxable.

A.M.

PR1/75

CONFIDENTIAL

ACSA
LEAHY
6/8

FROM: A C S ALLAN
DATE: 6 AUGUST 1987

MS LEAHY

cc PS/Financial Secretary
Sir P Middleton
Mr Cassell
Mr Monck
Mr D J L Moore
Mr Scholar
Mrs Brown
Miss Sinclair
Mr M L Williams
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
Mr Miller - IR
PS/IR

SHARE ISSUES: EMPLOYEE PRIORITY SHARES

The Chancellor has seen the further opinion from the Inland Revenue's Solicitor, saying that he remains of the opinion that the benefits in the BP case would be taxable.

2. In the light of this, the Chancellor is strongly minded to say that there should be no employee priority shares in the BP sale. The question of employee priority shares in future privatisations would then be considered separately in the autumn. He would be grateful for advice.

ACSA

A C S ALLAN

BANK OF ENGLAND
LONDON EC2R 8AH

7 August 1987

A S C Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Alex,

I understand that at last week's meeting between the Governor and the Chancellor, during which the present settlement problems were discussed, the Chancellor asked whether shares on which the second call had become due were still held in allotment letter form.

The answer is that newly-issued shares will circulate in the form of a renounceable letter of allotment until a share register can be established. When this can be done does not depend on the timing of the second call payment, but on such matters as the size of the issue, the efficiency of the registrars, etc. Until a register is established business is settled by payment against delivery of the physical paper; only after the stock becomes registered can it be transferred, partly paid, through the Stock Exchange's Talisman settlement system.

I understand that in recent privatisations, with the exception of Rolls Royce, a provisional register was established within four to twelve weeks of the initial offer for sale and certainly well in advance of the second call becoming due on the shares. With Rolls Royce the second (and final) call was due between four and five months after the initial offer and the decision was taken

(partly, I understand, on grounds of cost) not to set up an interim register. This did however mean that because Rolls Royce shares were traded throughout that period in allotment letter form, the paper-handling burden on firms' back offices was increased.

Yours

John

J R E Footman
Private Secretary
to the Governor

CONFIDENTIAL

FROM: Ms P M Leahy
DATE: 10 August 1987

CHANCELLOR

cc Financial Secretary
Sir P Middleton
Mr Cassell
Mr Monck
Mr D Moore OR
Mr Scholar
Mrs Brown OR
Miss Sinclair
Mr Lyne
Ms Huleatt-Jones
Mr Bent OR
Ms Pelham
Mr S Johnson
Mr Battishill
Mr Isacc IR
Mr Miller "
Mrs Green "
PS/IR

Content (if that is not too strong a word) to allow UK employees to have priority?

BP SALE: EMPLOYEE PRIORITY

Mr Allan's minute of 6 August suggests that you are not minded to give priority in allocation to BP employees in view of Inland Revenue's advice that this would lead to a taxable benefit. For future privatisations you would consider the question separately in the Autumn.

2. If at all possible officials would want to let BP's UK employees have some special priority in allocation for the following reasons:

(i) On the basis of a conversation with Mr Kuczys about his minute of 29 July we have now written to BP (and advisers) telling them that UK employees would receive priority in allocation. BP have done a considerable amount of work on the mechanics of priority. A changed decision is likely to make BP's attitude to other aspects of the sale negative.

Mr K distinguished between UK employees + overseas employees. He did not, as far as I am aware, say that UK employees should have priority allocation

(ii) BP are already concerned that we changed our minds about allowing their overseas employee/shareholders to have priority. You will recall that the Financial Secretary agreed to this (Mr Heywood's minute of 17 July). In the

light of Mr Kuczys' minute of 29 July however we returned to BP to say this was no longer possible;

(iii) the lack of any employee preference is likely to attract attention (as far as we can tell all other Government share issues have had some special provision for employees). We could give a plausible response - three-quarters of BP employees are already shareholders. But there is bound to be speculation about the tax position and we would far rather that attention was concentrated instead on the merits of the offer.

3. If your preference for not giving special provision to employees in the BP sale is because you do not want to be rushed into the recommended extra-statutory concession (ESC) but would still want in principle to encourage employee share ownership it would be possible to agree to give BP employees priority and to take action to prevent it being taxable but not to announce the proposed ESC yet. We could then continue discussions on the general principles and what action, if any, should be taken. This issue would however have to be resolved by the time of the BP sale (probably before the pathfinder prospectus came out at end-September).

Conclusion

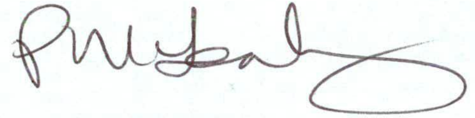
4. It would be unhelpful in the context of the BP sale if we do not allow the UK employees to have priority in allocation as we have already said they can. It ought to be possible to consider the issues and the Inland Revenue's proposed ESC thoroughly so that a policy decision suitable for all Government share sales not just BP can be reached before the sale. We recommend that you agree to us taking the question forward in this way.

OK

5. BP will have to write to their employees next week to tell them not to register with the SIO. They will therefore need

to know as soon as possible what our decision is.

6. This minute has been discussed with FP and the Inland Revenue.



P M LEAHY

3689/005

18

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)

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 [JWR].)

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.

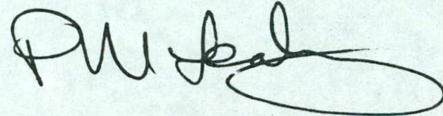
Conclusion

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

.4374/024

18

CONFIDENTIAL

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, <u>all</u> 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).

J.H.

JEREMY HEYWOOD
Private Secretary

ps3/42K

RESTRICTED

8.

FROM: A W KUCZYS
DATE: 29 July 1987

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr D J L Moore
Mrs M E Brown
Mr Lyne
Ms Pelham
Mr S Johnson
Mr Cropper
Ms Leahy

BP SALE: PREFERENCE FOR EMPLOYEES/PENSIONERS

The Chancellor has seen Ms Leahy's minute of 28 July. He does not like what is proposed at all. We must not let BP take us for a ride. The Chancellor recalls (and Ms Pelham confirms) that we resisted worldwide employees in the 1985 Cable & Wireless sale. The Chancellor sees no case for giving priority to BP overseas employees, no case for BP pensioners, and precious little for BP UK employees (who already hold BP shares for the most part). And what do we get from BP in return for all this?

