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The *Employee Share Schemes Bill*

Bill 13 of 2001-02

Mark Lazarowicz came sixth in the ballot for Private Member's Bills on 28 June 2001. He introduced a Bill to make provision relating to employee share schemes on 18 July 2001. It is due to have its second reading debate on 18 January 2002.

In the March 2000 Budget the Government announced the introduction of a new tax-advantaged plan – the Share Incentive Plan (SIP) as it is now known – to encourage employees to hold shares in the company or group for which they work. To this end legislation was introduced in the *Finance Act 2000*; a number of changes to make the scheme easier to administer were made in the *Finance Act 2001*.

The Bill would make three changes to these rules, with a view to encouraging the extension of employee share ownership to a wider range of businesses than at present. The Bill would apply to the whole of the United Kingdom.

Antony Seely

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Summary of main points

In December 1998 the Government published a consultation document on employee share ownership. Following the issue of a technical note in March 1999 and draft legislation in November 1999 a new employee share scheme – initially called the All-Employee Share Ownership Plan (AESOP), now called the Share Incentive Plan (SIP) – was introduced in the March 2000 Budget. The main legislative provisions are set out in schedule 8 of the *Finance Act 2000*, as amended by schedule 13 of the *Finance Act 2001*.

The new plan has three key elements:

- free shares: employers may give employees up to £3,000 worth of shares each year.
- partnership shares: employees may be entitled to buy shares each year out of gross pay (ie, prior to any deduction for income tax or national insurance contributions) up to a value of £1,500.
- matching shares: employers may give up to 2 free shares for each partnership share bought by the employee .

Companies may choose various combinations of these shares, as well as granting 'dividend shares', allowing employees to use up to £1,500 of dividends from their plan shares to buy further shares in the company through the plan. All shares covered by the plan must be held in a trust, set up for this purpose by the company. Other optional features include:

- performance-related awards: companies can link the award of free shares to performance measures.
- forfeiture: companies can make employees give up some or all of their free or matching shares if they leave, for certain reasons, within three years of the award date
- holding periods: companies can require employees to hold free and matching plan shares in the SIP employee trust for up to five years. Dividend shares must normally be held for three years.

Employees do not pay income tax or National Insurance on the value of the free or matching shares given to them provided they keep them in the plan for at least 5 years. If they leave, or take them out of the plan for another reason, after 3 to 5 years, there is a reduced tax and National Insurance charge. If they take them out of the plan within 3 years, income tax and National Insurance is payable, on the market value of the shares at the time the employee takes them out. No income tax is paid on the value of the dividends reinvested in more plan shares provided those shares stay in the plan for 3 or more years.

No capital gains tax is payable on any increase in value which occurs while shares are in the plan. When the shares are sold, the cost for calculating capital gains tax is the market value of the shares on exit of the plan and not the market value at acquisition. There is no tax or National Insurance charge where employees leave involuntarily for reasons such as retirement, or on death.

Companies will get corporation tax relief for their costs in setting up and running the plan, and there is further relief for companies for acquiring shares on behalf of employees.

The Inland Revenue has been approving SIPs which satisfy the requirements set down in the legislation since 28 July 2000. Detailed statistics on this employee share plan have not been published to date.[1] However the November 2001 *Pre-Budget Report* noted that "over 220 companies already have approved SIPs, potentially involving over one million employees in share ownership."[2] The Revenue provide a substantive amount of material on SIPs, and other tax-privileged share schemes, on their internet site.[3]

Mark Lazarowicz introduced the *Employee Share Schemes Bill 2001-02* on 18 July 2001, having come sixth in the ballot for Private Member's Bills. The Bill would make three changes in the rules regarding SIPs, with a view to encouraging the extension of employee share ownership to a wider range of businesses than at present – "in particular for those businesses which promote active participation by their employees in their decision making processes."[4] It provides for:

- elected employees to be able to act (at the discretion of the company concerned) as trustees of employee shareholders' interests;
- corporation tax relief where a substantial block of shares is transferred into a trust on behalf of employees;
- companies owned by employee trusts to have the power to set up a Share Incentive Plan to deliver tax efficient share ownership to their employees.[5]

The Bill has the support of the Co-operative Party and the TUC, although the Government's position has not been stated as yet.

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1 Statistics on other schemes are available at: www.inlandrevenue.gov.uk/stats/emp_share_schemes/menu.htm It is worth noting that figures on employee participation in tax-privileged schemes are not available on a sectoral basis (HC Deb 13 November 2001 cc 608-9W).

2 Cm 5318 November 2001 p 42

3 www.inlandrevenue.gov.uk/shareschemes/index.htm

4 Speech by Mark Lazarowicz MP to Scott Bader conference, 21 November 2001

5 Campaign letter by Mark Lazarowicz on the Employee Share Schemes Bill, 7 December 2001

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I Share Incentive Plans

A. The December 1998 consultation

Many companies reward their employees by granting them shares – or share options[6] – as a complement to their earnings, to give employees a personal stake in the company's future performance. In December 1998 the Government published a consultation document on employee share ownership, seeking views on:

- how the Government could encourage more companies, particularly smaller and unquoted companies, to offer all-employee share schemes;
- what the existing barriers to participation in such schemes were; and
- how the Government could encourage longer term holding of shares by employees.[7]

In the foreword to this document the Chancellor, Gordon Brown, stated that there were three aims to any future reform: "to reward long term commitment by employees … to encourage the new enterprise culture of team work in which everyone contributes and everyone benefits from success … [and] to double the number of companies in which all employees have the opportunity to hold shares."[8] In the latter case, this set the Chancellor's target at the involvement of another 1,750 companies.[9]

At this time three tax-advantaged schemes designed to promote employee share ownership were available: the Approved Profit Sharing Scheme (APS) and the Save As You Earn Sharesave Scheme (SAYE) – which must be offered to all employees – and the Company Share Option Plan (CSOP) – which may be offered to selected employees. Around one million employees were given shares and a similar number were granted share options each year though these schemes – representing about 7% of the workforce.[10]

A short summary of each scheme is given below:[11]

Under the **Approved Profit Sharing (APS)** scheme companies may make tax deductible payments to a trust to buy shares in the company and appropriate them to scheme participants. All employees (including part timers) with 5 years' service must be eligible to participate on similar terms, but in practice most companies have accepted those with

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6 A 'share option' gives an employee the right to purchase company shares at the then-current share price at some stage in the future, usually by a specified date.

