

A SOCIAL CHARTER FOR OWNERSHIP



PETER YOUNG

EVERY WORKER AN OWNER



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Making employee participation a reality

Adam Smith Institute

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Making employee participation a reality

By

Peter Young

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2. EXECUTIVE SUMMARY

Wider share ownership has been a key goal of the current government. The privatization programme, combined with other incentives, has encouraged a huge increase in the percentage of Britons owning shares from a miserable 5 percent to well over 20 percent. However, this capital ownership is insufficiently deep, and largely limited to a small number of privatization shares. Greater efforts must be made to widen and deepen share ownership.

Government efforts to encourage employee share ownership have largely failed. Tax approved share schemes are too restrictive and have not been widely adopted. The ESOP legislation introduced in the 1989 budget has yet to be taken up by a single company. These poor results can be attributed to a reluctant, negative and ill-informed attitude on the part of the Inland Revenue and insufficient determination on the part of the government to entrench employee share ownership in our society.

At a time when Britain faces the danger of the imposition of a socialist model of mandatory worker participation in management through the European social charter, it is all the more important that the British model of real employee participation through capital ownership becomes a reality.

If employee share ownership on a large scale is to become more than wishful thinking, then several significant policy changes must be adopted in the next budget.

This will require the government and the Inland Revenue to look beyond theory to what the market is demanding, and to examine the practical reasons why companies are not taking up share ownership incentives. It is particularly worth noting that the private, unquoted companies simply have not adopted share schemes, even under extreme competitive pressure. The very real particular problems of the unquoted company need to be urgently addressed. The quoted companies have adopted tax approved schemes, but have signalled their desire for discretionary schemes by adopting twice as many executive schemes in half the time of the all-employee schemes.

This market message is not based on executive greed. Far from it, it is intrinsic to the risk nature of shares. Shares do have an important participative and communications facet, which make them appropriate for all employees. But that aspect should not obscure the basic fact that shares are risk investments. Financial risk is a commodity that individuals can accept only in proper proportion to their income and expenditure.

The basic economic fact is that the capacity to take financial risk increases at a faster rate than income. At lower income, the proportion of total income that must be spent on 'necessities' is much higher than at higher levels of income. It

follows that the higher paid can afford to put a higher percentage of their total income at risk, and should be encouraged to do so.

Yet the all-employee tax approved schemes have insisted on all participants having the same proportion of their salaries in the form of the risk benefit of shares. This creates resistance at lower pay levels to the benefit and yet does not create significant benefits for the higher paid. Schemes should reflect the increasing ability of executives to take financial risk; the "risk wedge" that higher income brings.

The private, unquoted company needs to create a safe and limited market in its shares before it can adopt employee share schemes. It therefore needs an ESOP trust (Employee Share Ownership trust). The 1989 legislation for ESOPs put them on the Government's agenda, but this legislation must be developed before tax approved ESOPs become attractive to the unquoted company.

The need is to free the approved ESOP to provide the full range of share benefits that the market wants, and not just the 'same percentage of pay' profit sharing share scheme that flies in the face of the "risk wedge". An approved ESOP trust should be allowed to supply up to 49% of its shares to executive share schemes, provided not less than 51% are supplied to all-employee schemes on a "similar terms" basis.

The unquoted company also needs a 'level playing field' in the form of roll-over of capital gains when the family sells to an ESOP trust in preference to selling for shares in a quoted company. Such tax relief is as likely to lead to a net increase in tax revenues, as low family valuations of shares are abandoned for more realistic commercial valuations for sales to the ESOP trust.

The drive for wider employee share ownership should be maintained by revising the two all-employee tax approved share schemes (profit sharing share scheme and savings related share option schemes) so that they can supply the range of share benefits that the market has demonstrated that it wants.

In particular, benefits in excess of the 'same percentage of pay' approach should be permitted, with tax deferral and capital gains tax treatment of the whole benefit, within such schemes provided the range of benefits is not greater than four times the across-the-board 'same percentage of pay' approach.

Executives should be encouraged to shift from the volatile share option benefit into deferred share schemes which would produce genuine shareholding executives. As executives are encouraged to accumulate their own portfolio of equity investments to provide their own pension benefits in excess of the tax limit of £60,000 of pay, they should be encouraged to invest significantly in their own companies. The suggestion that such self-investment is wrong or harmful to the executive should be rejected.

2. INTRODUCTION

The successes

The successes of the Thatcher government's initiatives on share ownership are so obvious that they have shifted the political agenda for all political parties in the UK. In particular, the success of the privatization offers, both to the general public and the employees of the enterprises, has helped to force the Labour Party to move its policy progressively from the re-nationalisation of all these enterprises without compensation, to partial re-nationalisation in due course and with compensation, and finally to a new "social ownership" approach that is still developing and includes acceptance of at least some privatization.

The shift in political thinking by all parties is surely now irreversible when viewed against the total collapse of the Communist Bloc's blind faith that their system, centred on State ownership of virtually all enterprises, was succeeding and must eventually overcome Western capitalism. The East European countries have recognised the alienation that state ownership generates for the individual. They are urgently turning to individual share ownership since they have found that human beings do not identify with the state, and simply will not work as well for the state as they do for their own families and to meet their own aspirations. Although political events in other countries are stealing the headlines, it is in Poland that the new ground was broken and where progress is most dramatic.

The Adam Smith Institute organised a seminar in Warsaw in October 1989 for British experts in privatization to make that expertise available to Polish Ministers. The task facing Poland is the privatization of about 60% - 80% of the whole of their economy. The encouragement of individual share ownership, by all citizens and by employees, will form a central feature of the Polish initiative. The Polish Government recognise, with the perspective of distance, the remarkable successes of privatization in Britain, and is anxious to learn from our experience. Indeed, Britain's privatization programme was specifically praised by Mr. Lech Walesa on his recent visit to Britain.

These remarkable events demonstrate the importance in a modern society of constructing a new balance between labour and capital. It is perhaps easier for us to recognise that the gross imbalance in the Communist Bloc needs substantial correction. But there was a significant political shift behind the British privatization programme. The Government recognised that citizens who do not participate in the capital rewards of our society will not feel as committed to our democratic capitalist system.

Just as a worker with a capital asset in his home under a

mortgage will think twice about going on strike, so a citizen who has an investment in our successful enterprises will have an interest in their continuing success and prosperity. The wider the experience of participating in the formation of capital, the greater will be the electorate's preference for governments that do not stifle enterprise and prosperity, but encourage it.

The lacunae

However, Ministers have themselves recognised the current fragility of the pattern of share ownership that they have achieved in Britain. In the area of shares owned by members of the public, the principal difficulty is that the typical shareholding is concentrated in just a few privatized industries. To cement the revolution in place, there is a need to encourage individuals to spread their investments. The obstacles to this expansion do not form part of this paper, although it should be noted that the lack of a low cost dealing service for individuals remains a serious impediment to progress on this point.

This paper is concerned with employee share ownership. In that area, the wide gaps in the progress made over the last decade were recorded in Ian Taylor's influential report "Fair shares for all the workers" published by the Adam Smith Institute in 1988. There are two principal areas of difficulty.

First, the unquoted companies simply have not adopted employee share schemes to any noticeable degree. There is the odd exception, but the backbone of our enterprise system, the family company, has not adopted employee share schemes. That is a remarkable fact.

The private, family company is particularly appropriate for encouraging employee share ownership. The employees can so easily identify with the family owners that they can see in their midst. The appetite of employees for shares is evident to anyone who walks amongst the work force of private companies. The pressure on the family owners to provide share benefits was at its most intense in early 1987. By then executives in quoted companies who had received share options in 1984 were looking forward to making very large capital gains from their shares later that year. Since the 1984 share options were generally granted under a scheme approved by the Inland Revenue under the Finance Act 1984 provisions, the gain would be taxed at 30% as capital gain and not 60% as income. Between 1984 and mid-1987 a 'bull' market had ensured that even moderately successful quoted company shares had risen very rapidly in value. Some of the gloss was taken off the potential rewards as a result of the October stock market crash of 1987, but that simply put the clock back to the start of 1987 in terms of the gains that executives were able to make.

Meantime the executives in private companies began to realise that they were not receiving such benefits. The family owners were aware of the pressures on them to produce comparable rewards, in a competitive marketplace for talented people.

But the root of the problem lies in the very nature of an unquoted company: namely its shares are not freely saleable. Both owners and employees recognise the futility of providing share benefits when those benefits will remain theoretical unless the shares can be sold. Yet making the shares readily saleable would destroy the essence of the unquoted company. Employees have no wish to join family owners in that incongruous combination of paper wealth and shortage of cash. The solution to this problem was introduced recently into the United Kingdom. Ian Taylor's report commended ESOPs (Employee Share Ownership Plans) and the Government responded with specific provisions in the Finance Act 1989 to encourage ESOPs. The nature of a UK ESOP is described in Appendix 1, and later in this paper the need for immediate improvement in the ESOP legislation is addressed.

But to add to this first difficulty, the absence of employee share schemes in the unquoted company, there is a second difficulty. That is the low level of shareholding by employees in the quoted company. Just as the level of individual shareholding amongst the public under privatization offers is dangerously thin, so the significance of employee shareholding in the quoted company is low.

It is important to distinguish two levels of significance. The aggregate level of employee shareholding in a quoted company is generally low, typically being less than 2% to 3% at any one time. But often the level of the average individual holding is also low. Michael Bell in his recent Adam Smith Institute report argues cogently that, relative to pay, an individual employee's holding of shares may necessarily remain of low significance. But it is possible to build up to greater levels of holding if several consecutive years of allocation of shares are retained. That is the approach adopted by the Inland Revenue approved profit sharing share scheme (originally given statutory backing in the Finance Act 1978) where each year's shares must be held for 5 years for full tax relief to be earned. With regular allocations, an individual's holdings can therefore be at least five times one year's share allocation.

