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CHANCELLOR OF THE EXCHEQUER

FROM: N MONCK  
DATE: 25 February 1986

cc	Chief Secretary	Mr Shaw
	Financial Secretary	Mr G M White
	Economic Secretary	Mr Gilhooly
	Minister of State	Mr Culpin
	Sir P Middleton	Miss Noble
	Sir T Burns	Mr Guy
	Mr F E R Butler	Mr Cropper
	Mr Byatt	Mr H J Davies
	Mr Kemp	Mr Lord
	Mr Burgner	
	Mr Scholar	Mr Isaac )
	Mr Odling-Smee	Mr Lewis ) I/Revenue
	Mr Monger	Mr Farmer )

**PROFIT SHARING**

... I attach a draft consultative document. It is in two main parts. The first gives a political and economic statement of the case for tax relief to stimulate profit sharing (paragraphs 1-12). The second, which would be in a slightly smaller type face, describes the scheme. A final version would have an Annex with a worked example of a profit sharing agreement with tax relief in action. But this is not ready yet. The first section is largely Mr Davies' work and the second section IAE's making use of a very helpful contribution from the Revenue.

The tone

2. The draft could be attacked for not being enthusiastic enough or, alternatively, for under-playing the practical difficulties. What we have tried to do, following what you have said after seeing Lord Young, Mr Channon and my minute of 17 February reporting their officials' reactions, is to draft a document which:

- (a) is sufficiently positive to get people interested and to score the "political plus" which Mr Channon expected; but
- (b) sufficiently cool to allow the Government to drop the scheme without severe embarrassment.

3. Although the draft needs much more work, it probably gives you a fair basis for judging the general impression that a document steering between these two

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requirements will give. But I think it is true that the draft does understate the practical complexities, though most pay systems are in fact appallingly complicated to the outsider.

Specific points on the draft

4. I draw your attention to paragraph 17 in which we introduce the option of phasing the 20 per cent conversion over two years. Douglas Smith in DE has commented that this new feature "might go some way to mitigate" the danger of an initial inflationary blip from unions bidding-up fixed pay to offset the downside risk from the scheme.

5. In the opening section we have under-played the distinction between existing employee share schemes, which are mostly a negligible element in total remuneration, and the new scheme, in order to meet your desire to present the latter as building on existing schemes.

6. In paragraph 24 we plump for giving tax relief up to a year before the employee's remuneration is affected by the profit sharing agreement. This increases the risk of abuse (see paragraph 22) but also increases the attractiveness of profit sharing agreements.

7. You may think the last paragraph is rather too definite about legislating in 1987 if the response to consultation is favourable. In a desire to be positive we have not qualified it with any proviso about availability of resources etc. Nor have we repeated the requirement in paragraph 1 that the take-up should be "sufficiently large and broadly based" which is code for enough factories to outweigh the city slickers.

8. We envisage that the profit-linked income would be subject to employees' national insurance contributions. This means that we have to decide whether to rule out profit sharing income coming through a trust, as with the John Lewis Partnership, from access to tax relief, if DHSS do not block the loophole in the present NIC regulations.

Questions for decision and next steps

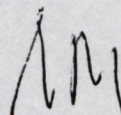
9. The first question is whether you want to pursue this proposal.

10. If you do, I recommend you to get Lord Young and Mr Channon to associate themselves with you. To do that, you will want to send them an improved version of the attached draft.



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11. The second question is what changes you want made in the draft.
12. You are also planning to consult Sir John Hoskyns.
13. At a later stage you will want to consider the handling of the proposal after a document has been issued. The possibilities include a discussion in NEDC and inspiring favourable Press articles etc.



N MONCK



**PROFIT SHARING: DRAFT CONSULTATIVE DOCUMENT****Introduction**

Profit-sharing brings considerable economic benefits. This paper explains the economic case for a further Government initiative to encourage expansion of arrangements for relating employees' income to profits, describes a possible scheme of tax relief which could promote profit-sharing on a voluntary basis, and invites comments, particularly on the likely take-up. If the response suggests that the take-up would be sufficiently large and broadly based, the Government will consider bringing forward legislation in the 1987 Finance Bill.