7 HM Treasury press notice 213/98, 18 December 1998. The Government's intention to consult on this question had been flagged in the *Pre-Budget Report* the previous month (Cm 4076 November 1998 pp 38-39).

8 HM Treasury, *Consultation on employee share ownership*, December 1998 p 1

9 Inland Revenue, *New all-employee share plan: final regulatory impact assessment*, April 2000 para 4

10 Further background on employee financial participation schemes enjoying tax-privileges is given in *Inland Revenue Statistics 2000* pp 68-74. A fully updated version of this data is available on the Revenue's internet site at: www.inlandrevenue.gov.uk/stats/emp_share_schemes/menu.htm.

11 This summary is taken from, *Consultation on employee share ownership*, December 1998 p 9

much shorter service. The shares must be left in trust for at least 2 years, and are free of income tax if left in trust for a further year. In 1998 859 companies offered this scheme and it had one million participants. The average value of shares per employee was £680. The scheme had a tax cost of £150 million.

Under the **Save As You Earn Sharesave (SAYE)** scheme employees may enter into a 3 or 5 year savings contract to save a fixed monthly income sum of between £5 and £250, receiving a tax free bonus at the end (with an additional bonus if 5 years' savings are held on deposit for a further two years). Bonuses, equivalent to fixed rate interest, are set by the Treasury. Proceeds of savings and interest may be (but do not have to be) used to exercise - free of income tax - share options granted at the start of the contract. Options may be granted at a discount of up to 20% of the market value. As with the APS scheme, all employees (including part timers) with at least 5 years service must be entitled to participate on similar terms, though again, most schemes have accepted those with much shorter service. In 1998 1,201 companies offered SAYE schemes with 1.25 million participants. The average grant per employee was £2,700, and the average amount saved per month was £59. The scheme had a tax cost of £380 million.

Under the **Company Share Option Plan (CSOP)** companies may grant employees options to purchase shares at a future date at the market price of the shares at the time of grant. Each participant may be granted options over shares worth up to £30,000 at any one time. No income tax is charged on the increase in value of the shares between grant and exercise provided the two main rules are observed: options must be held for at least three years; and there must be a gap of at least 3 years between each tax-relieved exercise. The scheme is discretionary: companies can select those employees or directors to whom they wish to grant options. In 1998 there were 3,769 companies operating CSOPs with 300,000 participants. The average grant per participant was £5,700. The scheme had a tax cost of £100 million.

In its consultation document the Government set out the economic case for extending employee share ownership as follows:

> Employee share ownership offers the prospect of bridging the gap between employees and shareholders, to the long term benefit of employees, managers and outside investors. By aligning more closely the interests of the workforce and the owners of the company, employee ownership can help increase cooperation. Over time, employees with a stake in the business have an incentive to contribute more actively to the development of the business by raising productivity. If the majority of employees have such an ownership stake, then individual efforts may become mutually reinforcing, and employees have an interest in the work of their colleagues.
>
> Once they have become shareholders, employees are more likely to feel greater commitment to the company for which they work. This in turn can help companies in their recruitment and retention, and enable them to obtain a better return from their investment in employee training. Finally, employees who are also shareholders may better understand the risks faced by the company and its

> investors, which in turn can encourage recognition of the case for pay responsibility.

Particular mention was made of the experience of the United States:

> Employee share ownership is widespread in the United States, and most of the research evidence on the practical impact of employee ownership relates to the US. The key conclusion of this research is that employee share ownership, especially when combined with other means of active employee participation, does have a positive impact on employee motivation, productivity and corporate performance. The benefits are enhanced when share ownership operates in parallel with modern management methods, so that financial incentives are reinforced by other practical measures.[12]

On the specific question of extending employee share schemes across the workforce, the consultation document noted that "most of the very largest companies already have at least one approved all employee share scheme":

> In order to increase the number of companies in which all employees have the opportunity to own shares, ways must be found to increase the attractiveness of employee share schemes to small and unquoted companies. The current design of schemes, together with the costs and administrative burden of setting up and running the schemes, may not favour participation by smaller companies. Smaller companies may also lack the information and advice to set up schemes easily, which might be remedied by more vigorous promotion of the schemes.[13]

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[12] *Consultation on employee share ownership*, December 1998 p 4. Although no specific study is cited, the National Center for Employee Ownership (1736 Franklin St., 8th Flr. Oakland, CA 94612 USA), publishes a considerable amount of material on their internet site (www.nceo.org), including a summary of research material on the relationship between employee ownership and corporate performance at: www.nceo.org/library/corpperf.html. Two other American organisations working in this field are the ESOP Association (www.the-esop-emplowner.org), and the Foundation for Enterprise Development (www.fed.org), both with offices in Washington DC.