But even if an individual employee holding were small, if it formed part of an aggregate holding by all employees that wielded influence on the company, then the impact of each individual holding might increase. However, at the 2% to 3% level the typical aggregate holding is not significant.

Opportunity for change

Both of the shortcomings emerging after the first decade of share ownership - unattractiveness in unquoted companies and too low a take-up in the quoted company to precipitate the expected political and social benefits - can be overcome. 1990 is an ideal, and perhaps unique opportunity to give a small but vitally important corrective touch to the direction of employee share schemes.

After listening to a wide range of representations, the Government did include in the 1989 Finance Act, as recommended in

Ian Taylor's "Fair Shares" report, a specific taxation regime for ESOPs (Employee Share Ownership Plans). No new tax relief was introduced, but the initial framework for ESOPs was set out. The detail of the legislation has been heavily criticised, but it was in the nature of paving legislation. Provided that it now quickly built upon, then it will have proved an historic start.

1989 also witnessed the removal of difficulties in the Companies Act. The accretion of company law had produced quite unintended risks that ESOPs could arguably involve unlawful financial assistance by a company in the purchase of its own shares. But the exemption in favour of employee share schemes has now been amended to remove such doubts, and when the relevant section is brought into force in early 1990, the development of ESOPs may witness a surge.

1990 commences, therefore, with all the pieces in place and also with some breathing space before the exigencies of the next general election begin to dominate the minds of Ministers. It is therefore an opportune year to assess the first decade of share schemes, to identify the strong and the weak points, and to point the way for the future.

There are two quite fundamental issues that will shape that future. First, for so long as tax rates for income and for capital gain remain the same, the emphasis should be on removing obstacles and granting further tax relief only where such relief is likely to increase the revenue base of taxation over time. Second, however, in an era when Government restricts its ability to influence behaviour through tax incentives, it must trust the market and give companies greater freedom to operate the schemes that suit their commercial needs.

The single statistic that stands out from the first decade of employee share scheme development is this: in the 10 years since 1978 there have been just under 2,000 all-employee approved schemes; in the five years since 1984 there have been over 4,000 executive approved schemes. More than twice the number of executive schemes in less than half the period of operation of the all-employee schemes sends a strong message.

That message has been misinterpreted as a manifestation of the propensity of directors to award themselves greater rewards. But those executive schemes have been approved in committees of non-executive directors, in general meetings of shareholders and by the discrete but powerful subcommittees of the investing institutions. The true market message - as explained in detail in Michael Bell's ASI report "Incentives through ownership" - is that share schemes need to be applied more aggressively at the top of enterprises than at the lower levels. That is not a surprising message, but it is essential that the analysis behind that market sentiment is understood. That understanding will prevent prolonging the attempt to 'buck the market' in this area of share participation.

3. THE CHARACTERISTICS OF SHARE OWNERSHIP

A risk investment

Equity capital is the form of financial investment in an enterprise that carries the highest risk and correspondingly the highest potential reward. That simple fact is often lost sight of when the complex issues involved in employee share schemes are being considered.

It is hardly surprising that employee share ownership should become complex, since shares are many-faceted. Employee share schemes can be regarded as:

- * a benefit in kind;
- * a mechanism for 'employee participation';
- * a better way to run a company;
- * a mechanism for spreading wealth.

Benefit in kind

As a benefit in kind, employee share schemes enjoy the feature of being 'performance related'. But the relationship they reflect is the experience of shareholders, not the efforts of individual employees. Share schemes do not, therefore, compete with cash bonus plans which provide immediate rewards tied to the performance of individual employees or teams of employees, or even groupings of employees in, say, a subsidiary. The motivation that a share scheme produces must accordingly be examined carefully. It might be said that if the company does well and its share price rises, then employee shareholders will also benefit and might therefore be motivated to behave in ways that will enhance share price. But the limitations of such motivation should be recognised. It is a generalised motivation that most employees would have great difficulty in relating directly to their own day to day contributions to the company's success.

But undoubtedly share schemes can be rewarding for all employees. To the extent that an employee shareholder enjoys the benefits accruing to shareholders, then the share scheme could erode any prejudices that employees may hold about capital investors.

It is easier to postulate a strong motivational effect of share schemes for the most senior executives of a company, and particularly for its executive directors. It is the strategic decisions of these directors that can directly affect share price, and over the long-term will that decisively affect the well-being of the company.

The appropriateness of shares to reward directors sits oddly with the virtual extinction of the traditional requirement in Articles of Association that directors hold shares in their company. That is a development that should be corrected, as discussed later in this paper. Each year, in the forum of the company's annual general meeting, the directors stand to account to their shareholders. How better to persuade shareholders that their directors have their interests at heart than for directors to hold shares in their company?

Employee participation

If an employee becomes a shareholder in his company, then he is entitled to the same information about the company as every other shareholder. He will be consulted about major decisions in general meetings, and will have an opportunity to vote on the appointment or dismissal of directors. This is one level of 'employee participation' and has promoted employee share schemes as one way to 'worker participation'. This form of participation is much preferable to the mandatory workers on boards schemes that are common on the continent.

But it is very important to note that such participation as employee share schemes produce is 'external' rather than the 'internal' participation that most people have in mind when they talk of 'worker participation'. Share ownership puts employees into the company of external shareholders who have invested simply their capital and not their labour into the business. It does not give workers any privileged access to information, nor does it give any privileged access to the decision-making processes in the business. In short, employee share schemes do not challenge the important British concept of 'a manager's right to manage'.

That feature can make share participation a useful and perhaps even necessary prelude to, or at least a concomitant of, the 'internal' participation that is the objective set by the EEC's Social Charter. But it is important to distinguish the meaning of the term 'participation' that is being used in any particular context.

As a participative mechanism, employee share schemes include employees as individual investors. That can be a powerful new bond between a company and its individual employees. The fact that a company can direct mail its employee shareholders in their homes on important issues means that directors can bypass not only the traditional barriers that collectivist trades unions can erect between directors and employees; it enables directors to bypass the whole of middle management if it so chooses. In the aftermath of takeovers, such clear lines of communication can be of great use in turning companies around quickly with the co-operation of the work force.

Running the company better

There is a widespread assumption that employee share ownership

will make employees work better, or more efficiently, and can therefore lead to the company performing better in financial terms. While there is a powerful logic to the thought, there needs to be some caution in insisting that the effect is proven at this early stage. The statistical evidence is not conclusive, although the anecdotal evidence is strong. There have though been studies which have concluded that the effect is present, discernible and perhaps even strong.

The hard-headed will recognise a symmetry between this issue and the argument about share schemes as a means of motivating people. If share schemes do provide genuine motivation, then it is easier to accept that they will lead to better financial performance of the company - provided on average that motivated employees know what things to do and what not to do to improve performance. But that symmetry suggests that the 'running the company better' effect is more likely to be generated by concentrating share schemes benefits on the more senior executives - though spreading the benefit wider is required to earn the co-operation of all employees.

Spreading wealth

Share schemes are sometimes seen as a way to spread wealth. To be effective, that requires first-time employee shareholders to be prepared to accept shares. It also presumes that share ownership comes 'free', so that employees do not have to pay for the benefits of receiving shares. This creates a difficulty, since employees are usually extremely suspicious of anything that is said to be 'free'. Indeed if the cost of a 'free' share scheme is met by the company's profits, then the benefit could reasonably be seen as being a substitute for a higher pay rise than the company has given. The suspicion of employees mirrors the philosophical difficulty of arranging the first experience of share ownership as a 'free' event. From that start, it is a constant uphill battle to communicate the fact that shares are instruments that require risk to be taken if any reward is to accrue.

But if, instead of the redistribution of wealth, it is the widening of participation in capital formation that is the objective, then share schemes do have an important role.

The two extremes: participation and motivation

The range of expectations from share schemes can usefully be clustered into two groups at either end of the spectrum. At one end there is the participation, communication, reward, wealth spreading, democratising aspects. These applications are clearly appropriate to cover all employees.

But these objectives can mostly be achieved by a modest allocation of shares to each individual employee, and on a fair basis that does not damage the objectives. This is the area in which tax incentives have been concentrated over the last decade.

At the other end is the motivation, allegiance with shareholders, performance-related benefits. These applications are most appropriate for senior executives where the connection between their effort and the impact on the company's fortunes is most direct.

These extremes are simply convenient descriptions of the competing themes running throughout share scheme design. It is a question of degree. As the scheme concentrates more on performance-relation it will focus on senior people; as it concentrates on the participation/communication aspects of shares it will expand to cover as many employees as possible. But it is essential to recognise that the nature of shares, as risk investments, inherently makes them particularly appropriate at the senior executive end of the spectrum.

The narrow interpretation of "similar terms"

A fundamental flaw of the share scheme policy development over the last decade has been the concentration of tax relief on schemes with an allocation on "similar terms". In the Finance Act 1978 Parliament decreed that allocations under a tax approved profit sharing share scheme should be on "similar terms", and that such allocations which had regard to salary, service or "similar factors", could satisfy the "similar terms" test.

In the whole decade the Inland Revenue has steadfastly refused to recognise that there are any other "factors" than salary and service. Further the Inland Revenue has insisted that the relationship with salary must be one of direct proportionality (or more favourable to the lower paid).