AWK

A W KUCZYS

PH1/101

RESTRICTED

Nigel, A minute cwt

FROM: J M G TAYLOR
DATE: 11 AUGUST 1987

MR MOORE o/r

cc Mr Monck
Mr Colman

REGISTER OF SHARES

... I attach a letter from the Governor's Private Secretary to Mr Allan. This responds to a question which the Chancellor asked the Governor at a meeting last week.

2. You will see that the letter refers (paragraph 3) to a provisional register being established in recent privatisations. The Chancellor has commented that he trusts there will be a provisional register established for BAA.

J M G TAYLOR

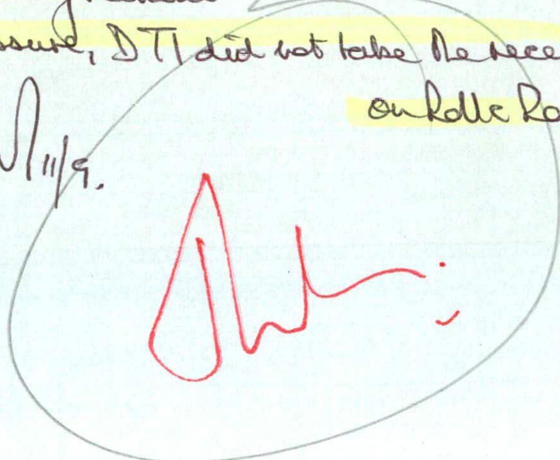
Mr Taylor

I am sorry that I have not replied before.

There was a provisional register for BAA: a consequence of our having an instalment agreement.

In spite of Treasury pressure, DTI did not take the necessary steps on Rolls Royce.

11/9.



BANK OF ENGLAND
LONDON EC2R 8AH

7 August 1987

A S C Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Alex,

I understand that at last week's meeting between the Governor and the Chancellor, during which the present settlement problems were discussed, the Chancellor asked whether shares on which the second call had become due were still held in allotment letter form.

The answer is that newly-issued shares will circulate in the form of a renounceable letter of allotment until a share register can be established. When this can be done does not depend on the timing of the second call payment, but on such matters as the size of the issue, the efficiency of the registrars, etc. Until a register is established business is settled by payment against delivery of the physical paper; only after the stock becomes registered can it be transferred, partly paid, through the Stock Exchange's Talisman settlement system.

I understand that in recent privatisations, with the exception of Rolls Royce, a provisional register was established within four to twelve weeks of the initial offer for sale and certainly well in advance of the second call becoming due on the shares. With Rolls Royce the second (and final) call was due between four and five months after the initial offer and the decision was taken

(partly, I understand, on grounds of cost) not to set up an interim register. This did however mean that because Rolls Royce shares were traded throughout that period in allotment letter form, the paper-handling burden on firms' back offices was increased.

Yours

John

J R E Footman
Private Secretary
to the Governor

PH1/107

CONFIDENTIAL

1. Julie
Pl. arg a mtg on 3 a 4/9, if poss.
2. b.f. to ACSA/o/r
NB/ ms. comment below.
JT 12/8

FROM: J M G TAYLOR
DATE: 12 AUGUST 1987

Ms LEAHY

cc Financial Secretary
Sir P Middleton
Mr Cassell
Mr Monck
Mr D Moore o/r
Mr Scholar
Mrs Brown o/r
Miss Sinclair
Mr Lyne
Ms Huleatt-Jones
Mr Bent o/r
Ms Pelham
Mr S Johnson
Mr Battishill - IR
Mr Isaac - IR
Mr Miller - IR
PS/IR

BP SALE: EMPLOYEE PRIORITY

The Chancellor has seen your minute of 10 August.

2. In the circumstances, he is prepared to agree that UK employees of BP should have a degree of priority in the application.

3. He does not want to be rushed into the proposed ESC (nor equally, of course, does he think we can contemplate some special arrangement for BP); he will, therefore, hold a meeting to decide this vexed question once and for all on his return from leave.

JT

J M G TAYLOR

psl/20A

FROM: A C S ALLAN
DATE: 4 September 1987

CHANCELLOR

3rd pty benefits (gifts) (but over £100)

EMPLOYEE PRIORITY SHARE SCHEMES

You asked me to set out the points we discussed on the plane on the way back from Venice. One was the "third party" benefit point - which I unsuccessfully tried on the Inland Revenue Solicitor.

2. The other points related to how on earth the charge is supposed to apply in practice. The Revenue's draft press release implies that there is an income tax charge on the difference between the value of the shares on allotment and the issue price. But what on earth is the value on allotment? The price quoted on the day that allocations are announced will certainly not be realisable by most investors. They will not have received their letters of allotment then. Do the Revenue then mean the date on which a letter of allotment is received? That seems to depend on the vagaries of the postal service; and the premium on privatisation issues can fluctuate pretty substantially over the first few days. And is the taxpayer allowed to offset notional dealing costs he would have incurred if he had sold the shares?

3. There is a real possibility that someone might have a tax charge on a "benefit" he never receives. Suppose he later sells the shares at less than the deemed price at allocation. There is presumably no income tax relief available to him (and the loss for CGT purposes will be small comfort).

4. The prospect of aligning possible capital gains tax rates and income tax rates* makes this all seem completely pointless. There are some differences between an income tax charge and capital gains

tax charge (because of the timing differences and the different thresholds). Do we really have to stir all this up, issuing ESCs etc, for such little benefit? Couldn't the Revenue just forget about it?

A C S ALLAN

* NB: not everyone at meeting is in on Task Force.

3692/001

CONFIDENTIAL

FROM: Ms P M LEAHY
DATE: 4 SEPTEMBER 1987

1. MR D J L MOORE

2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Scholar
Mrs M E Brown
Ms Sinclair
Mr Lyne
Ms Huleatt-James
Mr Bent
Ms Pelham
Mr S B Johnson
Mr Cropper

Mr Battishill)
Mr Isaac)
Mr Easton) - I.R.
Mr P Lewis)
Mr Prescott)
PS/I.R.)

