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MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

PROFIT SHARING AND SHARE OPTIONS

Memorandum by the Chancellor of the Exchequer

Earlier discussions in the strategy exercise have stressed the importance of encouraging employee involvement with their company. We have a manifesto commitment to this effect. A report by officials which examines the possibilities is attached.

2. Officials recommend that relaxations be considered in three main areas:

(i) More generous rules. Under the 1978 legislation the maximum annual value of shares issued to an employee under a profit sharing scheme is limited to £500. The proposal is to increase this to £1,000. Employees would be able to dispose of their shares after two years, compared with the present five. Income tax would then be charged on a reducing basis with full relief after seven years from the date of issue, compared with the present ten.

(ii) Extending the 1978 provisions to cover share participation schemes. Where an employee purchases shares in his company, either at their full market value or at a discount, he would receive income tax relief on the value of his purchase.

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(iii) The re-introduction of 1973 share option provisions.
An employee would be given an option to purchase shares in his company at a stated price. He would participate in a savings scheme to finance the eventual purchase, and no income tax would be charged where the market price was higher than the purchase price. Under these arrangements an employee has nothing to lose. If he decides not to exercise his option the savings are still in his hands.

The report recommends against the re-introduction of the 1972 "Top Hat" share option arrangements which allowed highly paid staff to purchase shares in their company in the future, equivalent to the value of four times their annual salary. I am disposed to take a more favourable view, but in current circumstances their selective character would be bound to open us to damaging criticism. It would be better, for the moment, therefore, to take the line that senior management will be encouraged best by our policies on higher rate tax and what we hope to do on the capital taxes.

3. In principle I am in favour of the positive conclusions, but I am by no means sure whether we will have the financial resources to make these changes in a single Finance Bill. We may, therefore, have to settle for a staged approach. There is the need, of course, to accommodate the privatisation arrangements, but the 1978 profit sharing legislation already allows the issue of free shares to employees, either on a continuing or on a once-for-all basis, and that must be attractive to the employees of the industries involved.

4. In terms of priorities, the stages I have in mind are:

(i) More generous rules for profit sharing, as recommended by the Working Party.

(ii) Re-introduction of the 1973 share option arrangements.

(iii) The extension of the 1978 profit sharing provisions to include share participation schemes. This is likely to be some way off.

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5. In coming to these conclusions I have in mind the following points:

(i) These schemes could, in time, cost a great deal. Because of the financing prospects, I cannot commit myself, therefore, to any firm timetable for their implementation. The present scheme already costs £100 million a year. To do no more than make the rules more generous (paragraph 2(i)) would cost between £100 million and £200 million more. To cover share participation (paragraph 2(ii)) would be a further £200 to £300 million. And the 1973 share option scheme (paragraph 2(iii)) would cost yet another £100 million.

(ii) We have a big programme of tax changes in mind, including reform of the capital taxes and many other urgent matters. These are going to take up a good deal of Finance Bill space, and there is a limit to what I can include in any one Bill.

6. My next point is especially relevant to the share participation proposals and raises rather wider issues. The share participation proposals would contribute towards our aim to encourage wider share ownership. This is a matter which must be tackled on a wide front. We need to consider:

(i) the role of the stamp duties, and the high cost of purchasing small parcels of shares;

(ii) the future of the capital gains tax and the investment income surcharge;

(iii) the big question of our general approach to tax concessions on selected forms of savings - pensions and life assurance contributions, for example.

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(iv) Whether there is a case for introducing anything along the lines of the French Loi Monory, which provides income tax relief in respect of small-scale purchases of shares out of personal savings.

7. These matters form part of the strategy exercise, and are in any case already under review. My Treasury colleagues and I are well advanced in our examination of the capital taxes. The share participation proposals must be seen as part of these studies, since they all have the central characteristic of encouraging wider ownership of shares.