[13] *Consultation on employee share ownership*, December 1998 p 6

B. Provisions to introduce the new scheme: the March 2000 Budget

In the March 1999 Budget the Chancellor announced that the Government would be consulting on two new employee share schemes:

> I propose next a tax reform that will reward risk and stimulate new enterprise at the cutting edge of technology. I want to recruit, motivate and reward Britain's risk-takers - the innovators capable of creating wealth and jobs in the Britain of tomorrow. In the past, share option schemes, subsidised by the taxpayer, have rewarded those already at the top whose risks are low and rewards already high - such as utility chief executives, often operating in a monopoly environment. Tomorrow, we will publish details of a very different kind of targeted tax cut for those who are prepared to move from secure jobs to venture their time and effort to create wealth for our country. The new enterprise management incentive will allow the award of equity worth up to £100,000 for success in building the new path-breaking companies our economy needs …
>
> To open Britain's economy to the enterprise of all, we propose employee shares for all. Britain can and must become a democracy of enterprise, that gives all who create wealth a greater stake in the wealth they create. Under our new programme of shares for all, employees will be able for the first time to buy shares in their own company from their pre-tax income. Every employer will be able to match, tax-free, what each employee buys. This will be the most tax-advantaged all-employee share ownership scheme that Britain has had. Our only stipulation is that it really must be shares for all, offered right across the company's entire work force.[14]

To this end, the Inland Revenue published an outline of both schemes in two technical notes,[15] and established an advisory group to assist in the development of the new schemes composed of tax practitioners, business people and other experts.[16] The design of the proposed all-employee scheme reflected observations made by respondents to the original consultation document:

> A key message from the recent consultation exercise is that the existing Inland Revenue approved schemes are not flexible enough, for example companies have to award shares on a similar basis to all employees in the scheme. This means that they must give shares to workers who are less productive than their colleagues, or who may be about to leave their company.
>
> A number of respondents have suggested that employees should be able to buy shares in their company out of their pre-tax salary, that is before PAYE and NICs

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[14] HC Deb 9 March 1999 cc 177-179. Further details were given in HM Treasury Budget press notices HMT2 & HMT11, 9 March 1999

[15] *Enterprise management incentives: a new scheme* & *A new all-employee share scheme*, March 1999. Both are available on the Revenue's site at: www.inlandrevenue.gov.uk/consult/index.htm.

[16] Inland Revenue press notice 80/99, 30 March 1999

> are deducted. Respondents also wanted greater freedom to restrict awards of free shares to employees who first bought shares in the company.[17]

Draft legislation was published in November 1999,[18] and a number of roadshows, run by the Revenue and ProShare[19], were organised for companies considering an all-employee plan.[20] Apparently respondents were very much in favour of the new plan, although the main concern expressed in response to the consultation exercise was that the new share scheme might replace SAYE.

Final details were given at the time of the March 2000 Budget; in his Budget speech the Chancellor described these measures as "the biggest boost for employee shareholding the country has ever seen" and "the next step on our road to a wealth owning democracy."[21]

Briefly, the Government proposed to retain both the SAYE scheme and the CSOP, though no new APS schemes would be approved from 6 April 2001. It was anticipated that the "the vast majority of companies with APS schemes" would replace this scheme with the new all-employee share option plan.[22] The main features of the new plan were set out as follows:

> - Employers can give employees up to £3,000 of shares each year free of tax and National Insurance, and
> - Some or all of these shares can be awarded to employees for reaching performance targets
> - Employees will be able to buy partnership shares out of their pre-tax salary, up to a maximum of £1,500 a year, free of tax and National Insurance
> - Employers can match partnership shares by giving employees up to 2 free shares for each partnership share they buy …
>
> The new plan will eventually cost around £400 million a year and it is expected that around 450 employers are expected to use the plan to set up their first all employee share scheme. As a result more than 500,000 employees will own shares in their company for the first time. The total number of employees having shares in a new plan is estimated to reach 2.5 million in the next 3 to 5 years.
>
> The existing approved schemes
> - SAYE Sharesave (SAYE) and the Company Share Option Plan (CSOP) are to continue unaltered.

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[17] *A new all-employee share scheme*, March 1999 p 6
[18] Inland Revenue press notices IR5 & IR6, 10 November 1999
[19] ProShare is an independent, not-for-profit organisation limited by guarantee and founded in 1992, to "promote responsible share based investment, including employee share ownership, primarily through education and research." For details see: www.proshare.org.
[20] Inland Revenue press notice 195/99, 8 December 1999
[21] HC Deb 21 March 2000 c 861
[22] Inland Revenue Budget press notice REV3, 21 March 2000

- No further tax free awards can be made under the Approved Profit Sharing (APS) from April 2002.
- Provisions in the Finance Bill will prevent the use of the APS and the new plan in arrangements designed to replace Profit-Related Pay rather than give employees a continuing stake in the business.[23]

Two aspects of the scheme distinguish it from existing schemes: the ability of employers to award free shares on the basis of performance, and the ability of employees to purchase partnership shares out of gross pay. A revised regulatory impact assessment was published at this time, which provided a summary of the benefits and costs of implementing the new scheme; this is reproduced overleaf:[24]

[23] Inland Revenue Budget press notice REV3, 21 March 2000

[24] "Appendix 1", *New all-employee share plan: final regulatory impact assessment*, April 2000