Although share benefits up to 10 percent of salary each year are allowed, in reality about 3 percent of salary has been the typical figure for such schemes. This means the benefit for a low income employee is usually around £300 a year and the benefit for an executive is say £1,500 a year, if that executive is earning £50,000 or more. The incentive for the executive is therefore almost negligible and for the low paid employee is large enough always to be preferred in cash.

The entrenched view of the Inland Revenue on this issue was well illustrated by its approach to contributory profit sharing share schemes. The Inland Revenue had barely received the Finance Act 1978 from Parliament when it faced two applications for such contributory schemes. One was from a very large enterprise then in state hands; the other was from a well-known family firm.

Both wanted to operate their profit sharing scheme on the basis that employees would receive 'free' shares under the tax approved regime only if they first invested their own money in buying shares. In the simple retailing jargon, they wanted "BOGOF" schemes: if you Buy One, you Get One Free. At very senior level in the Inland Revenue it was ruled that this approach was acceptable as a matter of policy. It then took months of technical discussion to agree how the policy could be implemented.

A particular difficulty was the application of the notorious Section 79 of the Finance Act 1972 (since re-enacted in heavily modified form). That section could have had the effect of charging any growth in value of the contributed share to income tax and not to capital gains tax. The Inland Revenue officials recognised the absurdity of the shares purchased by the employee to gain entry to a tax approved scheme being taxed so onerously. But the solution dictated by the Inland Revenue demonstrated their intention to defeat any meaning being given to the "similar factors" phrase of the legislation.

The Inland Revenue ruled that the contribution of a purchased share in order to receive 'free' shares was not a 'similar factor' but was an extra-statutory concession allowed by the Inland Revenue to the qualification criteria for the approved scheme. That approach allowed the Inland Revenue to lay down whatever conditions they liked, before they exercised their discretion. Thus they required that all employees be given the opportunity to purchase shares and be given the opportunity to refuse to contribute those shares towards the scheme.

That caused extreme difficulties when it came to privatizations. Typically, for the instalment period of some months after the privatization the only holders of shares, rather than special certificates denoting partial payment of the final purchase price, were a trustee (for all the shares sold to the public), the relevant Secretary of State (for the retained State holding) and, uniquely, the special trustee of the employee's profit sharing share scheme trust. That special trustee held not only 'free' shares that had been gifted to the employee by the Secretary of State, but also shares that had to be regarded as having been purchased by the employee and then voluntarily deposited with the trustee rather than retained by the employee outside the scheme.

It is quite remarkable how 100% of employees who purchased shares did actually deposit them. In truth the ability to buy the shares and then to refuse to deposit them was a legal fiction more than a commercial reality. It would have taken a very well-informed employee to notice that it was an option to buy and not deposit the shares. Had any employee (perhaps for the novelty of being the fourth member of the true Annual General Meetings held during the instalment period) actually chosen that option, he might have found that he came under gentle but compelling pressure to deposit the shares and obtain the matching 'free' shares.

But this does illustrate the restrictive interpretation put on the legislation by the Inland Revenue. The view could be based on the British Civil Service's traditional ability to impose its own view of what constitutes fairness - based on their complete lack of experience of a commercial environment.

It may also reflect the peculiar marriage of convenience that gave birth to the Finance Act 1978, when the Liberal Party entered into its pact with the Labour government, and extracted the approved profit sharing share scheme as part of its price for

keeping Labour in power long enough to keep its appointment with its fated "Winter of Discontent".

The "risk wedge"

The stranglehold of "similar terms" forced share schemes to adhere to the same proportion of pay for all participants. This is contrary to the very nature of shares as risk investments, to the needs of the market, as demonstrated by the disparity in take-up of approved schemes, and to basic economics.

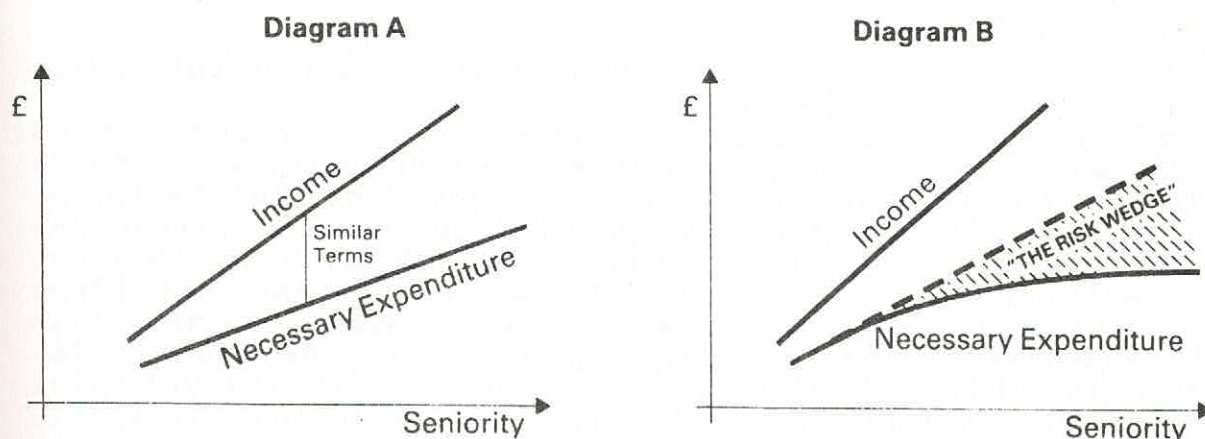
It is a common, and not unexpected, experience that rising income produces not a linear growth in disposable wealth but an accelerating increase. In short, there are a number of essential items of expenditure, on housing, clothing, food, transportation etc., that must, at some basic level, be incurred. Of course the level of expenditure will be a matter of choice by the individual, and there will be a wide range of views about what is the necessary minimum level for each item. As income increases, the choice of an individual will widen. The choice may be to spend more on improved housing, or food or clothing, and it may even be the case that the increased spending will be higher than the increase in income. But the increased spending can be cut back, if desired, and the choice made by the individual is in fact a decision to invest in the better housing etc. rather than in something else.

Although individuals show a remarkable ability to get used to improved circumstances and quickly generate aspirations for greater things, the fact is that once the essential elements are covered at basic standards, then further income increases are available to invest as the individual chooses. If everyone ever agreed on what constitutes the basic necessary expenditure for an individual or a family, then it would be easy to demonstrate this thesis: that as income rises the proportion of that income that is available for discretionary spending increases. But although no two people are ever likely to agree on what is the level of necessary expenditure, in concept it seems clear that necessary expenditure can reasonably be expected to slow its growth as it increases. At the extreme, the very wealthy may regard a yacht as a necessity, but once they own one or two yachts, their appetite for yet more yachts may be expected to reduce.

What then of the executive who seems perennially to be deep in debt? Most often that syndrome is the difference between cashflow and balance sheet. While executives on rising incomes do often encounter cashflow strains, they also find that their bank managers become progressively more friendly - since the bank manager can see the emerging asset base of his client as a better and better risk for the bank's loans to the executive. At all levels, the first universal home owning generation are finding that capital assets, particularly useful ones like houses, provide a way to carry past providence into the future as a cushion against hard times.

This point is perhaps best illustrated diagrammatically. The difference between income and necessary expenditure increases at

a faster rate as income increases. So it is diagram B and not diagram A below that reflects experience. Yet it is diagram A that seems to be believed by Civil Servants, with their insistence on flat proportions of pay in tax approved schemes.



Applying the "risk wedge" to share schemes

The importance of the "risk wedge" is that it demonstrates that those on higher income are able to put a higher proportion of their income at risk than those on lower incomes. Therefore, there is a greater level of appropriateness and a greater degree of acceptance of risk rewards at the higher levels of income.

Unless this is understood by government and allowed to influence tax incentives, government initiatives will fail. The much heralded Profit Related Pay failed this basic test. Since, like all schemes designed in detail by British Civil Servants, PRP produced the same percentage of pay for all recipients it failed at both ends of the spectrum. PRP was risk income, and therefore people on low incomes simply reject it if it is set at almost any level. It is no good Ministers arguing that low income people should take the risk, since if they do not they may lose their jobs. The fact is that low income people (like all employees) are already very large risk stakeholders in their employing company. They already have their jobs and their basic income tied up in the singular risk of their company. Their readiness to accept risk money will directly reflect where they are in the "risk wedge". Not surprisingly, the low paid, and all the trades unions on their behalf, roundly rejected PRP. Yet managers, higher in the "risk wedge" would (and shareholders would argue should) be ready to accept risk money - but not at the low percentages that might just be acceptable to the lower paid.

What was needed, and is still needed, is an increasing percentage of PRP with increasing income. That would keep the risk within the acceptable bounds at the low wage end and would provide acceptable risk and motivating reward at the higher paid end of the spectrum.

The same case can be made for profit sharing share schemes. The

benefits under them are currently insufficient to make executives sit up and take them seriously, yet they are too large for ordinary employees not to press to take them in cash rather than in shares. Of course the objection, from both officials and politicians, is that "perceived fairness" is the reason for a flat percentage of pay.

Maintaining "perceived fairness"

The superficial attractiveness of giving a benefit (or a tax relief) as a common percentage of pay across a work force, is the "perceived fairness" that it generates. That is not a feature that should be given up lightly, but in the post-1988 regime of equalised tax rates for income and capital gains tax, greater use should be made of the subtler forms of tax incentive. In particular, tax deferral is a powerful tool which delivers very real benefit and yet does not dent "perceived fairness" since ultimately tax will be paid. It is to tax deferral rather than further tax relief that the specific proposals set out later in this paper point. But first it is necessary to review the experience to date of shares schemes, for employees and for senior executives, before analysing the next steps.