TAXATION OF EMPLOYEE PRIORITY SHARES: BP SALE

You are meeting officials at 3.00 p.m. on Monday 7 September to resolve the tax problem arising from employees obtaining special priority in allocation in share sales which needs to be resolved in time for the BP pathfinder prospectus. This minute reminds you of the background and suggests a short agenda.

2. Key papers are:

(i) my submissions of 16 & 28 July to the Financial Secretary and of 10 August to the Chancellor;

(ii) Mr Bent's submission of 22 July to the Financial Secretary;

(iii) Mr Isaac's submissions of 17 & 23 July to the Financial Secretary;

(iv) Mr Lewis' submission of 29 July to the Financial Secretary;

(v) Mrs Brown's submission of 30 July;

(vi) Mr C C Allan's minute of 6 August;

(vii) Mr J M G Taylor's minute of 12 August.

Tax Implications

3. Inland Revenue have advised that priority in allocation for employees (when the extra shares they receive are worth more on allotment day than they paid) is a taxable benefit. Ministers have suggested the possibility of an extra-statutory concession (ESC); and the IR Minute of 29 July contained a draft which broadly provides that employees will be exempt from income tax, provided:

(i) that priority in allocation to employees and Directors is for no more than 10% of the shares in the fixed price offer and all are given equal treatment in the preferential offer;

(ii) there is a limit of, say, £5,000 on the subscription payable under the offer;

(iii) the issue price is considered to be the price at which the shares were acquired for capital gains tax purposes.

4. Treasury officials were not convinced of the case for a cap and consider the 10% rule and the 'similar terms' requirement adequate protection for the Exchequer against abuse.

CONFIDENTIAL

<u>Implications for the BP Sale</u>

5. You will recall that BP originally proposed that all employees worldwide who were also shareholders should be allowed priority in allocation for up to 1,000 shares. They were also keen for pensioners to benefit. You agreed in response to my submission of 10 August that all UK employees only should be given priority in allocation for up to an as yet unspecified number of shares (which would be more than the guaranteed number they would get if they registered as members of the general public with the Share Information Office (SIO) - the size of which has also not yet been set). As my minute pointed out, however, we have to come to a quick decision on what is necessary to prevent BP employees being taxed on the benefit. (Only the extra shares guaranteed above the public guarantee would give rise to a tax problem). At the very latest, a decision is needed by the time the pathfinder prospectus is finalised - just over two weeks' time.

<u>Agenda</u>

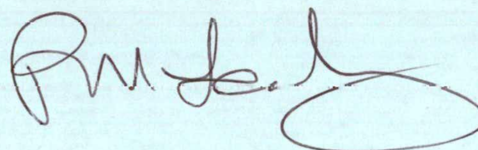
6. We suggest therefore the following agenda:

(i) the present position;

(ii) the terms of a possible ESC of general application (points for decision at end of IR submission of 29 July - mainly the question of a cap on relief);

(iii) the implications of the ESC for BP, subsequent privatisations and private sector issues;

(iv) timing and form of an announcement.



P M LEAHY

NOTE OF A MEETING HELD IN HM TREASURY
AT 3.00PM ON MONDAY 7 SEPTEMBER 1987

Present: Chancellor
Financial Secretary
Sir P Middleton
Mr Cassell
Mr D J L Moore
Mr Scholar
Mrs M E Brown
Ms Leahy
Mr Cropper
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr Lewis - IR
Mr Prescott - IR

TAXATION OF EMPLOYEE PRIORITY SHARES: BP SALE

Papers: Ms Leahy's minute of 4 September to the Chancellor, and the papers listed in paragraph 2 of that minute.

Opening the discussion, the Chancellor said that the papers raised a complex array of issues which needed to be examined thoroughly before reaching a conclusion. They did not relate to some new practice, but instead to one which had only recently been highlighted (by the Government's advisers). He noted, in passing, that it would be appropriate for advisers in future to approach Ministers direct rather than the Revenue if they identified similar problems. Mr Prescott said that the problem was not confined to BP; other companies had also sought advice from the Revenue on the same question.

2. The Chancellor said that the Revenue's approach was summarised in the draft press release attached to Mr Lewis' submission of

29 July to the Financial Secretary. The approach presented a number of difficulties. First, what precisely was the nature of the benefit received by an employee who was allocated priority shares? Conceptually, it was the excess of the number of shares received compared to what the employee would have received had he applied as an ordinary member of the public, multiplied by the rise in price. But it was hard to know what the employee would have got otherwise. Second, there were difficulties in relation to the date on which the price should be calculated. The Revenue confirmed that this was the date on which the employee became beneficially entitled to the shares. But this could be before he received the letter of allotment. Hence he could be taxed on shares whose profit he could not realise. Third, there would be no offset for dealing costs.

3. Mr Isaac, replying to questions, said that he thought there would be no liability both to capital gains tax and to income tax on the same gain. He would check this. He confirmed, however, that the employee could not claim a tax credit if the shares in question opened at a discount. The relevant law - rightly or wrongly - did not contemplate such a situation (and hence the Solicitor had not encompassed it in his Opinion).

4. The Chancellor said an employee priority was not a conventional benefit. It did not rest in the certainty of a profit, but in the opportunity to make a profit at a later stage. Moreover, the employer's desire to distribute shares arose from a wish to create an identity of interest, not to distribute extra cash. There was a clear benefit, but it was extremely difficult to determine precisely its nature or size.

5. The Chancellor asked whether we were certain that the Solicitor's view that these benefits were liable to income tax would be confirmed by others. Mr Isaac said that the Revenue had not consulted Counsel, but that other legal opinion had been canvassed and the same answer implied.

6. The Chancellor said that if the press release were issued, it would instantly attract a host of follow up questions. Apart from the difficulties noted above, unfavourable comparisons would be drawn with eg. the tax treatment of benefits under the 1984 share option scheme. This could all be highly contentious. Would extra problems be caused by going through an extra statutory concession rather than legislation? Mr Battishill said that there might be difficulties with the NAO who, with the PAC, were pressing the Revenue to remove as many extra statutory concessions as possible. Sir Peter Middleton noted that it would be hard to describe this concession as "minor" and "transitory".

