

FOUCH, 40-22 PTA

Part A.

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Begins: 22/9/87.

Ends: 19/2/88.



PO -CH /NL/0222



PART A

Chancellor's (Lawson) Papers:

PROFIT RELATED PAY

Profit Related Pay

Disposal Directions: 25 Years

13/9/95.

NL/0222

-CH

PO

PART A

Chancellor

12/2



This is only contact HMT can
trace. Uniden have been
talking to the PRPO.

With the Compliments
of the

Paymaster General's

Private Secretary

PMG ~~with~~ wants to talk to
CX + get Angus' comments
2nd hand.

Treasury Chambers,
Parliament Street,
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PS 12/2

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22nd September, 1987

Ch. / PRP
I passed on your
suggestion to the PMG's office, with
this result. Prayers?
25/12/11

Mr. P. Brooke,
Paymaster General,
Treasury Chambers,
Parliament Street,
SW1P 3AG.

Dear Mr. Brooke,

I am replying to your letter to our Chairman, Mike Angus, since he is
away at present on an overseas trip.

✓ | We are very much involved with the new Profit Related Pay arrangement
and we are seeking to get two of our subsidiary companies registered by
the end of this month. Whether they will qualify remains to be seen,
but your people and ours are working closely on it. Unilever in the UK
are very keen to support the Government's initiative in PRP and to that
end we are in close contact with your Mr. Allison.

Yours sincerely,



M.G. Heron

c.c. Mr. M.R. Angus
Mr. T.C. Thomas

tote

HORSERACE TOTALISATOR BOARD

Tote House
74 Upper Richmond Road
London SW15 2SU
01-874 6411

From the Chairman:
Lord Wyatt of Weeford

PROFIT SHARING

HM TREASURY - MCU	
REC'D	25 SEP 1987
ACTION	IR
	cc AB/CHX
SIGNATURE	CHX
REF No.	25074/87

PERSONAL

24th September 1987

Dear Nigel,

As you know the Tote is very keen on profit sharing and instituted its own scheme on 1st April 1985. It has worked very well to improve morale and the business itself. We were delighted to read of your tax proposals with regard to profit sharing and so were our employees who this year received 8 2/3rds per cent of wages from the profit sharing which we felt had been thoroughly earned. I told them in a letter to all employees that soon they would be getting some tax relief on future years of profit sharing.

I have now seen the Finance (No.2) Act 1987, section 6. I cannot think that it is intended to apply to our business as we are not a nationalised industry and so far as I can make out the government does not in any way own us, the ownership being wrapped in mystery. However it might be thought by the Inland Revenue Authorities on a very narrow interpretation that section 6 could apply to the Tote owing to the fact that the Home Secretary appoints the members of the Board though not of course any of the executives or anyone else down the line. The Home Office's powers of control over the Tote are limited entirely to appointing the members of the Board and confirming or otherwise the salaries proposed for members of the Board by the Board itself.

There will be considerable anguish here if the Tote, which is an independent business which has never had any money from the government since it was started in 1928, found its employees were to be classed in some way as being in the service of the Crown. I would be very grateful if you would be kind enough to assure me that section 6 will not prevent the employees of the Tote getting tax benefits available to members of other commercial organisations.

Yours truly
Lawson

The Rt.Hon. Nigel Lawson, PC, MP
Chancellor of the Exchequer

L. WYATT
CHX
24/9

cc - Mr Cwyn Owen



English China Clays P.L.C.

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Our Ref: ANGD/FGR/SVF Your Ref:

8th October, 1987.

The Hon. Peter Brooke, M.P.,
Paymaster General,
H.M. Treasury,
Treasury Chambers,
Parliament Street,
London. SW1P 3AG

Peter Brooke

Profit Related Pay (PRP)

Thank you for your letter of 14th September enclosing a copy of the Guidance Notes on the PRP legislation and inviting my general observations on PRP and your initiative to encourage it.

Our accounting year runs from 1st October and thus the earliest date we can introduce a PRP scheme is 1st October 1988. In the circumstances we have not yet finalised our views on the scheme but a preliminary review was undertaken when PRP was first announced last March and thus I am able to give you the present state of our thinking based on that review and a reading of the details which we have recently received. I would just mention that some of the more important queries raised in the course of our review have **not** been answered by the PRP 2 booklet and we may accordingly be sending a list of points to the PRP Office for clarification. The comments that follow are based on our present understanding of the scheme.

I regret that I have to say from the outset that there is very little I can see to recommend PRP. The carrot by way of tax relief which you have deemed necessary in order to encourage organisations to introduce it, seems to me to be the very thing which kills it, because the rules have to be so rigid to prevent tax evasion. Thus I believe the only reason why organisations will decide to introduce PRP is because they feel they are unable to deprive their employees of the opportunity to make a tax saving, rather than by reason of any inherent merits in the scheme. I do not believe that this is a good motive for reaching a decision on a profit sharing scheme and find it curiously at odds with government policy, which I had understood to be opposed to using arrangements which depend for their effectiveness on tax relief.

Obviously I need to justify such outspoken comments and this I will attempt to do while limiting myself to the "general observations" requested by you. I can support it with detail if required. The drawbacks, as I see it, are as follows:-

con. ...

1. The four stated benefits in the Treasury Introduction to PRP can only apply if the employment unit is sufficiently small so that the employees can see a direct correlation between their actions and the profits of the unit. However, in a Group our size, such small units would create an administrative nightmare in administering the PRP rules, providing audited accounts, allocating interest and overheads, dealing with inter-unit transactions etc. For practical reasons, therefore, we would almost certainly have to work on a Group basis. Once the Group criterion is introduced, the prime purpose seems to have been lost and the scheme would effectively just be introduced as a general employment benefit with tax advantages.
2. Working on a Group basis, however, creates other problems. It does not appear possible that companies subsequently acquired can be brought into a Group Scheme and therefore either new members of the Group will not be covered by PRP, or such new members will each have to be covered by a separate scheme, or the Group will have to introduce a new scheme each year.
3. Employees will not be willing (or in many cases able) to accept part of their basic pay becoming profit linked. This will necessitate either a profit linked increase of at least 5%, adaptation of an existing profit related scheme or replacement of an existing profit related scheme. In our case it would be the latter, because our profit sharing scheme cannot readily be converted to meet the PRP rules. This would mean the loss of a well established and, I believe, popular scheme for an unknown and much more complicated scheme.
4. PRP is much too complicated and inflexible to be a good incentive scheme, for example:-
 - (a) the need for accountant's reports on the introduction of the scheme and annually;
 - (b) the straight choice of method A (percentage of profits) or method B (variation in profits). Our belief, based on experience of our own profit sharing scheme over 22 years, is that a combination of the two is the best arrangement;
 - (c) the inability to make any changes in the scheme other than, in certain limited circumstances, a change in the employer;
 - (d) the need to produce two sets of audited accounts if there are changes in accounting policy;
 - (e) the rules will not be readily understandable by the average employee;etc. etc.
5. Because the Public Sector is not eligible for PRP, the scheme is divisive between the private and public sectors. It also seems to me that the public sector is where there is an even greater need for "changes in working practices and investment in new technologies" - but perhaps I am biased!

In summary, it appears to me that, in practice, the PRP arrangements will cause the introduction of totally unsuitable schemes for the sole purpose of achieving tax relief - which could be withdrawn at any time. I hope that I am proved wrong.

Yours sincerely,
Alan Sarron.

AMC 6 OCT 1987 -5



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ALL COMMUNICATIONS TO BE ADDRESSED TO THE COMPANY

✓ PB 87 x

OUR REF: CTCB/MEG

YOUR REF.

DATE 5th October, 1987

P. Brookes, Esq.,
Treasury Chambers,
Parliament Street,
LONDON,
SW1P 3AG

PAYMASTER GENERAL	
REC.	-6 OCT 1987
ACTION	Mr Wynn Owen Mr Gray pma

Dear Mr. Brooke,

Thank you for your letter of 14th September 1987 about Income Tax Relief for Profit Related Pay. You certainly do not need to convince us of the merits of a profit related pay scheme; we are enthusiasts, propagandists and participants. However, we do have some points which we feel need reconsideration and we would like to set out our experience with PRP.

Starting with our financial year beginning in July 1981 we introduced a stunningly successful Profit Participation Bonus Scheme together with a quarterly newsletter which outlined problems which if solved could lead to a growth in Profit Participation Bonus.

The rules of the scheme were as simple as the objectives were subtle. The first rule was that an employee had to have achieved at least five years service by the end of the year in question (75% of all employees).

The second rule was that 5% of profit on gross turnover was disregarded, but after that point was passed 30% of the profit over the 5% minimum was put into a pool and distributed pro rata to earnings. (Note: this is now a 5.6% on net turnover due to the changes in accountancy rules).

The third and most important rule was that anyone indulging in any form of industrial action during the year will put at hazard all or part of their bonus. (In particular all of the bonus for a strike, part for "action" short of a strike - after a warning).

Our objectives were simple and designed to incentivise good behaviour and penalize the bad. The first objective was to encourage our employees to give of their best in areas such as material waste and quality improvements knowing that success would lead to monetary benefits for themselves. (Effort was not a problem owing to universal work measured bonuses and piece rates). A second objective was to introduce a serious cost to undertake industrial "action", with the longer term aim of reducing the blind faith in "The Union" and increasing confidence in the proven track record of management. A third objective was to remove the stigma attached to profit (unpaid wages as the unions refer to it) and encourage the view that profit earned and reinvested is the only sensible road to security of employment.

continued /...2

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5th October, 1987

P. Brooke, Esq

A fourth objective was to improve communications with employees as quarterly letters are now sent to their homes (which could be of use in an "industrial action" situation - though happily untested).

The succession of payments under the scheme has gone like this:

1982	£334,000	(before tax)
1983	£410,000	(before tax)
1984	£654,000	(before tax)
1985	£759,000	(before tax)
1986	£719,000	(before tax)
1987	over £1,000,000	(not yet paid)

As you can see this year's payment which will be over £1,000,000 between just over 1,400 people (about £700 each on average before tax though it is paid pro rata to individual earnings) is substantial and the high level of bonus and the increasing amount has generated an enthusiastic dedication to profit improvement at all levels of the company. Shop stewards' power and union caused problems have been greatly reduced.

When the Government decided to introduce tax relief for Profit Related Pay we were and are enthusiastically in favour and responded to the Green Paper with suggestions. But! Oh Woe! It now appears that our scheme introduced for what we believed then, and know of experience now, was a sound business reason, falls foul of the highly restrictive rules which apply if tax relief is to be available.

Basically there are three problems. The first is the method of calculation which is not compatible with PRP's method (a) or method (b) (our lower override is 5.6% profit on turnover being just under £3 m - the PRP scheme only allows a lower override of 5% of the pay bill which of course is much less at around £600,000. We have for six years been educating our employees that a minimum level of profit on net turnover of 5.6% was required to fund investment and therefore we only "share" out profit in excess of this figure (albeit at the high rate of 30% of the excess).

The second and infinitely more serious problem is the condition relating to industrial action. We have had only one example of industrial action since the introduction of the Profit Participation Bonus system, and that was in the first year of the scheme when truth to tell the employees did not really believe that a bonus would be payable at all. Some 200 employees went on strike despite being warned about the effects. On the day the bonus was paid (average about £200 per person) everybody except the 200 employees got it and a substantial proportion of the work force walked through their department waving their envelopes at them. No industrial action has taken place since then.

Unfortunately we are advised by the Profit Related Pay Office that exclusion of participants for this reason would conflict with the requirements of the legislation that the scheme employees participate on similar terms. Obviously we would never voluntarily throw away this extremely strong incentive for careful consideration before industrial "activity".

continued/ ...3

5th October, 1987

P. Brooke, Esq.

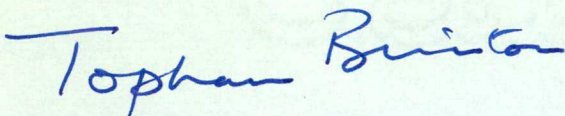
The third and last problem concerns people working overseas. We have about 30 people working in America, Germany and France for U.K. registered sales subsidiary companies each of which is a profit (or loss) centre. Because they are selling goods produced by the U.K. manufacturing companies the people (who qualify) are in the Profit Participation Scheme and the profitability of the group is considered as a whole being a self contained vertical operation or definable employment unit. As you know no overseas based employees can be included in a PRP scheme as they are not persons whose emoluments are subject to Schedule E (PAYE) - even though in this case most of the people are English though resident abroad.

Obviously we have a problem created by the tax relief since our PPS people will find it difficult to understand why our scheme does not qualify and they cannot enjoy the tax relief and this will cause resentment.

In principle therefore we believe that there should be scope for the Inland Revenue to look at existing schemes far more flexibly than new schemes that are being set up. It is clear to us that the gains to our employees compared to the loss to the company of changing the present scheme means that we cannot benefit from the tax advantages proposed even though our scheme is in no sense a dodge or device.

Clearly we do not want to disturb greatly a highly successful scheme for what might only be a temporary tax advantage for our employees. The "flexibility" of PRP has been vaunted, but from our point of view the flexibility seems incredibly limited. Perhaps some modification could be included that might permit existing schemes more latitude so that our employees can enjoy the benefit of the tax relief available?

Yours sincerely,



Topham Brinton,
CHAIRMAN



FROM: S P JUDGE
DATE: 15 October 1987

PS/CHANCELLOR OF THE EXCHEQUER

cc PS/Sir Peter Middleton
Mr Monck
Mr P R C Gray
Mr Wynn-Owen

PS/Inland Revenue
Mr Farmer - IR

PROFIT RELATED PAY: LETTERS TO THE TIMES 1000

The Paymaster General thought the Chancellor might like to see the attached letter from English China Clays PLC, as an indicator of the 100 or so responses he has had to date.

I also attach a letter from Brintons, which is fairly typical of the "deadweight" responses. IAE will be offering advice soon on how the Paymaster should deal with firms in this category.

Thinks.

*I am not quite
impressed by some
of the responses to
Brintons for ECC,
(even tho' it is a
ways an effective
response to the
is more wrong)
clear need to see
of new can be done.*

Mr.

S P JUDGE
Private Secretary

UNCLASSIFIED



pmf

FROM: J M G TAYLOR
DATE: 16 October 1987

PS/PAYMASTER GENERAL

cc PS/Sir P Middleton
Mr Monck
Mr P R C Gray
Mr Wynn-Owen
Mr S P Judge
PS/IR
Mr Farmer - IR

PROFIT RELATED PAY: LETTERS TO THE TIMES 1000

The Chancellor was grateful for your minute of 15 October.

2. He is not greatly impressed by the somewhat sour response from ECC, but the Brintons' letter (even though it is in many ways an effective response to the ECC missive) is more worrying, and we clearly need to see if there is anything that can be done.

JMG

J M G TAYLOR



25074/87

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

Lord Wyatt of Weeford
Horserace Totalisator Board
Tote House
74 Upper Richmond Road
London
SW15 2SU

30 October 1987

Am Wyatt

Thank you for your letter of 24 September. I am sorry that you have not received a reply before now.

As you are aware, the Finance (No2) Act 1987 rules out tax relief on profit related pay for employees of a business managed by Crown nominees. Since the Tote Board is appointed by the Home Secretary, that definition would include your employees.

I was glad to hear, though, that your existing profit sharing scheme is going well, and hope it continues to do so.

Nigel Lawson

NIGEL LAWSON

CH60
L. WYATT
30/10

PPS 12/2 [signature]



H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-270 5238
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2 November 1987

PROFIT-RELATED PAY

In a speech today, the Financial Secretary to the Treasury, the Rt Hon Norman Lamont MP, gave details of employers' response so far to the Government's new tax relief for profit-related pay (PRP). He said:

"Over 35,000 copies of the guidance notes have now been issued. By mid-October, the PRP Office in Cumbernauld had almost achieved its first century of registered schemes. Given the relative complexity of the guidance notes, which was necessary for the purposes of allowing maximum flexibility, and the obvious inexperience of a number of professional advisers in this field, I regard such a response as encouraging within just 6 weeks of the application forms having been made available.

"But, it is early days yet and it is foolish to judge the scheme in any way on a numerical basis at this stage. What is important is that the very existence of a tax relief has stimulated a widespread debate amongst employers, employees and advisers at all levels about the need to break the rigidities in the British pay system."

HM TREASURY
PRESS OFFICE
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69/87

Notes to Editors

1. In his speech the Financial Secretary also rebutted a number of criticisms of PRP. A copy of his full speech is attached.
2. The Financial Secretary was speaking in London at a conference organised by Legal Studies and Services Ltd.

1. I was particularly pleased to see that this conference is attempting to look at the subject from the perspective of both employees and employers. PRP is about involving employees, and if they do not understand it, or are mistrustful of it, then managers must know why and must try to do something about it. In my view, opposition to PRP from employees may be a sign of more deep-seated problems in a firm which need to be put right.

The Need for PRP

2. The main benefit a Government can confer on the economy is to create the right economic framework.

3. The markets must also work efficiently, and that goes particularly for the labour market which for years has not been working well enough.

4. The pay mechanism remains one of the greatest problem which our economy faces. The system is still dominated by the concept of a "going rate", which is reckoned to apply regardless of the circumstances of the business involved. And too few realise the simple truth that the business first has to earn the wages and salaries that it pays out.

5. All too often the concept of a "fair" rate for the job discourages employees from taking sufficient interest in the success of the firm or from making their contributions to improving both productivity and product. So if conditions become difficult, output takes all the strain, with serious consequences for the business and frequently for employment. Such a mentality must change if we are to keep up with our competitors. It is not a problem which can be tackled by dictated incomes policies, which simply reinforce rigidities, or social contracts at national level. The solutions have to be found within each business, by the people who work there.

The Benefits of PRP

6. It is worth reminding ourselves that the principle of PRP is very simple. A part of employees cash pay is formally linked in value to the profits of the business in which they work. Other things being equal, higher profits lead to higher pay, and lower profits mean that total pay is lower. But many significant benefits flow from this very simple arrangement.

7. Employees acquire a tangible and better perceived stake in the success of the business. It provides scope for building a community of common interest in the prospects of the business, breaking down the "them and us" syndrome. Employee share schemes can also achieve this, and they have proved very successful,

but PRP works through cash in the pay packet, and thus gives very strong signals. PRP reinforces employee share schemes and can complement them. Moreover, unlike employee share schemes, it can be applied in unincorporated businesses and can be disaggregated to company or sub-company units, building an identity of interest at working level in specific profit centres.

8. The higher the proportion of pay which is profit-related, the greater will be the incentive effects to employees. Of course there are other forms of pay flexibility, such as overtime schemes, cost-reduction schemes, incentive bonus schemes or value-added bonus schemes. But PRP differs in focussing on profit - the best comprehensive index of the success of commercial business and the security of jobs in it. The clarity of signal that it can give to employees should not be under-rated. The effects of PRP flexibility are simple - if profits improve, total pay will be higher than it would otherwise have been, thanks to the competitive success of the firms. PRP is emphatically not about low pay. But when times are difficult, total pay will be lower than it would otherwise have been, which will help to offset the fall in profits, making output more sustainable and jobs more secure. A reduction in pay is better than losing your job altogether. Nobody would claim that PRP makes output and jobs completely secure. Of course it doesn't. But it helps at the margin. Such flexibility can often be crucial to the survival and eventual prosperity of a firm.

The Purpose of an income tax relief

9. If there were more PRP schemes amongst UK business, involving significant proportions of pay, then productivity, output and employment would all benefit. Hence the Government's decision to introduce a new tax relief, despite our general presumption in favour of a neutral tax system with a broad tax base, low tax rates, and few specific reliefs.

10. The purpose of the new income tax relief is to help the process of change. To help to increase awareness and to overcome inertia by highlighting and by enhancing the inherent advantages of PRP. Good employers should already appreciate the need for PRP. But employees may be less familiar with the underlying thinking and that is where the Government can help.

11. I trust no one will underestimate the value of the new relief. For a man on average earnings with 20 per cent of his pay as PRP, it could be worth the equivalent of 4p off the basic rate of tax. Clearly not something to be disregarded lightly.

Criticisms of PRP

12. But I would like now to deal with some of the more significant criticisms made of PRP over the past year.

13. First, I often hear the criticism that **employees need a guaranteed income to cope with household budgets and mortgage and other commitments.** This argument rests on the misconception that incomes can be guaranteed. Plenty of wages do fluctuate in many circumstances. Ultimately no income is guaranteed for ever. What happens at the moment if there is not enough money coming in to pay wages is that jobs have to go. If the fixed rate for the job cannot be met, it is foolishly felt that it is better not to have the job at all.

14. So if we put to one side the illusion of guaranteed jobs and guaranteed pay - it becomes much clearer that PRP is in the interests of employees when profits are falling, as well as rising.

15. Another strand of criticism argues that when employees pay is linked in value to input measures over which they have control, as in many incentive bonus schemes, they can see it is fair and understand the mechanism. But when their pay is linked to profits, it becomes exposed to the consequences of management decisions and wider factors, such as the exchange rate, over which they have no control. They claim that is unfair, that PRP can then even give the wrong signals.

16. A variant of this argument is that PRP must go hand-in-hand with more rights for employees - more information and influence over decisions affecting profitability.

17. I wholly agree that we must overcome the "them and us" attitude which lies at the root of such criticism. But the truth is that employees already share in the consequences of management decisions and a host of other factors over which their control is limited.

18. Some faint-hearts claim that PRP schemes will be difficult to negotiate and implement. I have no illusions that negotiating the introduction of PRP schemes will be easy. Many decisions will need to be taken in each business, for instance concerning the interaction with superannuation, productivity bonuses or piece work already in place, overtime and so on. And a major job of selling PRP to employees will have to take place in each firm, if its introduction is not to be a complete add-on to existing pay levels, which may not be affordable and which may damage competitiveness.

19. PRP is an improvement which businesses will have to work for, but it is worth working for. And where the problem is employee resistance, that is something which needs work to be overcome anyway.

