Profit Related Pay

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Profit Related Pay (PRP) is that part of an employee's pay which rises, and falls, in line with the profits of the business in which they work. Tax relief to promote PRP schemes was introduced by the Conservative Government in 1987, with the intention of improving pay flexibility. Over the next ten years there was considerable evidence that although the number of PRP schemes increased significantly, the original purpose of this relief – to encourage pay flexibility – had not been met.

In addition the annual cost to the Exchequer of this tax relief had risen from £200 million in 1992-93 to £1,700 million in 1997-98.[1] Unchecked, it was estimated that the annual cost would rise to £3.1 billion by 2000-01.[2] In his Budget speech on 26 November 1996, the then Chancellor, Kenneth Clarke, announced the phased abolition of tax relief for PRP over the period 1 January 1998 to 1 January 2000.[3] For its part the Labour Government has not proposed restoring this relief. Indeed at the time of the March 1998 Budget it was announced that tax avoidance legislation would be introduced in the Finance Act that year, to prevent the exploitation of the transitional provisions for PRP's abolition.[4] This note provides a short history of the tax relief for PRP, and the reasons for its success, before discussing its abolition.

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1 HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, March 1999 p 10. Estimates for the cost of PRP, as with certain other tax reliefs, have, in the Treasury's words, always been "particularly tentative and subject to a wide margin of error."
2 Inland Revenue press notice, 26 November 1996
3 HC Deb 26 November 1996 c 165 Legislation to this effect is set out in section 61 of the *Finance Act 1997*.
4 Inland Revenue Budget press notice IR37, 17 March 1998 Legislation to this effect is set out in section 62 of the *Finance Act 1998*.

A. The introduction of PRP (1986-1991)

In his 1986 Budget speech, the then Chancellor, Nigel Lawson, floated the idea that companies could be encouraged to introduce PRP schemes with the introduction of a new tax relief:

> The problem we face in this country is not just the level of pay in relation to productivity, but also the rigidity of the pay system. If the only element of flexibility is in the numbers of people employed, then redundancies are inevitably more likely to occur. One way out of this might be to move to a system in which a significant proportion of an employee's remuneration depends directly on the company's profitability per person employed ...
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> This would clearly be in industry's own interest, and most emphatically in the best interests of the unemployed. It should therefore occur without any prompting from Government. But there is considerable inertia to overcome, so it might make sense to offer some temporary measure of tax relief to the employees concerned to help get profit-sharing agreements of the right kind off the ground, and to secure the benefits that would undoubtedly accrue if they really caught on.[5]

Following the publication of a consultation paper on PRP,[6] Mr. Lawson announced in his 1987 Budget that he would go ahead with this proposal:

> Last July I presented a Green Paper on profit-related pay in conjunction with my right hon. and noble Friend the Secretary of State for Employment and my right hon. Friend the Secretary of State for Trade and Industry. I now propose to introduce a scheme of tax relief broadly along the lines floated in the Green Paper.
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> My proposals depart from those in the Green Paper in one important respect. I am doubling the proportion of an employee's profit-related pay that will be tax free from a quarter to a half, and I am also increasing the upper limits on the relief. For a married man on average earnings receiving 5 per cent. of his pay in profit-related form, the tax relief will be equivalent to a penny off the basic rate of income tax. The cost will inevitably depend on take-up. It could be £50 million in 1988-89, building up to substantially more than that, as take-up grows, and as the proportion of an employees' pay which is profit-related rises.
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> Profit-related pay is no panacea. But then there are no panaceas. What it is is a tool to help British business gradually to overcome one of our biggest national handicaps - the nature and behaviour of our labour market. I am today challenging British management to take advantage of that tool and to make good use of it, for the good of their firm, their work force and their country.[7]

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5 HC Deb 18 March 1986 c 172

6 *Profit Related Pay*, Cmnd 9835, July 1986

7 HC Deb 17 March 1987 c 823

Legislation to implement the scheme was contained in sections 1-17 of the *Finance (No. 2) Act 1987*. In brief, employees could receive half of their PRP free of income tax, up to the ceiling of £3,000 or 20% of total pay, whichever was the lower (ie, in practice, tax relief on £1,500 or 10% of pay). Controlling directors were excluded from the scheme; part-time workers and those with under 3 years experience could be excluded. However, the growth in PRP schemes over the next four years proved to be disappointing. By the end of February 1991 there were just 1,245 schemes covering 285,000 employees,[8] despite the fact that a number of amendments had been made in this relief under the *Finance Act 1989* to make it more attractive (including a higher ceiling of £4,000). In his March 1991 Budget the then Chancellor Norman Lamont announced a substantial increase in this tax relief:

