BUDGET CONFIDENTIAL

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Dear Michael

SHARE INCENTIVES SCHEMES

Last summer George Copeman, of Copeman Paterson, wrote to the Prime Minister enclosing a paper on share incentive schemes. The Prime Minister expressed interest in his ideas and, following an exchange of correspondence between Tim Lankaster and Peter Cropper, it was agreed that officials would meet Dr Copeman.

As you know this meeting was held in September. It was attended by officials from the Treasury, Inland Revenue and Department of Employment. Professor Walters also attended. A record of the meeting is attached together with an assessment of Dr Copeman's main proposals.

In the run up to the budget the Chancellor has been examining various proposals in this area. He has considered Dr Copeman's ideas but does not find them attractive. There is no great pressure for them. He does, however, hope to be able to include in the budget some improvement and extension of the arrangements for employee share schemes. Following the measures introduced in the 1980 Finance Bill there has been an encouraging flow of new employee share schemes, with now over 380 schemes set up since the Government took office. The Chancellor feels it right to build on this success rather than introduce fundamental changes of the sort proposed by Dr Copeman.

The Chancellor is writing to the Chairman of the Stock Exchange about the possibility of some relaxation of their rules regarding these schemes. This picks up one of Dr Copeman's points.

Yours ever
Peter

P.S. JENKINS
Private Secretary

GEORGE COPEMAN : PROFIT SHARING

On September 16 Dr George Copeman and Professor Peter Moore gave a presentation on share incentive schemes. The audience included Professor Alan Walters from the Prime Minister's Office, a representative from the Department of Employment, three from the Inland Revenue and seven from the Treasury.

2. Dr Copeman argued that there was greater scope than was generally appreciated for profit sharing schemes ~~which~~ improved employees motivation. Such schemes benefitted employers and shareholders.

3. He saw a need for employees to identify more closely with their company - what he termed 'team enterprise'. He pointed out that only 3.8% of people in the UK directly owned shares. In these circumstances, it is not surprising if employers have little sense of community of interests with companies.

4. He went on to argue that, while wider share ownership was highly desirable, employees had to earn their share by increasing output and productivity. He had devised a scheme to achieve this.

5. On the basis of US evidence, he considered there was a roughly constant split between profits and wages in any industry. If employees could be pursuaded not to take out in wages their "normal" share of any increase in productivity, this would leave more cash for investment in the company. This investment would lead to further increases in productivity and so a virtuous cycle is set up.

6. Dr Copeman's scheme seeks to achieve this by rewarding employees in a mixture of cash and shares for increases in productivity. The element taken in shares represents the wage foregone to enable investment to be increased.

7. He noted that there was no guarantee that a bonus scheme of cash and shares would necessarily increase productivity. If there was no increase in productivity, no bonus was paid. The employees had to deliver before getting the bonus.

8. Dr Copeman gave evidence from the US to demonstrate a link between incentive schemes of this sort and improved company performance. He had introduced his scheme into a number of UK companies but it was too soon to draw firm conclusions about their effect.

9. Dr Copeman made a number of suggestions for Government action against certain obstructions to the widespread introduction of profit sharing schemes. These were :-

i) to end the need for shareholder approval of employee share schemes;

ii) to remove the £1,000 per annum limit on appropriation of tax-relieved shares;

iii) to bring back "vesting". Vesting makes the employees' ability to take up shares dependent on remaining with the firm for a specified number of years.

iv) to review corporation tax in the light of the role it can play in promoting individual employee capital accumulation and related objectives.