I must stress that although the actual legislation and guidance notes may at times look daunting, the scheme proposed really does contain a considerable degree of freedom and flexibility, as James O'Hare of the Inland Revenue will explain.

20. A more sophisticated criticism suggest that it will be **difficult to protect the taxpayer against comestic deals**, which will not carry the benefits I have suggested. I have more confidence than the critics in the intelligence of employers. But I have no reason at this early stage to suppose that it will be a significant problem. The only way to eliminate risk completely is never to do anything. But that is not an option for progress.

21. But some have gone so far as to suggest that employers may not be sufficiently interested and that in addition to the tax incentive for employees, **there should also be some sort of tax relief for employers** who introduce the scheme. Should the employer really need an incentive to do what is in his own best interests anyway?

22. Turning to the necessary conditions for registering a PRP scheme, two criticisms I have heard a lot of, are over **the complexity of the legislative requirements** and the stipulation that a PRP scheme giving tax relief should be **independently audited**. As employers and their advisers understand the

legislation better with the help of the guidance notes, I am sure they will come to appreciate the wide-ranging choice open to them - on methods of introduction, duration of schemes, definition of profits, method of calculating the PRP pool, extent of employee participation and so on. It is these freedoms of course which have themselves made the legislation look more complex.

23. In any Government measure of this sort which involves potentially large amounts of public revenue, there is a need for public accountability. In this case, there must be assurance that the pay attracting the tax relief really is related to profits, calculated on a consistent basis we will get this assurance from an employer certificate backed up by an auditor's report. Of course that audit requirement involves some cost for the employer, although in many cases it will not be large, because the auditors will only be doing work which they would have done anyway.

24. The alternative would be to rely on a special Inland Revenue audit. But though that would not involve an audit fee as such for the employer, let us not pretend it would be costless. The extra Government staff involved, and the time and inconvenience for employers, would all have to be paid for. In overall resource terms it would probably be more costly and much less efficient than the measures we have proposed. Indeed, one of many purposes has been to provide for

as little official intervention as possible by the Revenue in the administration of the new tax relief. The great bulk of the work necessary to assure public accountability will be done as an adjunct to the normal procedures of business management. I am sure that on reflection most employers would prefer that.

Progress to date

25. Many PRP enthusiasts are anxious to know about progress since the Inland Revenue published its guidance notes and made application forms available in early September.

26. But let me tell you the latest news such as it is. Over 35,000 copies of the guidance notes have now been issued. By mid-October, the PRP Office in Cumbernauld had almost attained its first Century of registered schemes. Given the relative complexity of the guidance notes, which was necessary for the purposes of allowing maximum flexibility, and the obvious inexperience of a number of professional advisers in this field, I regard such a response as encouraging within just 6 weeks of the application forms having been made available. But, as I say, it is early days yet and it is foolish to judge the scheme in any way on a numerical basis at this stage. What is important is that the very existence of a tax relief has stimulated a widespread debate amongst employers, employees and advisers at all levels about

the need to break the rigidities in the British pay system. Witness this conference. Some employers and employees will come to arrangements which meet the criteria for the PRP tax relief, but we expect this debate also to have wider effects in helping to change the climate of pay negotiation.

Conclusion

27. PRP is not a panacea. There are none. But it is an important part of successful business management we will need in the increasingly worldwide market. Government has done all it can to generate this debate, which we felt was so badly needed, and we hope that the existence of a tax relief will help to facilitate a new approach. But when it comes to the crunch, the onus for making greater pay flexibility work rests on those in the market-place - employers, employees and professional advisers. I very much hope you will take this opportunity in every way you can.



HORSERACE TOTALISATOR BOARD

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From the Chairman:
Lord Wyatt of Weeford

PERSONAL

3rd November 1987

Dear Nigel

Tax Relief on Profit Sharing

Thank you for your letter of 30th October. I cannot think that the Finance (No.2) Act 1987 was intended to apply to a business which has never been funded by the government in any way and has been entirely self-supporting since its inception. Our employees are going to be deeply disappointed that they have been singled out for exclusion from your tax relief on profit related pay though they are working in a highly commercial atmosphere competing with bookmakers who will be able to have the appropriate tax relief for their employees.

I would be grateful if you could look at this matter and arrange for the necessary amendment to be made to the Finance (No.2) Act 1987 to exclude any organisation run by nominees of the Crown which is self-supporting and receives no assistance from government funds.

I would be grateful if such an amendment could be made retrospective as our employees were informed that they would be getting this tax relief - this was before the Finance (No.2) Act 1987 was published. We were never consulted. If we had been we could have explained that an organisation like the Tote is a completely commercial operation and it is not owned by the government, the government officially accepts no liability for it and the only connection with the government is the appointment of the Board by the Home Secretary and the laying of our Annual Report and Accounts before Parliament.

Rt.Hon. Nigel Lawson, MP
Chancellor of the Exchequer

your letter

HM TREASURY - MOU	
- 4 NOV 1987	
MR GRAY / AEB	
C ADS/CHX	
PROVISION: 25074/87	
CHX	
77220/87	

FROM: P WYNN OWEN
 DATE: 6 November 1987

PS/PAYMASTER GENERAL

*Ch/ Content with the 'standards'
 reply to Tube Plastics?*

cc

PS/Chancellor
 PS/Financial Secretary
 PS/Sir P Middleton
 Mr Monck
 Mr Burgner
 Mr Gray
 PS/Inland Revenue
 Mr Farmer - IR

PROFIT-RELATED PAY: DEADWEIGHT CASES

Your minute of 15 October to Mr Taylor attached a letter from Brinton's as a typical "deadweight" response and said we would be offering advice on how to deal with firms in this category. Mr Taylor's response of 16 October said that we clearly needed to see if there was anything that could be done on the points raised in the Brinton's letter.

2. Since the guidance notes were issued in early September, the Inland Revenue have found that - as we have always expected - a volume of criticism has come from companies with existing profit-sharing or performance-related schemes of one sort or another who have found that their schemes as currently designed are not eligible for registration. The Brinton's letter is such a case. Another, more straightforward instance lies in the attached letter from Mr Tidmarsh on behalf of Tube Plastics Ltd.

3. If Ministers in due course so wished, the Inland Revenue could examine with the Treasury ways in which we might attempt to buy off the deadweight through amendments in the 1988 Finance Bill. But this could prove extremely difficult and complex. Definitions and judgements would have to be taken concerning the relative merits of various performance bonus arrangements across a very wide spectrum. This was one of the considerations, of course, which originally led to the decision to tax relieve pay which was simply profit-related. It is also surely much too soon to start contemplating concessions to deadweight. As the term implies, finding ways of granting tax relief in such cases would in no way confer on the economy, or the firms in question, any direct benefits which did not already exist. We therefore recommend that Ministers take a robust line with such deadweight cases. We shall, however, be monitoring the correspondence both to pick up and correct any points where firms are wrongly interpreting their eligibility, and to take note of any particular new points where the case for future legislative change might be borne in mind.

4. I attach a draft reply for your signature to Mr Tidmarsh of Tube Plastics Ltd. If the Paymaster General and Chancellor are content with this reply, we would use it as a basic reply for responses to deadweight campaigners, though we would tailor it to requirements.

5. For instance, the Brinton's letter raised three specific problems which appeared to them to disqualify the existing Brinton's scheme from eligibility for tax relief:

- (i) Their method of calculation is not compatible with method (a) or method (b), since their lower cut-off point is 5.6 per cent profit on turnover, whereas the PRP legislation allows a threshold for PRP limited to less than the initial qualification for registration of 5 per cent of pay.
- (ii) More seriously, the Brinton's scheme made it clear that no bonuses would be paid to those who participated in industrial action. Mr Brinton says the PRPO has advised that such conditions would conflict with the legislation that the scheme employees participate "on similar terms".
- (iii) Their scheme includes employees working overseas, whereas there is no provision in the Government PRP scheme for the inclusion of overseas based employees since their pay is not subject to Schedule E (PAYE).

6. Inland Revenue have looked at each of these three points and advise:

- (i) that Brinton's particular form of threshold would not be compatible with either the PRP legislation or the principles on which it is based. However the legislation offers employers very considerable flexibility in how they arrive at the amount of the PRP pool eg as to the prospective starting level of PRP (subject to 5 per cent of pay test), the measure of profits to be used, the inclusion of generous overrides on movement in the pool's size etc.
- (ii) that, on reflection, a rule which denied PRP to employees who had been on strike during the profit period would be acceptable as complying with the legislation, provided its terms were clear and applied without discretion to all employees.

(iii) that although overseas based employees whose pay is not liable to tax under Schedule E cannot receive a distribution of PRP under a registered scheme - they would not in any case benefit from the UK income tax relief - it would of course be open to employers to decide to make similar payments to such employees by reference to the level of PRP paid to UK employees.

7. I attach a draft letter to Mr Brinton, which takes the basic line provided in the Tube Plastics draft on deadweight, but is extended to meet the three specific points Mr Brinton raises.

Philip Wynn Owen.

P WYNN OWEN

DRAFT LETTER FROM PS/PAYMASTER GENERAL TO:

Topham Brinton Esq
Chairman
Brintons Limited
PO Box 16
Kidderminster
Worcestershire
DY10 1AG

PROFIT-RELATED PAY

Thank you for your letter of 5 October to the Paymaster General.

2. I can appreciate your annoyance that the terms of the PRP legislation do not enable you to operate the tax relief within your existing cash based profit sharing scheme. I also recognise that you are naturally reluctant to change the terms of your scheme, which you have carefully developed for over 6 years to reflect the needs of your particular business. Your reaction does, however, highlight a particular dilemma the Government has faced in developing its proposals in this area.

3. The first point to make is that, had the majority of businesses followed your example and developed cash-based profit sharing schemes on their own initiative, there would have been no need for the Government to take action. But, sadly, this is not so. One of the main remaining obstacles to the continued strengthening of our economy is, in the Government's opinion, the lack of flexibility in pay systems in the majority of our businesses. The lack of identification by employees with the profitability of the firms in which they work holds back the development and strengthening of those businesses; and makes it more difficult for employers to feel confident about creating new jobs.

4. You have already recognised that PRP offers a way through, but many other employers have not. So Ministers reached the conclusion that, to stimulate the

process of greater flexibility, it was appropriate to offer a tax incentive for PRP schemes. They concluded that, if - but only if - it led to more widespread adoption of such arrangements, using taxpayers money in this way would be justified by the resulting economic benefits.

5. Designing the terms of the tax relief has, however, involved striking a delicate balance. On the one hand, Ministers were anxious to provide maximum flexibility. On the other, as with any tax relief, certain basic safeguards had to be built in and Ministers had to be satisfied that the terms of the relief were justified. It was important to keep the scheme simple enough to facilitate the primary objective of attracting employers to PRP for the first time. It would not have been compatible with that aim to provide rules tailored to allow for all the widely differing features of existing schemes.

6. It is perhaps inevitable that the balance struck will not please everyone. At the same time, it is of course open to businesses such as yours to consider whether to adjust the terms of your existing schemes to bring them within the scope of the relief. I would be surprised if everyone reached the same view. In some cases employers may well decide the necessary changes would be worthwhile. In others the decision may be that they were not.

7. But the key point is that it is for individual businesses to reach their own decision. The Government should not, and is not, seeking to lay down the terms on which businesses must apply profit sharing, or any other aspect of their management arrangement. But the Government has provided a system for tax relief with substantial flexibility, but also, rightly, some basic terms and conditions. It must be for individual employers to decide whether PRP is at all that is right for their businesses; and if it is, whether it should be designed to fall within the terms of the tax relief.

8. In the context of your own decision concerning PRP, you raised a number of particular problems. I can understand why, having educated employees in the virtues of your own method of calculating the profit share, you may be reluctant to adapt it to the legislative requirements. I am advised however that a rule which denied PRP to employees who had been absent from work on strike would in fact be acceptable provided its terms were clear and applied without discretion to all employees. As regards overseas employees not subject to Schedule E chargeability and unable therefore to receive distributions of PRP under a registered scheme, you may care to consider whether such employees might receive some other payment calculated by reference to the level of PRP paid to UK employees.

[S P J]

**DRAFT LETTER FROM PS/PAYMASTER GENERAL TO:**

A C B Tidmarsh Esq
Sales Director
Tube Plastics Ltd
Activity Sports and Toys
Severn Road
Stourport
Worcestershire
DY13 9EX

PROFIT-RELATED PAY

Thank you for your letter of 5 October to the Paymaster General.

2. I can appreciate your annoyance that the terms of the PRP legislation do not enable you to operate the tax relief within your existing cash based profit sharing scheme. I also recognise that you are naturally reluctant to change the terms of your scheme, which you have carefully developed for over 10 years to reflect the needs of your particular business. Your reaction does, however, highlight a particular dilemma the Government has faced in developing its proposals in this area.

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Activity
Sports & Toys

Tube Plastics Limited
Severn Road . Stourport-on-Severn
Worcestershire DY13 9EX

Telephone: 02993 4516

Telex: 336559 TPTOYS

Our ACBT/PJL

5th. October, 1987

Mr. Peter Brooke,
Paymaster General,
H.M. Treasury,
Whitehall,
London.

PAYMASTER GENERAL
1200 007
Mr P. Gray
PSI ch lex
Mr Manck
Mr Brynner
Mr Schlar

Dear Mr. Brooke,

Re: Profit Related Pay

Mr Wynne Owen 27/5
Mr Tyne
PSI IR pmg

No doubt this is just one of many letters you will receive on this subject. When the Chancellor announced that he wanted to encourage businesses to adopt profit sharing and to that end he was going to give some tax relief, all our staff were delighted for two reasons:

1. As we had a profit sharing scheme we would all save some tax, and
2. Having experienced the benefits so succinctly explained in your leaflet dated September 1987 for 10 years we have been great advocates of this method of pay and have spent quite some time extolling its virtues to other local companies.

We have tinkered a bit with our scheme over the years and feel we have an excellent one which everybody understands. Our turnover has risen five-fold, our exports at least ten-fold, our profits over ten-fold and our labour force by 50% since its introduction - we are toy manufacturers, not exactly a growth industry. Some of our senior staff now earn more by way of profit share than their basic salary, and all staff members could get more elsewhere in basic pay but stay with us because of the profit sharing scheme - our staff turnover is virtually zero. So you can see that, in our case, you are preaching to the converted and, we like to think, to people with some knowledge of the advantages of different aspects of profit sharing schemes.

/continued.....

Activity Sports & Toys

Tube Plastics Limited
Severn Road . Stourport-on-Severn
Worcestershire DY13 9EX
Telephone: 02993 4516
Telex: 336559 TPTOYS

- 2 -

5th. October, 1987

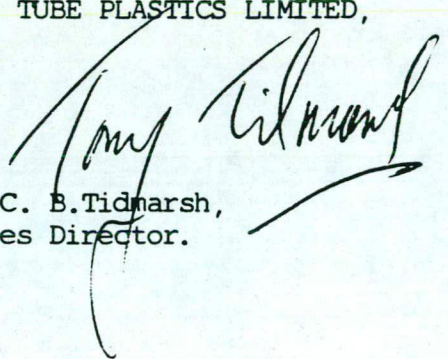
Mr. Peter Brooke,
H.M. Treasury,
London.

Imagine our distress and even anger when we find that the Inland Revenue, who have absolutely no knowledge of profit sharing schemes, are dictating how our scheme must work. Whilst, in theory, we could scrap our schemes (we have four different ones for different sections of our work force) and institute a revenue designed one, it would be such a retrograde step we would have to actually increase many staff members' basic salaries to compensate them, and this we would not wish to do. However, we all feel that providing schemes are fair and fixed in advance and are certified as such by the auditors, companies should be permitted to keep existing schemes and even devise their own. You stress in your leaflet the advantages of flexibility and so surely should not be introducing a straight-jacket in this area.

It is a great shame that a wonderful idea that could help transform attitudes in industry should be crippled by the Revenue's insistence on how the idea should be put into practice.

Should you need details of our schemes, examples of its effects on our wage costs over the years etc., we would be very glad to provide them.

Yours sincerely,
for TUBE PLASTICS LIMITED,


A. C. B. Tidmarsh,
Sales Director.

YMK 5 OCT 1987



ESTABLISHED 1793

Telephone: 0562 820000
TELEPHON TELEX: 338
FAX: 0562-8

SALES OFFICE DIRECT LINE
TEL: 0562-748000

BRINTONS LIMITED

P.O. BOX 16

KIDDERMINSTER
WORCESTERSHIRE
DY10 1AG



BY APPOINTMENT
TO HER MAJESTY THE QUEEN
BRINTONS LIMITED KIDDERMINSTER
WORCESTERSHIRE

ALL COMMUNICATIONS TO BE ADDRESSED TO THE COMPANY

OUR REF: CTCB/MEG

YOUR REF.

DATE 5th October, 1987

P. Brookes, Esq.,
Treasury Chambers,
Parliament Street,
LONDON,
SW1P 3AG

PAYMASTER GENERAL	
REC.	-6 OCT 1987
ACTION	Mr Wym Owen
	Mr Gray
	pma

28/9

Dear Mr. Brooke,

Thank you for your letter of 14th September 1987 about Income Tax Relief for Profit Related Pay. You certainly do not need to convince us of the merits of a profit related pay scheme; we are enthusiasts, propagandists and participants. However, we do have some points which we feel need reconsideration and we would like to set out our experience with PRP.

Starting with our financial year beginning in July 1981 we introduced a stunningly successful Profit Participation Bonus Scheme together with a quarterly newsletter which outlined problems which if solved could lead to a growth in Profit Participation Bonus.

The rules of the scheme were as simple as the objectives were subtle. The first rule was that an employee had to have achieved at least five years service by the end of the year in question (75% of all employees).

The second rule was that 5% of profit on gross turnover was disregarded, but after that point was passed 30% of the profit over the 5% minimum was put into a pool and distributed pro rata to earnings. (Note: this is now a 5.6% on net turnover due to the changes in accountancy rules).

The third and most important rule was that anyone indulging in any form of industrial action during the year will put at hazard all or part of their bonus. (In particular all of the bonus for a strike, part for "action" short of a strike - after a warning).

Our objectives were simple and designed to incentivise good behaviour and penalize the bad. The first objective was to encourage our employees to give of their best in areas such as material waste and quality improvements knowing that success would lead to monetary benefits for themselves. (Effort was not a problem owing to universal work measured bonuses and piece rates). A second objective was to introduce a serious cost to undertake industrial "action", with the longer term aim of reducing the blind faith in "The Union" and increasing confidence in the proven track record of management. A third objective was to remove the stigma attached to profit (unpaid wages as the unions refer to it) and encourage the view that profit earned and reinvested is the only sensible road to security of employment.

continued /...2

LONDON, W8 5TB
THE BRITISH CARPET TRADE CENTRE
99 KENSINGTON HIGH STREET
TEL: 01-837 3786
TELEX: 23280
FAX: 01-837 1087

GLASGOW, G51 3LW
8 HARMONY SQUARE
GOVAN
TEL: 041-446 5363
FAX: 041-446 5783

NEWCASTLE ON TYNE, NE1 5UQ
NEWGATE HOUSE, NEWGATE STREET
TEL: 0632-322150

MANCHESTER, M1 2HF
35 DALE STREET
TEL: 061-236 8083

BRISTOL, BS1 5RF
HARFORD HOUSE, FROGMORE STREET.
TEL: 0272-277601

5th October, 1987

P. Brooke, Esq

A fourth objective was to improve communications with employees as quarterly letters are now sent to their homes (which could be of use in an "industrial action" situation - though happily untested).

The succession of payments under the scheme has gone like this:

1982	£334,000	(before tax)
1983	£410,000	(before tax)
1984	£654,000	(before tax)
1985	£759,000	(before tax)
1986	£719,000	(before tax)
1987	over £1,000,000	(not yet paid)

As you can see this year's payment which will be over £1,000,000 between just over 1,400 people (about £700 each on average before tax though it is paid pro rata to individual earnings) is substantial and the high level of bonus and the increasing amount has generated an enthusiastic dedication to profit improvement at all levels of the company. Shop stewards' power and union caused problems have been greatly reduced.

When the Government decided to introduce tax relief for Profit Related Pay we were and are enthusiastically in favour and responded to the Green Paper with suggestions. But! Oh Woe! It now appears that our scheme introduced for what we believed then, and know of experience now, was a sound business reason, falls foul of the highly restrictive rules which apply if tax relief is to be available.

Basically there are three problems. The first is the method of calculation which is not compatible with PRP's method (a) or method (b) (our lower override is 5.6% profit on turnover being just under £3 m - the PRP scheme only allows a lower override of 5% of the pay bill which of course is much less at around £600,000. We have for six years been educating our employees that a minimum level of profit on net turnover of 5.6% was required to fund investment and therefore we only "share" out profit in excess of this figure (albeit at the high rate of 30% of the excess).

The second and infinitely more serious problem is the condition relating to industrial action. We have had only one example of industrial action since the introduction of the Profit Participation Bonus system, and that was in the first year of the scheme when truth to tell the employees did not really believe that a bonus would be payable at all. Some 200 employees went on strike despite being warned about the effects. On the day the bonus was paid (average about £200 per person) everybody except the 200 employees got it and a substantial proportion of the work force walked through their department waving their envelopes at them. No industrial action has taken place since then.

Unfortunately we are advised by the Profit Related Pay Office that exclusion of participants for this reason would conflict with the requirements of the legislation that the scheme employees participate on similar terms. Obviously we would never voluntarily throw away this extremely strong incentive for careful consideration before industrial "activity".