> If wages are inflexible, the burden of recession falls disproportionately on jobs: it is the only way for employers to cut costs. There is a considerable prize if we can get pay to take some of the strain. In 1987, we introduced a new tax relief to get profit-related pay off the ground. There are now about 1,250 such schemes in total, involving nearly 300,000 employees; but there can and should be many more, so I propose to make the scheme more attractive. At present, half an employee's profit-related pay is tax-free. From 1 April, PRP will be free of all tax up to the present limits. It is worth up to a full £1,000 to a basic-rate taxpayer. For some, that could be worth as much as 6p off the income tax rate.[9]

Following these changes, the rules for PRP were as follows:

Generally PRP can be paid free of income tax up to a limit of 20% of eligible employees' taxable pay plus PRP, or £4,000 a year, whichever is less. To qualify for tax relief, a scheme must be registered by the Inland Revenue before the start of the year - known as the "profit period" - which will form the basis for PRP payments.

Employment unit: a PRP scheme must apply to a specified employment unit, which must be carried on with a view to profit, for which a separate profit-and-loss account can be drawn up. In practice, a scheme can cover all or part of a company, a group, a division, a site or business unit or a partnership.

Eligibility: PRP must cover 80% of employees in any employment unit. Part-time workers must now be included (ie, those who work less than 20 hours a week). However employees with less than 3 years service may still be excluded from a PRP scheme. The extension of PRP, as well as the four other employee financial participation schemes (profit sharing, Save-As-You-Earn, employee share ownership trusts, and, discretionary share option schemes), to include part-time employees on the same basis as full-time employees, took effect from 1 May 1995.[10]

Profit: The definition of profit for PRP purposes must give a "fair and true view" of the profit and loss over a pre-determined 12-month period (the "profit period"). Profit can be stated before or after items such as interest, tax and PRP itself. Certain "extraordinary items" may be included, or excluded, from

8 Inland Revenue press notice, *PRP now tax free*, 19 March 1991

9 HC Deb 19 March 1991 c 172

10 under section 137 of the *Finance Act 1995*

PRP profit and loss accounts, so as to prevent one-off events distorting the relationship between PRP and the efforts of a workforce.

The profit pool: the pool of money generated for PRP purposes must be calculated in one of two ways:
Method A simply sets apart a fixed percentage of any profit and the same percentage is used each year that the scheme operates.
Method B determines the current year's profit pool - the fund of money to be distributed as PRP payments by applying the percentage rise or fall in profit from the proceeding year to the previous year's profit pool. To work out the distributable pool for the first or only profit period of a method B scheme, the employer uses the notional pool. Before applying for registration, the employer must decide how the notional pool is to be calculated and the scheme rules must state the amount or how it is to be calculated. If a formula is used, the employer is free to choose what factors to take into account in setting the notional pool.

Distribution: PRP must be distributed to those eligible on "similar terms", that is, either as equal amounts or as a percentage of pay, or according to some other common objective factor such as length of service. The PRP can be made as a single payment after the profit period, or using a series of instalments, either during or after the profit period.

Salary sacrifice: PRP can be paid as a tax-free supplement to existing earnings. Alternatively, employees may agree (either collectively or individually) to accept a reduction in their basic pay, to be replaced with a variable element. The Inland Revenue stipulates that the amount and timing of the salary sacrifice must be agreed with the employees before the start of the profit period.