7. The Chancellor canvassed views on whether there should be a cap on the relief. Mr Moore said that, in practice, this was not a problem in relation to the BP issue but that Mrs Brown had suggested that it might inhibit future issues. On the other hand, the Revenue had set out arguments (in the papers) which pointed to the need for such a cap. The Financial Secretary noted that, if there were a cap, the whole of the investment above the limit would be liable to income tax. This might cause problems in reality if we wished to encourage ownership. The Chancellor noted another unfairness in that the cap would apply equally to subscription for a quoted share and for a new issue, although the risks associated with one were much greater than for the other. A cap was, however, unnecessary if we followed the legislative route. Mr Cropper suggested that a clog eg. a bar on vending employee shares for a certain number of days might be an alternative possibility. The Chancellor thought this would further complicate the valuation problems.

8. Sir Peter Middleton suggested that the legislative option should be set out. It had clear advantages over an extra statutory concession and would, moreover, correspond with the situation as it was generally understood to be. The Chancellor wondered whether Counsel's opinion should be sought. Mr Battishill said he would not recommend this course at this stage.

9. The Chancellor said there was a practical choice between an extra statutory concession, or legislation. He invited comments: there was general agreement to the legislative route.

10. The Chancellor, summing up, said there was general agreement to the Revenue proposition that some action must be taken, and that this should be by legislation. This should be directed towards retaining the practice hitherto: ie. that there should be no distinction for tax purposes between employees and non-employees as far as new issues were concerned, and that only Capital Gains Tax should be levied. The legislation should include certain restrictions - notably the 10 per cent limit, and possibly others - but there was little enthusiasm for a cap. The position of employees in relation to tenders should be considered further. He invited Mr Isaac to submit on this. There should be an early announcement of the intention to legislate. Meanwhile nothing should be said to BP - or in response to other enquiries - in advance of that announcement.

J M G TAYLOR
9 September 1987

Circulation

Those present

FROM: N J ILETT
DATE: 9 September 1987

MR CULPIN

cc: PPS
PS/CST
PS/FST
PS/PMG
PS/EST
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Moore
Mr Scholar
Mrs Brown
Miss O'Mara
Mr Cropper
Mr Call

SHARE OWNERSHIP FIGURES: CHANCELLOR'S INTERVIEW ON "TODAY", 9 SEPTEMBER

The Chancellor said this morning that the "vast majority of the people who've subscribed to these new share issues have held on" and that "the people who want to make a quick buck are the tiny minority".

2. You may be asked to substantiate these points in view of a claim by Labour Research (copy attached) that 42% of all individual stakes in past privatisations have now been sold. The picture on individual issues varies.

3. The bull point is that there is little evidence that significant numbers of people are share "sellers" in the sense that they take a quick profit and then cease to be shareowners. There is evidence in a Stock Exchange study that people sell one issue to buy the next. They remain shareholders, which is the key point. If they did not - as the Chancellor pointed out -we would not now have 9 million plus individual shareholders. (There are various other factors which may be at work here - for example, the people who do sell privatisation issues may include a disproportionate number of experienced shareholders. But that takes us into uncertain statistical territory.)

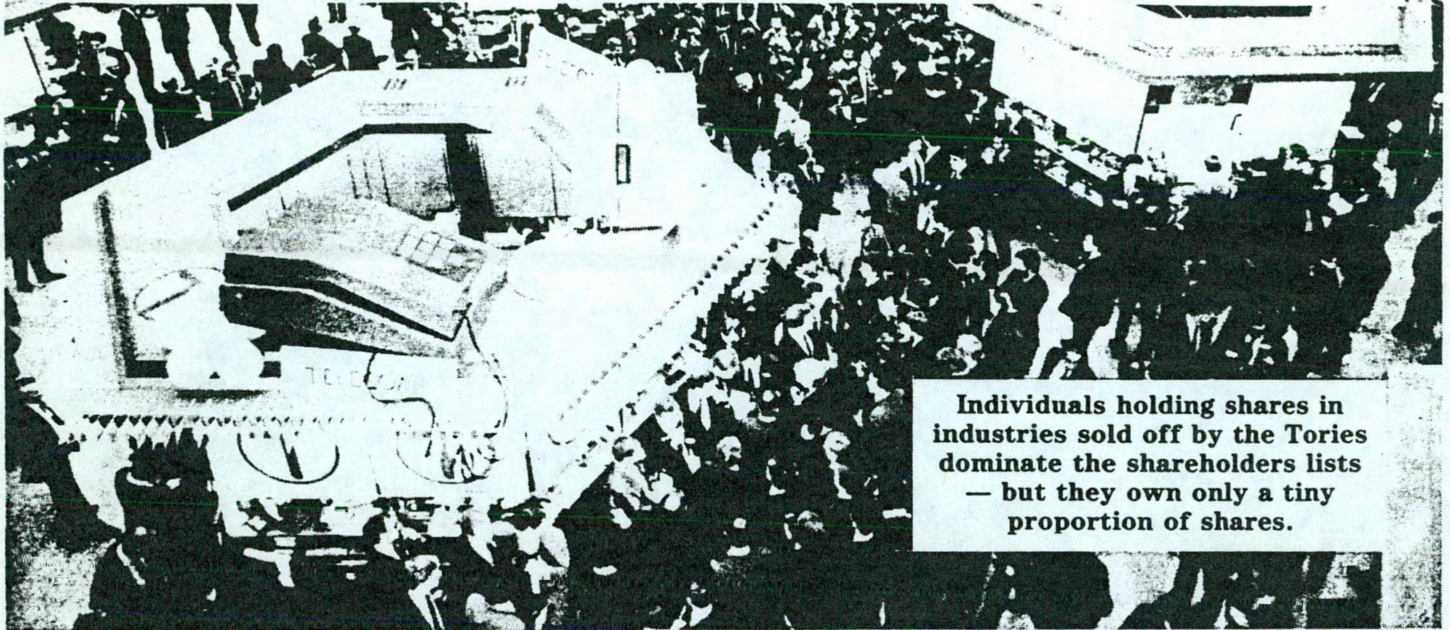
N J ILETT

Retention of Stakes in Major Privatisations

Company	Sell off Date	Number of Successful Applicants		% sold out
British Airways	Feb 1987	1,200,000		65 (May 1987)
British Gas	Dec 1986	4,500,000		31 (Apr 1987)
British Telecom	Nov 1984	2,300,000		38 (March 1987)
Britoil	Nov 1982	35,572	485,572	
	Aug 1985	450,000		54 (Dec 1986)
Cable & Wireless	Nov 1981	157,000		
	Dec 1983	35,000	411,000	56 (March 1987)
	Dec 1985	219,000		

Labour Research figures

Big fish grab sell-off shares



Individuals holding shares in industries sold off by the Tories dominate the shareholders lists — but they own only a tiny proportion of shares.