	Expected costs	**Expected benefits**
Business **Large**	One-off costs estimated at between £200,000 and £750,000 (based on a range from a bottom FTSE 350 to a major FTSE 100) Recurrent costs estimated at £100,000 to £200,000 each year (based on a range from a bottom of FTSE 350 to a major FTSE 100)	• Likely to benefit the economy as a whole, as well as individual employers and employees • Likely to improve productivity particularly when combined with modern management practices and other forms of active employee participation • Likely to help bridge the gap between employees, managers and shareholders • Likely to help reduce staff turnover by improving employee commitment and motivation • Provides payroll savings in the form of relief from employer's NICs • Provides relief from corporation tax
Business **Small**	One-off costs estimated at typically between £20,000 and £40,000 Recurrent costs estimated at typically £15,000 to £30,000 with £10,000 as a rock bottom minimum for a company with 50 employees	• Likely to be taken up by companies previously unable or unwilling to offer shares to their workforce • Likely to improve productivity particularly when combined with modern management practices and other forms of active employee participation • Likely to help reduce staff turnover by improving employee commitment and motivation • Likely to help bridge the gap between employees, managers and shareholders by aligning more closely the interests of the workforce and those of the owners of the company • Provides payroll savings and relief from corporation tax as for larger companies
Employees	• Time costs in understanding the new plan, resolving queries and completing any paperwork • Buying partnership shares may reduce the benefit entitlement of a small number of people	• Likely to strengthen the partnership between employee and employer by giving the employee a direct interest in the company's success and share performance • Provides relief from income tax and NICs • Allows for employees to receive dividends free of tax • Provides a capital gains tax shelter while shares are in the plan
Government	Negligible administrative costs	• Encourages the new enterprise culture by stimulating wider responsible share ownership where the shares are likely to be held for a longer time

Legislation to introduce the scheme was contained in the *Finance Act 2000*: specifically sections 47-56 and schedule 8 of the Act.[25] The then Financial Secretary, Stephen Timms, summarised the purpose of the new scheme:

> We want to build an economy that is modern and decent at the same time, and in which enterprise and fairness are not opposites but complement each other. Nowhere in the Bill is that clearer than in these clauses, which herald a big step forward for employee share ownership in the UK … Offering employees the opportunity to have shares in their company builds a community of interest between workers and owners, in making the company successful and helping it grow … The plan outlined in these clauses … was designed with the help of a private sector advisory group, representatives of companies with share schemes, service providers and the Trades Union Congress … Two periods of public consultation have taken place on the general shape of the new plan and on the first draft of the Bill. Many hon. Members, including some who are members of this Committee, have been involved in discussions and consultation, and have contributed, in a variety of ways, to the success of the initiative, culminating in these clauses. The plan should appeal to big and small companies, as they have had the opportunity to influence the policy. It is an excellent example of how modern government should work.[26]

Generally Conservative Members gave the scheme a cautious welcome, David Heathcoat-Amory noting that employee share ownership was something he and his colleagues "strongly support in concept."[27] Howard Flight raised the concern that lower-paid employees buying partnership shares out of gross pay might lose some entitlement to social security benefits, as a consequence of paying lower NICs. Mr Timms responded to this point as follows:

> We are well aware of the issues that the hon. Gentleman has raised. Our key concern was to ensure that low-paid employees were not excluded from the benefits of participation in the scheme … Information will be made available to employees to help them to decide whether they want to run any risk of damaging their future benefit entitlement if they choose to buy shares. Some will still decide to purchase them, if they consider that the advantages outweigh the potential loss of benefit entitlement. It should be up to them to decide … The Inland Revenue has worked closely with the Department of Social Security in examining the issue. The approach that emerged from that work - which is the correct one - was that we should ensure that everyone has full information on which to base a decision about share purchase; that is the right approach.[28]

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[25] These provisions were scrutinised at the Committee stage of the Bill on 25 May 2000 (SC Deb (H) cc 387-416), and the Report stage on 19 July 2000 (HC Deb cc 398-416).

[26] SC Deb (H) 25 May 2000 c 393

[27] *op.cit.* c 388

[28] *op.cit.* c 406. Mr Flight also raised this issue at the Report stage of the Bill (HC Deb 19 July c 399). The Revenue's guidance on this issue – *Inland Revenue leaflet IR177: Share Incentive Plans and your entitlement to benefits*, October 2001 – is available on their internet site.

One amendment made to the scheme at the Report stage is worth highlighting, in the context of the *Employee Share Schemes Bill 2001-02*; a change in the rules regarding qualifying shares to allow retail co-operatives to participate in the scheme.[29] The then Financial Secretary, Mr Timms, set out the purpose of this change:

> The new plan is designed to give employees a genuine stake in the company for which they work. Under Inland Revenue-approved share schemes, redeemable shares do not normally count as qualifying shares because they do not entail a full-blown stake in the company - employees can get their money back whenever they want to do so. Members of retail co-operatives hold redeemable shares, as do those in workers' co-ops. Shares in retail co-ops are bought at their face value. They carry a small amount of interest, providing a dividend based on the company's profit that varies according to the amount of purchases made by the member - often known as a divvy. The shares are also normally redeemable by the company at the same value.
>
> Retail co-ops want to improve their employees' participation in their business. They want to use the redeemable shares that they issue to other members in an all-employee share plan. Without an amendment to the legislation, such shares would not qualify for the new plan. The amendments extend the current exception whereby workers' co-ops may use redeemable share capital in a new plan to all co-ops that are registered industrial and provident societies.
>
> The Co-operative Union estimates that at present very few employees are members in this way - perhaps as few as 2 per cent. of the 40,000 employees in the 37 United Kingdom consumer co-ops. These changes will enable retail co-ops to encourage their employees to take a stake in the business, using the same redeemable share capital available to other members. Many more employees working in co-ops will be able to benefit from the tax reliefs in the plan. That will help us to achieve our goal of doubling the number of companies that offer shares to all their employees, and it will extend to co-operatives the substantial advantages that the new scheme offers.[30]

The Government also announced details of the new enterprise management incentive (EMI) in the March 2000 Budget; briefly, under the scheme:

- Independent trading companies with gross assets not exceeding £15 million will be able to reward up to 15 key employees with tax-advantaged share options, each receiving options worth up to £100,000 at the time of grant;
- There is no tax on the grant of the option and there will be normally no tax or National Insurance for the employee to pay when the options are exercised; nor will there normally be any National Insurance charge for the employer;