2. One way of linking income to profits is employee share ownership. This Government has taken a number of steps to encourage the growth of employee share ownership in the United Kingdom. The provisions in the 1978 Finance Act for employee share ownership were significantly relaxed in 1980. Tax relief for all employee Save As You Earn employee share option schemes was introduced in the Finance Act 1980, and in 1984 a discretionary share option scheme was brought in. Also throughout its period of office, in pursuing its policy of privatising state enterprises wherever possible, the Government has paid special attention to the desire of the workforce of those industries to own shares in them.

3. These policies have accelerated the spread of employee share ownership. Already more than a thousand all employee share schemes are in operation and a further 1300 FA 1984 share option schemes. More than a million employees have received shares or interests in shares in the companies in which they work - around 400,000 of them in the newly privatised companies.

4. It is clear from the success of these schemes that there is considerable enthusiasm among working people for a closer association with the companies in which they work. The growth of employee share ownership has been paralleled by an increase in the coverage of payments-by-results systems, and a very rapid expansion in the number of worker co-operatives, from some 300 in 1979 to more than 1,000 today. [After the passage of the 1986 Finance Act members of co-operatives will also be able to participate in employee share schemes.]

5. The Government recognises the importance of these developments. Closer identification of the interests of employees and employers serves to break down



the "them and us" mentality which has long been a damaging feature of industrial relations in the UK. Employee share ownership introduces a new element of flexibility into patterns of remuneration. It encourages employees to be more concerned about the long term future of the businesses in which they work, since part of their income is related to the long run profitability of the company's investment. As a result, employees will be more ready to raise productivity and to negotiate pay agreements which contribute to corporate growth. This, in turn, is likely to lead to higher investment and higher levels of employment.

6. Current trends suggest that employee share ownership will continue to expand in the existing fiscal and regulatory environment. But though the growth so far has been rapid - and the Government will continue to encourage such schemes - there are many companies and many areas of the economy in which little progress has been made. In part this may be because the existing forms of employee share ownership are not always applicable.

7. There is therefore a case for considering new initiatives to build on the success of existing schemes and to go beyond them. One such initiative would encourage the introduction of profit sharing schemes which did not depend on the issue of new shares, but which linked a significant proportion of total remuneration to the profitability of the employment unit.

### Profit Sharing

8. The economic case for profit sharing rests on what is a straightforward proposition. If a large number of employees convert a significant part of their remuneration from wages to a profit-linked income then output and employment are likely to be more stable and, on average over time, there is a higher level of economic activity. The economy as a whole will be more resistant to economic shocks, for example in a downturn some of the necessary adjustments could take the form of a small across the board reduction in profit-linked income, rather than redundancies and reductions in the size of the workforce. Adjustments, in other words, are more likely to take the form of changes in prices than of quantities\*.

9. At the level of the individual profit sharing firm, there will in general be a greater incentive to retain or take on labour. From the employer's

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\*The impact of profit sharing on output, investment, employment and competition has been discussed in a number of recent academic papers. [Annex B lists the principal references.]



perspective the short run marginal cost of employing an additional person is reduced. If the proportion of total profit available to the workforce is fixed, then employers will wish to take on additional employees as long as the value they add is higher than the non-profit-linked element of their remuneration. Since there should be an increase in the aggregate demand for labour, profit sharing does not in the long run imply any general reduction in employee incomes.

10. A large scale shift in patterns of remuneration from pure wage to wages and profit-linked income could, therefore, be beneficial to the economy as a whole. There are signs that many companies appreciate the benefits, in their enthusiasm to establish employee share ownership schemes. But some of the benefits of profit sharing go beyond the existing employers and employees of a particular firm. They accrue to the unemployed who may be taken on in the future, and to society as a whole which would benefit from a lower level of unemployment. There may therefore be a case for encouraging the spread of profit-sharing agreements by a tax concession to existing employees, lowering their average tax rate if they are prepared to convert a proportion of their existing remuneration to a share of profit.

