TAXREP 10/99

A NEW ALL-EMPLOYEE SHARE SCHEME

A Memorandum submitted to the Inland Revenue in April 1999 in response to a Technical Note and consultation issued in March 1999.

CONTENTS

A NEW ALL-EMPLOYEE SHARE SCHEME

Introduction

1. We welcome this opportunity to comment on the Inland Revenue's Technical Note setting out the proposals for a new share scheme. Our submitted response to the December 1998 Treasury Consultation Document on Employee Share Ownership contains many comments which are equally pertinent to the new scheme. It also contains many suggestions on how we believe share schemes can be improved and enhanced. Rather than repeat all the points again we have attached a copy of our initial representation which is referenced as TAXREP 2/99.

Summary Response

2. The New All-Employee Share Scheme being proposed is to be welcomed for providing an opportunity to take a close look at this area of tax. However, we believe the New Scheme is unlikely to have any greater impact than those schemes which are currently in existence. Our reasons are twofold:

   a) *The productivity objective is not attainable*

   It is doubtful to what extent most share schemes encourage employees to take a greater interest in the success of the business for which they work. Most employees regard the schemes as little more than a perk or some form of saving arrangement. Only in isolated examples do they lead to greater identification with the employer and that is usually because of good employment practices rather than the share schemes themselves.

   b) *The wish to significantly broaden share ownership is unlikely to be met*

   The new scheme does not appear to be attractive or feasible to companies other than quoted companies. There is still too little incentive to encourage entrepreneurs to offer an all-employee share scheme in smaller enterprises. The issues of control, marketability of shares, cost and complexity are not addressed in the New All-Employee Share Scheme and therefore it is unlikely to help meet the Chancellor of the Exchequer's stated desire to significantly broaden share ownership. We also note that the Technical Note in paragraph 1.9 states that 'another new scheme may be needed to help smaller and unlisted companies which lack a market in their shares'.

3. It is not yet clear if the New All-Employee Share Scheme is intended to replace the existing Inland Revenue approved share schemes or run in parallel with them. Another new scheme (and possibly two if the smaller enterprise share scheme proposal is taken up) will add to the complexity currently facing employers. Many employers already have an Approved Profit Sharing Scheme and/or a Save As You Earn Scheme and are very happy with them.

4. We therefore strongly recommend that the opportunity is taken in this consultation to merge the new scheme with the existing Approved Profit Sharing Scheme and Save As You Earn Scheme and to take on board the

problems affecting smaller enterprises. It may even be simpler to modify the existing schemes to allow a more flexible approach. This should lead to a simpler and less restrictive range of rules.

5. Furthermore it is unlikely that those employers who have not implemented share schemes to date will now to do so pending the introduction of new legislation. Consequently, we believe that it is very important to clarify at the earliest opportunity the fate of the existing approved schemes.

6. We believe that although the stated objectives of the share scheme are unattainable, the existence of such schemes does have a value and efforts should be made to enhance the present situation and to encourage their use by smaller enterprises. A key factor in the latter will be the identification of a non-contentious objective route to the appraisal of relevant valuations.

The Productivity Gap

7. The New All-Employee Share Scheme Technical Note mentions the intention to use the scheme to help bridge the ‘productivity gap’ in the UK in comparison with the United States, France and Germany. We believe that a share scheme alone is unlikely to assist in this area.

8. We have seen little evidence of employees becoming more committed to the success of the business they work in simply by receiving shares. Many are keen to simply convert the shares into cash at the first available opportunity or to use the schemes as a savings vehicle. We therefore do not believe that bridging the gap in productivity should be viewed as an attainable objective for share schemes nor should they be judged by this standard.

9. We believe increased productivity might better be achieved through some form of performance related pay.

Smaller enterprises

10. As referred to at some length in our earlier submission referenced as TAXREP 2/99 (see in particular paragraphs 10 to 16), we believe one of the major failings with all-employee share schemes is that they do not encourage entrepreneurs in smaller businesses to participate. The main problem areas are as follows:

a) Loss of control

The entrepreneur will be very reluctant to give up the equity in his or her business. This is especially because of the problem of valuing the company and the risk of giving away the equity at a very low price, thus depriving the entrepreneur of the fruits of his or her labour. There is the also the linked issue of losing the control of voting rights which might hinder the continued success of the business.

b) Marketability of shares

It is extremely difficult to value shares in unquoted companies. Any share offer will also be less attractive to employees because of the lack of an available market.