[29] Inland Revenue press notice 116/00, 10 July 2000
[30] HC Deb 19 July 2000 cc 398-9

- When the shares are sold, CGT taper relief will normally start from the date the options are granted.[31]

Legislation to introduce the new EMI was also included in the *Finance Act 2000*.[32]

Further refinements in the design of both schemes were proposed in the *Pre-Budget Report* in November 2000,[33] and announced in the March 2001 Budget.[34] For EMI schemes, the limit on the number of employees given options was removed and the maximum value of options doubled to £3 million per company.[35] (Subsequently the £15 million asset limit on eligible companies has been doubled to £30 million, with effect from 1 January 2002.[36]) A Budget 2001 press notice set out the changes to be made to all-employee share ownership plans (AESOPs):

> New enhancements will simplify the operation of All-Employee Share Ownership Plans (AESOPs) and ensure that stamp duty is not paid twice when firms grant shares to their employees. As AESOPs are run through a trust, there can be a stamp duty charge both when the trust buys shares and when these shares are subsequently bought by the employees. The changes announced today will remove the stamp duty charge when employees buy shares from an AESOP trust. The Government will also remove the possibility of employees facing an income tax charge when an employer or trust meets the stamp duty liability. The possibility of employees facing an income tax charge when an employer or trust meets incidental costs of operating the plan will also be removed.
>
> Another change will make the scheme both fairer and easier for groups of companies to use. Currently some people who have been employed by the group are excluded from participating in a plan, because they have moved around within the group. The changes announced today mean that an employee will satisfy a qualifying period of employment for AESOPs by having worked throughout that period in any company that was part of the group. These measures will make the administration of the AESOP simpler and help reduce compliance costs.[37]

Legislation was introduced to this end in the *Finance Act 2001*.[38]

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[31] Inland Revenue Budget press notice REV3, 21 March 2000

[32] specifically section 62 and schedule 14 of the *Finance Act 2000*. These provisions were scrutinised at the Committee stage of the Bill on 6 & 8 June 2000 (SC Deb (H) cc 506-565), and the Report stage on 19 July 2000 (HC Deb cc 418-426).

[33] Cm 4917 November 2000 pp 46-47

[34] HC Deb 7 March 2001 c 299

[35] under section 62 and schedule 14 of the *Finance Act 2001*. These provisions were scrutinised at the Committee stage of the Bill on 1 May 2001 (SC Deb (A) cc 87-100).

[36] Under SI 2001/3799 The Government announced it would double the gross asset limit in June 2001 (HM Treasury, *Productivity in the UK: enterprise and the productivity challenge*, June 2001 pp 13-14).

[37] Inland Revenue Budget press notice REV3, 7 March 2001

[38] under sections 61 & 95 and schedule 13 of the *Finance Act 2001*. These provisions were scrutinised at the Committee stage of the Bill on 1 May 2001 (SC Deb (A) cc 81-87).

C. Recent developments

At the time of the March 2001 Budget the Government noted that it was considering a further tax change to encourage share ownership:

> As well as creating targeted incentives for employees to take up share ownership, the Government also aims to reduce the fiscal barriers to companies using equity remuneration to provide incentives for their workforce, thereby enhancing the UK business environment. The Government will examine the corporation tax treatment given in respect of employee share awards and share options, including whether corporation tax deduction should be made available and how access to it could be streamlined.[39]

No further details were given in the November 2001 *Pre-Budget Report*, though it was noted that the Government were still considering this type of relief.[40]

Details of AESOPs/SIPs established in eight companies[41] are provided in a survey of all-employee share schemes published in July 2001.[42] It noted that the variety of plan shares available had resulted in a variety of combinations between the companies surveyed, although none of them had taken advantage of the opportunity to link the award of free shares to individual performance. "However, the new plan is still in its infancy and it may take companies some time to adapt their existing performance management arrangements to the Inland Revenue criteria for awarding shares on this basis." The authors went on to make a number of general comments on the pros and cons of this plan:

> AESOPs are widely regarded as the most tax-efficient type of share plan in the UK. The ability to buy partnership shares out of pre-tax salary and the fact that all categories of shares are not subject to income tax and national insurance if held for five years make AESOPs an attractive proposition for employees. Furthermore, if employees keep their shares in a plan for a minimum of five years, they are not liable for capital gains tax. (However, if they take them out of a plan and do not sell them immediately, they are liable for CGT on any increase in their value after they came out of the plan.)
>
> From the standpoint of employers, AESOPs offer more flexibility than other approved share plans, allowing them greater scope to adapt the plan to suit their own purposes. For example, the three different types of share can be offered singly or in combination. Companies are also free to decide whether reinvestment of dividends in plan shares is compulsory or optional for employees. Another advantage is that companies may decide their own forfeiture policy if

[39] HC 279 March 2001 p 43
[40] Cm 5318 November 2001 p 43
[41] Abbey National, Alliance & Leicester, AstraZeneca, BG Group, the Boots Company, Legal & General, Orange, Sterling Healthcare
[42] Incomes Data Services, *All-employee share schemes: IDS Studies 712*, July 2001

> employees leave or are dismissed within three years of receiving free or matching shares. An AESOP is the first approved share plan to enable employers to link the award of free shares to individual performance, which could be an attraction for some businesses.
>
> The downside
> But one of the main criticisms levelled at the plan is that the five-year holding period is too long for some employees and may deter them from buying partnership shares. The other main criticism is the risk involved in buying partnership shares, especially for lower earners, who may not be in a position financially to withstand losses. Because partnership shares constitute a greater risk than SAYE, employers are obliged to issue more 'health warnings' which can affect the take-up. This could mean that partnership shares are more attractive to higher rate taxpayers who are likely to be less risk-averse and who benefit more from the tax relief. The perception of risk could impact on the government's objective of widening employee shareholding, as higher-paid employees are more likely to participate in share schemes anyway. On the other hand, the monthly pre-tax limit of £125 for buying partnership shares may be regarded as insufficient for those higher earners who would be prepared to take more of a risk. [43]
>
> For employers, the perceived advantages can also have their downsides. The very flexibility of AESOPs and the different types of shares can make the administration more complex and onerous. Partnership shares are widely regarded as complicated to administer. There is also a relatively bureaucratic signing-up process for free shares. If employees do not formally apply for their free shares by a set date, they lose their entitlement. The complexity of AESOPs can also make them difficult to communicate to employees.[44]