5th October, 1987

P. Brooke, Esq.

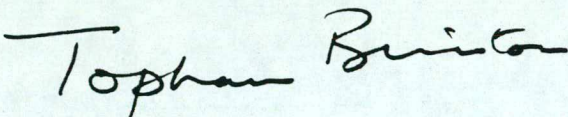
The third and last problem concerns people working overseas. We have about 30 people working in America, Germany and France for U.K. registered sales subsidiary companies each of which is a profit (or loss) centre. Because they are selling goods produced by the U.K. manufacturing companies the people (who qualify) are in the Profit Participation Scheme and the profitability of the group is considered as a whole being a self contained vertical operation or definable employment unit. As you know no overseas based employees can be included in a PRP scheme as they are not persons whose emoluments are subject to Schedule E (PAYE) - even though in this case most of the people are English though resident abroad.

Obviously we have a problem created by the tax relief since our PPS people will find it difficult to understand why our scheme does not qualify and they cannot enjoy the tax relief and this will cause resentment.

In principle therefore we believe that there should be scope for the Inland Revenue to look at existing schemes far more flexibly than new schemes that are being set up. It is clear to us that the gains to our employees compared to the loss to the company of changing the present scheme means that we cannot benefit from the tax advantages proposed even though our scheme is in no sense a dodge or device.

Clearly we do not want to disturb greatly a highly successful scheme for what might only be a temporary tax advantage for our employees. The "flexibility" of PRP has been vaunted, but from our point of view the flexibility seems incredibly limited. Perhaps some modification could be included that might permit existing schemes more latitude so that our employees can enjoy the benefit of the tax relief available?

Yours sincerely,



Topham Brinton,
CHAIRMAN

RESTRICTED

M

FROM: J M G TAYLOR**DATE: 9 November 1987****PS/PAYMASTER GENERAL**

cc PS/Financial Secretary
PS/Sir P Middleton
Mr Monck
Mr Burgner
Mr Gray
Mr Wynn Owen
PS/Inland Revenue
Mr Farmer - IR

PROFIT-RELATED PAY: DEADWEIGHT CASES

The Chancellor has seen Mr Wynn Owen's minute of 6 November. He is content with the 'standard' letter, to Tube Plastics Ltd., and with the letter to Brinton's.

A handwritten signature in black ink, appearing to be "JMG".

J M G TAYLOR

Ch / The Paymaster General could reply to this, or would you prefer to write yourself?

18 November 1987

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG.

From the Chairman of the ^{mpw} **FRP 24/11**
Taxation Committee
Bruce Sutherland CBE

HM TREASURY - MAIL	
DATE	24 NOV 1987
ACTION	MR GRAY IAE3
BY	CC AFS/CHX PS/PMG, MR Burgess, R
REFERENCE	CHX
FILE NO	28529/87

*PMG follow
look v.
@ these
I am
convinced
what!*

Dear Nigel,

PROFIT RELATED PAY

As you know the IOD has from the outset been a strong supporter of your proposals on profit related pay. We have been heartened, as I am sure you have, by the large number of companies which have expressed an interest in establishing an approved PRP scheme.

We are finding, however, that in many cases the initial enthusiasm has turned to dismay as companies have found that the detailed rules prevent them structuring schemes in the way most appropriate to their particular circumstances; in consequence, many companies which have examined with their advisers the possibility of introducing an approved PRP scheme have decided against proceeding.

Clearly some rules are necessary as to the sort of scheme which qualifies for tax relief and those rules will not suit everybody; but the present rules now seem likely to be acceptable only to a minority. The main problem area is the rules for the calculation of the PRP "pool". Rather than building on existing arrangements for communicating financial and divisional performance figures to the workforce some companies are finding that introducing PRP would mean re-educating the workforce to understand performance figures produced on a different and less easily understandable basis. More fundamentally, many companies set their overall business objectives in terms of return on capital and their entire management and financial structure is geared to those objectives; return on capital is not, however, permitted as a basis for calculating PRP.

We do not think there need be any great risk to the Exchequer from allowing companies more latitude to choose a measure of profit performance for PRP purposes which is readily communicable to the workforce and consistent with the overall objectives of the business. It would be regrettable and a missed opportunity if the excellent concept of PRP were to founder in its implementation as a result of unnecessary restrictions. We, therefore, urge you to deal in particular with the following specific points which members have brought to our attention:

*drawn in BS S's,
v. the company will select
"base" pay levels.*

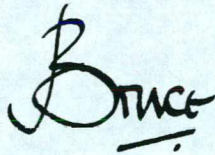
*What int. J.W.
in mind was
challenge a
comp. (baker's)
keep (pay)
Cashed &
give PRP
1/10m of
an annual
pay int.
Offering
PRP (to be)
LW (or)*

1. The percentage of profits going into the pool must not be less than the percentage which 5% of the estimated total pay bill at the inception of the scheme is of profits in the base period. This can give a very high minimum percentage for service companies with high pay bills relative to profit. For example, it is not unusual for service companies to have a pay bill which is normally five, seven or more times the annual profit, resulting in a minimum of respectively 25, 35 or more per cent of profits having to be put into the PRP pool. 10 or 15 per cent, however, may be the most that can be accommodated without unacceptable distortions to decisions on the profits to be retained for development of the business or on the division of rewards between the owners and employees of the business. We suggest that the minimum proportion of profits going into the pool should be determined as at present, unless this gives a figure higher than say 15% in which case 15% would be the minimum proportion.
2. A trigger level of profits may be set below which no pool is created but this trigger must be less than the 5% of total pay referred to above. Thus, if the nominal profit level is unchanged from the base year, PRP of at least 5% will be payable. But to stand still in cashflow terms a business usually requires profits not to remain static in money terms but to go up by somewhat more than inflation. In short, PRP cannot be used only to recognise real improvements in profitability; it must start to operate from a poor level of profits. The introduction of PRP without any reduction in previous pay levels is therefore not attractive but that is the only basis on which many businesses expressed an interest in PRP in the first place. We suggest that the minimum trigger level should be the relevant proportion of the base year profits indexed for inflation or preferably uplifted by say 150% of the inflation increase to allow for the greater effects of inflation on cashflow than on profits.
3. The pool has to be determined by reference to profits. Return on capital should be permitted as a criterion both for the pool percentage and for the trigger levels.
4. Profits in the statutory accounts can be adjusted to be broadly equivalent to profits in the management accounts, but any remaining differences could be difficult to explain and could dilute the message to a workforce used to following the actual management accounts month by month. We know of at least one case where this is a problem. Whilst we have no immediate solution to put forward, this is a point where we would welcome further discussions as to what might be done to ameliorate the difficulty.
5. Pay for PRP purposes is pay for PAYE purposes including all overtime, bonuses, shift premiums etc (but excluding the PRP). In practice it may be more appropriate to relate PRP to basic pay and this should be permitted.

6. Profit must be the net profit before deducting the remuneration of owner-directors. Clearly there would be excessive scope for manipulation if their actual remuneration was deducted. On the other hand it gives employees a misleading impression of the performance of the business if their attention is focussed on a "net profit" which is substantially higher than the true net profit. This particularly matters where the company wants employees to see how its profitability measures against that of quoted competitors. Could the manipulation be prevented by say substituting a standardised figure for directors remuneration eg the amount in the base year indexed for inflation?

We are sure that you would not wish the good idea of encouraging profit-related pay spoilt in practice because of minor defects in the detailed rules. Now that the practical problems are coming to light we urge you to remedy them promptly.

Yours sincerely

A handwritten signature in black ink, appearing to read "Bruce". The signature is stylized with a large, looped initial letter. Below the signature is a horizontal line.

UNCLASSIFIED



prp

FROM: MOIRA WALLACE

DATE: 26 November 1987

PS/PAYMASTER GENERAL

cc Mr Gray
Mr Burgner

PROFIT RELATED PAY: LETTER FROM INSTITUTE OF DIRECTORS

The Chancellor has seen Mr Sutherland's letter of 18 November. He would be grateful if the Paymaster General could reply to this. The Chancellor thinks these suggestions need to be looked at very carefully. He is particularly concerned at the suggestion that the introduction of PRP is not attractive without a reduction in previous pay levels. If true, this is not what the Chancellor intended. He had in mind a scheme that would enable a company to keep 'basic' pay constant, and give PRP in lieu of an annual pay rise. Otherwise, PRP take-up will be derisory: as Mr Sutherland says, very few companies will reduce 'basic' pay levels.

M.W.

MOIRA WALLACE

27270/87



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

Lord Wyatt of Weeford
Horserace Totalisator Board
Tote House
74 Upper Richmond Road
LONDON
SW15 2SU

27 November 1987

Stan Workman

Thank you for your further letter of 3 November.

The definition of an "excluded employer" in section 6 of the Finance (2) Act 1987 which covers the Tote refers only to a body under the control of the Crown, not to Government funding. Crown control is judged to exist when "in the case of a body whose affairs are managed by its members, [the Crown] has the power to appoint more than half of the members." I have, at present, no plans to change this legislation.

I appreciate the difficulty you face because of your previous assurance to your employees. But I have looked into this, and can find no record that you consulted my colleagues, or officials, who could have explained the details of the "excluded employer" clause to you.

Nigel Lawson

NIGEL LAWSON

tote

HORSERACE TOTALISATOR BOARD

Tote House
74 Upper Richmond Road
London SW15 2SU
01-874 6411

From the Chairman:
Lord Wyatt of Weeford

Tax relief on profit sharing

HM TREASURY - MCO	
REC'D.	14 DEC 1987
DISTRICT	Mr Bay IAS
	cc APS/CHX
	prevision 25074 & 27270/87
	10th December 1987 CHX
	29649/87

Dear Nigel

Profit Sharing

Sorry to bother you again about the Tote employees being denied the tax advantages of profit sharing from the quirky fact that the Tote Board members are appointed by the government though the government has never given any money to the Tote and has received considerable tax payments from it.

I wrote to you on 20th March 1986 about our Tote profit sharing scheme. You replied on the 21st April 1986 and in the last sentence of your letter indicated your pleasure at the success of our profit sharing scheme. I wrote to Tote employees a letter on the 8th June 1987 (copy enclosed) and the last paragraph was the one in which I stated your intention to allow 50% of the benefits of profit sharing schemes to escape taxation.

The Finance Act 1987 as I understand passed on the 23rd July. We had no idea that this inequitable provision militating against employees was going to be inserted in that Act. In view of my letter to you of 20th March 1986 I think someone from your Department should have warned us that this piece of unfairness was about to be perpetrated. In your letter to me of 21st April 1986 there was no indication that this was about to happen.

Surely it would be an act of natural justice to have a small amendment to the Finance Act in 1988 to allow any organisation which operates commercially, has never used government funds and has a profit sharing scheme to give the tax benefits available to others in profit sharing scheme to its employees despite the fact that the Board is appointed by the government.

The government has no control whatever over the Tote, than the sanction of dismissing its Board. The government does not own the Tote as I think your officials will tell you. We are in a highly competitive world operating completely commercially and rival bookmakers are able to give their employees tax advantages which we cannot which is an unreasonable discrimination against the Tote.

*Your true
Lawson*

The Rt.Hon. Nigel Lawson, PC, MP,
Chancellor of the Exchequer

*L. W. H. T.
CHX
10/10*

tote

HORSE RACING TOTALISATOR BOARD

Tote House
74 Upper Richmond Road
London SW15 2SU
01-874 6411

From the Chairman:
Lord Wyatt of Weeford

To: ALL MEMBERS OF STAFF

8th June 1987

STAFF PROFIT SHARING SCHEME

The Board and I are glad to be able to tell you that the profit sharing scheme for the year 1st April 1986 to 31st March 1987 has resulted in a profit share to everyone eligible under the scheme of an additional 6.2/3rds per cent of their annual pay. This is on top of the guaranteed Christmas profit share of 2 per cent. The 6.2/3rds per cent which will soon be in your pay packets amounts to over three weeks extra pay. Therefore the total of 8.2/3rds per cent profit share (including Christmas) amounts to over a month's extra pay.

We are delighted that this has happened. During the year in question our profits before tax and before the staff profit sharing scheme came in the £3.8 to £4.0 million band. So our profits were over three times as much as last year.

We were helped towards our increased profits by a favourable pattern of results but we were also helped by the efforts of all concerned and the general rise in standards of Tote presentation on the course and in the betting shops and by credit. Well done.

In the year beginning 1st April 1987 the profit sharing scheme will be as follows:-

On a profit of £1.6 million staff will receive an extra 1 per cent of annual pay on top of the guaranteed Christmas profit share of 2 per cent.

Thereafter for each additional £200,000 of net profit staff will receive ½ per cent of annual pay.

If we reach a profit of £4 million then the profit share will amount to 7 per cent on top of the 2 per cent annual Christmas profit share. Profits in excess of £4 million will attract a corresponding increase in profit sharing.

/ Contd.

L. WYATT
STAFF
8/6

- 2 -

STAFF PROFIT SHARING SCHEME

Whereas the Board and I hope that we will achieve much the same profit as this year and maybe more I must remind you that profits do not always reach expectations because of circumstances over which nobody has any control. For instance, we may be hit by an exceptionally long spell of bad weather which stops racing, or by spells of results unusually favourable to the punter in the betting shops and with credit and so forth. But if we all try hard we ought to be able to go on improving the Tote's performance.

Next year, beginning 1st April 1988, assuming there is no change in government it is intended by the present Chancellor of the Exchequer that 50 per cent of the benefits of the profit sharing scheme will escape all taxation.

Yours sincerely

David Rowlands

Ch/...
pnp

FROM: P WYNN OWEN
DATE: 17 December 1987

PAYMASTER GENERAL

You might like to see this advice.

cc APS/Chancellor
Mr Monck
Mr Burgner
Mr Gray
PS/Inland Revenue
Mr Farmer - IR
Mr Fraser - IR

N/A
mpw
18/12

IOD AND PRP

X Bruce Sutherland of the IOD wrote to the Chancellor on 18 November making several suggestions for the relaxation of PRP rules. Moira Wallace's minute of 26 November asked the Paymaster General to reply. The Daily Telegraph also picked up the existence of this letter (press cutting attached), but we have seen no other reports about it.

2. The Chancellor thought these suggestions needed to be looked at very carefully. He was particularly concerned at the suggestion that the introduction of PRP was not attractive without a reduction in previous pay levels. If true, this was not what the Chancellor had intended. He had in mind a scheme that would enable a company to keep "basic" pay constant, and give PRP in lieu of an annual pay rise. Otherwise, he feared PRP take-up would be derisory, since as Mr Sutherland said, very few companies would reduce "basic" pay levels.

COMMENT

3. We have discussed very carefully the six IOD proposals with Inland Revenue officials. All the proposals seek relaxations in the legislation so as to make it easier for employers to introduce a PRP scheme. The proposals are:

- (i) "The minimum proportion of profits going into the PRP pool" should be determined as at present, unless this gives a figure higher than say 15 per cent in which case 15 per cent would be the minimum proportion.
- (ii) The minimum trigger level of profits should be the relevant proportion of the base year profits indexed for inflation or preferably uplifted by say 150 per cent of the inflation increase to allow for the greater effects of inflation on cash flow than profits.

- (iii) "Return on capital" should be permitted as a criterion both for the pool percentage and for the trigger levels.
- (iv) Differences between profits in the statutory accounts and profits in the management accounts might be difficult to explain and could dilute the message to the workforce used to following management accounts month by month. IOD would welcome further discussions on how to ameliorate the difficulty.
- (v) Relate PRP to basic pay rather than pay for PAYE purposes, which includes all overtime, bonuses, shift premiums etc.
- (vi) Substitute a standardised figure for directors' remuneration (eg the amount in the base year indexed for inflation) in determining profit.

4. The attached draft letter for the Paymaster General to send deals with each of these in turn and explains why it would not be appropriate to make the concessions suggested. This cover note does not attempt to duplicate the analysis in the draft letter.

5. The claim on which the Chancellor commented can be found in the penultimate sentence of the second suggestion on page 2 of the IOD letter:

"The introduction of PRP without any reduction in previous pay levels is therefore not attractive but that is the only basis on which many businesses expressed an interest in PRP in the first place."

This claim is unsubstantiated in the IOD letter and is a red herring in the context of the IOD's second proposal. It was presumably introduced to attempt to lend weight to the argument that there should be some indexation of the trigger level of profit. But it is not clear, as explained in the draft letter below, whether that would make any significant difference to the problem the IOD says exists. The PRP rules contain no restrictions on how employers introduce PRP. It is a matter entirely for them whether they introduce it -

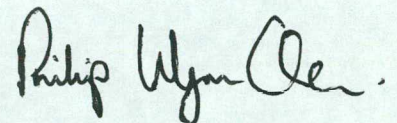
- (i) as a replacement for "basic" pay
- (ii) in lieu of an annual pay rise (as the Chancellor envisaged)
- (iii) as an "add-on" to basic pay and annual pay rises
- (iv) as some combination of (i), (ii) and (iii) above.

CONCLUSIONS

6. The IOD are simply suggesting various relaxations in the rules, apparently on the assumption that all schemes will be introduced wholly on an "add on" basis, and argue that these proposals will help the PRP initiative to be more successful.

7. It is surely too early to consider amending the legislation in the substantive ways suggested by the IOD. We need to form a much clearer picture of take-up before we can know whether their fears are likely to be fulfilled or not. Early indications, as witnessed by the monthly Inland Revenue reports, suggest that PRP take-up is on a gradual upwards curve. We knew the scope for major companies to register schemes by the end of the current calendar year was always going to be limited and that we could expect them to want to introduce schemes more carefully and on the basis of full consultation with their staff. It is thus early days to leap to any conclusions about what may or may not be deterring companies. But it would obviously be sensible if the IOD were to be invited to discuss with the Inland Revenue any specific cases where they knew problems had arisen, within the framework of current legislation.

7. I attach a draft for your signature.



P WYNN OWEN

DRAFT LETTER FROM PAYMASTER GENERAL TO:

Bruce Sutherland CBE
Chairman of the Taxation Committee
Institute of Directors
116 Pall Mall
LONDON SW1Y 5ED

1. Many thanks for your letter of 18 November to the Chancellor on profit related pay. Nigel asked me to reply.

2. We were pleased to see your reaffirmation of support for profit related pay and were heartened, like you, by the large number of companies who expressed an interest in profit related pay by asking for copies of the Inland Revenue's Guidance Notes (PRP2). These are still, of course, very early days. PRP2 was published only three months ago. While we understand the misgivings you have expressed, it seems to us too soon to draw any firm conclusions, whether optimistic or pessimistic, as to the likely level of PRP take-up or the nature of any particular problems which may impede take up. You may have seen that the number of registered schemes by the end of October was already about 150, and I can tell you that this number continues to grow. But, perhaps more significantly at this stage, we believe that a large number of employers will be seeking to set up carefully designed and negotiated schemes in the coming months.

3. You suggest that the only basis on which many businesses expressed an interest in PRP in the first place was that it could allow for a reduction in previous pay levels. I would question that. Certainly the legislation allows that if employers so wish, but it also leaves it open to employers to introduce PRP schemes by keeping "basic" pay constant, while giving PRP in lieu of an annual pay rise, or indeed by introducing PRP as an "add on" to existing pay, based on a judgement that it is worth paying an additional initial cost to secure the flexibility that a pay scheme including PRP will offer in subsequent years. It is, in short, a matter for employers how to introduce PRP.

Your letter itemised six specific proposals and it might be best if I deal with each in turn.

1. - The minimum proportion of profits going into the pool should be determined as at present, unless this gives a figure higher than say 15 per cent in which case 15 per cent would be the minimum proportion.

I accept that, in an arithmetic sense, some companies may have a very high minimum percentage of profits going into the PRP pool. But that simply reflects the particular cost structure of those businesses. Your contention that this is unacceptable seems to be based on an assumption that PRP schemes will only be introduced as an "add on". As I said, that is not necessarily the case. To the extent that PRP is in lieu of an annual pay rise that would otherwise have taken place, the position will be no worse for these sort of companies. And indeed I think you would agree that it is precisely those companies where the pay bill is large compared to profits or to relatively tight profit margins that are in most need of the flexibility that a PRP scheme can afford to management. You will no doubt also bear in mind the very generous "overrides" available, which enable employers considerably to limit the fluctuations of PRP payments to which they commit themselves. I am afraid the suggestion in your final sentence that the amount going into the pool should be determined by a "minimum proportion of profits" may reflect some misunderstanding of the position. We are, of course, talking about the amount of money devoted to PRP not being less, at the outset, than the value of 5 per cent of the standard pay of employee participants. What this value amounts to as a percentage of profits will depend entirely upon the circumstances of the employment unit in question. But if PRP is to produce real benefits in terms of pay flexibility, incentives etc, it must represent a significant proportion of pay - not least at the outset. We have fixed this proportion at the fairly modest level of 5%.

2. - The minimum trigger level of profits should be the relevant proportion of the base year profits indexed for inflation or preferably uplifted by say 150 per cent of the inflation increase to allow for the greater effects of inflation on cash flow than profits.

I understand you to be seeking this indexation of the trigger level to afford employers greater protection so that it is not necessary for them to pay PRP if profits fall beneath a level greater than that permitted by the present legislation. Here again, it appears you may be exaggerating the problem by assuming that PRP schemes will consist entirely of "add on", and by taking insufficient account of the existing generous override facilities. I note your case on this point, but you have made little allowance for this Government's determination to continue to bring down the rate of inflation, building on substantial past success in this area.

3. - "Return on capital" should be permitted as a criterion both for the pool percentage and for the trigger levels

This would amount, as I think you acknowledge, to a substantial departure from the whole concept of profit related pay. The measure of profit was chosen carefully. It allows crucial flexibility to employers to adjust their pay bill when the going gets hard, either due to external or internal factors, to the benefit of company and workforce alike. You will appreciate that the PRP legislation in fact allows an employer considerable scope, for the required return on assets to be taken into account in the design of a scheme. The necessary return on substantially changed assets on capital should be capable of reflection in the scheme by using the permitted profit adjustment (eg for interest) and the overrides - to the extent that such a return is not "below the line" anyway.