10. There have been considered by Treasury and Inland Revenue officials. Detailed comments are in the Annexes to this note. The main conclusions are :-

i) it does appear that the Stock Exchange rules are more restrictive than the Companies Act as regards employee share scheme (See Annex A). It is far from clear that this is actually inhibiting the introduction of schemes. It would be possible to prove the Stock Exchange on this matter if Ministers felt that would be desirable.

ii) this proposal is explored in Annex B. Ministers have been very wary of proposals of this sort which can be characterised as re-introducing substantial share benefits for top executives. The proposal would have significant staff requirements in Revenue to counter possible abuse.

iii) vesting is considered in Annex C. The key point is that "vesting" is already applicable under existing legislation. It is hard to see Dr Copeman's problem here.

iv) the proposals on corporation tax - see Annex D - are not being pressed hard by Dr Copeman. In general they amount to a subsidy for employee share schemes. The cost in terms of corporation tax foregone could be substantial.

11. On proposals (ii), (iii), (iv) above, ~~Copeman is~~ proposing a major structural change to the present framework of profit sharing shcemes. Profit-sharing is at the moment (perhaps surprisingly) bouyant. Inland Revenue are continuing to get a steady and encouraging stream of applications for approval of new schemes from companies. Given that the initial push occurred as long ago as 1978, the market is really holding up remarkably well, and this is something that the Government can rightly take plenty of credit for (the 1980 amendments to the profit sharing legislation look now to have been well judged). However, the system of tax relief for profit sharing is essentially a long-term exercise (invovling, as with share options, periods of up to seven years). Its continued success is likely to depend on companies' perception that it is continuing to keep a reasonably bi-partisan framework. The history of tax relief for employee share schemes in the 1970's has been a pretty scarred one, and companies who operate in this general are are going to look carefully at any changes to the legislation to see whether they are likely to make its general structure more or less long-lasting. Looking in the round at the radical change Copeman is proposing, above, firms may take the view that we are heading back into the "on-off" game that characterised the history of these schemes in the early 1970s and the flood tide of applications for approval of schemes may simply halt.

12. On the same sort of point, but at a slightly different level, Ministers are pressed from time to time to make approved profit sharing schemes more widely available (e.g. in the nationalised industries), but they are under no pressure at present from anywhere else to make the sort of structural change Copeman is proposing (no even to raise the £1000 limit). To implement Copeman's change would require considerable time and expense on the part of both the companies who run schemes and the Revenue. It should be borne in mind that we are still involved in negotiations with companies who are required to change the terms of their schemes by virture of the amendements to the Finance Act 1978 legislation introduced in Finance Act 1980. There is a lot to be said for a period of consolidation.

Shareholder approval for employee share schemes

As a condition of listing on the Stock Exchange, companies are required to undertake that they will have any employee share scheme, and any material improvement in an existing scheme, approved by shareholders in general meeting.

2. Dr Copeman considered this inhibits the introduction of share schemes as companies may not wish to call general meetings of shareholders, particularly companies who felt under threat of possible takeover.

3. This inhibition is far from self evident. A holder of 10% of the voting shares in a company can call an extra-ordinary general meeting at any time. A company must in any case hold an annual general meeting and this could be used to approve employees share schemes.

4. Having said that, it does appear that the Stock Exchange requirements in this matter are more demanding than the Companies Act. The 1980 Companies Act requires shareholder approval for issues of shares but there is no need for the company to specify the reason for the issue. As a result companies tend to seek authority from shareholders for an issue well ahead of expected need. When the issue is made, the Act requires it to be offered to existing shareholders. This rule does not apply to, inter alia, employee share schemes. This means that, under law, specific shareholder approval of an employee share scheme is not required. This can be taken as an indication of the value of Government places on such schemes.

5. It would be possible to probe the Stock Exchange on their more restrictive requirement. Ministers may consider this worth doing even if the effects of any change are unlikely to be substantial.

Removal of £1000 per annum limit on appropriations of tax-relieved shares

Dr Copeman's proposal is that the current statutory maximum of one thousand pounds' worth of shares in any year of assessment be replaced by a new maximum which would cover tax relief on both shares appropriated under an approved profit sharing scheme and other forms of capital accumulation, including payments to secure a pension. Share acquisitions under an approved scheme which exceeded a certain figure in a particular year would be reported to our Superannuation Funds Office. That Office would review individual cases on ensure that excessive tax relief for "capital accumulation" was not being obtained. After a certain time limit the employee could switch his share investment into index-linked savings certificates.