B. The growth of PRP (1991-1994)

The increase in tax relief announced by Mr. Lamont triggered a sharp increase in the use of PRP by the private sector. Within a year the number of registered schemes had doubled, to 2,597, and it continued to grow at a spectacular rate. One reason for this has been the use of “salary sacrifice” schemes, which one practitioner described in the *Financial Times*:

> Suppose, for example, that a company offered 10 per cent PRP in return for an equivalent pay cut. A worker on £10,000 would switch to £9,000 basic and £1,000 PRP. Paying no tax on the latter would mean that although his gross salary was unchanged, he would be £250 better off in terms of take-home pay [with the basic rate of income tax at 25%] ... A key - if obvious - point to remember is that the amount of PRP cannot be guaranteed in advance; it all depends on profitability. To allay employee concerns on this score, most companies pay out the bulk of PRP on account during the actual profit period. When the actual profits are computed, employees then get any balance owed. If, on the other hand, it transpires that profits are lower than expected and employees have, therefore been overpaid, most schemes provide that the company waives its right to be repaid. This is crucial because it puts a guaranteed floor under the PRP ... A properly structured 'salary sacrifice' arrangement should leave both employer and employee better off - with the bill being picked up by the taxman. [11]

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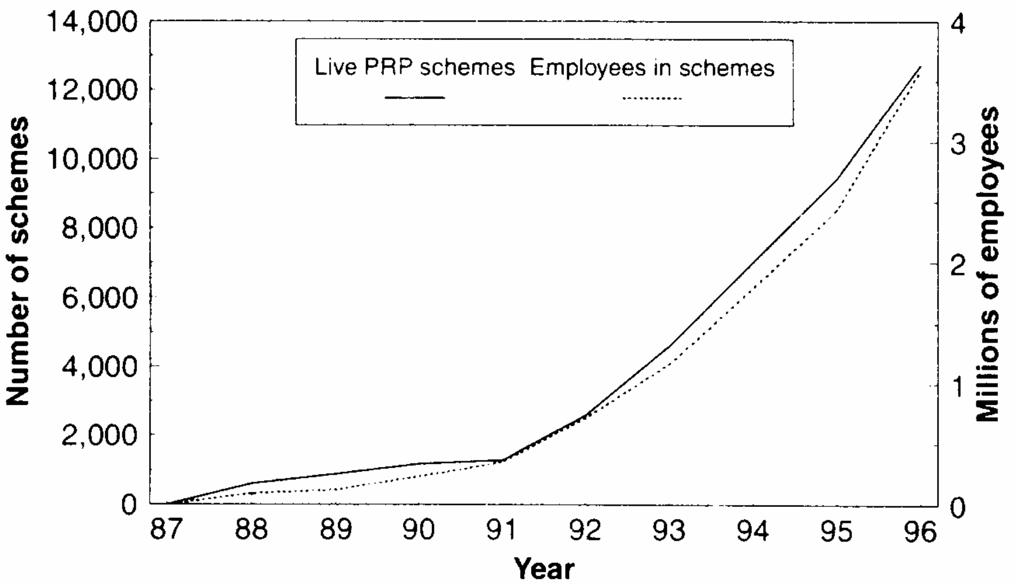
[11] "Whom the tax man pays", *Financial Times*, 28 August 1993

The author recognised two possible disadvantages to employees financing PRP by a cut in their basic salary: "If they belong to a company pension scheme, their entitlement might depend on their basic pay, with additional sums - such as PRP - being excluded from the reckoning. Similarly, if they apply for a mortgage, the offer from the lender is likely to be based on a multiple of salary with no account being taken of PRP."

In September 1994 the *IRS Pay and Benefits Bulletin* (no.360) published the results of a comprehensive survey of PRP use among 333 organisations. It found that those employers who used PRP saw three principal attractions: concentrates employees' minds on the organisation's profitability; increases employee commitment; and, creates a saving or contains rising costs for the organisation.

In a follow-up report the next year the *Bulletin* noted "half of the employees with schemes [in the survey] use PRP to award a profit-related bonus. One-quarter pay PRP as a tax-free replacement for part of an existing salary and one in five substitutes PRP for a basic pay rise. The most recent evidence suggests that the proportion of employers that pay PRP as a tax-free salary replacement is on the increase."[12] Nonetheless, the growth in approved PRP schemes showed no signs of slowing. Some idea of the success of this tax relief may be grasped from the diagram below, reproduced from the Institute for Fiscal Studies' *Green Budget*, published in October 1996: the number of PRP schemes is given on the left hand scale; the number of employees in schemes on the right (p 41):

Figure 5.4: Growth of profit-related pay



[12] *IRS Pay and Benefits Bulletin* issue 373 April 1995 p 7

C. Arguments for abolition (1994-1995)

By 1994 the significant growth in approved PRP schemes, and the evidence that companies saw their principal advantage in tax avoidance, lead a number of commentators to argue this relief should be abolished. The case was put strongly in an editorial piece in the Institute of Chartered Accountant's journal, *Accountancy*, in June 1994, part of which is reproduced below:

> There are two arguments for PRP. It provides an incentive to employees to work harder. And, by automatically cutting the pay bill when a company is doing badly, it makes it easier for the company to survive without making people redundant. These are both worthy objectives, but why should they be supported by the taxpayer? There are all sorts of ways in which companies can motivate their staff. PRP is just one of them. But how companies use pay and other benefits to motivate their people should be a commercial decision. If a scheme is worth doing, it should pay for itself. There is no reason why the taxpayer should foot the bill.
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> Again, it is desirable that companies and their employees should show a flexibility in pay agreements that makes it easier for companies to survive and for employees to keep their jobs. But the desire for survival on both sides should be strong enough to encourage such deals without a 20% to 40% subsidy from the taxpayer. It is also doubtful whether the PRP schemes now in existence are very useful anyway. They are largely structured so as to make them as little related to profit as possible, thereby removing the point of the whole exercise. So far as most of the employees involved are concerned, it is simply tax-free pay. So far as the employers are concerned, it is a way of cutting costs at the taxpayer's expense.
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> When tax incentives for PRP were introduced in 1987, there was some talk of its being a pump-priming exercise. The argument was that PRP was a novel and intrinsically unattractive idea, but one that was in the public interest; it was therefore worthwhile to invest a bit of taxpayers' money to get it accepted. Seven years have now passed and if the pump is ever going to be primed it must surely have been primed by now …
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> A further, minor consideration is that tax relief for PRP, like all other methods for using the tax system to provide incentives for this and that, adds to the complexity of legislation … In our view, tax relief for PRP should now be withdrawn. We suspect that the result would be that most of the existing schemes would collapse. This is because neither employers nor employees see PRP as inherently to their commercial advantage. Instead, they see it simply as a way of avoiding tax. As such, PRP is no more than a way of arbitrarily redistributing the tax burden from the fortunate minority in schemes to the majority outside them. There is no good reason why this injustice should be perpetuated.[13]

A separate argument against tax relief for PRP was put by Helen Liddell MP during the Committee Stage of the Finance Bill in March 1995:

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[13] "Tax, pay and profits", *Accountancy*, June 1994

> In the great burst of hype about profit-related and performance-related pay in the 1980s, it was claimed that such schemes were a means of involving employees much more in the performance and destiny of their companies. I contend that such schemes do the opposite. PRP is no excuse for the proper involvement in the destiny of companies or employees at every level within them. That is the way to ensure the increased profitability of companies, rather than under this varied system of tax relief for some employees, especially as such employees have a limited ability to affect the performance of companies.[14]

In his response, the then Financial Secretary to the Treasury, Sir George Young, cited the substantial take-up of PRP as clear proof of its success:

> When the Government introduced PRP, their primary goal was to promote the establishment of pay mechanisms in a number of companies that linked part of the pay of employees to the performance of the company. One can measure the success of the policy by the take-up. About 2 million employees are now in PRP schemes. About 8,000 companies have introduced PRP schemes. There were two objectives behind the policy. One was to promote an identity of interest between the employees of a company and the fortunes of a company. No one would object to that. Involving employees in the fortunes of a company is a goal of its own. There are other components of the policy, as the hon. Member for Monklands, East (Mrs. Liddell) suggested. The involvement of employees in decision making is not the only component, but it is important.
>
> The other objective, which hon. Lady mentioned, was to cope with the number of people employed in companies over the trade cycle. If a company's labour costs reduce automatically during a recession, the employer is not confronted with the option of reducing the number of people who work for him to reduce his labour costs. Because firms covered by PRP find that labour costs reduce automatically as their profits reduce, they are not confronted with the harsh option of reducing labour costs by cutting their work forces. Those are the two broad objectives of the policy. The cost is about £500 million, which is linked to the take-up. The fact that the cost is high does not mean that there have been no associated benefits or that the policy has not been cost effective.