4. PRIVATE COMPANIES

The reasons why private, unquoted companies do not adopt employee share schemes touch on the very nature of such companies. The essence of a private company is that there is no public market in the company's shares. The register of members is strictly controlled and shares have tended to be held by the immediate family alone. This essential feature is a significant obstacle to operating employee share schemes.

Private companies have come under increasing competitive pressure from quoted companies, as the latter have been able to offer shares options for key recruits who have seen these benefits produce very significant pay offs in 'bull' market conditions. Despite this pressure, private companies have not introduced employee share schemes, which demonstrates their need for special help if they are to join the wider share ownership process.

It is not simply the owners of private companies that resist share schemes. Employees recognise that it is fruitless for them to receive shares which are said to be valuable, but which they cannot sell. The answer is for the private company to establish an ESOP trust.

The ESOP trust was developed to provide a limited market for shares in the private company and so enable effective share incentives to be offered to employees. The ESOP trust can act either as market maker (buying shares on its own account for future release) or as a broker (which was successful for years inside National Freight Consortium) simply matching buyers and sellers. This function overcomes the essential problem of operating a share scheme in a private company - the lack of a ready buyer.

Once it is established as a buyer of shares, an ESOP trust can be a suitable purchaser of shares from a family shareholder who wishes to sell part or all of his stake, without a trade sale or a flotation.

Special legislative measures for the private company

More is said later about the type of ESOP legislation that is needed by the private company. But there are a few new tax reliefs that are needed to give private companies a 'level playing field' in this area.

The family owners need to receive Capital Gains Tax roll-over if they sell their shares to a tax approved ESOP trust provided that the sellers reinvest the cash in shares quoted on the International Stock Exchange in London within say, six months. This is what is provided for in the USA.

At the moment a family owner obtains capital gains tax deferral if he sells his company for shares in another, often quoted, company. In contrast, sale to an ESOP trust would precipitate an immediate charge to capital gains - and at the historically high rate of 40%. Experience in the US leaves no doubt that entrepreneurs respond to fiscal encouragement to sell their businesses to their employees.

Second, the family owners need to receive some relief from Inheritance Tax if they sell to a tax approved ESOP trust. This is in the nature of an extension of the current business asset relief.

These tax reliefs should not be costly for the Exchequer, and indeed they may even produce an increase in tax revenues. That is because of the positive effect that the adoption of an ESOP trust has on the share valuations of private companies. Family owners can spend inordinate amounts of time and money on professional advice to maintain astonishingly low valuations on their shares. That is directed at minimising taxes as those shares are passed down the blood line to future generations. But few families are willing to sell shares to their employees at these low family valuations. Adopting an ESOP trust does therefore lead family owners to accept as an irreversible step the shift to higher, commercial valuations for their shares. Those higher values must then be used for all subsequent transactions, thus giving the possibility of higher taxes as shares are passed on within the family.

Legislative encouragement for ESOPs

In 1989 the Government enacted two pieces of legislation specifically designed to encourage the development of ESOPs in Britain. The Companies Act 1989 removed any doubts about the provision of financial assistance by a company to its ESOP to purchase that company's shares. Since such doubts involved criminal penalties, their removal will be a material help to the ESOP development.

The Finance Act 1989 (Sections 67-74 and schedule 5) introduces a special tax regime for certain type of ESOPs. These provisions are long and complex, but in essence they define the circumstances in which a payment by a company to the trustees of an ESOP will be tax deductible by statute for corporation tax purposes. The main conditions are as follows:

The trustees of the ESOP must be UK resident. There must be no less than three trustees, at least one of them being either a solicitor or a trust corporation. The majority of the trustees must be employees who are not directors and must be selected either by a majority of employees or by persons elected to represent the employees.

A deduction is available where a company gives money to the ESOP which is used to acquire shares in the company (or repay capital, pay interest, pay cash to a beneficiary, or meet the trust's expenses) within nine months of the end of the period

of account in which the sum is charged as an expense. However, in broad terms, if (a) the trustees make a non-qualifying transfer of the shares, or (b) distribute the shares to beneficiaries on non-qualifying terms, or (c) retain the shares for more than seven years, tax (at the basic and additional rate) is clawed back on the amount originally deducted. This clawback is done by raising a tax charge on the trustees. A transfer of shares by the ESOP trust to an Inland Revenue approved profit sharing scheme is a 'qualifying transfer', but only if the transfer is made by sale at full market value.

Similar to the profit sharing scheme legislation, a distribution of shares is on qualifying terms if the shares are allocated according to salary and/or length of service and/or similar factors, but otherwise the distribution cannot discriminate in favour of higher paid employees.

It is not possible to operate a share option scheme, even one approved by the Inland Revenue, on the shares held by an approved ESOP since the actual transfer of shares at a time of option exercise will not be 'on similar terms' to all employees. In fact, the approved ESOP is designed simply to serve an Inland Revenue approved profit sharing scheme. Since this type of scheme already enjoys a statutory deduction for monies paid to it, the only benefit an approved ESOP appears to offer is the acceleration of the statutory deduction, since the ESOP can buy up to seven years' of shares at the outset. But the price for this acceleration is that the transfer to the approved scheme must be at full market value, thus crystallising a capital gains tax charge on the approved ESOP at that time.

Since an offshore ESOP trust will not suffer a capital gains tax charge, and can be funded by loan as well as cash gifts that may be deductible, it is difficult to see many circumstances in which an approved ESOP will be attractive, at least while legislation is in its present form.

Improvements to the 1989 ESOP legislation

There are many drafting changes that could usefully be made to the 1989 legislation for ESOPs, but the more important issues are the policy decisions that need to be made to make ESOPs attractive to companies, and particularly to the unquoted companies.

The single most important policy issue concerns the ability of an ESOP trust to service the type of employee share schemes that companies wish to implement. The disparity in the numbers of all-employee and executive tax approved schemes demonstrates beyond doubt that companies wish to use selective schemes to target the share benefit to key people. The "risk wedge" argument supports this logic, since it is the senior people who are best able to take financial risk, and who should be encouraged to take greater risk. Yet the tax approved ESOP trust can service only the tax approved profit sharing share scheme

which is a 'similar terms' scheme.

What is needed is to harness the commercial needs of companies to direct the risk benefit of shares towards senior people with the political and social objective of spreading shares as widely as possible. The mechanism for achieving this harnessing is to allow a tax approved ESOP trust to service any of the tax approved share schemes (i.e. include both tax approved share option schemes as well as the profit sharing share scheme) with one important proviso. That is that not less than 51% of the shares passing through a tax approved ESOP trust should pass to tax approved schemes on a "similar terms" basis. That single measure will ensure that many tax approved ESOP trusts are adopted. Even the most aggressive of executives, who want to get benefits from the 49% of shares that can pass on a selective basis, will have to operate all-employee schemes to accommodate the other 51%. In reality, 51% of something is a lot more than 100% of nothing! And the fact is that extremely few, if any, companies are contemplating introducing tax approved ESOP trusts of the 1989 vintage.

(Indeed, not one single company has to date introduced a 1989 tax approved ESOP trust. This clearly shows the inadequacy and indeed failure of the existing legislation.)

The other policy issue that will require careful handling is the selection of the trustees of the ESOP trust. The 1989 legislation exhibit an astonishing piece of "Euro-socialism" in its provision that the majority of the ESOP trustees be elected worker trustees. Directors were excluded, and the elective process seemed well designed to ensure that the trades unions would dominate the ESOP trustee boards. Whatever thinking was behind these provisions, it could not have been that of the reforming government of the last decade.

What is needed is a clear sweep, with the retention of the appointment of an independent trustee. This revision should not be as difficult politically as it might first sound. Very few employees, who were well advised, would want to become ESOP trustees. Not only would they be out of their depth in terms of the requirements placed upon them, they would run significant risk of committing offences under the Financial Services Act.

Prime amongst the drafting changes that are required in this legislation is removal of the unique xenophobia in this area of legislation which forbids the UK subsidiary of a company quoted overseas from establishing a tax approved ESOP. If there was ever any merit in excluding such companies and their employees, they should never have been allowed to establish all of the three tax approved employee share schemes in the first place. But this objectionable feature should be removed now, before States such as California recognise it as anti-USA legislation and begin to cite it in their attempts to impose unfair State taxes on the US subsidiaries of UK companies.

Future policy

If the wider spread of wealth is an objective of the government, and if the unquoted company remains the chosen mechanism of entrepreneurs to build wealth, then the encouragement of ESOPs in the unquoted company becomes of high priority.

The crucial future development of ESOPs in the private company should not be amongst special circumstance enterprises, such as buy-outs, but rather in traditional family-owned businesses which wish to sell off a minority stake to employees. The timing of this development is dependent on ESOPs receiving further fiscal incentives from government. But the importance of ESOPs for the future organisation of the private, unquoted company sector should not be underestimated. That importance is obvious in the new, high-technology businesses, but is no less relevant in the traditional manufacturing enterprise. The key issue will be to develop a range of employee stakes that can produce an acceptable balance between internal investors of labour - employees - and external investors of capital.

For the quoted company, the emphasis of further legislation needs to remain on the removal of obstacles to ESOP development rather than on fiscal incentives. More radical developments are likely to have to await a complete rethink by a government about whether it is appropriate to continue to tax employees becoming shareholders more harshly than non-employees becoming shareholders. A radical shift towards encouraging employee share ownership perhaps on a par with the momentum given to home ownership by mortgage interest relief (as proposed by Michael Bell), would sweep away much of the technical complexity of ESOPs and reveal their true simplicity - as a means of employees acquiring meaningful stakes in their company. But the modifications to existing tax approved share schemes deserve chapters to themselves.