11. When profits rise employees will benefit directly. But an individual employee converting a substantial proportion of current remuneration into profit-linked income undoubtedly faces the prospect of increased volatility in total remuneration. A reduction in tax, in the form of a percentage of total pay free of income tax would provide an inducement to workers to accept this volatility, giving higher net wages at current profit levels, and cushioning employees against the impact of a future fall in profit on take home pay.

12. The remainder of this paper outlines a scheme offering tax relief to participants in profit sharing agreements designed to deliver the benefits described above.



## A POSSIBLE SCHEME FOR TAX RELIEF

13 The precise form of profit sharing agreements is likely to vary from case to case. But if tax relief is to be granted certain minimum conditions would have to be met. The Government believes the following would be essential if the scheme were to yield savings:

- a. at the outset at least 20 per cent of pay must be linked to profit;
- b. at least 80 per cent of employees must be covered.

If these two principal conditions were met, then 10 per cent of total income could be tax-free, up to a maximum of £2,000 per employee. Other detailed conditions for qualification for tax relief are considered below.

14. Legislation would be needed to define the profit sharing agreements satisfying the criteria for tax relief. Existing arrangements which met the criteria would be eligible as well as new ones. Certain aspects would need to be precise. The legislation would have to strike a balance between the precision needed to attain the objectives and minimise abuse and the simplicity and flexibility needed to make the scheme workable.

15. The Government's provisional view is that the legislation would need to cover the following areas:

- a. the definition of employment unit to be covered by the profit sharing agreement and the minimum proportion of the workforce participating;
- b. the proportion of employees' remuneration to be converted to profit-linked income at the outset; the formulae for relating individual profit linked income to changes in profits; the measure of profits to be used, how frequently it should be recalculated, and how quickly changes in it should be reflected in profit-linked income;
- c. agreement by employees not to impede the taking on of extra labour;
- d. the duration of the agreement.



Each of these areas is discussed below.

#### The Employment Unit and Minimum Participation

16. An agreement could cover all the employees of a profit-making business, but the employment unit could be any identifiable group of employees for which a matching audited measure of profits is available. In practice it might not always be possible to achieve full participation because particular employees, or particular groups of employees, prefer not to participate. The introduction of such an agreement with less than 100 per cent employee participation is likely to be more complicated to operate because there would be two groups of employees with different pay arrangements and different interests. The introduction of such an arrangement would only be justified if a significant proportion of the employees decided to participate: it is suggested that the minimum limit of participation should be 80 per cent of the employees within the relevant employment unit.

#### Profit Linking

17. To get the benefit of tax relief on 10 per cent, at least 20 per cent, of total remuneration (including overtime and bonus payments) would need to be converted to profit linked income. This conversion could be made in a single move at the outset. Another possibility might be to include a year of transition. For example in the first year of any scheme tax relief might be available on five per cent of total remuneration if at least ten per cent of total remuneration were converted to profit linked income with agreement to a further ten per cent of income becoming profit linked in the second year, when tax relief would increase from 5 per cent to 10 per cent of total remuneration. After the initial period the proportion of total remuneration which was profit linked income would vary, reflecting changes to profits and the movement in the residual pay which would continue to be the subject of normal pay bargaining, but the proportion of total remuneration free of tax would remain the full 10 per cent.

18. The legislation would probably need to prescribe a standard formula for calculating changes in the aggregate profit linked income for the employment unit as a result of changes in profits. The distribution of the aggregate to each employee would be weekly or monthly in accordance with the normal pay arrangements, and would be pro rata to total non-profit linked income. Profit linked income for each individual would probably be fixed for a forthcoming profit-linked accounting period, and be recalculated to take account of changes in the workforce and the relative pay of individuals only when new profit figures were available. [A worked example will be appended]



19. The legislation would not need to prescribe a single definition of profits but there would need to be a requirement that the profit statement was certified by an independent qualified accountant as showing a "true and fair" picture of the results for the period calculated on a consistent basis for the purpose of comparing profits between successive periods. At the sub-company level this would require auditors to satisfy themselves that costs and revenues were fairly allocated between profit centres, and that fair transfer prices for goods and services within the company were used.