Sir George went on to refer to a study of employers' attitudes to PRP which, at that time, remained unpublished:

> What do we know about the impact of the scheme? As to the first objective - promoting an identity of interest between the employees and the fortunes of the company - most available studies of profit-sharing schemes support the view that the schemes increase employee involvement and that they are associated with modest increases in productivity. The information about the other objective - the impact of PRP on pay flexibility and employment - is less conclusive. That is partly because in the complex and varied world of commerce it is sometimes difficult to establish any

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[14] Standing Committee D 2 March 1995 c 581

> clear relationships between cause and effect. It was always expected that the benefits associated with that part of the policy would be more apparent in the longer term. The Government have commissioned an independent survey of employer attitudes to PRP. We hope to publish the findings soon. There may then be scope for further econometric work on that aspect of the policy. [15]

In May 1995 the Inland Revenue published the findings of IFF Research Ltd, which had interviewed 200 employers using registered PRP schemes, and a further 900 who had not. The report's conclusions were:

> 2.16 The overall conclusions from this survey are that:
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> - tax relief for PRP has stimulated **significant** additional take up of PRP schemes and was the main driving force for introduction by scheme operators
> - the main benefits of PRP from the employers' point of view were tax efficiency and employee involvement
> - employers are **not** using PRP as an instrument for greater pay flexibility
> - it is not possible to gain a quantitative picture from employers of the economic benefits deriving from PRP, eg of improvements in wage costs, productivity pay or employment. [16]

From a wider perspective, the OECD published a study on profit-sharing schemes in July 1995.[17] This found that only in a small group of countries did profit-sharing schemes cover over 5% of employees; namely, Britain, Canada, Germany, France, Germany, Italy, Japan, the Netherlands and the United States, in which schemes covered between 6% and 27% of all workers. In each of these - except Italy - legislation existed to encourage the use of schemes, such as the provision of tax relief. However, the report argued against the use of tax breaks to stimulate the use of PRP: "Firms with profit sharing tend to display higher levels of productivity than comparable firms without. However, by itself, higher productivity is not necessarily an argument for outlays from the public purse. When a firm raises its productivity, most, or all of the ensuing benefits accrue to the firm concerned."[18]

The OECD found little evidence to support the contention that profit sharing had reduced unemployment, or encouraged companies to foster the skills of their employees, especially in Europe. The report suggested that governments had a role in informing firms of the advantages of PRP, but not subsidising its adoption: "From an economic point of view, this may become more important in the years to come, as increased competition and modern production techniques demand more concerted and co-operative efforts from the workforce as a whole."[19]

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[15] *op.cit.* cc 581-582

[16] *Profit Related Pay - An Employer Survey : Inland Revenue Economics Papers No.2*, 1994 p 12 According to a written answer given in January 1996, this was the one official survey of the effectiveness of PRP (HC Deb 17 January 1996 cc 607-608W).

[17] "Profit-sharing in OECD countries", in *Employment Outlook*, July 1995 pp 139-169. The report was discussed in "Sharing the spoils", *Economist*, 30 November 1996

[18] OECD, *Employment Outlook*, July 1995 p 164

[19] *ibid.*

D. The rising cost of PRP (1995-1996)

On 17 July 1995 the then Chancellor Kenneth Clarke announced that he intended to introduce legislation in the next Finance Bill to withdraw income tax relief on executive share option schemes approved by the Inland Revenue, with immediate effect, in line with the recommendations of the Greenbury Committee.[20] At the time there was speculation that the Treasury was considering restricting the tax relief for PRP as well,[21] although some critics suggested that too many people were now covered by PRP schemes for the Government to take this course of action.[22] For its part, the IFS argued tax relief for PRP was now unnecessary, citing the 1995 IFF study mentioned above:

> It is clear from [the IFF] research that PRP is not allowing firms generally to be more flexible in their payments to employees, and that many firms simply turned their existing bonus schemes into PRP schemes in order to achieve a tax saving. Firms can use these schemes to give pay rises at little additional cost to themselves, but it is not at all clear why the government should subsidise this. The initial intention, that the tax relief should be reversed after a period of years, seems appropriate. This would leave firms in a position to decide whether the benefits of increased productivity and employee involvement arising from PRP outweigh the costs of running such a scheme, free from any tax considerations.[23]

As it turned out, the Chancellor stepped back from abolition of all discretionary share options, announcing in his 1995 Budget the introduction of a company share option plan (CSOP),[24] which set a £20,000 ceiling on any tax privileged share option plan (this threshold was subsequently set at £30,000[25]). At this time Mr Clarke also announced measures to make the two other all-employee share schemes - save-as-you-earn (SAYE) and profit sharing - more flexible, but he did not mention PRP at all.