British Telecom shares open on Stock Exchange Philip Wolmuth

As soon as the June election was over the Conservatives set out a range of state-owned industries to be sold off, which included the water industry and electricity. One of the prime objectives was to advance towards their ideal of a share-owning democracy. But past experience has shown that while the number of shareholders has increased, *control* of the companies merely passes to the large City institutions, such as pension funds. Many individual shareholders have been happy to take quick and easy profits.

The most recent privatisation was the delayed take off into the private sector of BAA, the airports concern. This sale attracted 2.47 million investors, of which 2.17 million were successful in buying shares. At the initial sale, each private investor was only allotted 100 shares each. First day trading on the Stock Exchange saw the shares, priced initially at 100 pence, show an immediate profit of 46 pence. Many individual shareholders sold out immediately for the 46% profit with over 64 million shares (15%) changing hands on the first day. National Westminster Bank, for example, did a record 26,000 first day deals on BAA compared to 23,000 for British Gas. Mopping up the shares were the City institutions.

Two other privatisations this year have also seen private investors selling out in droves. Rolls Royce, the aero-engine maker, will also have seen a large drop in the number of its shareholders. When it was sold off in May there were just over two million successful share applications. The company's debut on the stock market saw a scramble for shares. The buying interest was said to have come partly from the City institutions, who had their portion of the offer cut from 60% to 50% because of heavy public demand, and partly from overseas investors, particularly the Japanese. On the first day of trading 420 million (52%) of Rolls Royce shares had changed hands. And as it was the City institutions buying it was obviously the small investor selling to make a quick profit. The shares at a partly paid price of 85 pence reached a 147 pence peak on the first day, a 73% profit for the taking. John Smith, then Labour's industry spokesperson, said the company had been "sold for a song" and that ministers should be surcharged for "giving away hundreds of millions of pounds."

British Airways

More than 750,000 people who bought shares in British Airways seven months ago quickly sold out. That is equivalent to nearly two-thirds of original investors. The flotation, the penultimate privatisation before the election, attracted 1.2 million shareholders and the shares have soared from an issue price of 65p to 142p and have been as high as 178½p. In May, Lord King dismissed suggestions that investors had "cut and run" and said the remaining 450,000 people on the share register was a much larger figure than could be expected of companies of a similar size. "Cutting and running is nothing to do with taking a profit," he said in defence of those who had sold BA shares since the flotation.

More people had taken a profit by the time BA produced its annual report which showed that, at 21 May 1987, BA's share register had only 420,526 shareholders. No details were available of individual shareholders but those owning less than 10,000 (99.46% of all shareholders) held only 16.04% of BA shares. Large shareholders with one million or more shares each, numbering about 80, owned just over half (50.3%) of BA.

It is undeniable, however, that privatisation has increased the number of individual shareholders. Earlier this year the Treasury and Stock Exchange sponsored a survey on the extent of share ownership in Britain. The survey showed that:

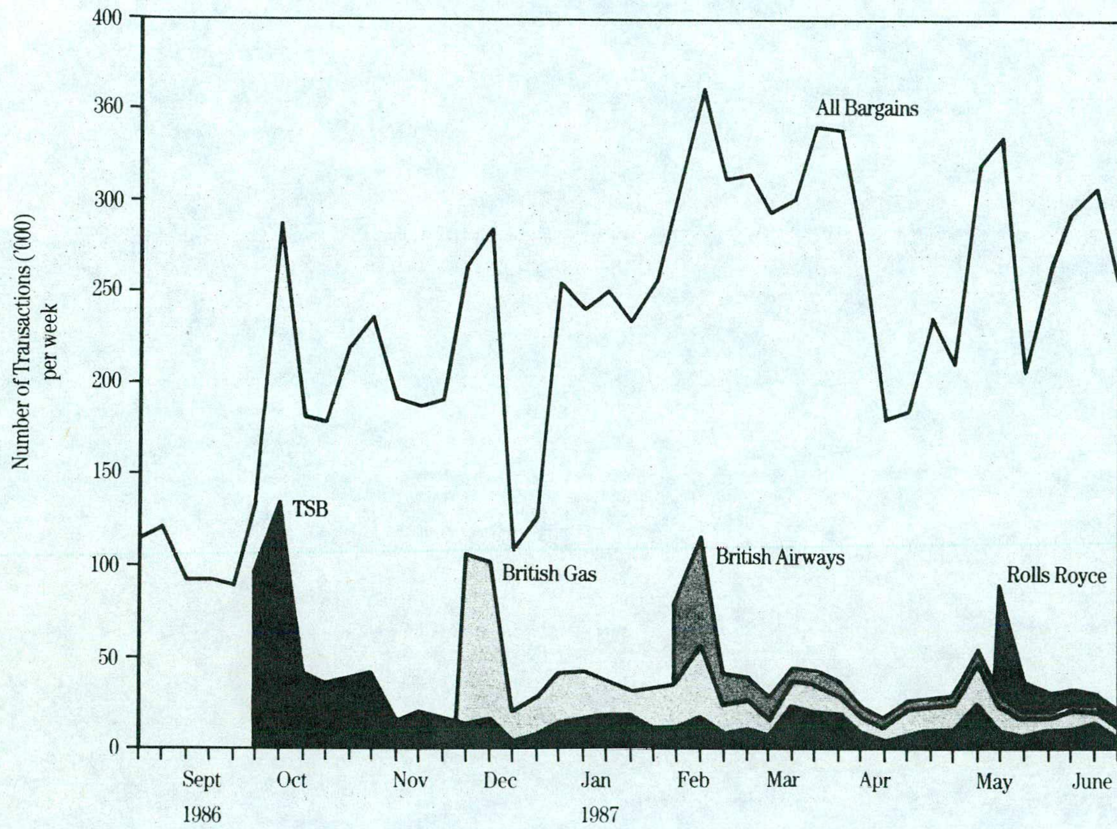
■ share ownership had almost trebled from 7% of the adult population when Thatcher came to power in 1979 to nearly 20%, or nearly 8½ million people, at the beginning of this year;