4. - Profits in the statutory accounts and profits in the management accounts may differ in ways which could be difficult to explain and could dilute the message to a workforce used to following the actual management accounts

I wonder whether this is likely really to be a serious problem for the employer interested in the real benefits of PRP, rather than simply securing the tax relief for his employees? I recognise that in cases where existing bonus schemes are adapted to enable employees to benefit from the tax relief, this may require management to provide additional, or different, information to the workforce than was previously the case. But in other cases, where profit-sharing schemes have not previously been in existence, an additional benefit from the introduction of PRP schemes should be an improved flow of information and dialogue between management and workforce. Only this way can we break down the "them and us" confrontational style of the past.

5. - Relate PRP to basic pay rather than pay for PAYE purposes

I have explained above the reason underlying the initial "5 per cent of pay" test. Against this background, what you propose could in many cases amount to a significant diminution of this test by excluding overtime, bonuses, shift premiums etc.

6. - Substitute a standardised figure for directors' remuneration (eg the amount in the base year indexed for inflation) in determining profit.

I agree with you that there would clearly be excessive scope for manipulation if the actual remuneration of owner-directors was deducted before the profit figure was determined. But I cannot help wondering whether your suggestion of a standardised or indexed figure for such remuneration would not be both an unrealistic and an excessive solution to the Communication problem

you describe. If an employer's PRP scheme is going to produce the benefits he seeks - including the trust of employees - communication will be particularly important. To explain the basis on which profit figures are produced, and to show employees how fairly these are calculated, would hardly be easier if it had to be admitted that owner-director costs were not true, but based only on some standard or indexed figure.

5. The Chancellor and I were most grateful to receive your views, and will bear these carefully in mind. We think it will be particularly important to the success of what has been a carefully thought-out proposal, however, not to yield to any temptation to rush into premature judgements of its likely success, or to contemplate major changes in its detailed conditions.

5. If, of course, you are aware of any particular companies experiencing difficulty in registering schemes under the existing legislation do please let Inland Revenue officials know, so they can offer further guidance to those concerned.

[P B]

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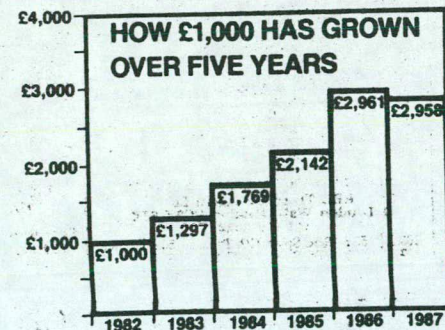
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The chart is based on the price of SIT ordinary stock units at 31 October each year with dividends

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Much of the business community believes that red tape is strangling efforts to link earnings to performance

Incentives at risk on profit related pay

TAX INCENTIVES for Profit Related Pay are in danger of being smothered by unnecessary and ill-thought out restrictions, claim a growing number of businessmen and accountants who are campaigning for reforms in next year's Budget.

More than 35,000 companies have asked the Inland Revenue for details of how the scheme works, but only 100 have followed through and registered for tax relief.

There may still be time for companies to begin PRP in 1988, but the taxman must approve each scheme for relief before the start of that company's business year.

The chief attraction for employees who agree to participate is that half the PRP they receive can be free of income tax. But tax relief applies only to PRP up to 20 p.c. of each worker's salary or £3,000 per person, whichever is lower.

Thus, people earning less than £15,000 a year stand to gain a higher proportion of tax-free income from PRP than better-paid counterparts.

Someone earning £15,000, of which £3,000 was PRP, could pay £500 a year less tax than they would if the whole £15,000 were salary.

"That may not sound a lot, but £10 a week net might come in very handy for many people," said Maurice Fitzpatrick, tax partner at accountants Blick Rothenberg Noble.

"The concept of PRP is to be applauded because it should start to break down the 'us' and 'them' attitude in pay bargaining.

"It may make employees more sympathetic to management attempts to improve efficiency because they stand to gain from increased profits."

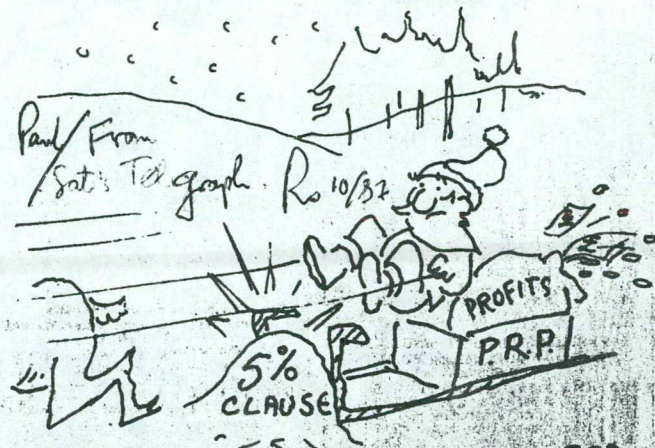
But Mr Fitzpatrick believes this beneficial reform is in danger of being thwarted by excessive restrictions, a view which the Institute of Directors shares.

As fiscal adviser to the Social Democratic Party, Mr Fitzpatrick was instrumental in the tabling of a written question in the House of Commons this week, which urged the

Canada in after the storm

THIS week saw the entry of the Canadian Imperial Bank of Commerce into the unit trust market in this country with the launch of the CIBC Growth Fund.

Far from being daunted by the current market conditions, director Mr Martin Sullivan



removal of PRP's controversial '5 p.c. clause.'

PRP funds must at least equal 5 p.c. of the firm's wage bill if the scheme is to qualify for tax relief.

"This can give a very high minimum percentage for service companies with high pay bills relative to profits," commented Bruce Sutherland, chairman of the Institute of Directors' taxation committee.

"For example, it is not unusual for service companies to have a pay bill which is five, seven or more times the annual profit, resulting in a minimum of respectively 25, 35 or more p.c. of profits having to be put into the PRP pool."

Added to this, Mr Sutherland pointed out, the current rules require PRP to be paid when there has been no significant increase in company profits.

He said: "A trigger level of profits may be set below which no PRP pool is created, but this trigger must be less than 5 p.c." Inflation could account for all

such a rise in profits at such a low level, he explained.

In a submission to the Treasury, the institute called for PRP to be linked to returns on capital, claiming this would be more easily understood by employees than calculations based on payroll size.

Difficulties in selling the idea to workforce may partly explain PRP's slow take-off. Schemes cannot be registered unless 80 p.c. of each firm's full-time staff vote for PRP.

But John Cahill, senior policy adviser at the Confederation of British Industry, says it is too early to write off PRP.

"It will take quite a while for substantial companies to introduce PRP, many are thinking of starting in 1989."

Application forms for companies considering starting a scheme may be obtained from the PRP Office, St Mungo's Road, Cumbernauld, Glasgow.

Ian Cowie

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FROM: MOIRA WALLACE

DATE: 26 November 1987

PS/PAYMASTER GENERAL

cc Mr Gray
Mr Burgner**PROFIT RELATED PAY: LETTER FROM INSTITUTE OF DIRECTORS**

The Chancellor has seen Mr Sutherland's letter of 18 November. He would be grateful if the Paymaster General could reply to this. The Chancellor thinks these suggestions need to be looked at very carefully. He is particularly concerned at the suggestion that the introduction of PRP is not attractive without a reduction in previous pay levels. If true, this is not what the Chancellor intended. He had in mind a scheme that would enable a company to keep 'basic' pay constant, and give PRP in lieu of an annual pay rise. Otherwise, PRP take-up will be derisory: as Mr Sutherland says, very few companies will reduce 'basic' pay levels.

M.W.

MOIRA WALLACE



Inland Revenue

Policy Division
Somerset HouseFROM: J D FARMER
DATE: 23 December 1987

PAYMASTER GENERAL

PRP : AMENDMENTS TO LEGISLATION (STARTER No 110)

1. Our submissions of 22 October, 17 November and 14 December ("Reports on Take-up") and of 2 December ("Enquiries and Published Guidance") have described our early experience in administering the new PRP legislation. They have reported briefly on the considerable volume and range of enquiries being handled, on PRPO reactions to early scheme registration work, and on the numbers of applications so far received for scheme registration. This submission reports on matters which we have so far been able to identify as possible candidates for inclusion in the 1988 Finance Bill as amendments to the PRP legislation.

Background

2. Four months into its life, the legislation is standing up fairly well to employers' and their professional advisers' study. We describe below a number of candidates for amendments, but only two or three of these may be regarded as of any considerable importance or urgency. Most are relatively

c Chancellor

Chief Secretary
Financial Secretary
Economic Secretary
Mr Monck
Mr Jenkins (OPC)
Mr Scholar
Mr Culpin
Miss Sinclair
Mr P R C Gray
Mr Riley
Mr Wynn-Owen

Mr Isaac
Mr Beighton
Mr Easton
Mr Cleave
Mr Lewis
Mr Calder
Mr Bush
Mr Eason
Mr Farmer
Mr O'Hare
Miss Dougharty
Mr Fraser
Mr Annys
PS/IR

small tidying to the legislation, some of which might be represented as minor easements.

3. As tends to be the case with most new tax initiatives once they have been studied, complaints have been heard about the conditions attached to the new PRP tax relief - though of the major representative bodies only the Institute of Directors has yet been particularly vocal. You replied to Mr Sutherland's letter on 21 December.

4. Generally it is still much too soon to judge the likely take-up of PRP by employers. Dealing with enquiries, holding meetings with employers and consultants and trade associations, participating in seminars etc, all continue to take a lot of time, evidencing active - even growing - interest in PRP. This interest will be further encouraged by Ministers' own planned speeches, and by the publication of additional guidance which we have recently proposed. It will however be difficult for some time yet to draw from the level of actual scheme registrations reliable conclusions as to the adequacy of progress. The larger schemes, the better prepared and so the longer-lasting schemes, the schemes providing PRP as part of a negotiated pay settlement (or even as a conversion of basic wages) rather than as a mere "add-on" - all these more worthwhile kinds will naturally take time for employers to get right, and to put forward for registration.

5. We suggest that this is the particular context in which Ministers will want to view the individual possible amendments which are referred to below. This is why the items identified are limited to matters considered in the summer plus some of the others which have been noted in the course of the past few months. They do not include major easements such as relaxations of the 5% minimum level of prospective PRP as a proportion of pay, or of the 80% employee participation test. We leave aside at this stage, for a possible later submission, whether there are any steps

we could take administratively that might assist take-up (eg publication of advice as to the way in which we intend using our discretion to cancel registrations).

6. In considering the individual possible amendments described below, Ministers will remember also that, in the event, the PRP legislation in the No 2 Bill in July was discussed only very briefly. Amendments to those provisions which were proposed in the 1988 Bill would give the House an opportunity to engage in a more extensive and thorough debate on the merits as well as the detail of the whole PRP initiative.

Candidates for amendment of the PRP legislation

7. You will recall that we took the opportunity of deferment of the PRP legislation (until the No 2 Bill after the summer election) to make a number of improvements in the final provisions enacted; but that three matters had to be left aside. These three remain the leading candidates for legislative action and they are described in paragraphs 11-16 below. We then identify and comment on six other possible candidates (described in greater detail in Annex D).

8. Before addressing these particular points, however, another concern recognised in the summer needs updating. Mr Collen's submission of 18 June described possible problems with insurance companies' access to the PRP relief. Whilst these problems did not seem insurmountable, they might in practice deter this sector from seeking to register schemes. You agreed that no immediate action should be taken, but that consultations with the industry should proceed if pressure emerged.

9. Since the summer we have corresponded with, answered enquiries from, and met several insurance companies and their advisers, and we have recently met the Association of

British Insurers (ABI). No very great or concerted pressure for concessions or legislative change is yet evident, but this may nevertheless build up as the issues crystallise. The ABI has been invited to let us have a description of their problems. The picture emerging so far is essentially as anticipated - particular difficulties (though no-one has yet said it is impossible) in meeting the PRP requirement to produce Profit and Loss Accounts complying with Schedule 4 Companies Act 1985, a schedule not normally used by these companies. (But we should note that one company has sent us only this week an Opinion that the existing legislation does not in fact contain this requirement. We shall be examining this urgently.)

10. We propose continuing these contacts, without commitment, with a view to offering you advice when conclusions can sensibly be drawn.

11 The first of the three items carried forward from July is the 'Brennan Guarantee'/'purpose of PRP' topic, which you agreed - most recently in Mr Judge's minute of 7 September - should be pursued with Parliamentary Counsel. The possible need identified was an amendment of the legislation to prevent its purposes - in particular pay flexibility - from being subverted by employers' promises to their employees to make up any future falls in PRP. Counsel has not yet come back to us with any draft text, but has said that it is likely to prove very difficult to find a form of words which adequately prohibits systematic arrangements to frustrate the purposes of PRP, while avoiding the effect or flavour of a tax-based incomes policy.

12. We will, of course, be pursuing this matter to see whether a useful and acceptable provision can be produced. The question will then be whether to include it in the Bill. While Mr Brennan has continued spasmodically to promote his 'guarantee' approach in contributions to PRP conferences, these references have not appeared to excite any great

interest. We have only rarely encountered the question in our other and frequent contacts with employers and their advisers. However, in their 'Guidelines for Negotiators' published at the end of November, the TUC have now taken up the idea. They explain in some detail how it can work to protect the employee from falls in his take-home pay (leaving him only with the prospect of gains), and to reduce the employer's prospective cost of pay settlements. A copy of the first page of the TUC's Appendix is attached as Annex A. The effect of the TUC publication is difficult to predict; but it could actually deter many employers from guarantee ideas to find their unions angling for them.

13. It remains to be seen, of course:

- whether any useful and acceptable provision can be drafted to strengthen our resistance to guarantee arrangements (some of us are sceptical whether this will in fact prove possible);
- whether such a provision could be shown to amount to much more than a paper tiger, frightening only to the innocent. In practice it might be very difficult to prove the existence (and operation) of guarantees - though we do of course have legal advice that there is a reasonable chance of our being able to resist some kinds of guarantee even under the present legislation;
- whether a guarantee approach is actually likely to prove so attractive to many employers and employees that the net result is to distort the whole perception of PRP (rather than merely to provide an initial and easy introduction to flexible pay);
- whether, in short, early legislative action is practicable and seems necessary.

14. We suggest that for the moment we pursue the drafting of a possible provision with Counsel, while keeping watch on the extent of interest in guarantees, and that the matter be reconsidered early in the New Year.

15. The second item carried forward from July is another on which we have already approached Counsel for drafting - the consequences of the death of a sole proprietor who was a registered scheme employer. Annex B describes this problem, and explains why, though no questions has yet been addressed to us on it (indeed only 3 schemes have yet been registered for sole proprietors), we would favour amendments on this matter.

16. The last of the outstanding three July items may turn out to be quite the most important. It is one which has only recently been raised for the first time in MP correspondence. This is the consequence of alterations made or sought in the rules of a scheme which has already been registered. Annex C describes the problem, and proposes that Counsel be invited to draft - though depending on the approach and scope chosen for the legislation this may not be straightforward.

17. There is, finally, a range of more minor individual matters which merit consideration as possible amendments to the existing PRP legislation. Annex D describes briefly the following possibilities:

- i. amendment of the tax recovery powers;
- ii. clarification of the remuneration to be included in PRP accounts in respect of those excluded from participation because of 'material interest';
- iii. resolution of an apparent conflict between two provisions relating to distribution of the PRP pool;

- iv. confirmation that PRP must be paid in cash.

All of these items are essentially 'tidyings' of the existing legislation, which would have little general impact other than to confirm or clarify the intended impact of the existing provisions.

- v. an expansion of the permitted adjustment to exclude PRP itself from PRP accounts, to cover NIC on that PRP;
- vi. a simplification of the requirement that PRP profit and loss accounts observe Schedule 4 of the Companies Act 1985.

These items might be represented as easements in the existing provisions.

Conclusion

18. Ministers will no doubt wish to take a view on these PRP candidates for the 1988 Finance Bill in the light not only of experience to date with the (4 months' old) legislation - our recent reports on enquiries and take-up, and the brief overall assessment attempted in paragraphs 3-4 above - but also taking account of pressures on Finance Bill space, revenue impact etc.

19. As to the latter, we would estimate the revenue cost of adoption of all the items mentioned would be very small - perhaps less than £5 million - though in easing access to PRP and demonstrating Ministers' continuing interest it could indirectly contribute more significantly to the overall cost of the PRP tax relief. The amount of Finance Bill space (perhaps substantially contained in a single Schedule) could be as much as three to four pages, though this would depend on the difficulty encountered in drafting, particularly on the 'death of a sole proprietor' and

'alterations in scheme rules' items. However, whether or not Ministers favour promoting any or all of these candidates in the 1988 Bill, most of them appear likely to be useful or needed at some time in the future, and so time and effort spent now in pursuing them into the form of draft legislation is unlikely to be wasted.

20. Subject to all these considerations, we invite you:

- i. to note the present state of play on insurance companies' access to PRP (paragraphs 8-9);
- ii. to note that we are pursuing the 'Guarantee/purpose of PRP' point with Counsel, and propose to report progress to you early in the New Year. It may then be a little clearer how great employers' interest in the guarantee approach will be (paragraphs 11-14 above);
- iii. to agree that we should pursue with Counsel the drafting of special provisions to deal with the 'death of sole proprietor' scheme employers (paragraph 15 and Annex B);
- iv. to decide whether we should instruct Counsel on the preparation of amendments to enable alterations in the rules of registered schemes to be accepted - and if so which kinds of alterations to cover (paragraph 16 and Annex C). This appears to be the single most useful item at present identified;
- v. to decide whether, and if so which of, the range of more minor matters (paragraph 17 and Annex D) should be pursued with Counsel.

21. We should, of course, be happy to discuss this raft of issues with you if this would be helpful.



J D FARMER

Encls.

Extract from TUC "Guidelines for Negotiators" on PRP
(published, undated, at end November 1987)

1. This Appendix examines the form that an earnings guarantee might take within a PRP scheme. This is not a recommended response to PRP but provided for information only.
2. Tax relief on PRP goes only to employees. Apart from the prospect of PRP improving performance as a form of conventional profit sharing, the only incentive for employers to push for PRP is as part of pay bargaining. Unions and workers will resist the pressure to take all or part of a pay increase in the form of PRP. However, employers may include the guarantee of a minimum level of take-home pay, to minimise the risks to workers.
3. There is nothing in the Inland Revenue requirements which prevents employers from offering an earnings guarantee. However, the regulations may be changed if this proves to be a common reaction of companies and workers. If a clause is subsequently introduced preventing an explicit earnings guarantee as part of a PRP scheme, there are strategies for providing a guarantee outside any scheme, which would share the risks and rewards of PRP.

DECEASED SOLE PROPRIETOR AND PERSONAL
REPRESENTATIVES

Present position

1. Under current legislation when the sole proprietor of a concern which has a registered PRP scheme dies the scheme will have to be cancelled because the deceased will be unable to administer it. Any PRP tax relief given in the profit period in which the death occurs is recoverable by the Revenue.
2. Normally a scheme employer who becomes aware of an event which gives grounds for cancellation can ensure that the cancellation has effect only from the date of the event. But he must make a request for this treatment within one month of the event. Clearly the deceased is unable to make such a request.
3. A scheme employer may dispose of his business to another person and a joint application by both of them will secure continuance of the scheme in the new hands. The new employer becomes responsible for all aspects of the PRP scheme including any past misdemeanours of the original employer regarding PRP. Again a joint application cannot be made where the original employer has died.

The problems

4. No representations have yet been received on this subject but:
 - a. A scheme employer's estate could suffer a financial penalty following his death in circumstances where he had operated the registered scheme with complete propriety and accuracy.

b. No such negative results follow when a member of a partnership dies (the surviving members are the "scheme employer"). This would be seen as anomalous.

c. There is no way that the personal representatives of the deceased can do anything about the situation.

d. On the other hand, the Revenue has no one to go to in order to determine whether relief was correctly operated before the death (eg an end of year return can currently be demanded only from the scheme employer).

Conclusions

5. In theory there are two ways of dealing with these problems. One would be to permit the registered scheme to pass to another employer following the death of a sole proprietor. We do not recommend this, for three main reasons. First, the change is so profound that the business has effectively come to an end. Second, any new scheme employer would be treated in law as if he had been the scheme employer throughout. This would potentially involve him in actions of the deceased where clearly facts could not be properly ascertained. Third, timing problems. A transfer of business can normally be accomplished within the month provided for. Following the death of a sole proprietor, however, there are inevitably delays, which would prevent the swift switch-over needed.

6. We propose the alternative course, which involves:

- i. requiring the personal representatives to notify the death. This will lead to cancellation of the scheme;
- ii. giving the personal representatives the option of requesting (within one month of their appointment) that the registration of the scheme be cancelled

only from the date of the death. This will ease the problem of recovery of PRP tax relief given in the period up to the date of death;

- iii. laying on personal representatives the responsibility for carrying out PRP actions which the scheme employer would have undertaken had he not died - in particular, the duty to render annual returns. Such responsibility would be consistent with the proposed facility to operate a shortened final profit period.

Proposed form of legislation

7. The approach proposed above has already been referred to Parliamentary Counsel, who sees no particular drafting difficulty.

ALTERATIONS TO SCHEME RULES

1. Ministers agreed in June 1987 that the draft PRP legislation should be changed to enable the Board to ignore changes in the terms of a registered scheme (and so not to have to cancel registration) where those changes were in

- rules unregulated by the statutory provisions
- the identity of any employers named in the scheme.

It was not possible to deal with this, however, in the provisions finally enacted.

Recent Consideration

2. Further consideration of this matter is based on recent legal advice that if any change of any significance is made in the terms of a registered scheme (other than a change of "scheme employer" for which the legislation makes express provision), the effect is that the original scheme as registered comes to an end. The result is that it is not necessary for the Board to cancel the registration because of the change, or to exercise its discretion not to do so. The scheme has ended, and so the registration lapses.