In October 2001 the Chancellor launched a national roadshow to publicise employee share plans and encourage employee share ownership, supported by a new consortium of organisations – the Employee Share Alliance.[45] Following concerns that the AESOP acronym was too similar to older schemes, this scheme was renamed the Share Incentive Plan (SIP).[46] On this occasion the Chancellor was quoted as follows:

> The Share Incentive Plan is a key component of the Government's productivity agenda. Research in the US and UK has shown clearly the link between employee

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43 Deductions from salary for partnership shares must not exceed £1,500 a year – £125 a month – nor 10% of the employee's salary.

44 Incomes Data Services, *op.cit.* pp 1, 4-5

45 Members include: the TUC, CBI, Institute Of Directors, Industrial Society, Job Ownership Ltd, ProShare, the Employee Share Ownership Centre, the Centre for Tomorrow's Company, the Chartered Institute for Personnel Development, the Co-operative Union and the Industrial Common Ownership Movement. Some details are given on the internet site: www.employeeshareallliance.co.uk.

46 Research was commissioned in 1999 to determine a better name for the scheme; apparently "employees expressed an overwhelming preference for [the name] Share Incentive Plan" (HC Deb 8 January 2002 c 807W).

> share ownership and increased productivity, and there is no better incentive for employees than for their work to be recognised and for them to share in their firm's success. Evidence shows that employee commitment is a vital strength of companies, with these companies consistently out-performing their competitors in the global economy.
>
> Employee share ownership is a milestone in removing once and for all the old 'them and us' culture in industry. Today, 470 companies and 700,000 employees are set to enjoy the benefits of the plan, which represent a perfect example of how each and everyone of us - businesses, trades unions, employees and Government - can contribute towards achieving our productivity goals.[47]

Writing in the *Financial Times* at this time, Michael Peel argued that this exercise underlined the fact that the take-up of the new scheme had been disappointing to date:

> Accountants say a number of their corporate clients are cautious about the plan. Businesses that have won shareholder permission to run schemes are holding back because they are reluctant to be among the pioneers. "Companies are not wanting to be the first to dip their toes in the water," says Alan Olivey, a partner at Ernst & Young, the professional services firm. "They are waiting to learn from others' mistakes."
>
> One problem for the government is the extra burden the new scheme places on employees. Workers have to put money up front to buy shares, taking the risk that their investments could go down. The approach contrasts with the SAYE scheme, under which employees put money into a fund and are given options to buy shares: if the shares perform poorly, people can claim back their stake plus interest. The government's attempt to shift the balance of risk looks unappealing in the context of economic slow-down and international crisis. The FTSE All-Share index fell 20 per cent in the year to Monday this week. It is hardly surprising if people are still keen on the no-lose aspect of SAYE schemes, which the Revenue has approved for use by about 2,000 companies.
>
> A further drawback is that the attractiveness of the share incentive plan is highly dependent on the largesse of companies. Under the plan, employees are allowed to buy up to £1,500 of shares a year out of pre-tax salary, which the employer can then supplement with up to £3,000 of "matching" shares and £3,000 of free shares. If a company is generous, an employee could receive £7,500 of equity for an investment of £1,500; the downside is that an employer in hard times could give nothing.
>
> Tax experts highlight other structural features of the plan that could deter employers and employees. The scheme is seen as complex for smaller companies to administer and the five-year qualification period for tax exemption on sales of the shares is deemed too long. "It's an imaginative and

[47] Inland Revenue press notice 29 October 2001

> generous scheme," says Aidan Langley, a partner at Deloitte & Touche, the professional services firm. "It just needs more doing to it than changing its name and having a series of seminars around the country."[48]

In part answer to a PQ in November 2001, the Economic Secretary, Ruth Kelly, noted that both the share ownership plan and the enterprise management incentive were "being closely monitored to assess how far they are meeting the needs of companies of all sizes and sectors."[49]

48 "Sizing up the options", *Financial Times*, 1 November 2001
49 HC Deb 14 November 2001 c 771W

II The Bill

Mark Lazarowicz introduced the *Employee Share Schemes Bill 2001-02* on 18 July 2001.[50] Mr Lazarowicz summarised the purpose of his Bill in a speech on 21 November 2001, to a conference organised by the Scott Bader company on employee share ownership:[51]

> Although 3 million employees can participate in SIPs, most are almost certainly involved in schemes where there is no, or little, real participation by those employees in the active ownership of their business. In some cases, the SIP is simply a device to take advantage of the favourable tax regime. In other cases, the SIP will be aimed more at raising new capital. In other cases still, the SIP will indeed give the employee concerned a direct stake in the financial success of the business. In the last two cases, the SIP is of course being used to a greater extent for the purpose for what the concept was originally intended, namely to foster a community of interest between management and workers so as to contribute to the general well-being of the business.
>
> These last two objectives are laudable; but ownership by employees of shares in their business can also be, and in my view is most successfully, used when it encourages not just a passive identification with the success of a business, but also an active participation in the decision making of that business, which as examples such as the John Lewis Partnership show, can make a real contribution to the success of the business.
>
> And so what my PMB aims to do is to encourage the extension of the benefits of employee share ownership to a wider range of businesses than at present, and in particular for those businesses which promote active participation by their employees in their decision making processes.