■ 15% (6½ million, or over three-quarters of share owners) held shares in privatised companies, or the Trustees Savings Bank (TSB). (The TSB was not privatised as the shares weren't held by the State but the Conservatives passed legislation to sell off the TSB); and

■ 8% — or 3½ million people — held shares *only* in privatised companies or TSB.

According to Stock Exchange

STOCK EXCHANGE: QUALITY OF MARKETS SURVEY, SUMMER 1987



CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

Ch / Points for decision in para 21.

FROM: M PRESCOTT
DATE: 10 SEPTEMBER 1987

1. MR ISAAC

2. CHANCELLOR

SHARE ISSUES: TAXATION OF EMPLOYEE PRIORITY SHARES

1. At your meeting on 7 September it was decided to introduce legislation, rather than an extra-statutory concession, to regularise the Revenue's current practice and exempt employees from a charge to income tax on any benefit arising from a priority allocation in a sale of shares in their company. The decision to legislate needs to be announced shortly - ie in time for the BP sale - and that in turn means that decisions need to be reached quickly on the detailed terms of the proposed legislation so that these too can be announced. There were a number of such points on which you asked for further advice.

MAIN PROPOSAL AND POINTS OUTSTANDING

2. The legislation will apply where there is an offer of shares at a fixed price to the public, and directors or

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cc	Chief Secretary	Mr Battishill
	Financial Secretary	Mr Isaac
	Paymaster General	Mr Easton
	Economic Secretary	Mr Beighton
	Sir Peter Middleton	Mr Lewis
	Mr F E R Butler	Mr German
	Mr Cassell	Mr Cayley
	Mr Monck	Mr Prescott
	Mr D G L Moore	Mr Peel
	Mrs M E Brown	Mrs Eaton
	Ms Sinclair	Miss Green
	Miss Leahy	Miss McFarlane
	Mr Cropper	Mr Swann (SVD)
	Mr Jenkins (OPC)	PS/IR

employees of the company concerned are entitled to a priority allocation. You have already agreed that exemption should be restricted to cases where

- the priority allocation does not exceed 10% of the total shares allotted at the fixed price in the flotation etc, and

- the priority shares are offered on similar terms to all directors and employees of the company.

3. But it is also for consideration whether

(a) there should in addition be some sort of limit on relief to any one individual, expressed either as a cap on the amounts subscribed or on the "benefit" received;

(b) similarly, whether - by analogy with the approved employee share schemes - the exemption should only apply if the shares were held for some minimum period after acquisition; and

(c) what treatment should apply in cases where the sale of shares is by way of an offer to tender, and the employees are able to acquire their shares at a lower price than members of the public.

We consider these points in more detail below.

LIMIT ON RELIEF TO ANY INDIVIDUAL (relevant back papers on this flagged below)

4. The issues for consideration are whether or not there should be a limit and, if so, what form it should take.

5. Dealing with the latter first, the choice is between a limit relating to the total amount the individual may subscribe for the shares, and one relating to the total quantum of the

i.e the difficulty of determining the precise "quantum" of the benefit

benefit that is to be exempted. For reasons explained in earlier papers, the arguments seem to point fairly conclusively in favour of linking it to the amount subscribed - mainly on grounds of giving the employee certainty from the outset as to whether and to what extent the limit will apply to him.

6. It is also for consideration whether, if the limit was exceeded, tax would apply only to the benefit on shares that exceeded the subscription limit, or to the benefit on all of the shares subscribed for. The main argument for the former - the excess only - is that this would avoid the familiar problem of a high "marginal rate" for the individual who just exceeded the threshold. And, while the main aim of the legislation is presumably to help encourage the majority of employees investing relatively small amounts, rather than the minority who are prepared to invest larger amounts, there is no reason positively to discourage the minority wishing to acquire large amounts by applying the charge other than on the amounts that exceed the limit. On the other hand, with an "all or nothing" approach, no one should get into a high marginal rate accidentally because the relief would be based on the amount subscribed which the employee would know for certain from the outset.

7. Finally, there is the level of the limit itself. This would be essentially arbitrary, but could of course subsequently be amended if that was thought necessary. We have suggested a ceiling of £5,000 and the Treasury has since confirmed that this would not cause any difficulty with the BP sale, though it could have caught a number of earlier privatisations. The general view at your meeting seemed to be that, if there were to be a limit, £5,000 was about the right level for it.

8. The more fundamental question is whether or not there should be a limit at all. The main arguments in favour would seem to be

- there could otherwise be very large benefits in individual cases, and even though the number of such cases might be relatively few this could be a source of criticism (the "similar terms" condition - paragraph 2 - would not necessarily prevent this if, for instance, any employee in a particular case was allowed to subscribe up to, say, £100,000 but only a very few were able to do so);

- the employees concerned would undoubtedly be getting a benefit, and it would be unfair on those employees not in a position for any reason to get such benefits not to have some kind of limit;

- introducing legislation to deal with this problem might highlight the parallel with the approved employee share schemes in which, of course, there are limits per individual on the amount of relief that is available.