3. This may have some attractions, insofar as practical administration is concerned, but it may appear somewhat harsh - despite the fact that under the existing legislation any employer could replace his existing scheme with another by going through the registration procedure again. It is harsh in that rule changes may often be sought in non-statutorily regulated matters, to which we would have no objection since they did not impinge on PRP policy objectives. And even in some regulated matters changes

might be of a relatively minor administrative kind, or of a kind helpful to employees or employers which appeared generally attractive from a policy standpoint (eg changes in "other employers" which enabled the scheme to continue; the introduction of interim payments; the removal of overrides on PRP pool fluctuations).

Possible permitted rule alterations

4. There is of course a wide range of possibilities as to the matters in respect of which changes in the rules of already registered schemes might be expressly permitted by amendment of the existing legislation. Three types of change are recommended on the ground that they would serve to increase scheme employers' flexibility and capacity to protract the life of their registered schemes:

- i. changes in rules on matters which are not regulated by or the subject of existing legislative requirements: in brief, these will be changes which do not affect the definition of eligible employees, the amount of the PRP pool, the distribution of that pool amongst employees, or the timing of PRP payments (schemes may well include rules relating to such matters as communication of profits and PRP results to employees, negotiations on continuance of the scheme etc). It seems to us in the interests of PRP to enable employers to make changes of this kind, without going to the trouble of registering a new scheme.
- ii. changes in the identity of any subsidiary PAYE employers named in the scheme rules (the legislation already contemplates changes in the scheme employer. Other things being equal, there is no reason to deny changes in other employers (named in the scheme) of employees to whom the

scheme relates - this may prove necessary where subsidiaries in a group scheme change);

- iii. the addition of rules as to the use of an abbreviated profit period (this facility, for use in some circumstances where registration is cancelled part-way through a profit period, is already expressly provided for in the legislation. There seems no reason to deny its subsequent availability to someone who did not take the opportunity ab initio).

Subject to further consideration with regard to the first of these, we contemplate that the first two kinds of change in the rules of an already registered scheme should be permitted, subject to the Board's satisfaction with an application for amendment of the registration which was made no later than one month after the change. This matches the present 'change of scheme employer' provision. The third (and possibly also the first) of these changes should be acceptable only if it is the subject of a satisfactory application made before the start of a future profit period for which it is to have effect.

5. Other matters in respect of which changes in registered scheme rules might be permitted depend on Ministers' views as to how far additional flexibility, at this stage, may be desirable. The basic approach in the existing legislation is to require the 'game-rules' under which PRP is to operate to be set down clearly in the written scheme, before its registration and before it comes into effect. But perhaps the crucial requirement is to deny any facility to alter those scheme rules which are central to the PRP intention that tax-relieved payments are fixed by reference to future profits in advance of their determination. This leaves some scope for legislation to enable us to accept three other kinds of rule changes - so long, that is, as the proposed new rules themselves fall within the present statutory

requirements, and so would have been acceptable if included within the original registered scheme.

6. These three might either aim only at enabling the scheme employer to improve the attractions and incentive effect of the scheme to employees; or they might enable him to tighten up his rules, perhaps to reduce his own risk from PRP (instead of only loosening them in the interest of his employees). The candidates are

- iv. changes in the rules defining the 'employees to whom the scheme relates' - either by admitting more such participants (eg bringing in part-timers or short-service employees previously excluded); or, more widely, by excluding part-timers originally included, or by allowing also the removal of some originally included participants (eg those who join or leave during the profit period). In either case it would be desirable to accept any such rule change only from the start of the second or any subsequent profit period, to avoid prejudicing the original 5 per cent test of a scheme's eligibility to registration;
- v. changes in the 'overrides' on the effect of profit changes on the size of the PRP pool - either by permitting only the removal or relaxation of these 'overrides'; or by permitting also their introduction or tightening. In either case it would be desirable to accept any such rule change only from the start of a future profit period;
- vi. changes in the rules defining when PRP payments will be made - permitting either changes in the direction of more frequent or earlier payment, or changes also in the direction of less frequent payment. Again such a rule change would be accepted only from the start of a future profit period.

Conclusion

7. Especially perhaps in these early days of PRP it may be expected that a number of registered schemes will be found by scheme employers to require alteration. The possibilities mooted above are not intended to provide a safety line for those whose schemes are discovered to be founded on any significant misunderstanding of the legislative requirements (we have reported our fears that several such schemes may have been registered) - these cases will fall to be dealt with as they are identified, and our discretion to cancel registration will be relevant. But if changes in at least more minor and relatively insignificant respects were not to be permitted, this could deter PRP take-up. Although legislation to permit the rule changes described above could encourage demands for the acceptance of other more extreme and unattractive rule changes (eg changes in pool determination or pool distribution rules mid-way through profit periods), a proposal even limited in the way suggested could be presented as a helpful initiative.

8. We invite Ministers:

- i. to agree that we should ask Counsel to draft provisions enabling us to accept changes in the rules of registered schemes, on the lines described in paragraph 4 above;
- ii. to decide whether we should pursue with Counsel possible provisions on the lines described in paragraph 6 above - and if so, whether these should be addressed only to rule changes in favour of employees (the first variant in each case), or to such changes in whatever direction they moved.

MINOR ALTERATIONS IN PRP LEGISLATIONi. Tax Recovery Powers

1. The legislation places all the responsibility for the operation of PRP on the scheme employer. Where cancellation of registration means that some tax relief has to be recovered, it is from the scheme employer that it has to be recovered. Where the scheme employer is the parent company of a group of subsidiaries, recovery is from the scheme employer even if it is the subsidiaries who are actually operating PAYE. If that group scheme employer happens to be (or becomes) a non-UK resident company, we may be unable to recover the tax relief. In circumstances such as this it would be helpful to have a secondary right of recovery against the PAYE employer, and we therefore propose one amendment to Section 11 to deal with the point.

2. In this context Ministers may wish to be aware that at present our power of recovery of tax relief wrongly given derives only from a cancellation of registration. There may be some circumstances where we would wish not to cancel the registration but nevertheless to recover tax relief which has been given excessively eg where interim payments of PRP exceeded the final amount actually due. In practice, we will normally use our discretion not to cancel the registration - although in the example given such an error would be grounds for cancellation - but, as a condition for such an exercise of our discretion, will seek repayment of the excess tax relief and an assurance as to future operation of the scheme in strict accordance with its rules.

ii. Excluded Employee's Remuneration

Employees who have a material interest in a company which has a PRP scheme are to be excluded from receipt of PRP. Moreover, the remuneration of such employees (usually controlling directors) must not be a deduction in arriving at the profit of the unit for PRP purposes. Remuneration is not defined in the legislation and some questions have arisen as to what it includes. There is in the Companies Act 1985 (Schedule 5 Part IV paragraph 22(3)) a definition of directors' emoluments. It would remove doubt if this definition could be attracted to the PRP provision. That definition provides that "emoluments" for this purpose includes fees, percentages, expense allowances (insofar as liable to income tax), contributions paid under a pension scheme and the estimated money value of non-cash benefits. We propose the attraction of this definition.

iii. Provisions relating to PRP pool distributions

There is an apparent conflict between the requirements in the legislation's Schedule 1 paragraph 6 (which requires that a scheme must provide that no payments of PRP are paid for any profit period in respect of which the 80 per cent test is not satisfied) and paragraph 16 (which requires that the whole of the distributable pool must be paid out). It would be reasonable to conclude that paragraph 16 must be subject to paragraph 6 but, if a range of other minor amendments to the PRP legislation was being pursued, we would propose an amendment to confirm this.

iv. PRP payments to be in cash

Since the definition of "pay" in Section 1 expressly excludes its application in the phrase "profit-related pay", it has been argued by one correspondent that PRP can be paid in vouchers rather than cash. Based on inferences from other parts of the legislation, the legal advice we have received is that PRP should only be paid in cash and not otherwise; but it would be an exaggeration to say no other view was possible (though few may press it). A reference to cash in the definition of PRP would dispel this doubt (provided such a reference included cheques, direct credits etc). We propose inclusion of an amendment to this effect in any package of minor amendments to the legislation.

v. Adjustment to PRP profits to include NIC on PRP

1. The present legislation permits the PRP profit and loss account to be drawn up excluding the PRP item itself. This adjustment was agreed because of the difficulty employers would face in determining the size of the PRP pool based on an account which itself included PRP.

2. It has now been pointed out that the permitted adjustment for PRP itself should extend also to the NIC liability on such payments. We propose that this amendment should be made.

vi. Simplification of the Profit and Loss Account requirement

1. The profit and loss account produced for a registered PRP scheme must comply with the profit and loss account requirements of Schedule 4

Companies Act 1985. This schedule codifies the accounting principles and rules under which the great majority of companies produce accounts and is seen as a necessary objective standard for measuring a PRP profit.

2. Inevitably, those rules are extensive and complex. We have now examined them further, in response to some comments, and have concluded that a useful measure of simplification of the legislation would be possible by disapplying specific parts of Schedule 4 for PRP purposes. We believe this can be done without affecting in any material way the adequacy of the information produced for PRP purposes. Such disapplication in a 1988 Bill would have the added advantage of being effective before any profit and loss account needed to be compiled for submission to the PRPO.

3. We propose such a relaxation might be included in any package of minor amendments to the PRP legislation.



INLAND REVENUE
MANAGEMENT DIVISION
SOMERSET HOUSE

FROM : J O'HARE
DATE : 5 January 1987 8

PAYMASTER GENERAL

Profit-Related Pay : Annual Return

1. I enclose for your approval a draft of the annual return relating to profit-related pay schemes.
2. This version has been arrived at after consultation with the official Treasury and the main accountancy bodies. In addition comments have been sought from a number of individual accountants who are known by the PRPO to have an interest in profit-related pay.
3. In general the form has been well received as being simple and easy to follow. The comments which were made were, with one exception, on relatively minor or presentational matters. Most have been incorporated in this revised version.

c PS Chancellor
PS Chief Secretary
PS Financial Secretary
Mr Monck
Mr R I G Allen
Sir A Wilson
Mr J MacAuslan
Mr Wynn-Owen

Mr Isaac
Mr Lewis
Mr Cherry
Mr Easton
Mr Miller
Mr Bush
Mr Farmer
Mr O'Hare
Mr Fraser
Mr Simpson
Mr Annys
PS/IR

4. The exceptional comment related to the content of the report to be signed by the independent accountant (part 5 of the form). The draft requires the accountant signing the report to say that, in his opinion, the relevant profit and loss account gives "a true and fair view" of the profit or loss for the period for which it has been prepared. That expression mirrors the PRP legislation. Both Institutes of Chartered Accountants (England and Wales and Scotland) and some of the accountants who commented sought to replace those words with some lesser phrase like "present fairly". Some even expressed the view that, because of the adjustments to the profit and loss account permitted by the legislation, it might not be possible for them to state that the accounts gave a "true and fair view". But the accountancy bodies said that they did not expect accountants to refuse to sign the report as presently drafted.

5. The Board's accountancy adviser has little sympathy with these suggestions, believing - as we do - that the present version is preferable and gives us greater security and reassurance over the make-up of profit and loss accounts than any of the proposed alternatives. We have therefore decided to stay with the original draft.

6. When you have agreed to the content of the form I shall arrange its immediate printing and issue to all those who have expressed an interest in PRP. A copy of the additional guidance which you recently approved (Mr Fraser's note of 15 December 1987) will be included. It is clear that content of the return is one of the aspects taken into account in setting up a PRP scheme and completing the application. We therefore wish to make copies available as soon as possible.



J O'HARE



Inland Revenue Profit-Related Pay Scheme

Annual Return

For official use only

Return rec'd
Return
processed

See
Note
1

1 **Period of Return**

PRP reference

2 **Return due by**

Your reference

Name of
Employment
Unit

If any of the above particulars need amending please give details on a separate sheet.

Please read the enclosed notes before you start to fill in this form. You may ask the Profit-Related Pay Office (PRPO) if you need further assistance or information about completing the form. If you find there is not enough room for your answer in any part of the form please include the details on a separate sheet and attach it to the form.

You are required to complete Part 1 if the return is in respect of the first or only profit period of a profit - related pay (PRP) scheme and the scheme is not a replacement scheme. The other parts are to be completed in all cases.

When you have completed your parts of the form and your independent accountant has signed Part 5, send it to the PRPO at the address shown on page 4.

Do not send the profit and loss account with this annual return. It may be called for at a later date

3 **Part 1 First or only Profit Period**

Method A Schemes

Please enter the base year specified in the scheme

				to				
--	--	--	--	----	--	--	--	--

Enter the profit for the base year.. *If there is a loss write "LOSS"*

£

State the fixed percentage of profits used to determine the size of the distributable pool

%

Method B Schemes

Please enter the profit for the twelve month period ending immediately preceding the start of the scheme.

If there is a loss write "LOSS".

£

Part 2 Profit, distributable pool and payment details

For this Profit Period

4 Please state the profit of the employment unit.
If there is a loss write "LOSS".

£

State the amount of the distributable pool.

£

5 Enter, showing separately the amounts paid in each income tax year, the payments distributed from the pool.

Income Tax Year	Amount

State whether further payments are to be made from the distributable pool

Yes	<input checked="" type="checkbox"/>	No	<input type="checkbox"/>
-----	-------------------------------------	----	--------------------------

If "Yes", state the expected date of final payment.

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6 At the beginning of the profit period did the employees to whom the scheme relates constitute at least 80% of all relevant employees in the employment unit?

Yes	<input checked="" type="checkbox"/>	No	<input type="checkbox"/>
-----	-------------------------------------	----	--------------------------

If "Yes", but no PRP payments were made, please give the reason for non - payment

For any earlier Profit Period

7 Enter details of any payments made since the date of the last annual return in respect of any earlier profit period.

Profit period	Income Tax Year	Amount

Part 3 Scheme Employer's Declaration

False statements may result in prosecution

To the best of my knowledge and belief -

- the particulars given in this return are correct and complete.
- no change has been made to the terms of the scheme since the date it was registered.
- the terms of the scheme have been complied with.
- any part of any payment of PRP made under the scheme without deduction of income tax was properly exempted under the provisions of Section 3 of the Finance (No 2) Act 1987.
- the emoluments paid to any employee to whom the scheme relates and to whom minimum wage legislation applies satisfied that legislation without taking account of profit-related pay.

Signature _____

Capacity in which signed _____ Date _____
(Secretary, Treasurer, Partner, Proprietor)

Part 4 Additional Information

Please enter the number of employees receiving PRP payments for the profit period

Full time *

Part time *

State the total pay (excluding PRP) in the profit period of employees receiving PRP payments.

£

State the number of employees for whom tax relief on PRP for the profit period was limited by:

The first limit of one fifth of pay and PRP

*

the second limit of £3,000

*

* Please write 'Nil' if appropriate

Part 5 Independent Accountant's Report

See
Note

13

Name of Employment Unit

I / We* have reviewed the profit-related pay profit and loss account(s)* and records for the above - named employment unit which I / we* considered necessary for the purposes of this report on the return for the profit period dated _____ to _____. The details given in Parts 1 and 2 of the return are as disclosed by those records and / or in the relevant profit and loss account(s)*.

In my / our* opinion :-

- 1 the profit and loss account(s)* referred to above has (have)* been drawn up in accordance with the terms of the scheme and the provisions of Chapter 1 of Finance (No 2) Act 1987 and gives (give)* a true and fair view on that basis of the profit / loss for the period(s)* for which it has (they have)* been prepared.
- 2 the calculation and distribution of profit-related pay and the giving of the associated tax relief are in accordance with the terms of the scheme and the provisions of Chapter 1 of Finance (No 2) Act 1987.

* Delete as appropriate

Signature _____ Qualification _____

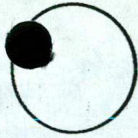
Name and address _____

_____ Postcode _____ Date _____

Telephone number _____ Reference _____

When completed send this form to :-

**Inland Revenue
Profit - Related Pay Office
St Mungo's Road
Cumbernauld
Glasgow
G67 1YZ**



Inland Revenue Profit-Related Pay

Annual Return

Notes on completion

These notes are to help you fill in the annual return; the numbers on the left hand side of the form refer to these notes.

You may also find it helpful to read the Inland Revenue booklet PRP 2 "Tax Relief for Profit-Related Pay; Notes for Guidance" which is available from the Profit-Related Pay Office (PRPO) whose address is shown on the annual return.

1. Period of return

Any reference in the form to "the profit period" means the period of return indicated by the dates shown.

2. Return due by

The period allowed for sending a return is -

- a. seven months from the end of the profit period if the scheme relates to a public company, and
- b. ten months from the end of the profit period in any other case.

The date by which you must make the return is as shown. If before the date shown on the form you give written notice to the PRPO that the Registrar of Companies has allowed a three month extension to the period for laying and delivering a company's accounts, then the PRPO will allow the same extension to the time for making the return. This exception applies only where the company's financial year corresponds to the profit period. See Chapter 7 of the booklet PRP 2.

3. First or only Profit Period

If the annual return relates to the first or only profit period for which a scheme is registered, details are required of the profit or loss in the base year (**Method A cases**) or in the twelve months immediately preceding the start date (**Method B cases**). See Chapter 6 of the booklet PRP 2. This part should not be completed if the return relates to any subsequent profit period or where the scheme is a replacement scheme.

4. Profit in the period of return

The amount of profit entered here should be taken from the audited profit and loss account for the profit period drawn up in accordance with paragraph 19 of Schedule 1 to the Finance (No 2) Act 1987. See Chapter 6 of the booklet PRP 2.

5. Details of PRP payments made

The profit period identified in the scheme rules need not coincide with an income tax year, which starts on 6 April and ends on 5 April the following year. So a profit period will often span parts of two income tax years. As payment of PRP for a profit period will be made after the end of, as well as during, a profit period, those payments may be made in more than two income tax years. Please include details of all payments already made from the distributable pool for the profit period showing the total amounts paid in each income tax year in which payments were made.

Example

Profit period: 1 January 1989 to 31 December 1989.
Interim payments made quarterly with annual adjustment.

Income tax year	Amounts
1988/89	£5,500
1989/90	£16,500
1990/91	£22,000

6. **The 80% test**

Broadly, no payments from the distributable pool for a profit period may be made unless at least 80% of the relevant employees in the employment unit are eligible to receive payments from the pool. Relevant employees are all employees in the employment unit who are not excluded under paragraph 7 (employees with a material interest) or paragraph 8 (part-timers or new recruits) of Schedule 1 to the Finance (No 2) Act 1987. Employees to whom those paragraphs relate, who are excluded from receiving payments under the scheme, are left out of account in determining both the total number of employees in the employment unit, and the employees to whom a scheme relates. For more details see Chapter 6 of the booklet PRP 2. The 80% test must be satisfied at the beginning of each profit period.

7. **Details of payments for earlier profit periods**

The distributable pool for an earlier profit period may not have been fully paid out when the return for that period was made. Enter details of any payments made for a period earlier than the profit period covered by the return which you have not previously included in a return. State the period to which the payments relate, the income tax year in which they were paid and the amount of those payments.

Example

Profit period 1 April 1988 to 31 March 1989.

Final payment made 15 December 1989.

Profit period	Income tax year	Amount
1 April 1988 to 31 March 1989	1989/90	£20,000

8. **Change**

Changes to the terms of a scheme as registered are not normally permitted and, if made, could lead to cancellation of registration. If there have been any changes not already notified, you should tell the PRPO now (on a separate sheet if necessary). See Chapter 9 of booklet PRP 2 for further information.

9. **Scheme Employer's Declaration**

A return will be accepted only if the declaration is made by a person who has authority to sign on behalf of the employer making the return. In the case of a body corporate that is the company secretary or person acting on his / her behalf. For a company which is not a body corporate it is the treasurer or the person acting on his or her behalf. See Taxes Management Act 1970, Section 108. In other cases, a partner or the sole proprietor should sign.

10. **Employee details**

Include here your best estimate of the number of employees who have received or are expected to receive PRP payments for the profit period. A part-timer for this purpose is an employee who is required by the terms of his/her employment, to work for less than 20 hours a week. Any employee who received PRP payments and who is required to work for more than 20 hours a week should be included as a full-timer.

11. **Pay**

Pay means the emoluments paid under deduction of PAYE after allowing deductible superannuation contributions and charitable deductions. It does not include any benefits in kind treated as emoluments of the employment and chargeable to income tax.

12. **Limits of Relief**

See Chapter 2 of the booklet PRP 2 for further information regarding the limits. If the PRP pool for the profit period has not been fully distributed include, in addition to those employees for whom tax relief has already been limited, your best estimate of those for whom tax relief is likely to be limited when the final payment is made.

13. **Name of Employment Unit**

Include here the name of the employment unit shown on page 1.



Ch/ PMG is pursuing, as you asked, Treasury views on whether the "Revenue restrictions" complaints have much substance.

FROM: A J G ISAAC
6 January 1988

Good. I am told that a particular request is that no papers of the unit should be used a PRP scheme applies must be audited.

PAYMASTER GENERAL

PRP

1. You will have seen some unhelpful (in the case of the Evening Standard, unpleasant) publicity about the take-up of PRP.
2. On the rate of response, there is no disputing that take-up so far has been towards the lower end of the reasonable range of expectations. However, the likely size and (above all) speed of employers' response has always been most uncertain. In particular, you will remember from the early meetings in the Chancellor's room, there was always uncertainty, and some differences of view, about how far or how quickly large employers would in practice be willing or able to accommodate PRP to their (often complex) wage systems. Thus, at the moment, the "jury is

cc **Chancellor of the Exchequer**
 Chief Secretary
 Financial Secretary
 Economic Secretary
 Sir P Middleton
 Mr Monck
 Mr Scholar
 Mr Culpin
 Mr Cropper
 Mr Tyrie

Mr Battishill
 Mr Isaac
 Mr Painter
 Mr Rogers
 Mr Pollard
 Mr Lewis
 Mr Beighton
 Mr Cherry
 Mr Farmer
 Mr Bush
 Mr Fraser
 Miss McFarlane
 PS/IR

out" on the wider success of PRP. By precisely the same token, however, as Mr Farmer emphasised in his note to you last month, it is much too soon to form an adverse judgment.