8. While I am entirely in favour of wider share ownership as part of privatisation, I think there should be some restriction on the extent to which we encourage employees to buy shares.

Recommendations

9. I invite my colleagues to agree that we approach these issues on the basis of the following order of priority:

(i) More generous rules governing the profit sharing provisions in the 1978 legislation, along the lines recommended by the report of officials.

(ii) The re-introduction of the 1973 provisions to cover share option schemes.

(iii) Consideration of the extension of the 1978 provisions to cover share participation schemes to be included as part of our general studies of wider share ownership.

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REPORT OF THE INTERDEPARTMENTAL GROUP ON FISCAL ASPECTS OF THE STRATEGY EXERCISE

PROFIT SHARING AND SHARE OPTIONS

SUMMARY

Introduction (paras 1-3)

This report examines the case for extending the 1978 profit sharing provisions and for reintroducing tax incentives for share option schemes.

Extending the 1978 legislation (paras 4-12)

The report argues that the extension of profit sharing should encourage wider share-ownership and greater employee participation - with beneficial effects on workplace relations between employer and employee. The report argues that the 1978 provisions should be made more generous, and should be extended to apply to public offers of shares, including those associated with the privatisation of nationalised industries. The cost depends on take-up, which is difficult to predict: a rough estimate might be up to £400m a year after a few years.

Share option schemes (paras 13-19)

The report recommends against the reintroduction of incentives for "top hat" share option schemes on the lines of legislation introduced in 1972 (paras 14 to 16). This would be politically controversial and could damage workplace relations.

However, the report recommends in favour of reintroducing provisions to encourage savings-linked share option schemes on the lines of legislation introduced in 1973. This would constitute a further incentive for employee participation, and should again facilitate the privatisation exercise. The additional cost of these provisions could eventually be £100m a year. But priority should be given to the extension of the 1978 legislation.

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PROFIT SHARING AND SHARE OPTIONS

Introduction

1. This is a report by an interdepartmental Group of officials - set up as part of the strategy exercise - to examine ways of providing further tax reliefs to encourage profit sharing and employee participation. Two further reports by the same Group cover a number of tax proposals directed towards investment in small firms.

2. The Group met under Treasury Chairmanship and included representatives from a wide range of Departments, the No.10 Policy Unit, the Central Policy Review Staff and the Bank of England.

3. The Group has considered in particular the possibility of:

(i) Extending the 1978 tax incentives for profit sharing.

(ii) Introducing new tax incentives for share option schemes on the lines of either the 1972 provisions (mainly limited to directors and senior executives) or the 1973 provisions (linked to SAYE contracts and open to more or less all employees in a company).

In the review, special attention was paid to the needs of privatisation. The objective was to devise schemes which may be used to facilitate the sale of shares to employees on the privatisation of various nationalised industries (the proposed arrangements for which vary from industry to industry).

Extending the 1978 legislation

4. The Government's Election Manifesto said: "we will expand and build on existing schemes for encouraging employee share ownership".

5. Limited incentives for profit sharing were introduced in 1978. The legislation provides that when the trustees of an approved profit sharing scheme allot shares to a participant, the usual income tax charge on the value of those shares does not apply. In particular, if the shares are held for 10 years, then no income tax is charged at all; while, if the shares are retained for between 5 and 10 years, the charge is tapered. The value of shares allotted to any one individual in any single tax year must not exceed £500.

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6. The case for improving the existing arrangements for employee share ownership is that it should encourage a wider take-up of shares, which, in turn, should lead to a closer identification of the interests of the workforce with those of their employing company - with beneficial effects for productivity and industrial relations. It should, in particular, improve the general workplace atmosphere and help minimise restrictive attitudes.