5. WIDER EMPLOYEE SHARE OWNERSHIP

There are two all-employee tax approved share schemes in Britain: the approved profit sharing share scheme (since the Finance Act 1978) and the savings related share option scheme (since the Finance Act 1980).

Profit sharing share scheme

The principal features of the profit sharing share scheme are set out in Appendix 2. Essentially it allows shares to be given free to employees provided that the employee does not sell the shares for 5 years. The no-sale period is policed by trustees, who otherwise pass through the benefits of being a share holder to the employee. Generally the employee votes the shares, receives any dividends on them and is able to receive the report and accounts and attend general meetings. (Some of the non-financial features are not mandatory in the legislation, but are common practice.) The tax relief is based on ensuring that employees actually experience share holding for five years, and the public policy hope is that employees, having enjoyed the experience, will freely choose to remain shareholders.

This scheme does produce real employee shareholders (in contrast to many share option schemes). It gives the company a direct means of communication with employee shareholders. It gives the individual employee a quantifiable amount of risk investment in the company. The administration is detailed, but is no more so than for comparable benefit schemes.

Over time other methods than the simple 'free shares' as an additional benefit and cost to the company have been evolved. With suitable and very careful footwork, an existing discretionary cash bonus scheme applying to all employees can be modified so that employees can take shares or cash under a comparable scheme. The employee who takes the shares receives them gross, without any tax charge, and also free of any liability to National Insurance Contribution (hence the name 'gross contributory approach'). The employee who takes cash will suffer immediate income tax, NIC liability and possibly a deduction on account of pension if the bonus is pensionable.

The third approach, to add to the 'free shares' and the 'gross contributory approach', is the 'net contributory approach'. Here employees receive 'free shares' as a multiple of the number of shares that they buy out of their net, after-tax income and 'contribute' to the scheme. "Contribution" in this context means agreeing to leave the shares unsold with the trustees of the scheme for a minimum period of time.

The Inland Revenue has ruled as a matter of policy that the company must put more money into the scheme than employees, so

that the minimum acceptable ratio of 'free shares' to employee contributed shares is one-to-one. Thus certain US thrift plans, where the employee can acquire shares at a 10% discount have been rejected by the UK Inland Revenue for inclusion under profit sharing. There would have been nine employee-contributed shares to each one 'free share', and this breached the unwritten rule of one-to-one contribution. Whether that policy stance is necessary is debatable, and whether it is desirable is also open to question.

Each of the three approaches does involve employees in the risk element of shares. Even 'free shares' can reasonably be regarded as a benefit in kind that could have been paid in cash. The employee is therefore required to take the risk that the value put into shares on his behalf may not maintain its value over the life of the no-sale agreement. Of course, he has the cushion of the tax relief on the benefit to protect him if the share price falls. But he will suffer at the very least a loss of expectation if share prices fall, so he will experience real risk taking in regard to the benefit. The other two approaches actually require the employee to take a voluntary risk, of choosing shares rather than cash or of investing in shares in order to receive further shares free. They do therefore give the employee the risk decision that is so much a part of the nature of shares as risk investments.

The principal drawback of profit sharing share schemes is that not enough of them have been adopted, and not enough shares are being channelled through them to produce significant impact on employees. Since 1978 there have been about 900 such schemes approved. Within that number there are known to be multiple applications by one company, so that the total overstates the number of companies which have adopted such schemes. (There are technical advantages in terms of flexibility for a company to adopt one approve scheme for each subsidiary company which employs people.)

The investing institutions have set some stringent guidelines for such schemes, allowing not more than 5% of pre-tax profit attributable to the UK operations of a company to be allocated to the scheme in each year. That limit has led to such schemes producing a slow, drip-feed of benefit to employees which is modest on an annual basis, but which can aggregate over the five year no-sale period to a reasonable benefit. But since the absolute ban on sale is for two years only, after which sale is permitted with decreasing claw-back of the original tax relief, not all employees actually accumulate even the five year train of benefit.

In short, this scheme does require risk investment by employees but produces too few shares too slowly to have real impact and suffers from the rigid "similar terms" approach of the Inland Revenue.

Saving related share options

The detail of this scheme are also set out in Appendix 2. An

employee agrees to save for five years with a building society to earn a tax-free bonus, which is equivalent to rolled-up interest on his savings. The company agrees to allow him to use the proceeds of his building society savings plan to buy shares in the company at a price than can be as low as 80% of their market value at the start of the five years. The employee is protected against a fall in share price, not only through the 20% discount on price, but also because his money is safe with the building society and he need never buy the shares.

A policy decision by the Inland Revenue has complicated the relationship between the savings contract and the related share option. The saver can decide to leave the savings invested for two more years, making seven in all, in order to double the bonus. However the Inland Revenue insist that the choice of a share option for five or seven years be made at the outset. Since such a decision would challenge the ingenuity of a professional investor, let alone an employee, most companies make the decision by permitting only five year options.

The scheme does provide employees with a low cost way into share ownership. By freezing the share price while the employee is saving the money to invest, he gets into the share ownership world on favourable but affordable terms. When he exercises the share option, he actually has the money required to buy the shares in his building society account. There is therefore no intrinsic pressure on him to sell any of the shares straight away.

However the disadvantages of this scheme are that the benefit is very volatile (more of which later) and during the five year savings period the employee simply is not a shareholder. It is possible that the employee could buy the shares at the end of the five years and sell them again immediately, thus becoming an "overnight" shareholder only. In the near decade since the schemes were introduced (in the Finance Act 1980) there have been about 900 schemes adopted. That number is similar to the profit sharing share schemes. Much of the growth in savings related share option schemes can be attributable to the fact that option schemes became the vogue approach for executive reward so that the corresponding all-employee option scheme found favour as an accompaniment to the executive schemes - and therein lies a powerful message of how to increase the use of all-employee schemes.

In short this scheme does produce meaningful share holdings for employees, and provides a low cost entry, but it does not involve any compulsory experience of shareholding other than an overnight period.

Improving the approved share schemes

The approved schemes can be improved to encourage their greater adoption and use. This can be achieved without greater tax relief, though some tax deferral would be needed.

If the approved profit sharing share scheme is to break out of

...policy straightjacket and be free to respond
... it must accommodate increasing benefits
... the "risk wedge". It must permit executives to
... shares than the single percentage of salary that

... legislation does provide a tax regime for shares
... the scheme but over the "similar terms" limit.
... are termed "excess shares". They can arise only by
... the company undertakes not to break the "similar
... The tax regime for excess shares is that
... charged both on the original gift of shares and on
... value of those shares.

... possible to alter the legislation so that tax relief
... of free shares was retained for the "similar terms"
... of the distribution, but that excess shares were
... deliberate choice of the company. Provided they are
... least five years the value of the excess shares could
... capital gain and only when the shares are actually
... ensure that this liberalised regime did not cause
... embarrassment, it would be politic to limit the ratio
... element to say, four times the "similar terms"

... that such an amendment to the approved profit
... would increase the amount of resources that
... would allocate to such schemes. The market has
... its appetite for increased executive reward in the
... shares, through its rapid adoption of tax approved
... share option schemes. But to ensure that resources
... diverted from low paid employees to executives, it could
... that excess shares are permitted only when the
... value of shares being appropriated on "similar terms"
... than the value so appropriated in each of the three
... years. That ensures that all employees would receive at
... the same if not more than they previously received in any
... excess shares are allocated to executives.

... be argued later, it must be better for all parties to
... executives off the option scheme and get them to look to
... share schemes instead. If they found the approved
... sharing scheme a suitable vehicle, then that could lead to
... numbers of such schemes being implemented and greater
... going into them. That would benefit not just
... but all employees.

... as the saving related share option schemes are concerned,
... missing element of share ownership during the five year
... period can be replicated by operating such a scheme in
... with an ESOP trust. If the share options are
... by shares in that trust, then the trustees can also
... through to the savers the right to vote and to receive
... and attend the general meetings. If the finances
... the trustees could even pass through the dividends on the

6. DEEPER EXECUTIVE SHARE OWNERSHIP

The worship of the share option

The last decade has seen an inordinate adoption of the share option as the principal method for executives to acquire shares. Much of the steam for what has become almost an obsession with the share option is the combined force of tax incentives and a 'bull market'.

In the early 1980's legislation was introduced to defer the income tax due on the exercise of an unapproved share option. Then, as now, an unapproved share option lead to an income tax charge being assessed at the point that the option was exercised. Since the marginal tax rate was 60% this charge inevitably led executives to sell immediately all the shares that they acquired from exercising their share option.

Consider the finances involved in an executive exercising a share option. Assume that the shares over which he had been granted an option were originally worth £100,000 and had increased in value to say, £250,000 when he exercised the option. The executive would need to sell 40% of the shares to raise the £100,000 option price. He would then need to sell a further 36% to pay the £90,000 income tax charge due on his gain of £150,000. He could therefore retain 24% of the shares if he wished to invest in his company. The tax deferral both tested out the water for greater tax relief to come and also allowed the executive to retain 60% of the shares in the example, since the tax charge was calculated immediately but collected in five instalments over five years.

But in 1984 full tax relief was granted for executive share options. This meant that any gain made by the executive was actually taxed as capital gain and not as income. It was also taxed only when the executive chose to sell the shares. While this move led to an explosion in the adoption of such schemes - there have been over 4,000 such approved schemes adopted in the last five years - they have signally failed to encourage executives to hold onto shares and to become executive shareholders.