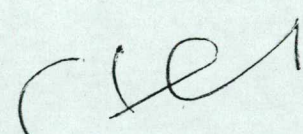
3. Mr Farmer's note last month also warned that some disappointed employers would seek to shift their frustration on to "Revenue restrictions". As you will have seen, this surfaced - in a very extreme form in the Evening Standard article.

4. Again, as we have all recognised from the outset, there is a real point somewhere in this argument. There are a thousand and one ways in which employers can quite reasonably seek to motivate their workforce, encourage a greater sense of participation between employer and employee, raise productivity, and improve their profits. They include, for example, pay related to

- profitability
- value added
- loss reduction
- productivity
- share/cash alternatives
- output (at its simplest piece-rate pay)
- sales bonuses
- long-service pay/merit/no-strikes pay
- PRP distributed on a "merit" basis
- and profit related pay itself which is only a tiny margin of total pay (the 5% rule).

5. Most reasonable people probably accept that the criterion for any tax relief has to be clear and objective: we couldn't give tax relief simply on the basis that an employer paid his employees (eg) merit pay. Equally, on practical grounds, there has to be some - not too ambitious - limit to the length and complexity of the legislation. But it is plain that a number of employers do not yet either understand or accept the arguments (including the Weitzman argument) why Ministers have based the tax relief on profits, as such. Being human, they react to the bad news by blaming the PRPO messenger.

6. If you agree, we think that it might in many ways be helpful if you could take the opportunity of your speech next week to develop a little more firmly and fully the Government's thinking on these two points. The draft speech being submitted to you tomorrow will include passages on these. We can, of course, offer you something rather more forthright if, in the light of recent developments, you feel that would be appropriate.



A J G ISAAC

Inflexible taxation rules on staff rewards deter directors

Firms drop plans for profit-related pay

By Roland Rudd

Most British firms have failed to introduce profit-related pay because Inland Revenue strictures are too narrow and complicated, Incomes Data Services reports.

The independent research group adds that those companies intending to introduce the scheme do so for the tax benefit and not for the reasons the Government would like, namely to make pay and/or employment more flexible.

At the end of October only 146 companies had registered profit-related pay schemes with the Inland Revenue after 26,000 requests for copies of

the guidelines. Researchers were in contact with 50 companies which previously had expressed strong interest in introducing the scheme and found that only two had registered such arrangements by last month.

Several intend to introduce profit related pay this year but a large number have postponed their plans indefinitely.

Many companies are waiting to see if the scheme becomes more flexible or attractive. Businesses which had dropped plans included Boots, British Airways, T I Desford and the TSB.

Among companies which

had difficulties with the scheme, one objection was that pure profit could be a poor indicator of a company's performance and of employees' efforts.

Employee share schemes created greater and more long-term employee identification with the company than profit related pay.

The complexity of the scheme and the costs and time to set it up appeared to outweigh the benefits to employees, particularly when companies employed many low-paid workers.

T I Desford Tubes abandoned its proposals because

the Inland Revenue insisted that no account could be taken of performance issues other than profit, such as sales or capital employed.

The researchers state: "A number of companies with existing profit sharing schemes object to the loss of the discretion they currently enjoy when determining the amount of profit to make available for distribution".

● A Leicester firm, True Engineers Ltd, is offering a company car, London rates of pay, 24 days' paid holiday and a company pension scheme to attract skilled auto-setters from Coventry.

West Midlands Manpower Services Commission reports that up to one in seven manufacturing companies in the region is being hampered by lack of skilled workers — particularly engineers.

The commission believes that is a legacy of the cost-cutting in the early years of the recession when apprentices were regarded "as an expendable luxury".

The report states: "This has resulted in the pool of skilled labour getting smaller and smaller, and steps are now being taken by many firms to expand in-house training.

Test engineers, skilled op-

erators, electrical and electronic engineers, qualified welders and machine tool designers are in high demand.

There is a rapid rise in demand for professional engineers, particularly from the office and data processing equipment industries.

The problem has been aggravated because "current graduates are being attracted to other sectors to which their degree is irrelevant". The financial services sector recruits many science and engineering graduates each year.

Incomes Data Services Report 5/2 (193 St John Street, London EC1V 4LS; by subscription).

EVENING STANDARD



Evening
Standard

MONDAY, 4 JANUARY, 1988

Profit-related ?

EMPLOYERS are staying away from profit-related pay in droves, because a series of tiresome and unnecessary restrictions imposed by the Inland Revenue make the system expensive and difficult to operate. Tying part of workers' earnings to the performance of their company helps them to share in their employers' commitment to success. Profit-related pay is, therefore, an objective which the Government ought to support. Yet after 26,000 copies of the guidelines on the scheme had been issued, only 146 companies had registered by the end of last October.

The Inland Revenue is internationally notorious for its arrogant and vicious mean-mindedness in tax matters. The Government should have brought it to heel years ago. Ministers have failed to act because their thirst for ever-higher public spending has predisposed them to ride along with the Revenue's often specious argument that any given tax exemption may turn out to be a massive tax leakage. The Government should learn to turn a deaf ear to the Revenue and should now be generous in giving tax relief both for profit-related pay and for employee share-ownership.

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Profit-linked pay scheme fails to score

Philip Bassett reports that few companies have taken to PRP

THE GOVERNMENT will next week spell out how extensive - or otherwise - have been companies' responses to its proposals for linking pay directly to profits by means of its profit-related pay scheme.

But in advance of a speech on profit-related pay by Mr Peter Brooke, the Paymaster General, indications of the take-up of the scheme do not look too helpful to the Government's wider PRP ambitions for pay and the labour market.

Latest figures from the Treasury show an enormous gap between people interested in PRP - more than 35,000 inquiries for the Inland Revenue's voluminous and complex guidelines on the operation of PRP schemes - and those actually putting it into place. In all, 243 schemes have been registered, of which 146 have so far been approved. Mr Brooke is expected to give current figures next week.

"It must be very disappointing for the Government," says Mr Laurie Brennan, of New Eridge Street Consultants, a company which has promulgated PRP and is advising companies on its implementation - so far with absolutely no take-up at all.

The Treasury claims otherwise: PRP, it says, was always a "long-term plan." While Incomes Data Services, the pay research company, says settlements this month and in April may show

the impact of some PRP schemes, other analysts say most companies have gone ahead with planning and bargaining for this pay round, and the earliest any PRP deals will start to emerge will be towards the end of this year.

Mr Brennan predicts an increase in take-up, but thinks the number of schemes may still rise only to 300-400 by then. "It will be a question for the Government of keeping its nerve over PRP, and saying the scheme will work next year."

Companies are clearly being cautious: IDS says that of 50 concerns which expressed a strong interest in PRP last year, only two had registered a scheme by December.

An important reason is that for many companies, PRP schemes do not fit easily with their present remuneration arrangements. "It's quite baffling to dovetail PRP within an existing framework for pay," says Mr David Reid, a tax partner with Clifford Chance, the commercial law firm. (He has nonetheless helped submit three or four schemes to the Revenue for approval.)

"The first question you get asked is: how do you operate all these arrangements at the same time. And the answer is - with

difficulty." For instance, Boots, the pharmaceutical company, actively considered a PRP scheme when the proposals were first introduced. But with separate profit-based bonus schemes for staff and management, and a staff share ownership scheme, it found it impossible to integrate these with PRP. The company now feels that PRP as it now stands is not flexible enough.

The point is echoed by another company, TI Desford Tubes, the Leicestershire-based maker of hollow machining members for components. It says the Revenue's application of PRP is "extremely restrictive", and that the Revenue's Cumbernauld PRP advice office was not able to help tailor PRP schemes to fit individual companies' requirements.

For TI Desford, pure profit as a base for calculating PRP is a virtually worthless idea, taking no account of such factors as exchange rates or different markets. The company thinks profit on sales should be the determinant.

Mr David Beevers, a TI Desford director, says: "Our belief is that the Government will have to change the scheme. We are not unique in not liking it."

But though examples of PRP schemes are hard to find - the Revenue is unwilling to disclose them, though it may be forced to do so under MPs questioning - they do exist. However, most seem to apply to small companies which conduct little or no collective bargaining.

Hay MSL, the management consultant, introduced a Revenue-approved PRP scheme last October and it made its first, interim, payment of 2½ per cent just before Christmas to the company's 200-odd employees. Final payments of 10 per cent are forecast if the company meets its profit targets for this year.

Mr Cliff Waite, a Hay consultant, says the scheme was introduced to take advantage of the offered tax benefits, and because it had an "important educative value" in demonstrating the value of profits to pay and, ultimately, employment.

Perhaps more significantly, because of its size and its long history of profit-sharing, the retail John Lewis Partnership is actively considering introducing a PRP scheme. Mr Peter Lewis, the company's chairman, told its worker-partner employees recently that the company hoped to introduce a scheme by 1991. Ironically, though, the main reason is to try to use the PRP tax benefits to recover tax lost when the Government withdrew tax exemptions from established profit-sharing schemes.

A SLOW START FOR PROFIT-RELATED PAY

By the end of October, 146 companies had registered profit-related pay schemes with the Inland Revenue. A further 97 applications had been received but, for various reasons, had not been approved. October was likely to have been a relatively busy month for registrations as a large number of companies have financial years which begin in January, and any later application might not be in time for operation from January 1988. Given that the Inland Revenue received over 26,000 requests for copies of their guidelines on PRP, it would appear that the response from companies to the final details of the scheme had been less than overwhelming.

This is borne out by our own research. Of over 50 companies contacted by IDS which expressed a strong interest in introducing PRP (or converting existing profit-sharing arrangements to take advantage of the tax benefits) last year, only two had got as far as registering a scheme by the beginning of December. Some had not been able to formulate schemes in time to take effect from January 1988, and a couple found they were not eligible. Several still plan to introduce schemes this year. But a large number have either abandoned plans for introducing PRP or shelved them indefinitely.

Although the principle of PRP seems attractive, the practice of meeting the Inland Revenue's strictures has deterred many organisations. Few have abandoned PRP altogether, but, as one company put it, 'we shall wait till the scheme is more flexible, or more attractive, or both'. Companies which have abandoned their plans for the time being include Boots (who announced early in 1987 that they were considering a scheme - see IDS Report 495, p.3), British Airways, TI Desford, Cooking & Drury, the TSB, the Mansfield Brewery, and MBS Plc. Among companies which have faced difficulties with the schemes four main objections were raised:

- 'Pure' profit can be a poor indicator of a company's performance and an even poorer indicator of employees' efforts. There are particular problems defining profit in transnational companies.
- Companies which operate ADST or other share schemes have said that they created greater, and more long-term, employee identification with the company.

However, it seems that it is not possible to run such a share scheme from PRP payments, and most companies do not seem willing to replace a share scheme with PRP or introduce PRP 'on top'.

- Other restrictions in the scheme caused problems - in particular the provision that, if profits remain the same in the first year, there should be a minimum pay-out of five per cent. This apparently unavoidable cost has deterred many companies who had hoped to introduce self-financing schemes.

- Because of the complexity of the scheme the costs and time expended in setting up and administering PRP can outweigh the 'minimal' benefits to employees. This is particularly the case for companies which employ a large number of relatively low paid workers; although the tax benefits in companies with, for example, a small number of relatively well-paid staff (such as Hay Consultants - see IDS Report 509, p.2) are greater.

'Pure Profit'

TI Desford Tubes has not proceeded with an application having found that the Inland Revenue insisted that the only indicator of performance which could be used in a scheme was the absolute level of profit. No account could be taken of other issues in the company's performance such as sales or capital employed. The company felt that absolute level of profit as the sole basis of incentive was not a good idea.

Other companies also wished to take other factors of performance into account in determining profit but were refused clearance by the Inland Revenue. A subsidiary of a Swiss company wanted to exclude the impact of exchange rate fluctuations from its profit calculation but was told by its accountants that it could not. It also wished to exclude the management fees charged by its parent company from the calculation, as these were totally unrelated to the performance of UK employees. Again they were denied. The company's personnel director described the scheme as an 'accountants charter'.

A number of companies with existing profit sharing schemes object to the loss of the discretion they currently enjoy, when

determining the amount of profit to make available for distribution, which would result from them converting their existing schemes into PRP schemes. In addition, those with mixed cash/ADST or share/ADST schemes felt that converting their schemes into PRP could adversely affect some employees. The problem for companies which give employees the option of having the shares held in trust to completely avoid income tax is that the tax-break involved in PRP is much smaller.

One investment management company intends to make a 'token' application for a scheme to operate in 1988. It already operates a mixed cash/ADST scheme and feels that conversion to PRP could leave a substantial minority of staff worse off. It intends to wait and see what the likely pay-out would be and then choose whether or not to implement the PRP scheme.

But once a company is registered, this approach could face problems. There is a legal obligation under the Act for registered employers to operate their scheme according to its rules. It is difficult to see what sanctions the Inland Revenue could apply in these circumstances beyond withdrawing approval from the scheme. However, the legal obligation on companies to implement their schemes could make PRP arrangements an 'implied term' of employees' contracts, thereby opening the company up to legal action from unions and/or individual employees. This is an important contrast with many existing profit-sharing arrangements which are discretionary.

Costs

One of the reasons cited by some companies, such as the TSB, for not going ahead with PRP is the requirement that if profits remain unaltered between the base year and first year of operation a minimum bonus of 5 per cent must be paid. Others have found that trade unions have been unwilling to accept PRP bonus payments as part of existing earnings. They are demanding that such bonuses are in addition to current pay. However, a number of companies are negotiating the introduction of PRP bonuses as part of this year's pay award. Many organisations, including British Airways, found that the restrictive and complex scheme rules added considerably to the cost and time that would be spent in drawing up and administering schemes.

The process was not made any easier when substantial changes were made to the original proposals issued by the Chancellor. This has resulted in some companies opting-out of the scheme for their 1988/89 financial years. Others have decided

that the link between establishing a scheme in November/December 1987 and the declaration of a bonus in April 1989 is too remote to act as a motivator and have therefore decided to stick with their existing bonus systems.

A small paper processing company, employing 250 people, has introduced a PRP scheme to run alongside an existing cash-based profit-sharing scheme. The company's profit-sharing scheme has proved very effective, but employees were ineligible for tax relief. A deferred share trust scheme could not be introduced as the company is a wholly owned subsidiary of an American company.

Following the announcement of the government's PRP proposals the company's employees, who are not unionised, made it clear that they would like to benefit from the tax concessions and the company felt it had little choice but to devise a scheme to meet the rules. However, the company had found it difficult to create a scheme which remains within the government's rules. It has adopted method A to determine the profits pool and will distribute bonus payments to employees on a quarterly basis, but believes it has had to adopt fairly artificial means to achieve a PRP scheme.

At this stage, any general conclusions about the number of companies that will introduce PRP must be tentative. A fuller picture is likely to emerge in April - the most common date for the start of companies' financial years. By then, firms will have had sufficient opportunities to digest and conform with the Inland Revenue's rules in time to get a scheme registered. Many 'missed the boat', for January 1988 start-ups. At present, however, it seems likely that a large number of companies have decided not to go ahead for the time being. A few have lobbied for a relaxation of the rules in this year's Budget.

Perhaps even more importantly, most of the companies that intend to push ahead with their plans seem to be doing so just for the tax benefit. Any consideration that it will make pay and/or employment more flexible is, to say the least, secondary. Many admit that PRP will have no such effect.

Again, drawing conclusions about the type of company that is able to introduce PRP must be tentative at this stage. However, from our researches a large number are small and often do not have collective bargaining. The benefits tend to be greatest in companies where employees' earnings, and hence the tax benefits, are relatively high.

CONFIDENTIAL

prp



FROM: J M G TAYLOR
DATE: 7 January 1988

PS/PAYMASTER GENERAL

PRP

We had a word about seeking Treasury views on whether the "Revenue restrictions" complaints about PRP have much substance. You are pursuing this.

2. The Chancellor has mentioned that he understands that a particularly irksome requirement is that the profits of the unit to which a PRP scheme applies must be audited.

JTG

J M G TAYLOR

17/2917

Papers psc

FROM: SIR ANTHONY WILSON

DATE: 7 January 1988

PAYMASTER GENERAL

pp

cc PS/Chancellor *12/2*
PS/Chief Secretary
PS/Financial Secretary
Mr Monck
Mr R I G Allen
Mr J MacAuslan
Mr Wynn-Owen
Mr Inglis

Mr Isaac
Mr Lewis
Mr Cherry
Mr Easton
Mr Miller
Mr Bush
Mr Farmer
Mr O'Hare
Mr Fraser
Mr Simpson
Mr Annys
PS/IR

Mr Cropper
Mr Tyrie
Mr Call

PROFIT RELATED PAY: ANNUAL RETURN

You asked for comments on the submission dated 5 January 1988(7) from Mr O'Hare in relation to the content of the report to be signed by independent accountants as part of the PRP Scheme Annual Return.

2. The independent accountant is required as a result of the wording of paragraph 19(2) of Schedule 1 to the Finance (No.2) Act 1987, to report in "true and fair" terms on the profit and loss account of an "employment unit". However, paragraph 19(5) states that "notwithstanding the preceding provisions of this paragraph," (ie including the requirement that the profit and loss account must give a true and fair view), the scheme may provide for adjustments to the Companies Act Schedule 4 content. Section 12 of Part 1 of the Finance (No.2) Act 1987 contains the requirement for "a report by an independent accountant in such form and containing such

information as the Board (of Inland Revenue) may prescribe, and stating that in his opinion the terms of the scheme have been complied with in respect of the profit period".

3. Some accountants feel that there is a problem for them in reporting on/ ^{the} adjusted profit of a PRP employment unit in "true and fair view" terms because of the adjustments permitted to the full accounts of a company drawn up in accordance with Companies Act Schedule 4 requirements, which also have to show a true and fair view. The Auditing Practices Committee of the accounting profession has issued its formal views on reports by accountants on documents which do not constitute a complete set of financial statements in the following terms:


"Because the information on which the accountant is reporting does not constitute a complete set of financial statements on a comprehensive basis of accounting, it will not be possible for the accountant to report in "true and fair view" terms. Consequently it will generally be appropriate for the accountant to express an opinion in terms such as "fairly stated" or "properly prepared".

4. The problem for most PRP enterprises will probably focus on the allocation of group management charges and dissection of the accounts of larger units into the figures relevant to the smaller PRP unit. Such adjustments are part of the techniques widely used by accountants in practice and I do not think they should have much difficulty in using them effectively when drawing up PRP accounts in accordance with the Act.

5. Audit reports are expressed as showing "a true and fair view", rather than "the true and fair view", and it is necessary in making such reports to identify the accounting policies under which the accounts have been prepared and the purposes for which they have been prepared in order to provide the framework within which the accounts are set. I do not think, therefore, that independent accountants would face technical

difficulties in giving a "true and fair view" opinion on PRP accounts drawn up with different accounting policies and for different purposes from the main Companies Act statutory accounts merely because the latter are also required to attract a "true and fair view" audit opinion. This is because the independent accountant's report in Part 5 of the PRP Annual Return already sets out the basis on which the accounts have been prepared and their purpose.

6. Nevertheless, I think it would be helpful to the general campaign to clarify what is really meant by audits as distinct from other reports by accountants if the professional representations on this score could be taken into account and the phrase at the end of the second line of clause 1 of the independent accountants' report, "...and gives a true and fair view on that basis", could be replaced by "...and presents fairly on that basis". It would be unhelpful to the promotion of PRP schemes if the accountants were to hedge them round with technical difficulties such as that now raised when the solution suggested above seems (a) to comply with statutory requirements and (b) still gives the Inland Revenue the assurances they quite rightly require.



A WILSON



Inland Revenue

pmj

Policy Division
Somerset House

FROM: J ANNYS
DATE: 8 January 1988

PS/PAYMASTER GENERAL

PRP : REPORTS ON TAKE-UP

1. The figures for the end of December are now available and are attached.
2. Table A gives details of registrations and Table B gives some statistical details. The estimates given in Table B are prepared in the same way as the October figures and are subject to the same caveats described in paragraph 3 of Mr Farmer's note of 17 November.

J. Annys

J ANNYS

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Monck
Mr Culpin
Mr R Allen
Mr J MacAuslan
Mr Wynn Owen
Mr RILEY.

Mr Isaac
Mr Beighton
Mr Lewis
Mr Bush
Mr Eason
Mr Farmer
Mr O'Hare
Miss McFarlane
Ms Dougharty
Mr Simpson
Mr Fraser
Mr Annys
PS/IR

TABLE A

Applications for registration of PRP Schemes

	Number of applications for registration	Number of applications rejected	Number of applications subject to outstanding queries	Numbers of applications not yet considered	Number of schemes registered
<u>1987</u>					
31 October	243	22	75	0	146
30 November	363	49	74	8	232
31 December	575	78	65	2	430

TABLE B

Profit-related pay:	As at 31 October	As at 30 November	As at 31 December
Total number of registered schemes	145	232	430
Total employee participants	26411	42560	71827
Estimated average earnings of employee participants (£ pa)	13055	13043	13572
Distribution of PRP annually			
- number of schemes	58	85	137
- number of employee participants	7006	8752	17336
Distribution of PRP more frequent than annually			
- number of schemes	87	147	293
- number of employee participants	19405	33808	54491
Method A - number of schemes	89	146	285
Method B - number of schemes	56	86	145
Estimated amount of initial PRP (£m)	26	43	71
Estimated amount of initial PRP as a percentage of participants pay	7 ¹ / ₂	7 ¹ / ₂	7 ¹ / ₂

From: Nigel Forman.

8th January 1988.

To: Chancellor.

Ch,
If you are content, we'll circulate
this to the briefers.

Dinner with Sir Hector Laing.