11. Neither of these issues are addressed in the Technical Note. We have made some suggestions as to potential solutions in our TAXREP 2/99 submission at paragraphs 17 to 32.

12. One suggestion is to permit employers to offer shares other than ordinary shares. The Technical Note does stipulate if there will be any restriction in this area. If there was the facility to offer shares other than ordinary shares there would still be an issue

The New Scheme

13. We believe the proposed new scheme with its three types of shares, each with their own tax rules, is excessively complicated. The workforce at which the scheme is aimed are unlikely to be able to understand the scheme properly and there is also the fear that any resulting legislation will be hedged with further complicating restrictions.

14. We welcome the intention to allow some flexibility into the share scheme with the use of Partnership Shares. However, the rules relating to Partnership Shares are very complex and this is likely to hinder their attractiveness.

15. Partnership Shares are the element of the scheme which is intended to introduce a ‘risk element’, believed by the Government to be fundamental to encouraging productivity. However, they are also the only element of the scheme that will attract a tax charge after 3 years if the shares are removed from the trust, as tax will be due on all or part of the pre-tax income which was allocated originally to buy those shares. This means that the scheme organisers and administrators will have to track the original sums used to buy the shares and each request to remove shares. They will also have to consider at each stage whether they are ‘readily convertible assets’ subject to National Insurance Contributions.

16. These rules are difficult to administer and apply to the only shares which are a true investment risk for the employee. We believe the risk involved should be offset by more favourable tax treatment.

17. In relation to the Partnership Shares, we note again that the employee is being asked to shoulder an investment risk. Will the employee share schemes be subject to regulation under the Financial Services Act? We would also like to be sure that if the scheme progresses that employees are made fully aware of their financial exposure and of the consequences of a fall as well as a rise in share prices. It may not be advisable to be persuading employees to invest their savings and livelihoods in the same investment.

18. A related issue is that the tax charge on employees arising from any share scheme should be clear to an employee, in order that they can self assess correctly. We

therefore believe this should be an inherent aspect of any share scheme.

19. More generally, it is not clear in the Technical Note how holding the scheme shares in trust will safeguard the interests of the employees. It appears that employees can dictate how and when the shares leave the trust which suggests it is little more than a bare trust.

20. It is also unclear whether there will be one master trust and whole series of sub-trusts or whether it is necessary to run a series of trusts. If there is a single composite trust and no sub-trust this would probably need to be discretionary. This leaves the issue of how the employee can have any rights.

Capital gains tax

21. The capital gains tax consequences for the employee are dealt with at paragraph 2.25 of the Technical Note. It is intended that the trust will also suffer a capital gain by reference to the increase in value from the date the shares were put into trust to the date they are taken out. If this is to be the case, we would like to know how the tax on any gain is to be funded given that there be no payment by the employee at that time.

22. Taper relief is another important issue. Almost certainly the shares will not constitute a business asset in the hands of the trustees and consequently taper relief would only apply once the shares have been held in the trust for three years. Moreover, the extent of taper relief would depend on the whim of employee choice as to when the shares are to be taken out of the trust.

23. In practice we believe it is doubtful whether there is any real capital gains advantage for the vast majority of employees for the same reasons as are given in paragraphs 3 and 7 of Annex 1 in the Technical Note.

Advisory Group

24. We welcome the introduction of an Advisory Group to assist in the debate on share schemes. It is not readily apparent from the Inland Revenue press release dated 30 March 1999 the extent of the representation from those involved in dealing with share schemes in small unquoted enterprises and we believe this is an area that requires particular attention. The Advisory Group does not seem to include any representatives of small businesses or firms of accountants who deal with such businesses. This reinforces our concern that even the Government does not think the scheme is suited to small organisations. In these circumstances we think it is important that once the Advisory Group produce recommendations, these are made available for public comment before being finalised.

Conclusion

25. In light of the above we recommend that any new scheme should not overlook the advantages of the existing Inland Revenue approved schemes. A modification of the existing arrangements could for example allow for a linkage between scheme shares and shares brought by the employees themselves (which can

already be done to some extent under the Approved Profit Scheme). These additional features could be optional so the employer could adopt them or not as he chose and tax relief for the cash invested by the employees themselves could be provided as a free-standing relief.

26. We are happy to discuss any of the points raised above further if required.

FCL/AM/14-5-97
28.4.99