7. In practice, the achievement of these kinds of benefits may take time to come through. In a large firm, the actions of individual members of the workforce are likely to be too remote to affect the overall performance of the company - and in these circumstances it is difficult to see that the employee shareholder would have much incentive to improve his own work performance. Moreover, employee share schemes are not costless to the company; they have to be paid for somehow, either out of retained profits (which will affect company liquidity), or by increasing prices, or by the dilution of existing share ownership. Finally, it may be undesirable to encourage an employee to put all his eggs in one basket, tying up in one company both his job and his savings particularly where there is doubt about the future performance of the shares. These arguments point towards the advisability of avoiding over-generous concessions in this area.

8. At the same time, there is a case for broadening the existing incentives for employee share schemes, particularly by providing a wider choice of possible arrangements. The aim should be to have a number of schemes which together offer a range suitable for the differing circumstances of individual firms, and, at the same time, provide sufficient flexibility to cover cases where the nationalised industries are privatised. The recommended package would cater for 4 main approaches to profit sharing. In brief, the circumstances covered would be:

(a) The issue of free shares as part of a continuing profit sharing scheme. The value of the shares would not attract income tax.

(b) The issue of free shares to employees on privatisation (or on a once-for-all basis), with the same income tax concession.

(c) Purchase at the market price, but with income tax relief provided to the purchaser, related to the cost of the purchase.

(d) A preferential issue at a reduced price, combined with income tax relief on the purchase as in the previous case.

Categories (a) and (b) are covered by the present legislation, (c) and (d) are the extensions.

9. In each case, the shares would have to be retained in trust for a period. This could be rather less than the 5 years retention period under the 1978 legislation. On balance, the Group recommends:

(a) A ban on the sale of shares held for 2 years.

(b) An income tax charge on 100 per cent of the original value of the shares (or the sale proceeds if less) on sales in years 3 and 4.

(c) An income tax charge on 75 per cent, 50 per cent and 25 per cent of the original share values (or sale proceeds) for sales in years 5, 6 and 7 respectively.

(d) No income tax charge on shares sold after 7 years.

10. The Group also recommends that an overall limit should be placed on the value of shares qualifying for tax concessions in any one year. It is suggested that this limit should be set at £1,000 per annum (as compared with the present £500 limit under the 1978 legislation). Whilst it could be argued that this limit might be extended in certain circumstances - for example, for a once for all issue of shares on privatisation -it was generally felt that £1,000 was sufficiently generous and that no exceptions should be made.

11. Directors and higher paid employees are taxable under the 1976 Finance Act on the value of loans from employers at less than a commercial rate of interest. The acquisition of shares at an under-value, or of partly-paid shares, may also be treated as an interest-free loan for this purpose. The Group recommends that if the 1978 legislation is extended to give relief for share purchases, there should be comparable relief from tax on the benefit of such loans by employers to assist withthe purchase of shares.

12. The cost of these proposals would obviously depend on the limits set and the take-up, and is difficult to determine. But if the proposals prove attractive to companies and employees, they could after a few years involve revenue losses of £400m a year or more. This is a very rough estimate, based on the assumption that about five million employees are

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allotted £300 worth of shares each every year. This will be in addition to the cost of the 1978 provisions which could eventually reach £100m. The potential cost of the new proposals could be reduced by making the details of the scheme somewhat less generous.

Share option schemes

13. A rather more sophisticated method of encouraging employee share ownership is to give directors and employees an option to buy the company's shares at some future date at a price fixed at the time the option is granted.

14. The 1972 "top hat" provisions. Under provisions introduced in 1972 (and ended in 1974), fiscal incentives were provided for share option schemes designed to encourage the take-up of shares by directors and senior executives. Assuming the scheme satisfied certain conditions, there was no income tax liability (though there could be a Capital Gains Tax liability) on the difference between the market value of shares when acquired and the favourable price paid under the option. One of the conditions for the approval of such a scheme was that the options given to any one individual should not exceed four times his annual salary. The provisions meant that very generous tax reliefs -running into many thousands of pounds - could be available to participants.