25/1
Nigel Forman

1. You asked me to do a brief memo on the more interesting points which arose at the dinner with Sir Hector Laing and his business colleagues on 6th January.
2. All the businessmen present were agreed that they knew of no change in the investment plans of their firms or competitors since Black Monday. They made it clear that such decisions have to be robust over a longer time-scale, since their lead-times are typically at least three years.
3. Hector Laing and Archibald Forster were both concerned that we might be putting insufficient public investment into space research, although the latter was dubious about the amount of money going to high energy particle physics, e.g. CERN.
4. Mike Angus of Unilever gave some positive figures for payroll giving in his firm (20% of all employees) and use of the SAYE scheme (35% of all employees). However, he was concerned about the Inland Revenue rules on Profit Related Pay, especially that which insisted upon an "auditable entity". He thought something simpler was required to encourage firms to use the scheme at the level of operating units.

FMF

gmp

FROM: N MONCK

DATE: 11 January 1988

TMA
5 Jan 25 12/11

PAYMASTER GENERAL

- cc Chancellor
- Chief Secretary
- Financial Secretary
- Economic Secretary
- Sir P Middleton
- Sir A Wilson
- Mr Scholar
- Mr Burgner
- Mr C W Kelly
- Mr Odling-Smee
- Mr R I G Allen
- Mr MacAuslan
- Mr Wynn Owen
- Mr Guy
- Mr Corry
- Mr Cropper

Oh / This is the immediate follow up to your request. The PMG is holding a meeting with officials on this tomorrow p.m.

I think he PRM had your while to have a chat ASAP with Mike Angus, Chairman of Un?uk.

PRP

You asked for Treasury comments on take-up and current criticisms. This note reflects exchanges with others in the Treasury who are or have been involved in PRP.

2. We have always regarded PRP as a long term initiative with great uncertainty both about the initial and the ultimate level of take-up. It is certainly too early to reach gloomy conclusions and in any case the number of schemes registered (430 at the end of December 1987 against 146 at the end of October 1987*) compare well with figures in the early days of the employee share schemes, particularly since PRP schemes, unlike FA78 schemes, have to be registered in advance of the first profit year for which tax relief is given. Annex A gives figures in the first twelve month periods for the 1978 profit sharing scheme and the 1980 SAYE scheme. The number of registered schemes shows that the terms cannot be all that onerous and can presumably be managed by small firms since the average number of employees per scheme is about 170. The signals to employees from PRP should be stronger the smaller the number of participants per scheme. I do not think we should be apologetic about the fact that the total numbers of employees in schemes registered by the end of 1987 is little more than 70,000.

* The latest Inland Revenue figures are reproduced at Annex B for convenience.

3. A more sensible time to attempt some sort of quantitative judgement would be when figures for registered schemes up to the end of 1988 and 1988/89 are available. (We should remember, however, that the continuing NIC exemption for trusts established before April 1985 will not end until April 1990. Some big employers eg John Lewis will delay PRP registrations until after that.)

4. Much of the criticism of the present scheme is to my mind unimpressive and directed at rules or procedures which look justifiable in terms either of the rationale of the tax relief or of having a defensible scheme.

5. Of course most businessmen do not understand and certainly do not accept the part of the rationale for the PRP tax relief that is based on pay flexibility and direct employment effects. The more popular part is based on employee involvement to which Ministers have given at least equal emphasis, arguing that it can bring improved effort and performance. Many critics think that any incentive scheme should qualify for tax relief, even if it is subjective. The recent letter of 6 January from Brent Chemicals to you is fairly typical:

"We would like to suggest a more practical scheme ... so that an employer would certify that a particular person participates in a performance related bonus and has achieved a certain reward under this scheme, some of which would then be tax free."

This approach is often associated with the argument that pay should not vary with profits because profits are influenced by factors other than employee effort, such as the exchange rate. Of course a decline in profits due to a rise in the sterling exchange rate can threaten jobs at least as much as inadequate employee effort. The direct employment benefits part of the rationale may be even harder to sell now that unemployment has come down. But without pay flexibility the justification for tax relief would be weaker: we can reasonably expect employers to set up incentive schemes without tax relief, whereas some of the benefits of PRP accrue to society as a whole, strengthening the case for tax relief.

6. A good deal of criticism comes from potential deadweight employers who do not want to adjust their existing schemes. Ministers endorsed a robust line on this, which is now reflected in their replies (Mr Wynn Owen's submission of 6 November).

What can usefully be done from now on?

7. There are several kinds of action with different timing:

(a) some useful minor changes could be made this year, eg Mr Farmer's

suggestion about relaxing the need to re-register schemes after they have been changed, and Sir A Wilson's proposal on the wording of the accountants' report. You will be discussing these with us tomorrow;

- (b) for marketing reasons we should do everything possible to attract some large companies or large schemes, even if they are deadweight. We might discuss the latest news and the scope for any helpful action tomorrow;
- (c) the revision of the Revenue's Guidance Notes (PRP?) already planned will for the first time allow enough time to achieve improved presentation. This will help and the sooner it is available the better;
- (d) in time for the 1989 Finance Bill the Revenue and we should do what we can to judge which rules or procedures are putting employers off but are not justified by the rationale or at least are not clearly necessary. This may well include looking again at at least some of the variants we and the Revenue put forward earlier which had to be rejected for the sake of simplicity and economising in scarce drafting capacity. Unless you disagree, I suggest this work should assume that we are sticking to the pay flexibility/employment part of the rationale. To carry this forward, we could talk to outsiders such as accountants/consultants and some individual firms whose cases we learn about from letters (or from the CBI who are about to start discussions designed to lead to representations). We might also use the results of survey work which we are considering as part of normal evaluation of the scheme in preparation for a submission to you. Until we have done some work of this kind, bringing together both evidence of actual difficulty and some analysis of the merits, I don't think we can sensibly do more than minor changes, which I do not think will have a major effect.



N MONCK

SHARE SCHEMES - INITIAL TAKE-UP

	FA 1978 Profit Sharing Scheme		FA 1980 SAYE Scheme		FA 1984 Executive Scheme	
	Applications	Approvals	Applications	Approvals	Applications	Approvals
April	} 60	-	-	-	10	-
May		-	-	-	20	-
June		-	-	-	15	-
July		-	-	-	32	-
August		6	-	-	85	-
September		4	-	-	100	-
October		10	-	-	98	4
November		7	-	3	109	13
December		6	-	4	438	15
January		11	-	3	61	29
February		13	2	18	62	51
March		23	1	20	95	90
TOTAL	96	3	82	22	1125	202

TABLE B

Profit-related pay:	As at 31 October	As at 30 November	As at 31 December
Total number of registered schemes	145	232	430
Total employee participants	26411	42560	71827
Estimated average earnings of employee participants (£ pa) *	13055	13043	13572
Distribution of PRP annually			
- number of schemes	58	85	137
- number of employee participants	7006	8752	17336
Distribution of PRP more frequent than annually			
- number of schemes	87	147	293
- number of employee participants	19405	33808	54491
Method A - number of schemes	89	146	285
Method B - number of schemes	56	86	145
Estimated amount of initial PRP (£m)	26	43	71
Estimated amount of initial PRP as a percentage of participants pay	7 ¹ / ₂	7 ¹ / ₂	7 ¹ / ₂

* The figures in this row may be compared with figures for April 1987. Average earnings (men and women, manuals and non-manuals) for the whole economy then were about £10,400. The PRP average was somewhere between the upper quartile (£12,350) and the upper decile (£17,050).

29649/87



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

Lord Wyatt of Weeford
Horserace Totalisator Board
Tote House
74 Upper Richmond Road
LONDON
SW15 2SU

11 January 1988

John

Thank you for your letter of 10 December. I am sorry that you have not received an earlier reply.

In my letter to you of 21 April 1986, I expressed my interest in your experiences with PRP. I did not comment on whether or not Tote employees would be eligible for tax relief. Indeed I could not have done so, as our ideas were then only at a formative stage. We had not started to draw up the details of the legislation. The pre-election Finance Bill, which was published on 23 March 1987, contained clauses excluding certain employers, including the Tote.

I appreciate the difficulty you face because of your assurance to your employees on 8 June. But, as I said in my letter to you of 27 November, I or my officials would have been glad to respond to a request to explain the details of the legislation to you.

Although your employees are not eligible for tax relief, I am sure that they will, like you, continue to recognise the benefits that profit-sharing can bring.

Nigel Lawson

NIGEL LAWSON

CHEX
L. WYATT
11/1

BUDGET CONFIDENTIAL



FROM: S P JUDGE
DATE: 13 JANUARY 1988

MR FARMER - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Sir Anthony Wilson
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling-Smee
Miss Sinclair
Mr MacAuslan
Mr Riley
Mr Wynn Owen
Mr Jenkins - OPC
PS/Inland Revenue
Mr Isaac - IR

Handwritten in red ink:
A. Wilson, M
off at @ W
Papers

PRP: AMENDMENTS TO LEGISLATION (STARTER No 110)

The Paymaster General discussed this yesterday with Sir A Wilson, Mr Monck, Mr MacAuslan and Mr Wynn Owen; Mr Jenkins and Mr Davies (OPC); and Mr Miller, Mr Fraser and you from the Revenue. **Papers:** your note of 23 December; Mr Isaac of 6 January and Mr Monck of 11 January on general strategy; Mr Annys of 8 January (on take-up); and (on the annual return) Mr O'Hare of 5 January and Sir A Wilson of 7 January.

Handwritten in black ink:
not attached

2. The following decisions were taken:
 - i. the annual return would require accountants to certify that the relevant accounts provided a "true and fair" estimate of the unit's profit or loss, rather than "fairly stating" them. Mr Miller thought that, given the present low level of understanding in the profession of terms like "fairly stated", the Revenue needed the stronger form in order to be able to satisfy the NAO;
 - ii. it would not be appropriate to proceed with the proposed simplification of the profit and loss requirement (section (vi) of Annex D to your note) until it was clear what modifications DTI were going to make to the audit requirements for small businesses;

iii. no further work should be done on the "purpose of PRP" clause - paragraphs 11-14 of your note. The Paymaster could foresee a lively debate in the House on Counsel's latest draft clause (attached) - which could also put legitimate companies off;

iv. there should not be any PRP clauses in this year's Finance Bill. The Paymaster was attracted to waiting until 1989, when we would have 15 months experience of how the legislation worked. This decision was reinforced by the pressures on Finance Bill space and Counsel's time. He hoped that the four sole traders at present registered would survive for another year (your Annex B);

v. it might be necessary to look again at the position on insurance companies (your paragraphs 8-9). Your solicitors were prepared to mount a test case if a company tried to use the Schedule 9 definition, but were not over-confident of winning. If they did not, legislation would be needed to clarify the position one way or the other. The Paymaster thought it would not be desirable to have to legislate only on this point this year: a slightly larger package would then be sensible. (Mr Jenkins thought the Annex C proposals (on minor changes to schemes) could be dealt with by a power enabling the Revenue to make regulations. This should be relatively simple to draft, although the Government might be pressed to say in Committee whether the changes envisaged in paragraph 6 were to be made symmetrical or not); and

vi. you would look further at the question of issuing a statement of policy on the Revenue's discretion over deregistration.

3. Turning to the more strategic issues, the Paymaster was grateful for the notes from Mr Isaac and Mr Monck. On the proposals in paragraphs 7 b-d of the latter, the following decisions were taken:


i. it would be useful to have a list of "household names" with PRP schemes, for use in public (with their permission). The moment to use it would be when a single scheme with

more than, say, 10,000 employees was registered;

ii. it would be sensible to revise the PRP guidance notes: Mr Monck hoped the new edition could issue in late summer, rather than early autumn; and

iii. IAE would put advice to the Paymaster over the next few months on identifying which rules were causing companies problems whilst not helping to secure the Government's objectives. The Paymaster would in any case like a meeting around the end of June on this.

4. Finally, Mr Monck expressed his slight concern about the high average pay of those registered for PRP schemes (his Annex B). He accepted the Paymaster's point that PRP might end up being introduced at the top, and then spread downwards. It was pointed out that the allocation of employees to full- and part-time categories was crucially important. I would be grateful if IAE, in consultation with you, could consider whether any more robust statistics can be produced, and provide - in response to the Paymaster's query - an estimate of the pay bill of employees in PRP schemes consistent with the revenue cost of £50 million in 1988-89 shown in the 1987 FSBR.



S P JUDGE
Private Secretary

DRAFT CLAUSES/SCHEDULES

of s. 7 Finance Act

Profit-related pay

1.—(1) In section 175(1) of the Taxes Act 1988 (applications for registration of profit-related pay schemes) after paragraph (b) there shall be inserted—

Relationship
with other pay
[emoluments].
[j1101]

5 “(bb) shall contain a declaration by the applicant that no term
of the scheme, and no written or oral agreement or arrangement
other than the scheme, makes provision designed to secure that
the pay [emoluments] (apart from profit-related pay) payable to
10 any of the employees to whom the scheme relates will vary to
compensate (in whole or in part) for any fluctuations in profit-
related pay or for any differences between its actual and
forecast [projected] levels”.

(2) In section 178(1) of that Act (cancellation of registration) after
paragraph (c) there shall be inserted—

of s. 10 Finance Act

15 “(cc) that the scheme, or any other agreement or arrangement,
makes in relation to any profit period provision of a kind
mentioned in section 175(1)(bb) above, or”.

(3) This section shall have effect in relation to applications for
20 registration made on or after [], and in relation to schemes registered
on such applications.



FROM: S P JUDGE
DATE: 14 January 1988

MR FARMER - IR

cc PS/Chancellor
Mr Monck
Mr MacAuslan
Mr Wynn Owen
PS/Inland Revenue

PROFIT-RELATED PAY: MEETING WITH MIKE ANGUS OF UNILEVER

I attach extracts from:

- a note from Nigel Forman MP, the Chancellor's PPS, reporting on a dinner he had attended; and
- the note of Post-Prayers yesterday.

The Paymaster will probably want to see Mr Angus. But before setting this up, he would first like an urgent reminder on the audit issue. I would be grateful for something by close tomorrow, if at all possible.

S P JUDGE
Private Secretary

Profit Related Pay

[POST PRAYERS]

The Paymaster General said he was in favour of waiting until we had more experience before making a decision on legislative changes needed to PRP. Research could then be undertaken during the summer on what is getting in the way, and new guidance notes produced by the Inland Revenue in late summer/autumn. The Chancellor said that Mike Angus of Unilever believed that a significant barrier was posed by the Inland Revenue's requirement that PRP could only apply to an auditable entity. Even though the management information system of a company like Unilever could indicate the profitability of a subsidiary, they could not meet the Revenue's technically exacting requirements. It was possible that changes in this area would not require legislation. The Paymaster General would discuss this with Mr Angus.

NB

There was a more general compliance point, in that the Revenue did not want to police the scheme, mainly because of the staffing implications. The legislation is thus framed so that the burden of compliance falls on participating companies and their auditors.

A large company setting up such a scheme would provide useful publicity. However, large companies had the alternative of employee share schemes, so PRP had special advantages for smaller companies. The average unit registered to date had 170 employees.

[FORMAN]

4. Mike Angus of Unilever gave some positive figures for payroll giving in his firm (20% of all employees) and use of the SAYE scheme (35% of all employees). However, he was concerned about the Inland Revenue rules on Profit Related Pay, especially that which insisted upon an "auditable entity". He thought something simpler was required to encourage firms to use the scheme at the level of operating units.

X



Inland Revenue

Policy Division
Somerset House

FROM: I FRASER
15 January 1988

Paymaster General

PROFIT-RELATED PAY: MEETING WITH MIKE ANGUS (UNILEVER)

1. You asked for a reminder of the audit issue to which Mr Angus has apparently referred.

Legislative requirements

2. The PRP legislation requires that a profit and loss account be prepared in accordance with the requirements (Schedule 4 Companies Act 1985) laid down for companies and that this must give a true and fair view of the profit of the employment unit. The basic profit measure, by which PRP is to be calculated, is the profit on ordinary activities after taxation, but a number of adjustments to this basic measure are permitted such as tax, interest receivable, interest payable, goodwill etc.

3. A company's statutory accounts must bear an auditor's report which must confirm that they give a true and fair view of the state of affairs and the profit of the company. To do this the auditor must have audited the books of the company.

cc PS/Chancellor of the Exchequer ←
Mr Monck
Mr MacAuslan
Mr Wynn Owen

Mr Isaac
Mr Lewis
Mr Beighton
Mr G Miller
Mr Farmer
Mr O'Hare
Mr Fraser
Mr Annys
PS/IR

4. Where the PRP employment unit chosen is a whole discrete company (or a whole group of companies) it should be possible to use the statutory Companies Act accounts for PRP purposes. Where however the employment unit is:

- a. a subsidiary of a group which produces consolidated accounts;
- b. a partnership or other unincorporated business; or
- c. a sub-unit of a company or other business, a profit

and loss account on Schedule 4 lines will probably have to be specially prepared for PRP purposes.

Why audited profits?

5. The July 1986 Green Paper (eg para A40) made it clear that "audited profit figures matching the employment unit" would be required. If PRP is to be credible its basic element, the measure of profit used, must be reliable and present a true picture of the prosperity of the unit chosen. Even if the Revenue were more involved in the day-to-day operation of PRP, there would still need to be an independently audited profit. When calculating the taxable profit of companies the Revenue may require adjustments to be made to the accounts profit figure, but they will not normally question the adequacy of the audit. At the time of the Green Paper representations were made about the need for audited figures in the case of sub-units, but these were directed more to the likely compliance cost than that to the practicality of such a requirement. We have always recognised that there would be additional compliance costs associated with the choice of a sub-unit as the employment unit for PRP, but our advice is that these costs would be largely the frictional costs of initially setting up accounts for the base period and first profit period, the costs in subsequent years being much less significant. Any such costs are deductible for tax purposes by the employer. Permitting employers, if they wish, to have PRP schemes for

sub-units has always been, for policy reasons, an important flexibility Ministers wanted to offer. That some employers decide against such an option on compliance cost grounds should not lead to an abandonment of what are considered to be minimum auditing requirements.

UNILEVER

6. Unilever are reported (post Prayers note) as being unable "to meet the Revenue's technically exacting requirements, even though their management information system ... could indicate the profitability of a subsidiary". We find this difficult to accept. On the contrary we would have expected a company like Unilever to have a management information system which, compared with the systems of smaller groups, would enable them to construct the necessary accounts more easily and at less expense. The Revenue Guidance Notes (a copy of the paragraph 6.55 is annexed) point out the need for sub-unit accounts to reflect transactions between the sub-unit and the rest of the business. We are not aware of any claims that this is impossible.

7. Mr Forman's note of Mr Angus' views may indicate that Unilever feel that the use of existing management accounts for sub-units should be accepted for purposes of calculating PRP. This would not be adequate for two main reasons:

a. whilst management accounts may give a good indication of the performance and productivity of the sub-unit (depending on the precise measures required by individual managers for control purposes), they do not necessarily give a true indication of the profits of the business and its ability to employ, because a variety of critical factors - particularly external ones - are very likely to be absent from such accounts;

b. there are no statutory guidelines on the composition of management accounts comparable to the clear and well understood (by accountants at least) requirements of the Companies Act for company accounts. It is of course entirely a matter for managers' discretion what measures of performance they require for control purposes.

The permitted adjustments from profit on ordinary activities after tax should be of particular value in constructing an account for a sub-unit. Certainly any change from the present requirement for audited accounts would require legislation; the matter concerns the statutory provisions rather than "the Inland Revenue's requirement".

I. Fraser

I FRASER

6.50 Employees who join or leave

6.50 No specific provision is made in the legislation for dealing with employees who join or leave during the course of a profit period. Employers have discretion in compiling the scheme rules about whether and how they provide for payments of PRP to be made to employees who join after a profit period starts or leave before it ends. If payments are made, the reduced limits on tax relief which apply to part-year payments will be relevant (see 2.5-2.9).

6.51-6.52 Timing of Payments

6.51 A scheme must include terms which cover the timing of profit-related payments to employees. Employers are free to decide what provision they wish to make. A scheme may provide for a single annual payment to be made only after the size of the distributable pool is known, say, within 31 days after the date on which the profit and loss account of the employment unit has been audited. Alternatively half-yearly, quarterly or monthly payments may be chosen. Employees may find a PRP scheme more attractive if they receive a profit-related element in their monthly or even weekly pay. Once determined and the scheme registered, the terms must be consistently applied. Where payments are made on an interim basis a final adjustment will be necessary when the actual profits for the period are known.

6.52 If interim payments are made and later it becomes clear that there is a loss in the accounting period, any tax relief given on the earlier payments would have to be recovered from the scheme employer (see 12.2-12.4). Employers may want to link interim payments to profit figures based on the employment unit's periodic interim internal accounts if they produce them.

6.53 Method of distribution

The terms of the scheme must determine the basis on which individual employees receive their PRP. All employees to whom a scheme relates must participate in the scheme on similar terms. This does not mean that each employee must receive precisely the same amount. Individual payments of PRP may vary to reflect length of service, the levels of remuneration or other similar factors. The terms of the scheme governing distribution should be clearly set out and consistently applied.

III PROFITS

6.54-6.61 Ascertainment of profits

6.54 Each scheme must provide for the preparation of a profit and loss account of the employment unit for each profit period or any other period for which the profits must be ascertained (the specified base year in a method A scheme or the twelve months immediately preceding the start of the scheme in a method B scheme). An employer will be expected to forward the profit and loss account of the employment unit with the annual return for that profit period.

6.55 Where the employment unit is a sub-unit of the business, it will be necessary to include in the profit and loss account figures relating to transactions between the sub unit and the rest of the business. A formal invoicing system to support those figures is not essential, but the independent accountant (see Chapter 8) must still be able to sign a report that the profit or loss is a "true and fair" one.