Mr Lazarowicz went on to argue the aims of his Bill fitted well with a more general move toward wider employee share ownership:

> The proposals I make would not be mandatory; they would not be forced on any unwilling company, board of directors, shareholders or employees. They offer, rather, an **optional** model which can be utilised by those who can see the potential of encouraging active employee share participation in their business.
>
> I believe, nevertheless, that the changes I propose will offer a major opportunity to extend employee ownership in this country. The active participation of the workforce is especially important in the "new economy" where access to a wide range of creative input is vital for success. Employee shareholders have a strong

[50] HC Deb 18 July 2001 c 306

[51] The lobbying organisation Job Ownership Ltd published details on this conference – "Sharing success: why Britain needs employee owners" – as well as general material on employee ownership, and their support for Mr Lazarowicz's Bill, on their internet site at: www.jobownership.co.uk.

> interest in seeing their companies do well, and are often best placed to identify opportunities for growth. I know that the Labour Government is keen to improve the productivity of UK firms by encouraging employees to become shareholders, and I believe my Bill would be a further significant step towards this objective …
>
> I believe one can say employee ownership is an idea whose time has come. I say that because I know that within the Labour Party there is an increasing interest in encouraging that wide range of models of corporate organisation which seek to make it easier for the "stakeholder" – the person, or organisation, whether employee, shareholder, consumer, local resident or member of a non-geographic community who has a stake in the success of a business (and I include in that both financial success and success in performance) – to take an active role in the decision making process of that business. In so doing, that stakeholder can contribute to the success of that business and can reap real benefit from that involvement.[52]

The Bill has received active support from the Co-operative Party,[53] and is also supported by the TUC though there has been relatively little attention in the media or comment from other organisations.

As noted above, the Bill seeks to extend employee ownership by:

- Widening the application of tax relief on employee shareholding to a greater range of companies;
- Enabling employee shareholders to collectively play a greater role in the management of their shares;
- Making it easier for companies to be transferred into full employee ownership.[54]

To this end, Clause 1 of the Bill makes three amendments to the main legislative provisions regarding Share Incentive Plans (SIPs) – which are contained in schedule 8 of the *Finance Act 2000*, as amended by schedule 13 of the *Finance Act 2001*. The second of the Bill's two clauses provides its short title.

Widening the coverage of SIPs

At present only 'eligible shares' may constitute an SIP; these are defined as:

(a) shares of a class listed on a recognised stock exchange; or
(b) shares in a company which is not under the control of another company; or

[52] Speech by Mark Lazarowicz MP to Scott Bader conference, 21 November 2001

[53] Co-operative Party press notice, *Bill offers employee shareholders greater say*, 16 July 2001 Further details are available on the Party's internet site: www.co-op-party.org.uk

[54] Mark Lazarowicz's office, *Employee Share Schemes Bill: Briefing and background information*, January 2002

(c) shares in a company which is under the control of a company (other than a company which is, or would if resident in the United Kingdom be, a close company) whose shares are listed on a recognised stock exchange.[55]

As a consequence only subsidiaries of UK quoted companies may operate a plan, not trust-owned companies – such as the John Lewis Partnership – as a recent PQ underscores:

> **Mr. Love:** To ask the Chancellor of the Exchequer how many employees of (a) mutual, (b) co-operative and (c) employee trust [owned] companies would benefit if the present rules were changed to permit such organisations to participate in employee share ownership plans; what plans there are to expand ESOPs in this way; and if he will make a statement.
>
> **Ruth Kelly:** Employees of registered industrial and provident societies which are co-operatives are already able to participate in the Share Incentive Plan introduced last year. Companies such as mutual organisations and trust-owned companies that do not issue shares are not able to participate. We estimate that some 70,000 staff are employed by mutual organisations and around 60,000 are employed by trust owned businesses in the UK. We have not yet been able to devise a way in which the link between share ownership and company performance might be reflected in such corporate structures.[56]

Clause 1(2) of the Bill adds to the list of 'eligible shares' a fourth category: "shares in a company under the control of another company which holds its shares in the company as assets vested in it for charitable purposes only or as assets of an employee benefit trust." In effect companies controlled by corporate employee trusts or corporate charities may be entitled to set up a plan.

Generally there is a requirement that shares used in a SIP do not have restrictions that do not also apply to other shareholders. Private companies often have restrictions attached to shares that employees and directors can purchase. To enable more of these companies to participate, the legislation allows certain limited restrictions.[57] Unless they apply to all ordinary shares, the only restrictions that may be set are those affecting voting rights, forfeiture or pre-emption.[58]

It is common for trust-controlled companies to set different restrictions – say in relation to dividends – on shares held by trustees and shares held by employees. The ordinary share capital of such a company may therefore consist of shares of more than one class. To allow these companies to operate a plan while maintaining these arrangements, **clause**

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55 paragraph 61 of schedule 8 of the *Finance Act 2000*
56 HC Deb 13 November 2001 c 608W
57 *Share Incentive Plans: guidance for employers and advisers IR 2005*, October 2001 pp 19-20
58 Any restrictions required in the Model Code in the stock exchange listing rules are ignored for these purposes.

1(3)-(4) makes provision with regard to 'eligible shares' issued by an 'employee-controlled company'. For these purposes, a company is 'employee-controlled' if:

(a) the persons holding shares in the company are, by virtue of their holding, together able to control the company; and
(b) those persons—
    (i) are or have been employees or directors of the company or of another company which is under the control of the company, or
    (ii) hold the shares as assets vested in them for charitable purposes only or as assets of an employee benefit trust."

Under these circumstances, "eligible shares may be subject to restrictions that affect only shares of the same class as the eligible shares."