Unlike the US regime, the UK tax relief was not made conditional on the executive holding the shares for at least one year after the exercise of the share option. The result has been a dramatic increase in the rewards received by executives from share price rises but no increase in executive share holding.

But the option benefit has its weaknesses. It is a highly volatile benefit. On the day that it is granted there is no discernible value on the option, since it is granted at the full market value. (Of course futures dealers will be quick to point out the value of a fixed price option, but since this option cannot be exercised for three years which is beyond the term of

any option written in the futures market, it is difficult to put a value on the option benefit at the time of its grant.) Any increase in price will then lead to an infinite increase in the value of the option. The option will always be more volatile than the underlying share price. For example if an option is granted at the full market value of £1 and the share price then moves to £1.10, to £2.20 and back to £1.65 the percentage movement in share price is as follows: 10%, 100%, (25%). The value of the option at each point is: 0, 10p, £1.20 and 65p, while the percentage movement in the option value is: infinite, 1200% and (46%).

The full sting of the volatility of the option benefit was felt in October 1987. Just as many tax approved options were reaching their third anniversary of grant in late 1984, the Stock Market crashed. In fact by the end of that year the market had reverted to the position at the outset of 1987 and gains were still made. But executives are as quick as any of us to presume on our good fortune, and they had seen the market take their option gains out into remarkable realms by October 1987. The crash destroyed many hopes. The hard headed investing institutions were not too displeased that such damage was done to executive's hopes, since the institutions claimed that options should make executives share the hopes and fears of shareholders. That approach does not, however, give enough weight to the fact that for an executive the share option was perhaps the only way that he could accrue a really sizeable capital sum from his long hours at work.

The executive pension benefit, while of perhaps greater value, paid out after the executive was finished in work, and at a time when his capacity to enjoy the income was diminished. Indeed the pension was designed as an income into retirement (except for that now lost tax-free lump sum) and was not meant to provide capital sums during a career. The loss of admittedly inflated option gains was therefore a real blow to executives' morale. Not only did they find the market gyrations unpalatable or even incomprehensible, but they were hurt personally by the events.

The echoes of that pain go on reverberating even now. The subsequent mini-crashes of the market have each thrown up an increasingly determined attempt by executives to protect themselves against such 'losses'. There are now several discreet ways quietly to bury options that prove to have been granted at an unfortunately 'high price' in favour of lower priced options with more potential for gain.

Before we criticise such behaviour, it is worth considering why executives should accept the roulette of the market, so that junior executives who happened to join the firm later receive options at a significantly lower price than the senior executives who are charged with the major responsibility of leading the company out of the doldrums (although they may well have been the same senior executives who led the company into those same doldrums).

The difficulty of operating tax approved executive share option schemes have been added to by narrow decisions of the Inland

Revenue. The Inland Revenue restrictions sit oddly with a scheme that is based on discretionary entry. Perhaps the best example is the stubborn refusal of the Inland Revenue to permit companies to set certain performance-related conditions to be met before the share options are exercised. The Inland Revenue has insisted that only 'objectively' measurable conditions can be set at the outset and they can never be changed thereafter. Since such options are granted for a period of 10 years, it is not surprising that companies look for some flexibility on this point. But the Inland Revenue has maintained its objection in the face of several contrary Opinions from contract and tax Counsel and through a case before the Special Commissioners which the Inland Revenue lost comprehensively, but which they are now appealing in the High Court. The question that the Inland Revenue has not answered is 'whom are they protecting?'. The companies granting the rights want to set the conditions, the executives receiving the rights recognise the commerciality of the conditions, and the investing institutions are keen to see performance conditions set to the exercise of the options. If, as is the case, learned Counsel have advised that the desired conditions are lawful and comply with the legislation, why are the Inland Revenue so opposed? Part of the answer lies in the fact that the Inland Revenue are uncomfortable with administering a discretionary scheme and bring to it their prejudices formed in dealing with the all-employee "similar terms" schemes. This illustrates the need to ensure that when the political decision is to allow enterprise to flourish, officials must be required to give entrepreneurs room to breath and flourish.

But is it in the interests of shareholders, and of society, to encourage the executive option rather than executive shareholders? It is hard to see why shareholders should vote through share option schemes without murmur when other approaches are available. Perhaps part of the answer is that until 1988 the Government set the agenda in this field by deploying tax reliefs for some approaches and not for others, and the Government signalled that it was share options that it favoured for executives.

Of course, share options have their positive side. Every penny that the executive makes, the shareholders have made also. It is therefore performance related reward of a high order. It is extremely defensible pay, at least to shareholders. But it does not create executive shareholders and share options have absolutely no downside risk.

One technical feature that requires consideration is the requirement on executives not to sell shares for the minimum period of time. Until very recently, restrictions on shares were regarded by tax legislators as abhorrent. The infamous section 79 Finance Act 1972 levied an income tax charge on any capital gain made by an employee from shares which carried a 'restriction'. That was because 'restrictions' were viewed as being ways to manipulate share values in favour of the employee. The fact that legislation threw the baby out with the bath water, and that some restrictions are positively to be encouraged. Fortunately the review of section 79, incorporated in the Finance

in 1987, distinguishes 'restrictions' and permits time-related restrictions to be treated favourably. Thus the restriction required under a deferred vesting share scheme would, since it wastes away over a pre-determined time, not be taxed onerously under the current tax regime.

Perhaps one could expect an aversion to shareholding amongst directors. There are now onerous insider dealing laws which should make any director pause before he deals in any shares let alone those of his own company. Newspapers publish records of directors' dealing in his company's shares. The pattern tends to suggest that either the director sold when he knew, or should have known, that the price was at a high, or that because he sold when the price was low, he is incompetent in share dealing and presumably in other aspects of his business decisions. On top of this there is the argument about self-investment.

There is currently a proposal that executives should be protected against too much self-investment in their own company. The proposal is that small self-administered pension schemes should, like broader company pension schemes, be limited to investing not more than five percent of their assets in the employing company of the beneficiaries. The logic of that restriction is compelling (under the "risk wedge" analysis) for lower paid employees who must spread their risk since their income and their pension is simply too near their break-even point to allow them to take risk. But why do the higher paid need to be protected against any risk they choose to take?

The Government has limited tax relief in the pensions field so that only pay up to £60,000 per annum will be pensionable under a tax approved scheme. That will, under the chosen price rather than wage indexed limitation, force progressively more executives to make their own pension provision.

Since such provision must be in the form of investments in securities, given the long-term nature of the pension benefit, the executive will be forced to accumulate his own clutch of investments. If he chooses to put all or most of that investment in his own company, thus maximising his loss (of job, current income, and future pension) why should Government interfere? Better to argue that such an executive might work harder to make his company successful if he freely chooses to invest heavily in it. Once again the "risk wedge" analysis suggests that anyone who has a secure, diversified tax approved pension benefit based on pay of £60,000 he is able to take such risk with further pension provision as he wishes. He is unlike to become a burden on society on a pension of 'only' two-thirds of an indexed £60,000!

The need for deferred vesting share benefits

The Government should give encouragement to a shift from the share option benefit towards genuine share ownership (like the approved profit sharing share scheme) with a progressive allocation of the benefit (or 'vesting' as the Americans term it) to executives.

Thus, for example, an executive would not receive an option on £100,000 worth of shares - so that he makes a big gain or none depending entirely on share price movement. Instead he might receive the benefit of say, £25,000 worth of shares - but he would receive the shares in any event on a pre-ordained date. If the share price halved, he would still receive £12,500 worth of benefit, so that the value would be less volatile than a share option, and would in the meantime be an executive shareholder on the same footing as other shareholders.

The mechanism to encourage such schemes was suggested earlier in the discussion of the approved profit sharing share schemes. The gift of the excess share should, it is suggested, not attract an income tax charge but rather a capital gains tax charge when, and only when the executive sells the shares. The shares must be held for five years by the executive to earn this tax treatment. If he should sell the shares after the minimum two year hold period then a pro rata amount of the initial gift should be subject to an immediate income tax charge.

This treatment conveys deferral of tax until the shares are actually sold. It also conveys the capital gains tax treatment provided only that the shares are held in the trust for a minimum of five years. Currently, of course, there is little difference between capital gain and income so far as the marginal rate of tax is concerned. But it seems preferable to treat the gain for what it is namely capital gain, and the original gift of the shares as a capital event in view of the five year holding period.

Such a regime is likely to encourage companies to divert more of their performance related bonus payments to executives into deferred share schemes. That would reduce the cashflow out of the company, increase the executive's genuine identity of concern with shareholders, increase the habit of personal securities investment for retirement amongst executives and generally increase companies interest in making greater use of the approved profit sharing share schemes. That is likely to wash back to the benefit of all employees.

The ESOP dimension

Such deferred schemes will be helped as quoted companies begin to establish and operate ESOP trusts. The existence of a trust which holds existing shares and which can gift them on deferred terms to employees and executives alike, will encourage directors to consider switching their policy emphasis away from options and towards deferred share ownership.

It is important that one vital feature of the option benefit is retained. That is its ability to lever an executive into a large shareholding that he simply could not otherwise afford. An option is, in effect, a transaction where the executive is given an interest-free loan to acquire the shares. The option benefit is so powerful because it can generate really significant benefits for executives because the effective loans being made to

him are very large.

An ESOP is itself a leveraged transaction and can replicate the option effect. The ESOP trust is able to borrow, buy shares, and service its interest and principal repayments tax efficiently. As it unlevers itself, it can allocate shares directly to executives on deferred terms without any financial input by the executive. The shares can vest after the minimum five year period so that executives can become significant shareholders.