6.56 In all cases a profit and loss account prepared for the purposes of a registered PRP scheme should satisfy the requirements of Schedule 4 to the Companies Act 1985 in the same way as the profit and loss account of a company for a financial year. It will therefore show the profit or loss on ordinary activities after tax, which is the basis of the measure of profit for PRP purposes (but see 6.57). This provision is subject to an overriding requirement that the profit and loss account gives a true and fair view of the profit or loss of the employment unit. The obligation to produce a profit and loss account which satisfies the requirements applies equally to a business undertaking which is not a company for the purposes of the 1985 Companies Act, for example, a partnership or unincorporated business.

6.57 Employees with a material interest

6.57 In arriving at the profit or loss of an employment unit, no deduction may be made for the remuneration of any person employed in the unit who has a material interest in the company and who is excluded from the scheme (see 6.10 and Appendix C).

tote

HORSERACE TOTALISATOR BOARD

Tote House
74 Upper Richmond Road
London SW15 2SU
01-874 6411

From the Chairman:
Lord Wyatt of Weeford

BY HAND

Dear Nigel,

Profit Sharing

Your letter of 11th January. May I appeal to your sense of equity and justice.

Nowhere in the July 1986 Green Paper on profit related pay was there any suggestion that employees of the Tote would be excluded from any tax relief proposed. Nor was there any such suggestion in our correspondence of 1986.

The Inland Revenue press release of 8th April 1987, sent to the Tote, said on page 2,

" With certain specified exceptions (mainly employers in or under the control of Central or Local Government), employers may register a scheme for any profitable group, company or firm or for a profitable sub-unit of any of these."

The Tote is not under the control of central or local government and we could not possibly have guessed from the press release of the Inland Revenue that it was to be discriminated against in subsequent legislation.

You refer to the pre-election Finance Bill being published on 23rd March 1987. We do not have time here to read through all the provisions of Finance Bills and would have supposed that we had no cause for alarm in view of the Inland Revenue press release of the 8th April. If there was cause for alarm, in view of our correspondence on the subject, it surely should have been the responsibility of your officials to speak to us about it.

As you know, the Tote is not owned by the government, and it has never had any money whatever from the government but it has had a specific waiver from the Home Secretary, dated 5th September 1979, of any government liability for any debts which the Tote might incur. By a quirk of the 1928 Act which set the Tote up the appointment of the Board was left to the Home Secretary as being a suitable person to make the necessary choices but this does not in any way imply control by the Crown of the activities of the Tote and there never has been any such control. The Home Office has no statutory power to give directions to the Tote.

*1 share grant - 1/2
pmt wtd 1000 @
wsgm*

HM TREASURY	
DATE	26 JAN 1988
ACTION	MR MACANISAN
	25th January 1988 IASB
	CC PMG
PROVISION	25074/87 27270/87
	29649/87
	CHX
	1/1994/88

/ Contd.

WYATT
CHECK
25/1

25th January 1988

In good faith I informed our employees that they would be the beneficiaries of your long canvassed arrangements for tax relief on profit related pay. I had no reason to suppose that this commercial organisation, entirely separate from the government and not reliant on it in any way, was to be excluded. This would be regarded as extremely unfair by all Tote employees as the exclusion is clearly meant to cover state owned bodies which the government supplies money to and is financially liable for.

I would be extremely grateful if you would consider an amendment to the Finance Act of 1987 along the following lines:

At the end of section 6 a new sub-section (6):

This section shall not apply to any body which is a trading organisation and which does not receive and never has received any government funding and for which there is no statutory provision for it to receive any instructions from the Crown as to its conduct.

I am sure that you must see the fairness and justice of this as the Tote is on its own and always has been as a commercial organisation. In recent years by the enthusiasm of the staff the Tote has been raised from near bankruptcy to a solid and continuing profitability with greatly increased assets. One of the means used was and is our profit sharing scheme and I cannot believe you wish to discourage our employees from doing their best by this sudden selective swipe at them.

*Yours truly
Lawson*

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



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

2 February 1988

Colin Miller Esq
Private Secretary to the Home Secretary
50 Queen Anne's Gate
LONDON SW1H 9AT

Dear Colin,

PRIVATISATION OF THE TOTE

The Home Secretary and Mr Patten met the Chancellor and the Financial Secretary at No.11 Downing Street at 10.30 on 26 January.

The Home Secretary said that he was glad of the opportunity to discuss the Government's approach to the Tote. Lord Wyatt was keen on privatisation, but on his own terms. These could pose a number of problems for the Government. First, there was his insistence on retention of the Tote's statutory monopoly post-privatisation. Secondly, privatisation could put at risk the money currently ploughed back into racing by the Tote, and there would be a need to think further about the question of racing finance generally. Thirdly, it would be necessary to think about some form of consumer protection. Fourthly, there was an awkward decision about the allocation of the proceeds of privatisation: these had been estimated at around £60 million, admittedly pre-Black Monday, and Lord Wyatt would obviously argue for them to be ploughed back into the business. The Home Secretary said he thought it was necessary to consider whether Lord Wyatt's attitude meant that privatisation plans should be shelved for the moment.

The Chancellor said that although it would not be disastrous if the Tote could not be privatised in the immediate future, it looked odd to keep it in State ownership when it served no particular social purpose. The Chancellor thought the best course of action would be to appoint financial advisers to report on the options for privatisation - including privatisation with the monopoly intact, as this was not an unthinkable outcome. It would then be possible to assess whether there was an option acceptable to both the Government and Lord Wyatt. If there was not, privatisation could be shelved until the end of his current term.

MPG
Miller
2/2



The Financial Secretary agreed that privatisation with an intact monopoly was not unthinkable. He wondered if there was any way of preserving the Tote's obligation to contribute to horse racing post-privatisation. The Chancellor said that it would be worth putting this to Lord Wyatt as a quid pro quo for retention of the monopoly. The Home Secretary commented that he thought it made sense to go down the route indicated by the Chancellor.

It was agreed that the Treasury should compile a list of possible financial advisers, and the two Departments could then consider the field together. It was also agreed that, although Lord Wyatt should obviously be told, there would be no public announcement at this stage.

I am copying this letter to Richard Kornicki.

Yours,

Moir

MOIRA WALLACE



FROM: PAYMASTER GENERAL
DATE: 8 February 1988

CHANCELLOR

cc Financial Secretary
Sir Peter Middleton
Sir Anthony Wilson
Mr Monck
Mr Scholar
Mr Odling-Smee
Mr Culpin
Mr MacAuslan
Mr Wynn Owen
PS/Inland Revenue
Mr Farmer - IR

*Ch: Interesting. PMG proposed to
ask Sir A Wilson to look at the
"possible way through" in para 6 after
the discussions in para 7 have
taken place.*

8/2

PROFIT-RELATED PAY: MEETING WITH MIKE ANGUS

Following the remit from the 25 January overview, I had a very cordial meeting on Friday with Mike Angus, Chairman of Unilever, Mike Heron (Director UK and Europe) and Trevor Thomas (National Personnel Manager, UK).

2. Unilever stressed their strong commitment to our general ideas on pay flexibility. They did not themselves need the tax relief, but wanted to see the idea catch on. One of their UK subsidiaries had recently registered a PRP scheme, and this would enable them to gain some experience. Their view was that the unions were not pulling for PRP: management would need to push.

3. Mr Angus explained how Unilever's subsidiaries are required to produce frequent management accounts. These are used to motivate employees and communicate with them. Their unions were slowly becoming accustomed to the concept. Unilever's problem with the PRP legislation was not the audit requirement itself - their management accounts were anyway externally audited to a high standard - but the fact that the PRP legislation required accounts on the different, statutory, Schedule 4 basis. It was inconsistent to use management accounts to motivate and communicate, and statutory accounts to reward.

4. Mr Angus identified two features of their management accounts that their auditors, Coopers and Lybrand, said were inconsistent with the Schedule 4 requirement:

- i. their notional charge against profits for holding working capital; and
- ii. the valuation of assets (and hence depreciation) on a replacement rather than historic cost basis.

5. They accepted that a "common touchstone" definition of profit was needed, rather than letting people do whatever they liked. They understood why we had used Schedule 4, rather than setting out an entirely novel definition of profit for PRP purposes.

6. A possible way through, which I tentatively raised, would be to allow firms to use management accounts, provided that they conformed with a (new) code of accountancy practice. Mike Angus doubted that the accountancy industry could agree a code that could be applied to all businesses in a reasonable time. He accepted that, although Unilever's definition of profit was doubtless consistent with our general philosophy, others might manipulate rules looser than the present rules based on Schedule 4, and abuse the tax relief.

Future action

7. It would be a significant boost to PRP if a large part of Unilever's UK subsidiaries registered PRP schemes. I have therefore asked the Revenue, together with their accountancy advisers, to discuss with Unilever and Coopers the precise problems with reconciling their management and statutory accounts. (Officials' initial view is that the problems in paragraph 4 may turn out to be more imaginary than real.) It would of course be useful to straighten out any misconceptions that Coopers may have - after all they are learning about PRP just as much as everyone else is. The Revenue will report to me on these discussions.

8. I am afraid that, at this stage, we are still a long way from identifying what if any changes to the legislation in this area would greatly increase take-up without leaving unacceptable scope for abuse or weakening our original objective to relate pay to profit. I am sure that we will not be able to legislate before next year.

P.B.

PETER BROOKE

NM/12

cc: Paymaster General
Mr Monck
Mr Burgner
Mr Revolta
Miss Sinclair
Mr MacAuslan
Mr Brook
Mr Wynn Owen



Mrs Burnhams
Mr Flanagan
Mr Fray

11994/88

PS/IR
Mr J D Farmer IR
Mr J Annys IR

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

9 February 1988

The Lord Wyatt of Weeford
Chairman
Horserace Totalisator Board
Tote House
74 Upper Richmond Road
LONDON SW15 2SU

Thank you for your letter of 25 January.

As I said in my letter of 11 January, I appreciate the difficulty you face as a result of your letter of 8 June 1987 to your employees. But the Inland Revenue press release of 8 April 1987, part of which you quote in your letter, also noted that "employers will be responsible for ensuring that their schemes comply with the statutory requirements". As you pointed out, it also referred to "certain specified exceptions (mainly employers in or under the control of Central or Local Government)". In these circumstances, I am surprised you did not check at the time the "specified exceptions", as well as the other requirements in the legislation (published on the same day as the press release, not subsequently), and make further enquiries, as you ultimately did in September.

Neither the press release nor the legislation suggested that exclusions would be defined in terms of public subsidy. As the entire Board of the Tote is appointed by the Home Secretary on behalf of the Crown, it is reasonable for it to fall within the definition of the Crown control.

Having said that, I hope that you will understand that I cannot at this stage comment further on your request for an amendment to the PRP legislation, which I note as a Budget representation.

NIGEL LAWSON

CHES
L. WYATT
9/2

*1 Tank
2 py mp*



FROM: A C S ALLAN
DATE: 9 February 1988

PS/PAYMASTER GENERAL

cc Financial Secretary
Sir P Middleton
Sir A Wilson
Mr Monck
Mr Scholar
Mr Odling-Smee
Mr Culpin
Mr MacAuslan
Mr Wynn Owen

PS/IR
Mr Farmer - IR

PROFIT-RELATED PAY: MEETING WITH MIKE ANGUS

The Chancellor was grateful for the Paymaster General's minute of 8 February. He hopes a way through can be found.

ACSA

A C S ALLAN



→ Jonathan 26/2
FROM: S P JUDGE
DATE: 10 February 1988

MR FARMER - INLAND REVENUE

cc PS/Chancellor
Mr Monck
Mr MacAuslan
Mr Wynn Owen
PS/Inland Revenue

PROFIT-RELATED PAY: UNILEVER

As you know, the Chancellor has now seen the Paymaster General's minute of 8 February.

I would be grateful if a progress report on your discussions with Unilever could reach me by 26 February.

S P JUDGE
Private Secretary

FROM: M W N TOWERS
DATE: 17 FEBRUARY 1988

- 1. MR ALLEN
- 2. PAYMASTER GENERAL

cc

PPS - 12/2.
 PS/FST
 Mr Monck
 Mr MacAuslan
 Miss Sinclair
 Mr Bush
 Mr Wynn Owen
 Mr Farmer - IR (FAX)

*V. Atkins
 for a PRG
 that will be
 a success.*

*Ch - You may like to
 be aware of this unusual
 scheme.*

at 17/2

1 DCs

PRP: AN UNUSUAL SCHEME

I have received the attached letters from the public relations advisers of a small and apparently successful design company, Crighton Limited, who, with the assistance of Deloitte, have recently registered an unusual scheme.

2. The scheme is thought to be unique in that its UK employees have opted to reduce their basic salary in order to enjoy tax relief and, furthermore, have opted for a reduction of 20 per cent so as to receive maximum tax relief from the start of their scheme.

3. The PRP advisers have proposed that you might attend a reception at, say, noon on 24 March in Crighton's offices in New Oxford Street, to mark both the company's successful introduction of PRP and the receipt by their employees of the first additional payment under the scheme.

4. The media would of course be invited to the reception.

5. This could be a good opportunity to promote PRP at a useful time of the year - ie, between the Budget and your major speech on PRP on 12 April. The most natural thing for you to do at the reception would be to present the employees with their first PRP payments in a symbolic and photo-appelling way, and also say a few words on the merits of PRP. You might also be able to do

one or two radio interviews afterwards if we can drum up sufficient interest.

6. In addition, the words of your brief address could be incorporated into the press notice which Crighton intends to put out to coincide with the reception.

7. More generally, patting individual companies on the back in this high profile way would be useful in keeping the PRP option in the minds of potential 'customers'.

8. On the other hand you and officials may not wish to appear to endorse one particular company and one particular approach to PRP in this way. If that is so, I believe that giving Crighton a message for incorporation into its press notice would be a reasonable minimum.

9. Subject to what officials may advise, do you wish to attend the reception?

10. Or would you prefer to decline the reception but send the message for incorporation into the press notice?

N. TOWERS

NICK TOWERS

POINT TO POINT
COMMUNICATIONS

12th February 1988

Nicholas Towers Esq
Press Office
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Mr Towers

Further to my letter of 8th February 1988 regarding our client Crighton Limited and its introduction of PRP, we now have an outline of the planned 'celebration'.

Crighton propose to host a reception on the suggested date of Thursday, 24th March at their offices in New Oxford Street. We are flexible on this date if it proves inconvenient with the Treasury. Timing would ideally be 12.00 am.

To coincide with the reception Crighton will issue a press release announcing the introduction of PRP and giving general comments on its strategic objectives for the company.

The reception will mark the company's successful introduction of PRP. Also, employees receipt of their first additional payment under a new performance bonus scheme.

Crighton plans a lunchtime reception for senior members of the company to which its non-executive Directors will be invited together with interested media. Crighton would welcome the support of the Treasury at this reception through the presence of one of your Ministers.

On the evening of the 24th March, Crighton will hold a party for its staff to which journalists from the design press will be invited.

We have asked Crighton's designers to come up with an original way of marking the introduction of PRP - I have no doubt in their ability to come up with an original and highly photogenic idea.

Please do let me know if you need further detail and of course I hope very much you will be able to support the event.

Yours sincerely



Debbie Davies



POINT TO POINT
COMMUNICATIONS

Nicholas Towers Esq
Press Officer
H.M. Treasury
Parliament Street
London
SW1P 3AG

February 8th 1988

Dear Mr Towers

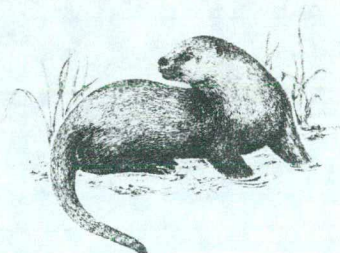
PROFIT-RELATED PAY (PRP)

Further to our conversation last Wednesday regarding Profit-Related pay, I can confirm that our client, Crighton Limited design consultants, has successfully communicated the benefits of PRP, to the extent that 100% of its UK employees have decided to reduce their current gross basic pay by 20%, so that each person may receive maximum tax relief. This 20% reduction is across the board even though employees earning more than £15,000 will be limited to relief on £3,000 of PRP.

The Inland Revenue and Crighton's technical adviser, Calvin Jackson of Deloittes, know of no other business where its employees have opted to reduce their basic salary by any amount, let alone 20%. We understand that none of the other 429 businesses who registered by 31st December 1987 are implementing PRP in the purest form intended by the Government. Rather, they are applying PRP to future increases in base salary or to bonuses available to all staff.

The radical approach adopted by Crighton (and its 70 employees) is consistent with its enlightened attitude to its staff and resultant business success. Crighton started in September 1984 with £1/4 million of venture capital, much of it from the Prudential. This in itself was a first for the design industry, especially as the company had no clients, due to the founders then recent overseas experience.

Crighton has, during a period of rapid growth (enhanced by government policies) for the UK's commercial design industry, doubled its turnover each year, opened an office in Oslo to serve the important Scandanavian market and achieved excellent export growth and profits in 1987.



Marketing and Public Relations Consultants

Commerce House, 6 London Street, London W2 1HR

Telephone 01 258 0253 Fax 01 723 2462 Vat Registration No. 437 1496 39

Point to Point Communications is a fellow of The Otter Trust


Crighton's ability to attract the best people and retain and motivate them is key to its success. It believes that PRP is an important element in this process. The Crighton PRP scheme started on January 1st 1988 and the first tax relief payment was made with January salaries. Other important remuneration and benefit programmes include (some subject to company performance): highly competitive salaries, share options at par value (1p) for all staff, individual merit awards up to 25% of total salary (and PRP) for all staff and a contracted out money purchase pension scheme as soon as Government rules allow it.

Crighton is keen to publicise, with Deloitte's assistance, its introduction of the best form of PRP. To add weight to its publicity and drive Crighton would very much like to invite a senior Government Minister to take part in its announcement, at its West End offices.

Crighton believes that the take up of PRP, either incremental or through salary reduction, can only be enhanced by its own example and therefore sees benefit from publicity for the Government as well as itself.

I would, therefore, very much appreciate your contribution to publicising Crighton's initiative in reducing salaries and I look forward to hearing from you shortly.

Yours sincerely


Debbie Davies



Inland Revenue

Policy Division
Somerset House

FROM: J D FARMER
DATE: 18 February 1988

PS/PAYMASTER GENERAL

PRP : AN UNUSUAL SCHEME

1. Receipt of my copy of Mr Tower's note of 17 February prompted me immediately to endeavour to establish the nature and circumstances of the Crighton Ltd PRP scheme said to have been registered. This seemed an obvious precaution if the Paymaster General was to consider participating in publicity for and celebrations of the operation of this particular scheme.
2. Information received urgently from the PRPO then indicated that it could be unwise to pursue the suggestion made, and you therefore agreed following conversations with Mr Towers and myself last night to await further advice.
3. Our principal reservation centres on the possibility that Crighton Ltd, doubtless with very close assistance from Deloitte, appear to have found a way of taking advantage of their own particular circumstances to provide their employees with maximum PRP tax relief for virtually no risk. Their method is complex, depending not only on a 20 per cent conversion of existing pay to PRP, a high Method A fixed percentage and a ceiling 'override', but also on an extremely high pay to profits ratio in the chosen base year. But though risk-free tax relief is not the purpose of PRP, the Crighton scheme appears at first blush quite legitimate.

c PPS
PS/Financial Secretary
Mr Monck
Mr R I G Allen
Mr MacAuslan
Miss Sinclair
Mr Towers
Mr Wynn-Owen

Mr Isaac
Mr Beighton
Mr Lewis
Mr Bush
Mr O'Hare
Mr Farmer
Mr Fraser
Mr Annys
Mr Simpson
PS/IR

4. We will now study this case more closely, and attempt to assess what sort and size of problem it may represent, with a view to reporting fully to Ministers as soon as possible.

5. There are other features of the Crighton case which suggest the need for caution:

- the 8 February letter attached to Mr Towers' note allege that the Revenue and Deloittes know of no other business which has introduced PRP by conversion of basic salary, "the purest form intended by Government". We do not know the basis for this statement. Certainly nothing contained in application forms for registration (PRP10s) enables the PRPO to draw any conclusions as to how scheme employers are financing the introduction of their schemes;
- Crighton Ltd has only 75 employees according to its PRP10 (70 to judge from the 8 February letter);
- according to its PRP10, Crighton's scheme provides for 'monthly or more frequent' PRP payments. The projected 24 March reception is intended, apparently, to mark not only the PRP scheme, but also "employees' receipt of their first additional payment under a new performance bonus scheme". We know nothing about the latter, but it seems to be nothing to do with PRP.

6. For all these reasons we suggest it would be undesirable for Ministers to attend or to lend their overt support in any way to the reception or press release planned on Crighton Ltd's behalf in March. It may be considered preferable that Mr Towers should decline the invitation contained in the letters he has received.

J D FARMER

UNCLASSIFIED



FROM: J M G TAYLOR
DATE: 18 February 1988

PS/PAYMASTER GENERAL

cc PPS
PS/Financial Secretary
Mr Monck
Mr R I G Allen
Mr MacAuslan
Miss Sinclair
Mr Bush
Mr Towers
Mr Wynn Owen
Mr Farmer - IR(FAX)

PRP: AN UNUSUAL SCHEME

The Chancellor has seen Mr Towers' minute of 17 February. He has commented that this is an interesting scheme, but that the Paymaster General will need to be circumspect.

J M G TAYLOR





FROM: S P JUDGE
DATE: 19 February 1988

MR TOWERS

cc PPS
PS/Financial Secretary
Mr Monck
Mr R I G Allen
Mr MacAuslan
Miss Sinclair
Mr Bush
Mr Wynn Owen
PS/Inland Revenue
Mr Farmer - IR

PRP: AN UNUSUAL SCHEME

The Paymaster General has seen your submission of 17 February, and the comments dated yesterday from the Chancellor and Mr Farmer.

2. He is content with Mr Farmer's advice to:
 - a. decline this invitation; and
 - b. await further advice from the Revenue on the general issue.

S P JUDGE
Private Secretary