2. Dr Copeman sees this as encouraging job mobility. Employees lose pension rights by changing jobs. Employee share schemes offer such people an alternative way of building up capital for retirement.

3. The first - and probably the most important - point to be made about this is that in all likelihood it would be characterised in some quarters as a means of re-introducing substantial share benefits for top executives; it would very considerably widen the margin between the lowest and highest amounts of share appropriated to different employees within a single firm. This is a point on which Ministers have been up until now very wary.

4. Perhaps the second point to make is that these proposals seem to be a long way from the purpose which tax relief for superannuation is intended to serve. The principle of such relief was considered by the recent Treasury Working Group on Taxation and Savings. Their findings in effect endorsed the view taken at least since the Royal Commission on the Taxation of Profits and Income (1955). The Royal Commission identified superannuation relief as a form of spreading income which was not and could not feasibly be a form of relief generally available. Its justification lay in the fact that the man whose income is derived from retirement and the care of his dependants as a charge upon those earnings. So long as the spreading which is allowed by way of tax relief is controlled so as to serve this purpose only, they felt that superannuation relief was entitled to its place in the system.

5. The principal aim of Copeman's scheme, however it is dressed up, would be to encourage the employee to invest in his firm. In recent years an increasing amount of SFO's effort has been used in supervising the degree to which self-administered pension schemes invest in the company which has set them up, our concern being to ensure that contributions which have been given superannuaton relief should be invested for the purpose of producing pensions. It is not necessarily the case that self-investment is the best way of guranteeing that the administered pension schemes are allowed to invest up to 50% of the scheme monies in the employer's firm. If Copeman's suggestions were accepted it would be very difficult to insist on any limitation on self-investment by pension schemes.

6. Elaborate provisions would be necessary to ensure that tax relief intended for superannuation provision was not used for the member's earlier advantage. This could happen for example through the manipulation of share prices. Alternatively the employee might seek to use his share as a security for a loan. It is also worth noting that the pension benefits Copeman's proposals might ultimately produce would depend on the performance of the shares or the yield of the savings certificates. These could be considerably less than a pension linked to ⅔ final salary.

7. Copeman's proposals are not explained in enough detail to assess the additional workload which would be involved for SFO, but on almost any reckoning it could be a great deal. He may be under the impression that SFO keep an eye on individuals' tax relieved entitlements under approved pension schemes. They do not. Under the code, limits are imposed on the emerging benefits from approved schemes. Where the scheme is insured, SFO simply satisfy themselves at the outset that the funding is unlikely to produce excessive benefits. Self-administered schemes are required to send SFO periodic acturial reports which are examined for signs of over-funding. In contributory schemes the employee contribution is usually fixed and will be limited by the rules to 15% of remuneration. The employer pays whatever balance is required. The ongoing level of employee contributions during working life does not therefore involve any workload for SFO. In Copeman's scheme however the control would be on the input for every year in respect of which an employee received profit sharing bonus shares in excess of £500. Apparently SFO would be required to ascertain the employee's prospective maximum approvable pension on each occasion, and, after taking account of the emplo er's contributions, notify the employee of the tax relief available to him for that year. The Inspector would have to be notified about what proportion of the profit sharing appropriation, if any, would be liable to tax.

Very likely the sponsors would insist that the scheme, to be fully effective in securing its purpose, should allow carry forward of unused tax relief, thus necessitating the keeping of running records.

8. All this would be entirely new work, for which the scheme offers no corresponding staff savings. Those who would be most attracted by it would be those for whom further provision for retirement as such has a low priority but who would see in this type of scheme an opportunity of obtaining tax relief for personal investment. Even with limitations written into the legislation to prevent abuse, there would be no gurantee that these would be effective without considerable administrative effort. In terms of the staffing effect, this speaks for itself. Under the present system, policing of the profit-sharing share appropriation limit is a matter for companies and the turstees of share schemes. It is a simple enough operation to involve virtually no staffing resources.