9. The main arguments in favour of not having a limit would seem to be

- since we have not been assessing these benefits to income tax hitherto, a legislative relief but with an upper limit would amount in practice to the imposition of a new charge in cases where the limit was exceeded;

- the benefit in question does not escape tax altogether; CGT still applies, provided the shares are subsequently sold at a profit (in practice, particularly if the shares are sold in stages, the CGT gain would often be covered, in whole or in part, by the annual exempt amount);

- the proposed 10% limit on overall employee allocations would help indirectly to limit the value

of relief in a particular flotation etc, though the benefit to individual employees could still be large;

- a limit might in a few cases mean less employee take-up in future privatisations than otherwise - ie in respect of those employees who would otherwise have subscribed for an amount above the limit, particularly if the limit itself operated on an "all or nothing" basis;

- any limit would be arbitrary, and there would always be someone who was just the wrong side of it. There would, therefore, be the constant irritation and pressures to increase or abolish it.

- administratively much simpler for the Revenue (and possibly for companies also) not to have a limit.

MINIMUM HOLDING PERIOD

10. One reason for not wishing to tax this benefit is that it might discourage employees from taking up an offer to acquire shares in their company, and that would not be compatible with the Government's wider employee share ownership objectives. By the same token, however, it could be argued that if employees are to get this benefit free of income tax they should at least be required to hold on to the shares for some minimum period, and not be free to dispose of them immediately. There is an obvious and direct analogy with the approved employee share schemes, under all of which there is a minimum holding period in one form or another.

11. However, there would no doubt be considerable resentment with such a limit - particularly if any "benefit" that there was at the time of acquisition was subsequently eroded, during the holding period, as a result of a fall in value of the shares. There would also be considerable administrative

difficulties for the Revenue in monitoring such a limit, bearing in mind the very large number of employees (150,000 in the case of BT) that could be involved in a particular case.

12. On balance, therefore, we would recommend against such a requirement.

TENDER OFFERS

13. The proposed "10%" formula at paragraph 2 above is designed to target exemptions on cases where the employee priority allocation is only a small proportion of the total of the shares being offered to the public at a fixed price. The formula as expressed also deals neatly with cases such as BAA where part of the offer to the public is by way of tender, while avoiding the need for further rules specifying the minimum proportion of the total offer in such cases that should be by way of the fixed price issue. Under the formula, the proportion of the total shares which can be given to employees simply falls as any tender element in the offer increases.

14. It may be suggested, however, that the Government should go a step further and also exempt the benefit in cases where the offer to the public is only by way of tender, and the employees are able to acquire shares at a fixed price that is lower than the striking price(s) for the tender. As noted in the earlier papers, we assume Ministers would not wish to go that far and we ourselves would strongly advise against it. But it may help if we set out the considerations.

15. If anyone wanted to argue for exemption, they might deploy two main arguments. First, they might argue, the benefit in the case of a fixed price offer is the extra number of shares that the employee receives over a member of the public as a result of his priority allocation, multiplied by the difference between the value of the shares on the date they are allotted to him and the price he actually pays for them. In the tender case, the benefit would - depending on the

precise facts - be the number of shares acquired by the employee multiplied by the difference between the price at which the other shares are actually sold under the tender and the fixed price at which the employee is entitled to subscribe for his shares. In both cases, the employee has secured a benefit in the form of shares whose value in total is greater than what he paid for them. The fact that in the one case he got preference as to quantity and the other preference as to price is irrelevant; the benefit in both cases is the same, and indeed depending on the numbers in a particular case the quantum of the benefit could be identical.

16. A second argument might be that while under the proposed formula the proportion of the total shares which can be given to employees will fall as any tender element in the offer increases, the fact remains that the employees would be getting their shares at a (lower) fixed price while the bulk of the shares were being sold to the public by way of tender at a higher price.

17. However, these arguments ignore the fact that the benefit in these two cases is fundamentally different. In the case of a priority allocation in a fixed price offer, a benefit - if there is one at all - arises only because of the priority allocation and depends on the value on allotment day being above the issue price. The employee is still paying the same price for the shares as a member of the public; and the proposed 10% rule means that the vast majority of shares being offered at that price are going to the public, not to employees as such. By contrast, in the tender case the employee is being allowed to acquire the shares at a lower price than that paid by members of the public - thus the employer is deliberately giving the employees a benefit by selling them shares cheaply so that they (unlike the public) may still make a profit even if market value subsequently falls below the striking price(s). The purpose of the proposed legislation is merely to ensure that any benefit the employee gets by virtue of the priority allocation is not treated as part of his income and taxed

accordingly. The object is not to allow employees to receive benefits in kind, in the form of shares at undervalue, free of income tax.

Start Date for legislation

18. If there were to be no limit or restrictions at all on relief under the new legislation, we should in effect simply be perpetuating our present practice - but giving it statutory backing - and the start date for the legislation would be of little consequence. As noted, however, if there was to be a "cap" on the amount of benefit per individual employee, the legislation would in effect be introducing a new charge in future cases where the £5,000 limit was exceeded. Similarly the proposed "10%" and "similar terms" conditions (paragraph 2) do not apply at present so we shall in effect be introducing a new charge in future cases (probably very few in practice) where the 10% limit was exceeded or the similar-terms provision was not satisfied. In short, while compared with present law the legislation will be of a relieving nature, subject only to certain limits, it will where those limits are exceeded represent a tightening up when compared to our present practice. The start date will, therefore, be important.

19. We think that this would have to be the date on which the intention to legislate was announced. If the start date was different, the Revenue would be in the awkward position of having to decide what treatment should apply in any relevant cases (ie those where one or other of the new limits were exceeded) that might arise in the intervening period. It would, of course, be difficult for us to continue our existing practice of not charging anything once there had been an announcement to legislate (it would be implicit if not explicit in the decision to legislate that these benefits were taxable under present law), and where the proposed legislation would itself limit the relief in certain cases. But we would be justified in continuing to apply our present practice to any case where the employee had applied for priority shares in a

flotation and the application was still outstanding on the date of the announcement.

OTHER POINTS

20. At your meeting one or two other points were touched on concerning the present treatment of priority offers, and in particular the interaction of income tax and CGT as regards gains on employee-acquired shares. I can confirm that there would in practice be no overlap, ie with the same "benefit" being charged both to income tax and to CGT. In some cases there are specific statutory provisions to prevent this happening. For technical reasons (to do with slight differences in the bases of valuation between the Schedule E and CGT codes) there could in a minority of cases be an overlap; but the circumstances would be very unusual and our Instructions to Tax Inspectors ensure that in practice there would be no double charge in these cases either.