Extending membership of trusts managing SIP shares

When an SIP is set up, it is necessary to set up a trust to hold the shares. The legislation details various requirements for this trust, and the duties and responsibilities of its trustees.[59] The trustees must be a body that is separate from the company setting up the trust and can be either a collection of individuals, or a specially created trust company. As the Revenue's guidance notes, trustees may be employees or directors of the company, but they must act in accordance with the trust deed and the Share Incentive Plan legislation, and in the best interests of the beneficiaries of the trust, that is, the employees of the company.[60] In his speech on the Bill cited above, Mr Lazarowicz suggested that more should be done to encourage employee participation given that "the practice is for employee shareholders to rely on company-appointed trustees to manage their shares and participate in company decisions on their behalf."[61]

Under paragraph 68(1) & (2) of schedule 8 of *Finance Act 2000*, the trust needs to be

- constituted by a trust deed that complies with the SIP legislation
- subject to local UK law
- administered by trustees who are resident for tax purposes in the UK.

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59 under part IX of schedule 8 of the *Finance Act 2000*

60 *Share Incentive Plans: guidance for employers and advisers IR 2005*, October 2001 p 44. The IDS survey of share schemes cited above found a variety of practice across companies operating SIPs. Some use third parties to act as administrators, and, in one case, as plan trustees; others retain these functions in-house (*All-employee share schemes: IDS Studies 712*, July 2001 p 12).

61 Speech by Mark Lazarowicz MP to Scott Bader conference, 21 November 2001

In addition the trust deed must not contain any features that are neither essential nor reasonably incidental to the purpose of complying with the Share Incentive Plan legislation.[62]

Clause 1(5) of the Bill adds a further provision – paragraph 68(4) – with the aim of encouraging companies, when drawing up a trust instrument, to include provisions for the appointment of employee-elected trustees. In more detail, the clause allows a trust instrument to "contain terms that

(a) define who is a professional trustee and who is a non-professional trustee;
(b) the trustees include at least one person who is a professional trustee and at least two persons who are non-professional trustees;
(c) at least half of the non-professional trustees were, before being appointed as trustees, selected in accordance with a specified process of selection;
(d) the trustees so selected are persons who are employees of the company or, in the case of a group plan, of a participating company."

Such terms "shall be deemed reasonably incidental to complying with the requirements" – set in paragraph 68(3) of schedule 8 – that the deed not contain any features that are neither essential nor reasonably incidental to the purpose of complying with the SIP legislation.

Corporation tax relief on share transfers

Provided the necessary conditions are met, an employer can claim relief against corporation tax – and is not liable for employer's NICs – on shares given to, or purchased by, employers through a SIP. In the case of free or matching shares, the deduction is equal to the market value of shares when they are acquired by the plan trustees. In the case of partnership shares, a deduction is allowed for the amount by which the market value of the shares at the time that they are acquired by the trustees exceeds the amount of partnership money deducted from a participant's pay. The deduction is given for the accounting period during which the shares are awarded.[63]

In a background briefing on the Bill, it is argued that the operation of this relief discriminates against companies – particularly family-owned concerns – that want "to make a significant move towards employee ownership" because "if a company moves a large proportion of its shares into the [SIP trust], it might take years for the company to distribute them to the employees." Under the current regime, "the company has to bear

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[62] paragraph 68(3) of schedule 8 of *Finance Act 2000*. This means, for example, that the trust deed must not enable employees to receive cash rather than shares out of the plan.

[63] paragraphs 106-109 of schedule 8 of *Finance Act 2000* There are certain circumstances under which a deduction is not allowable; furthermore, an award of dividend shares does not attract tax relief.

the financial cost of having paid corporation tax on the whole cost of all the shares remaining in the trust, until the shares are finally distributed."[64]

To tackle this cash flow problem, **clause 1(6)** of the Bill inserts a new provision in schedule 8 – paragraph 112A – to allow for a deduction for contributions made by a company for trustees to purchase shares "from persons (other than companies)" – provided the contribution is used for this purpose, and the trustees' share holding meets a minimum threshold – so that relief is given only in cases where a substantial transfer of shares is made. The trustees must "at any time in the entitlement period, hold, for the beneficiaries of the plan trust, shares in the relevant company that—

(a) constitute not less than 10% of the ordinary share capital of the company; and
(b) carry rights to not less than 10 per cent of—
    (i) any profits available for distribution to shareholders of the company;
    (ii) any assets of that company available for distribution to its shareholders in the event of a winding-up."

In this context the 'entitlement period' is defined as "the period beginning with the acquisition of shares to fulfil the stated purpose and ending on the expiry of 12 months beginning with the date of the acquisition." This is to allow trustees a year to finalise any transfer of shares, in a transaction that may take some time to complete.

[64] *Employee Share Schemes Bill: Background briefing no.2*, January 2002

III Further reading

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Inland Revenue press notice, *Chancellor launches share incentive plan roadshow*, 29 October 2001
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Inland Revenue, *Share Incentive Plans and your entitlement to benefits IR177*, October 2001
http://www.inlandrevenue.gov.uk/shareschemes/ir177.pdf

Inland Revenue, *Share Incentive Plans: guidance for employers and advisers IR 2005*, October 2001
http://www.inlandrevenue.gov.uk/shareschemes/ir2005.pdf

Other material on SIPs is available from the Revenue's internet site at:
http://www.inlandrevenue.gov.uk/shareschemes/share_incentive/index.htm

B. Other

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Andrew Pendleton, Erik Poutsma, Jos van Ommeren & Chris Brewster, *Employee share ownership and profit-sharing in the European Union*, European Foundation for the Improvement of Living and Working Conditions 2001
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http://www.nceo.org/library/corpperf.html