TAXREP 11/99

Enterprise Management Incentives

Memorandum submitted to the Inland Revenue in April 1999 in response to a consultation paper issued in March 1999.

CONTENTS

ENTERPRISE MANAGEMENT INCENTIVES

Introduction

1. We welcome the opportunity to comment on the Technical Note published in March 1999 on a new scheme for Enterprise Management Incentives ('EMI').

2. We note that the proposed scheme is still in an early stage and the Technical Note raises many questions but does not provide many details of how such a scheme would operate. We trust that this does mean the scheme will be moulded by the full consultation process with all interested bodies as well as via the advisory group.

Summary response

3. At present, private companies find various ways to retain and motivate senior managers. This is often achieved by bonus arrangements but also with shares, where circumstances permit. We believe it would be better to allow companies to continue to choose their own methods of rewarding key staff rather than to force them into a regulatory straitjacket which would be accompanied with a lot more complex legislation along the lines of an Enterprise Investment Scheme (EIS).

4. The proposed new scheme appears to be little more than a gimmick that will do little to achieve its aim of encouraging high quality managers to move to and stay with small high risk companies.

5. We believe that if such assistance is needed for smaller companies it would be better to review section 77 onwards in the Finance Act 1988 and make it easier for companies to offer worthwhile employee share schemes rather than to go down the route of EMI.

General comments on the scheme

6. The Technical Note provides a very hazy and earlier draft of what an EMI might involve. However, we are not convinced that such a scheme can provide the incentives being suggested. Whether to take on high calibre, senior managers is fundamentally a commercial decision. Entrepreneurial smaller businesses require a level playing field and reduced red tape. A new scheme hedged in with complicated legislation and strict regulations will therefore not assist such companies.

Detailed comments on the Technical Note

7. Below are set out our comments on the EMI scheme as shown in the Technical Note. All paragraph references are to that Note.

8. Whilst we accept that a single definition for qualifying trading companies is helpful the effect of adopting the rules used for EIS and Venture Capital Trusts ('VCT'), as referred to in paragraph 2.3, is to exclude some information technology companies. We believe it is therefore a good opportunity to review the basic EIS and VCT definitions to cover such situations.

9. Paragraph 2.6 presupposes that there is a limit to the number of key individuals that a company needs to grow. This may be the case but why choose the figure 6? This seems an unnecessary limitation on the scheme and the reasoning is not substantiated in the Technical Note.

10. We do not think that the fact that a person has an existing equity interest should prevent him using the proposed new scheme but we believe there should be an overall limitation on the amount of shares that such an individual could hold. For example, if an overall limit of, say, 25% was set and an individual already held 10% of the equity, he could then qualify to take a further 15%.

11. Paragraph 3.3 sets out a number of value statements relating to the US experience. We would question whether the experience in the US is appropriate given the UK tax system, whether there is statistical evidence that backs up the assumptions made in the paragraph and whether this shows that EMI or its equivalent is capable of encouraging the 'entrepreneurial spirit'.

12. Paragraph 3.5 suggests that remuneration might include 'free or cheap shares'. We would recommend that before granting such shares the true cost of such a form of remuneration should be considered. For example, how will it impact on existing shareholders? Will they still be committed to a company that brings in managers from other companies and offers them free or cheap shares from the outset, before they have made any contribution to the company?

13. Paragraph 3.11 seems to add more cumbersome complexity to the scheme. We believe if the shares are themselves subject to performance conditions the effect will be the same.

14. Fixing a minimum time before the sale of shares as suggested in paragraph 3.12 could be a disincentive to an exit by way of trade sale if the company is successful within a short time. This would be distortive and contrary to the policy behind the proposal. One solution could be to set a longer overall period between awarding the equity remuneration and the individual being able to realise the value of the shares, but with a sliding scale of tax breaks. This would allow a less tax advantaged let-out at an earlier stage if required.

15. In relation to the nature of the tax relief and the intentions expressed in paragraph 4.2., we strongly believe that individuals should not be taxed at a point when they have not derived realisable value from shares in such a scheme.

Conclusion

16. We do not believe that the introduction of EMI will significantly add to the armoury of a entrepreneurial company.

17. We are happy to discuss further any of the points raised in this consultation document if required.

FL/AM/14-5-97
28.4.99