7. SPECIFIC PROPOSALS

This paper has advocated a number of fundamental changes in policy which require legislative amendments. The fine detail of the amendments required depend on the precise policy decisions taken. But to illustrate the practicability of the policy changes recommended, an outline of the major legislative amendments are set out below.

The purpose of the amendment is first set out and then the detail of the relevant sections that would require amending, although not all the consequential modifications are set out here.

ESOP improvements

* Enabling a tax qualifying Employee Share Ownership Trust ("ESOT") to transfer shares not only to the trustees of a tax approved profit sharing shares scheme on "similar terms" but also under any of the three tax approved schemes provided that at least 51% of the ESOT's shares are distributed to beneficiaries on "similar terms".

Amend sub-paragraph 5(2)(d) of Schedule 5 to the Finance Act 1989 to read:

"(d) to transfer securities to persons who are beneficiaries or to trustees acting on behalf of such beneficiaries through the operation of any scheme approved under Schedule 9 to the Taxes Act 1988 (approved share option schemes and profit sharing schemes) provided that a simple majority of shares so transferred in any year of assessment are so transferred in accordance with either section 26 or section 36 of the said Schedule 9."

Add a new sub-paragraph 9(5) to Schedule 5 to the Finance Act 1989 as follows:

"(5) For the purposes of this paragraph a security shall be deemed to be transferred to a beneficiary at the time that such security is made the subject of an option right granted under the operation of any share option scheme approved under Schedule 9 to the Taxes Act 1988 provided that if such option is not exercised for any reason the period for which the option could have been exercised shall not be counted when computing the period of seven years referred to in sub-paragraph (1)(b) above."

* Enabling the subsidiary of a company quoted on any recognised stock exchange to establish a qualifying ESOT and for that ESOT to use the quoted parent company shares.

Amend sub-paragraph 2(2) of Schedule 5 to the Finance Act 1989 by the deletion of the words at the end of that sub-paragraph: "and not controlled by another company".

Replace paragraph 7 of Schedule 5 to the Finance Act 1989 with the following:

"7. Subject to paragraph 8 below, the trust deed must provide that the securities acquired by the trustees must be securities which satisfy the requirements of paragraphs 10 to 14 of Schedule 9 to the Taxes Act 1988 (in this Schedule referred to as 'qualifying securities')."

Amend paragraph 8 of Schedule 5 to the Finance Act 1989 by substituting the words: "qualifying securities" for the words: "shares in the founding company" wherever the latter words occur.

Amend Sub-section 67(4)(a) to read:

"(a) the acquisition of qualifying securities;"

* Permitting the trustees of an ESOT to be a sole independent trustee but with an obligation on that trustee to consult employee beneficiaries on matters of major significance to the company upon which the ESOT trustees must act or vote.

Delete sub-paragraphs 3 (3) (a), (d), (e) and (f) and sub-paragraph 3 (4) of Schedule 5 to the Finance Act 1989 and replace with a new sub-paragraph 3 (4) as follows:

"(4) The trust deed must provide that the trustees are obliged so far as practicable to consult and the grantor obliged to facilitate such consultations with those persons who are beneficiaries of the trust who are in employment at the time on any offer to purchase the shares which the trustees hold which is a general offer made to all shareholders and which could lead to a change in control of the grantor and the trustees shall take account of such views as may be expressed by such beneficiaries".

* Providing Capital Gains Tax roll-over relief to family shareholders if they sell shares to an ESOT and re-invest the cash in quoted securities listed on the International Stock Exchange in London.

Add new Section 67A to the Finance Act 1989 as follows:

"67A. Capital gains tax roll-over relief

(1) Sub-paragraph (2) below applies where an individual disposes of qualifying securities in a company none of the shares forming part of whose ordinary share capital are quoted on a recognised stock exchange or dealt in on

the Unlisted Securities Market to the trustees of a qualifying employee share ownership trust and before the expiry of six months beginning on the day following the date of the disposal the consideration which he obtains for the disposal is applied by him in the acquisition of shares which are listed in the Official List of The International Stock Exchange (in this paragraph referred to as "listed shares").

(2) The individual shall on making a claim as respects the consideration which has been so applied be treated for the purposes of the Capital Gains Tax Act 1979 -

(a) as if the consideration for the disposal of the qualifying securities were (if otherwise of a greater amount or value) of such amount as would secure that on the disposal neither a gain nor a loss accrues to him; and

(b) as if the amount or value of the consideration for the acquisition of the listed shares were reduced by the excess of the amount or value of the actual consideration for the disposal of the qualifying shares over the amount of the consideration which he is treated as receiving under paragraph (a) above;

but neither paragraph (a) nor paragraph (b) above shall affect the treatment for the purposes of the said Act of the trustees or of the other party to the transaction involving the listed shares.

(3) Where sub-paragraph (2)(a) above applies to exclude a gain which in consequence of any provisions of the Capital Gains Tax Act 1979 is not all chargeable gain the amount of the reduction to be made under sub-paragraph (2)(b) above shall be the amount of the chargeable gain and not the whole amount of the gain.

(4) The provisions of the Capital Gains Tax Act 1979 defining the amount of the consideration deemed to be given for the acquisition or disposal of assets shall be applied before this paragraph is applied."

* Providing 50% relief from Inheritance Tax on the value of any shares transferred by family shareholders to an ESOT.

Add new Section 67B to the Finance Act 1989 as follows:

"67B. Inheritance tax relief

(1) Where -

(a) the value transferred by a transfer of value made by an individual is attributable to qualifying securities in a company none of the shares forming part of whose ordinary share capital are quoted on a recognised stock exchange or dealt in on the

Unlisted Securities Market which become subject to a qualifying employee share ownership trust; and

(b) the transfer of value is not an exempt transfer by virtue of section 28 of the Inheritance Tax Act 1984 (employee trusts);

the value transferred shall be treated as reduced by one-half.

(2) For the purposes of sub-paragraph (1) above, the value transferred by a transfer of value shall be calculated as a value on which no tax is chargeable.

(3) Where the value transferred by a transfer of value is reduced under Chapter 1 of Part V of the Inheritance Tax Act 1984 by reference to the value of any relevant business property the value to be reduced under sub-paragraph (1) above shall be the value as reduced under that Chapter (but subject to sub-paragraph (2) above)."

Improvements to profit sharing share schemes

* Enabling shares to be appropriated to executives in excess of the "similar terms" allocation to all employees, but on the basis that the permitted excess shares do not number more than four times the across-the-board "similar terms" percentage benefit and so that the taxation regime for such permitted excess shares is that the whole of the value received by the executive will be taxed as capital gain when he sells the permitted excess shares (unlike the "similar terms" element where only the increase in value of the shares is taxed as capital gain when the employee sells the shares).

Amend sub-paragraph 6 (2) of Schedule 10 to the Taxes Act 1988 by adding immediately after the definition of "excess shares" the following:

" "permitted excess shares" means such excess shares as do not exceed three times the relevant amount; and"

Amend sub-paragraphs 6 (4), (5) and (6) of Schedule 10 to the Taxes Act 1988 by adding the words "(not being permitted excess shares)" after the words "excess or unauthorised shares" wherever they occur.

Add new sub-paragraphs 6 (8), (9) and (10) to Schedule 10 to the Taxes Act 1988 as follows:

"(8) Permitted excess shares shall be treated as excess shares if -

(a) the aggregate initial market value of the shares appropriated in the year of assessment as the purported permitted excess shares is less than the similar aggregate for any of the three previous

years of assessment; or

(b) the purported permitted excess shares are disposed of before the release date or if it is earlier the date of death of the participant whose shares they are.

(9) Sub-section 186 (2) shall apply to permitted excess shares as if the reference in that sub-section to shares was to permitted excess shares.

(10) For the purposes of the Capital Gains Tax Act 1979 and notwithstanding sub-section 144A (1) of that Act on a disposal of the permitted excess shares after the release date the participant whose shares they are shall be treated as if he had acquired the shares for nil consideration."

Amend sub-paragraph 30 (3) of Schedule 9 to the Taxes Act 1988 by adding at the end the following:

"except to the extent that permitted excess shares are appropriated to that individual".

Improvements to share option schemes

* Enabling shares acquired as a result of a tax approved executive share option to be required to be held for a period not exceeding five years by the executive.

Amend sub-paragraph 12 (1) (c) of Schedule 9 to the Taxes Act 1988 by inserting the words; "or sub-paragraph (2) (A)" between the words "restriction authorised by sub-paragraph (2)" and "below".

Add new sub-paragraph (2) (A) to paragraph 12 of Schedule 9 to the Taxes Act 1988 as follows:

"(2) (A) A share option scheme (not being a savings-related share option scheme) may require the shares to be acquired under the scheme not to be disposed of for periods of time not to exceed five years after the date on which the option is exercised."

* Enabling performance criteria to be set which must be met if the tax approved share option is to become exercisable by the executive.

Add new sub-paragraph 27 (1) (A) to Schedule 9 to the Finance Act 1988 as follows:

"(1) (A) The scheme may include provisions which make the exercise of the right under the scheme to be conditional on the satisfying of any criteria as are stated at the time the right is obtained including criteria the satisfaction of which require a reasoned judgement to be made by the grantor."

8. CONCLUSION

The last decade has witnessed a sea change in British politics. The true value of those changes may be better understood with the perspective that distance and 40 years of Stalinist rule gives, since the East Europeans now wish to follow Britain's privatization path.