CONCLUSION AND NEXT STEPS

21 Once we have your decision on the detailed points raised in this minute, we can prepare a draft statement announcing the proposed legislation. We assume this would be done by way of an Inland Revenue Press Notice. The questions for decision are

C. Content with this? JF

- do you wish there to be a "cap" on the maximum relief an individual can obtain under the proposed legislation?

- if so,

    - do you agree that it should be based on the full subscription the employee undertakes to pay, rather than on the quantum of the benefit?

    - are you content that it should be set initially at a level of £5,000 per individual?

- should any charge relate only to the excess of shares over the limit, or be on an all or nothing basis?

- do you agree that there should not be an additional requirement of a minimum holding period?

- do you agree that the exemption should be confined to employee priority allocations under a fixed price offer, and not extended to include tender offers where employees are entitled to subscribe for shares at a fixed price below the price for which shares are sold in the tender?

M. Prescott

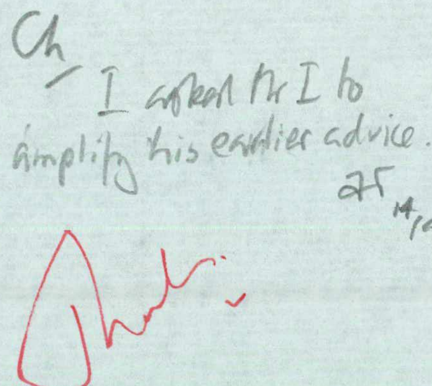
M PRESCOTT

1530/003

FROM: N J ILETT

DATE: 11 September 1987

PS/CHANCELLOR
(MR TAYLOR)



cc: PS/FST
PS/EST
PS/Sir P Middleton
Mrs Lomax o.r
Mrs Brown
Mr Culpin
Miss O'Mara
Mr Hurst
Mr Cropper
Mr Call

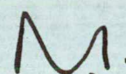
LABOUR RESEARCH : SHARE OWNERSHIP FIGURES

We discussed the sources of the Labour Research suggestion that 42% of initial individual shareholdings in privatisation issues have subsequently been sold. (My minute of 9 September to Mr Culpin refers.)

2. The source of the "box" on disappearing shareholders is company registers, in some case using figures quoted in annual reports, in others by contact with the company registrar.

3. We have checked the figures shown for British Airways, Britoil and British Telecom. The figures shown in the latest reports are the same as the figures in the Labour Research article. We have also confirmed that the British Gas figure (which is not in the annual report) is correct.

4. The Stock Exchange people who monitor market developments from day to day (who are responsible for the charts showing the relationship between sales of one privatisation issue and demand for the next which I attached to my minute to Mr Culpin) have looked carefully at the the Labour Research analysis and have not been able to fault it on points of fact.



N J ILETT

MR 12/69

UNCLASSIFIED

Pmp

FROM: J M G TAYLOR
DATE: 14 September 1987

MR ILETT

cc: PS/FST
PS/EST
PS/Sir P Middleton
Mrs Lomax
Mrs Brown
Mr Culpin
Miss O'Mara
Mr Hurst
Mr Cropper
Mr Call

LABOUR RESEARCH: SHARE OWNERSHIP FIGURES

I have shown the Chancellor your minute to me of 11 September. He was grateful for your advice.

JT

J M G TAYLOR

MR 12/72

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 14 September 1987

PS/FINANCIAL SECRETARY

cc: CST
FST
PMG
EST
Sir P Middleton
Mr F E R Butler
Mr Cassell
Mr Monck
Mr D J L Moore
Mrs M E Brown
Ms Sinclair
Miss Leahy
Mr Cropper
Mr Jenkins - OPC
Mr Isaac - IR
Mr Lewis - IR
Mr Prescott - IR
PS/IR

SHARE ISSUES: TAXATION OF EMPLOYEE PRIORITY SHARES

The Chancellor has seen Mr Prescott's minute of 10 September.

2. He would be grateful for the Financial Secretary's views. He has commented that the advantage of legislation is that it can be amended; his inclination would be to announce a limit, in the first instance, and for the charge to be applied to the excess of shares over the limit.

J M G TAYLOR

CONFIDENTIAL

PS/CHANCELLOR

FROM J J HEYWOOD
DATE 14 SEPTEMBER 1987

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr F E R Butler
Mr Cassell
Mr Monck
Mr D J L Moore
Mrs M E Brown
Ms Sinclair
Miss Leahy
Mr Cropper
Mr Jenkins - OPC
Mr Isaac - IR
Mr Lewis - IR
Mr Prescott - IR
PS/IR

SHARE ISSUES: TAXATION OF EMPLOYEE PRIORITY SHARES

The Chancellor asked for the Financial Secretary's views on Mr Prescott's minute of 10 September.

2. The Financial Secretary thought that what Mr Prescott proposed on tenders was right. He also agreed that there should not be a minimum holding period requirement: this would simply introduce a new complication. However, the Financial Secretary finds the question of a limit more troublesome.

3. The Financial Secretary thinks that Mr Prescott has identified most of the major drawbacks of a limit (in paragraph 9 of his minute). The Financial Secretary has two central objections:

(i) He points out that when Ministers first considered

this issue they started by disagreeing strongly with the legal advice. As far as the Financial Secretary was concerned, this was in large measure because this advice was rather unpalatable. The Financial Secretary does not, therefore, see why we should not simply restore the position to what we had always thought it and wanted it to be.

(ii) The Financial Secretary also thinks that if previous privatisations are any guide, there will be employees who will want to invest more than £5,000 in their own companies at the flotation. 20,000 out of 90,000 British Gas employees, for example, subscribed for more than £5,000 worth of shares. These people would face an income tax charge in future under the present proposals. The Financial Secretary feels we too often end up our discussions introducing new taxes. Why shouldn't the mass of employees have a "slice of the action" comparable to managers' share options?

4. In short, the Financial Secretary's preference would be for no limit; the higher the original investment, the greater - on past experience at least - the Capital Gains Tax liability that would ultimately result.

J.H.

J J HEYWOOD
PRIVATE SECRETARY

021 4367