ANNEX C

Bringing back "vesting"

1. Copeman proposes that the concept of "vesting" be introduced into the approved scheme legislation; the form suggested being that of share forfeiture if employment terminates before a certain period of service (5 years?) has been completed. His aim is to reassure companies that an employee will not leave and take his shares after only a short period of service.

2. The main point to make about this is that the general concept of "vesting" is already freely applicable under the legislation introduced in 1980 by this Government giving tax relief for savings-related share option schemes. Copeman's proposals focus on the profit-sharing legislation (the framework for which was set up in 1978), but it is perfectly possible for a firm to run both a profit-sharing and a share otpion scheme. If the firm wants to start giving a new employee a stake right from the start, without the risk of him absconding with his shares in a short period of time, this is possible under the share option legislation. The share option legislation is proving attractive to companies.

3. Even under profit sharing schemes, there is no bar to admitting employees new to the firm. (As a minimum, a scheme has to encompass all employees in the firm with more than five years' service, but that is only a minimum.) The reasons for a vesting provision advanced by Copeman seem to be relevant really only for small private companies. Such companies are laready able to achieve under profit-sharing schemes what Copeman is seeking by having a provision in their Articles requiring employees to serve a transfer notice on termination of employment.

4. Finally, Copeman implies that the introduction of vesting would be a simple matter - a new clause, with the basic rules remaining the same. This is not so. The current legislation is drawn in terms of the participant, subject to the terms of a contract between him and the <u>company</u>, being absolutely entitled to the shares held by the trustees from the time of appropriation. Vesting would alter that relationship to render the employee's interest contingent and this contingency would presumably extend to the cash and new shares, etc, resulting from capital reorganisations. Because of the trustees' increased interest in the shares the administration of the schemes would be more difficult rather than less.

Review corporation tax for the role it can play

Dr Copeman's specific proposals are :

(i) there should be a maximum percentage of taxable profits available for capital allowances and stock reliefs in any year; the balance should be taxed;

(ii) the tax scale should be graduated from 40% up to ay 64% according to the size of consolidated profits of the ultimate controlling company;

(iii) the specific, chargeable company should have relief of a few percentage points on the tax scale for each and any of the following :

(a) having a share quotation, thereby creating a market measure of share value and general access to the company's shares;

(b) having approved share scheme facilities, operated on a significant minimum scale (e.g. an average issue or purchase of no less than one-half of 1% of share capital per annum;

(c) acquiring at least half the employees' shares by purchase rather than new issue - as a guard against takeover bids;

(d) reducing the size of disclosure unit until it coincides with the pay determining unit.

2. It was clear from Dr Copeman's comments at the seminar that he regards these proposals as the icing on the cake.

3. His first proposal for a "maximum percentage" seems to be borne of expediency (it ensure that all companies have sufficient taxable capacity to make sue of the new tax reliefs which he goes on to propose). It does not have any obvious basis in principle. On what grounds of accountancy practice, equity or economic welfare would we base the rule that (say) a company that has invested £10m in machinery should get the same depreciation allowances as the company that (with the same equity capital) has invested £5m?

4. The proposal for a graduated rate of corporation tax has been considered already - and rejected - by Ministers. However, it is being looked at again in the forthcoming Green Paper.

5. Third, Copeman's four specific tax reliefs - for companies getting a market quotation etc etc - meet the familiar objections to any special tax privilege for matters which are unconnected with the company's own taxable capacity. They are, in effect, a deliberate Government subsidy, designed to induce companies to offer particular kinds of share incentive schemes. As such, they should in principle be tested for cost-effectiveness in the same rigorous way as proposals for additional public expenditure. On the fact of it, it seems possible to us that the corporation tax cost of the proposals - up to 12 points on the rate of tax - could in certain cases be equivalent to a very large proportion - if not the whole amount - of the cost of the share incentive scheme to the company.