Share ownership, and employee share ownership, is central to the political shift towards encouraging individual enterprise and the individual accretion of capital that goes with it.

Yet this is an area where policy needs to be renewed if the changes are to be pushed still further forward. The Finance Act and the Companies Act of 1989 laid the foundation for a leap forward in 1990. The need now is for the Government to return to its basic market-orientated instincts and to enact the necessary policy changes to make its vision a reality.

These steps are essential if the capital ownership is to spread into the pool of employees employed by the most important supporters of the enterprise society, the family entrepreneurs. They are also essential if the momentum in the quoted company towards greater share ownership is to be maintained and deepened.

At stake is no less than the British revolution of the last decade; the guiding principle must be to encourage risk taking to the fullest extent that an individual can accept - and thus in accordance with the "risk wedge".

Inaction, timidity and delay may prove fatal. If advocates of the market economy in Britain cannot show their version of employee ownership to be a widespread reality and a success, then others may be able to impose their own anti-capitalist schemes.

9. APPENDICES

Appendix 1 - What is an ESOP?

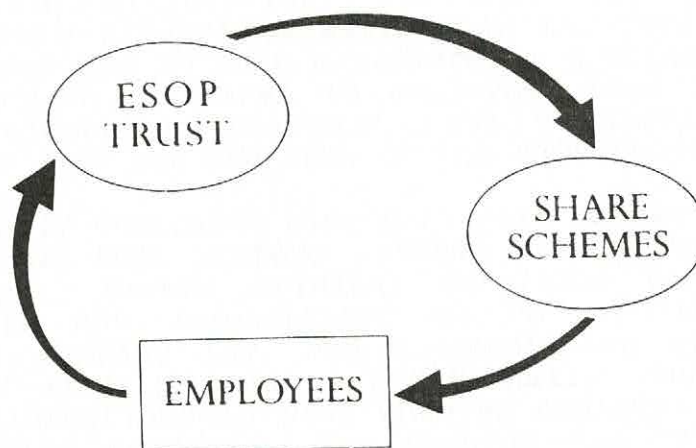
An ESOP consists of two parts: a discretionary trust to benefit employees and one or more employee share schemes. The ESOP trust has the role of collecting shares, and the employee share schemes have the role of distributing those shares to employees. The trust must have the potential to borrow money, to enable it to purchase blocks of shares when they become available.

The new element, for the UK, in the ESOP arrangement is the first part; the ESOP trust with its borrowing powers. Since 1978 a comprehensive range of distributive employee share schemes has developed; ESOPs are not just another share scheme. It is the ESOP trust, as a supplier of shares to the existing share schemes, which is new.

In the quoted company, the ESOP trust provides a new way to finance the employee share scheme programmes already in hand, and it can help to expand those programmes. Instead of constantly issuing new shares under those schemes, the company can use debt in the ESOP trust to buy the shares that the programme needs. In the unquoted company, the ESOP trust provides a way in which employees can sell their shares for cash. This 'quasi-market' is safe; it will not result in outsiders becoming shareholders, thus destroying the essential characteristic of the private company. The ESOP trust makes employee share schemes possible in the private company.

The essence of an ESOP

An ESOP creates a cycle (as in the diagram below): the trust supplies shares to employees through schemes, and buys back those shares for recycling to future employees.



The pieces

The trust

The trust is a discretionary trust in favour of the employees (and the ex-employees and their dependants) of a company. Because it is discretionary, the trustees are free to apply the assets of the trust to benefit one employee only or every employee equally or anything between these two extremes.

The trustees

The trustees of the trust are generally appointed by the company. They can be individuals or a corporate body. Generally a quoted company will see merit in appointing an independent corporate trustee, while an unquoted company might prefer to appoint one of its subsidiaries. The trustee votes the shares and receives any dividends on them while they are in trust. When making awards to employees, the trustee must have sufficient information to be able to exercise discretion with proper judgment. In the case of a quoted company using an independent trustee, therefore, the company will need to establish a committee to communicate with the trustee.

The scope of the trust

There is, in theory at least, no limit on the trustees in terms of the amount they can borrow or the number of shares in the company they can acquire. However the trustees have a duty to act prudently, and no sensible lender will finance the trust unless the proposal stands the test of commercial viability.

The sheer flexibility of the trust often makes it difficult to deal with. Too often 'they' are expected to have set rules and limits to any arrangement: 'they' can be the government, institutions, auditors or regulators of the many hues that the City is producing these days. In fact, the trust is extremely flexible and must be tailored to the specific role that is appropriate for each case.

The employee share scheme(s)

As a matter of strict law, the ESOP trust is itself an 'employees' share scheme' as defined in the Companies Act 1985. But it is preferable to make a commercial distinction so that it is the allocation of shares to employees that is the employee share scheme element of the ESOP. The 'collection and storage' aspects of the ESOP are the role of the ESOP trust.

It is not usually desirable simply to pass shares in a company to the employees of that company without some structured basis to that transfer. Severe criminal penalties can apply if the arrangement is not demonstrated to be an 'employees' share scheme' under company law, and documentation of the scheme is desirable for that purpose. Additionally, there are complex taxation considerations in play when an employee acquires shares in his employing company. Tax demands can be triggered that exceed the value of the share right to the employee and/or at

times when he cannot sell the shares to raise the cash to pay the tax demanded. In short, employees can acquire shares safely with their company's help only through a structured and documented employee share scheme.

The ESOP can use any one or more employee share schemes, whether or not they are approved by the Inland Revenue.

Appendix 2 - UK Inland Revenue approved share schemes

The Inland Revenue approved profit sharing share scheme

This scheme is basically a means of distributing a limited number of shares to all or most of the group's employees, free of charge. Each year, an employee can be appropriated free shares worth up to 10% of his salary, up to a maximum of £6,000 per annum. Employees earning less than £20,000 per annum can still be appropriated up to £2,000 worth of free shares each year. It is known as an 'all-employee' type scheme, since all those who have completed a specified service period - which cannot exceed five years - must be invited to participate.

The scheme works as follows. The company gives funds to the trustees of a conventional approved profit sharing scheme, who use that money to purchase shares in the market or from the trustees of an ESOP trust. In the latter case the sale price can be any between the market value of the shares at the time of sale and the ESOP's book value. The profit sharing trustees then allocate the shares to qualifying employees. The shares are initially registered in the name of the profit sharing trustees, and the employee cannot normally sell his shares for two years. However, to all intents and purposes, the employee is the real owner of the shares; he will receive any dividends paid on them and can direct the trustees as to how they are to be voted. After two years, the employee is free to sell his shares, but if he does so he will pay income tax. After five years, the shares are automatically transferred into the employee's own name, free of income tax, and he is then in exactly the same position as other shareholders.

This scheme has been used in private companies where ESOP trusts have been introduced as a means of facilitating widespread employee ownership for two main reasons. First, because the shares are free, virtually all employees become shareholders, and the tax structure encourages them to retain their shares for five years. It is also very tax efficient for the company. The gifts to the profit sharing trustees are deductible for corporation tax purposes, and since the money is used to purchase shares from the ESOP trust, and so to enable the ESOP trust to repay its loan, a deduction is effectively available for repayments of both interest and capital.

Although the profit sharing scheme is primarily a means of providing free shares to employees, it can also require them to pay a modest contribution. The scheme can be operated so that an employee receives free shares only if he agrees to buy (and retain for, say, two years) an equal or lesser number of shares from his own funds. Known as the 'Buy One Get One Free' scheme (or BOGOF for short!) it is effectively a share purchase scheme at a discount of at least 50%. Adding a contributory element to the scheme often helps to deepen the experience of share ownership, although it does mean that not all employees will become shareholders.

The Inland Revenue approved savings related share option scheme

The second 'all-employee' type scheme is a savings related share option scheme. This enables employees to acquire relatively significant numbers of shares, but on risk free terms. All qualifying employees are invited to save between £10 and £150 each month with a building society for a period of five years. In return, the company, or where an ESOP trust holds shares, the trustees of the ESOP, grant the employees options to acquire shares at a discount of up to 20% of the value of the shares when the options are granted; the number of shares under an employee's option is determined by the amount the employee has agreed to save (plus a guaranteed interest rate) over the five year period.

At the end of the five years saving period (or after seven years if chosen at the outset) and assuming that the share price is above the option price, the employee can elect to use the savings plus the interest to purchase shares. If the share price has fallen, he can simply withdraw his savings and the interest in a cash sum.

Because it requires a contribution (albeit on a risk free basis) only a proportion of employees are likely to take part, but the incentive value may be greater because of the more significant benefits available to employees. Where there is an ESOP trust it can also be used to simulate the effects of real share ownership during the option period, since the trustees of the ESOP can pass on to the employees the dividends and consult their wishes on the votes of the shares under option.

The Inland Revenue approved executive share option scheme

Unlike the other two Inland Revenue approved schemes, this is not an 'all-employee' type scheme. The company or the trustees of the ESOP can select which employees benefit, and the limits on the value of shares an employee can receive are much higher. An executive share option scheme is therefore generally used to target share incentives on senior managers.

Under the scheme, employees are granted options by the company or the ESOP trustees to acquire shares from the ESOP trust, and the option price is fixed at the market value of the shares when the option is granted. The life of the option cannot exceed 10 years, but provided it is held for at least three years, the employee pays no tax when exercising the option. Capital gains tax is payable on the eventual sale of the shares. At any one time, an employee can hold four times salary (or, if higher, £100,000) worth of shares under option, with the value of the shares being calculated at the date the option is granted. Once an option has been exercised, the market value of the shares under that option no longer count for that limit.