15. The Secretary of State for Industry has suggested reviving the 1972 legislation or something near to it. His view is that, while much of the thrust of the Government's proposals for encouraging enterprise lies within the small firms field, it is no less important to ensure that existing medium sized and large firms make the most of the entrepreneurial talents within their organisation. The shift towards entrepreneurship within such firms and away from bureaucratic styles of management, could, he suggests, combine with existing market positions and manufacturing facilities to create a major source of innovation and enterprising activity. A share option scheme on the 1972 model would provide in effect an incentive to the relatively few people in a company who can individually affect its fortunes, and motivate them by a prospect of substantial capital accumulation. The scheme offers one of the few means available to achieve this kind of objective.

16. A scheme based on the 1972 legislation would raise some difficult presentational problems, even though the revenue cost would be likely to

be quite small. It would appear to run counter to the Government's general policy on perks and would be seen as directed to those who have benefited from the reductions in higher rate tax. The scheme would almost certainly be politically controversial, and would therefore undermine the improvement in workplace relations that is one of the main objectives of the extension of the profit sharing legislation discussed in the previous section. The Department of Industry would favour the introduction of such a scheme. The majority of the Group believes, on the other hand, that the scheme could well prove counter-productive, and therefore recommends against its reintroduction.

17. The 1973 SAYE provisions. Under provisions introduced in 1973 (and again ended in 1974), fiscal incentives were provided for share option schemes which were open to all full time employees in a company (so long as they were over 25 and had completed 5 years service). The feature of schemes set up under this legislation was that each participant had to save through an SAYE contract - of either 5 or 7 years. When the contract matured, the proceeds (savings plus terminal bonus) could be used to take up the share option, and income tax would not be chargeable on the difference between the market value of the shares when acquired and the favourable price paid under the option. There would be no income tax relief for the cost of the shares.

18. The Department of Trade regard the reintroduction of provisions on the lines of the 1973 legislation as a help to the privatisation programme. And the Group as a whole accepts that the reintroduction of these provisions would provide further encouragement for employee share ownership.

19. The Group recommends the introduction of tax incentives for share option schemes on the lines of the 1973 arrangements (in addition to the proposed amendments to the 1978 profit sharing legislation). However, if it is thought desirable to limit the overall amount of resources given to encouraging employee participation, priority should be given to extending the 1978 profit sharing legislation in the ways discussed earlier. The cost of reintroducing the 1973 provisions could eventually be £100m.

Recommendations

20. The Group recommends the following changes to the 1978 profit sharing legislation:

(i) An extension of the provisions to apply to (a) the issue of free

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shares as part of a continuing profit sharing scheme, (b) the issue of free shares to employees as part of the arrangements for any public issue of shares including those made on privatisation of nationalised industries, (c) purchase at the market price but with tax relief on the purchase, and (d) a preferential issue at a reduced price combined with income tax relief on the purchase.

(ii) A reduction in the period of time during which shares have to be held in trust and before which full income tax relief can be obtained. In particular, there should be a ban on sales of shares for two years, 100 per cent tax liability on shares sold in years 3 and 4, and 75 per cent, 50 per cent and 25 per cent tax liability on shares sold in years 5, 6 and 7 respectively. Thereafter, no income tax would be due on the sale of shares.

(iii) The limit on the annual take-up of shares under an approved scheme should be increased from £500 to £1,000.

21. The Group also recommends that the 1976 Finance Act be amended to exempt from tax the benefit of cheap loans made to assist with purchases of shares which would qualify for relief under the 1978 legislation if extended.

22. The Group also recommends, in principle, the introduction of provisions to encourage share option schemes linked to regular savings on the lines of the 1973 legislation. If there are problems of additional cost and legislative constraints, the Group recommends that priority be given to improving the 1978 scheme. Unless the 1973 scheme is introduced in April 1980, it may not be available for the privatisation exercise.

23. The majority of the Group recommends against the introduction of provisions to encourage share options for directors and senior executives on the lines of the 1972 legislation.

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