20. Agreements could differ about the frequency with which profit declarations were made. For the purposes of receiving tax relief new profit figures would have to be calculated at least annually. Some employers might make profit declarations for the purposes of the scheme every six months or more frequently to make profit linked income closely responsive to profits. Agreements would need to provide for a maximum period after the accounting period within which changes should be made in the profit linked income, in order to prevent either side deliberately delaying the provision and use of new profit figures when there was a sharp change in either direction in the level of profits.

#### Freedom to engage additional workers

21. One of the main purposes of profit-sharing in the longer term would be to increase the flexibility of the labour market by making labour costs more responsive to profitability. Employers should then be more willing to accept the risks associated with expanding the labour force. It would need to be part of any profit sharing agreement that employees participating and receiving the benefits of tax relief would undertake not to obstruct the employment of extra workers who would be allowed to join the profit sharing scheme.

#### Duration of agreements

22. The full benefits of profit-sharing would arise in the medium to longer term. Therefore the tax relief would only be available for profit sharing agreements intended to last for a minimum of three years. It would defeat the purpose if agreements could be broken at will by either side and mutual agreement to termination would be no guarantee against abuse of tax relief. However circumstances might arise in which it would be unreasonable or impossible to require an agreement to run its full course, for instance in the case of take-overs or amalgamations. Therefore there would be a need to allow break clauses in agreements which when activated would not prompt recovery of tax relief. The intention would be to allow reasonable commercial flexibility in the changing of agreements whilst ensuring so as far as possible that there were safeguards to prevent abuse. The earlier the tax relief became available the greater the risk of abuse.



### Other issues to be covered in agreements

23. Agreements would have to deal with other issues which might not be covered in legislation. For example agreements might contain provisions as to arbitration between employer and employee in cases of dispute. Employers would have to consider the implications of conversion to profit-linked income for incentives provided for promotion, overtime and shift working. They would need to assess the implications of profit linking for superannuation arrangements.

### Operation of Tax Relief

24. It is for decision whether the tax relief should take effect immediately an agreement is implemented - or only after the first remuneration dependent on profit-linked income becomes payable. As the tax relief is intended as an encouragement to an employee to enter into a profit sharing agreement there is a strong case that tax relief should be available from the date of implementation of a profit sharing agreement approved by the Inland Revenue. On the other hand, this would mean tax relief became available for up to a year before the employee's remuneration was affected by the terms of the agreement.

25. The aim would be to make the administration of the scheme as simple as possible to the employer. Tax relief would be given in the same way that relief is given to superannuation payments so that it would be reflected in the weekly or monthly take-home pay of participants. Employers would make returns to the Inland Revenue certifying the amount of relief awarded and the necessary records would be subject to audit checks, similar to those applicable to PAYE. The intention would be to streamline the approval procedure with as much guidance as possible being provided. An appeals procedure would be needed for disputes about entitlement to tax relief.

### Coverage

26. All employees including those in unincorporated businesses would be eligible to participate in qualifying agreements, with the exception of those employed in the public service and those employed in non-profit making organisations or others which do not produce profit and loss accounts. Special consideration would have to be given to the position of the trading public sector. Controlling directors and the self employed would not be eligible for tax relief under this scheme. In general, employers rather than employees would be liable to the Inland Revenue for repayment of sums falsely given in tax relief under profit-sharing agreements.



27. The initial direct revenue cost of the tax relief would depend upon the take-up. If ten per cent of taxable pay up to £2,000 per annum became free of income tax under a profit sharing agreement approved for the purpose by the Inland Revenue the cost to the Exchequer would be approximately £250 million per annum for every one million participating employees.

#### Conclusion

28. The legislation proposed would not in any way alter the existing freedoms of employers and employees to agree pay levels and pay systems in the normal process of collective bargaining, but if the pay system involved profit sharing by an agreement consistent with the proposed legislation income tax relief would become available.

29. Profit sharing offers benefits for employers, employees, potential employees and the economy as a whole. But these benefits will not be achieved unless a substantial number of employees are involved. Likely take-up will therefore be a key factor in the Government's decision on whether to proceed with legislation. If, taking account of reactions to this consultative document, the Government decide to go ahead, the intention would be to legislate in the 1987 Finance Bill.