The cost of providing tax relief for PRP continued to soar, from £300 million in 1993-94 to £1,500 million for 1996-97.[26] In February 1996 the Committee of Public Accounts took evidence from the then Chairman of the Inland Revenue, Sir Anthony Battishill, on a number of issues, including PRP. Tim Smith MP asked Sir Anthony whether this tax relief was achieving the aims the Government had set for it:

> 65.Paragraph 134 dealing with profit related pay sets out the two principal advantages which the Government stated PRP would offer. Have you been able to measure? We know what it has cost: it is costing £550 million now. It is obviously very difficult to

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20 HC Deb 17 July 1995 cc 889-890W

21 "Comment: Clarke may be gunning for profit-related pay", *Independent*, 25 July 1995

22 "Outcry if tax break is axed", *Independent*, 26 July 1995

23 IFS, *Options for 1996: the Green Budget*, October 1996 p 42

24 HC Deb 28 November 1995 c 1069

25 HC Deb 23 January 1996 cc 228-230

26 Over that last financial year alone, the cost rose by 50% from just £1,000 million for 1995-96 (*Tax Ready Reckoner and Tax Reliefs*, July 1996 p 10).

measure these benefits but have you done a comprehensive assessment of the scheme to see to what extent these two advantages have actually been realised in practice?

(Sir Anthony Battishill) We commissioned some research by IFF Research Limited, which is mentioned in the Comptroller and Auditor General's report. That focused on a survey of employers and produced some fairly reliable results, particularly in relation to the first of these two points, that is the closer identification of employees with the companies in which they work. Generally speaking the responses coming back, as the report indicates, indicated that employers did feel that PRP got a closer association between their employees and the work place and there is some research evidence also to suggest that goes with improving productivity in firms.

I cannot claim that we have yet got a very clear idea on the second of those two propositions. The research company looked at it. They found in their own words that the picture was fairly muddy on things like pay flexibility. It is pay flexibility which is at the heart of more variable employment responses. It is probably the case anyway that it would need a fairly long run of years over the full economic cycle, both the upturn and the downturn stages, to see whether in fact market conditions and employment rates and therefore employment levels responded more sharply to changes in the economic environment with profit related pay than in a regime where we did not have that. We are considering, with Treasury Ministers, with the Financial Secretary, the next stage of research in this area and how best to take that forward. These are the sort of questions that will be addressed.

66. Is there any evidence that employers have effectively split the difference with their employees and said that if they introduce a scheme of this kind the employees can have half the tax relief and they will have the other half by cutting pay?

(Sir Anthony Battishill) There was a device early on which became known as pay sacrifice,[27] which involved the employer asking the employees to give up a predetermined amount of pay, which then, because of the way the scheme operated with the upper profit limit, produced a situation in which it was quite forecastable on the part of the employer that that amount of pay would simply be replaced by an equivalent amount of profit related pay so that everyone gained except the exchequer. That abuse was put to an end by statutory means.

It was notable that when asked, Sir Anthony saw no reason why the numbers of employees on PRP schemes should not continue to rise strongly:

67.What is the potential number of employees who could participate?

(Sir Anthony Battishill) I do not know; I do not think anyone knows what the potential number is. The actual number is growing very fast indeed. Certainly the figures for 1995-96 show a very large upward movement again.

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[27] *Note by Witness:* Pay sacrifice does not fully describe this device. It involved *both* a pay sacrifice, *and* exploitation of the way the upper percentage limit operated before the legislation was changed to prevent the abuse (PAC82).

68.Do Treasury Ministers have a target figure? The relief was doubled and it is that which has prompted the substantial increase. There must at some point be an argument for cutting the relief to 50 per cent on the grounds that it has now achieved its objective.

(Sir Anthony Battishill) I do not know that I would necessarily accept the proposition you make. It was one factor. There have been other factors in the growth, including change in the economic cycle, a greater familiarity of employers generally with the scheme; perhaps there was some initial hesitation, people felt it was all rather complex and they did not want to change their existing systems. Those early days are now behind us and employers now recognise that a profit related pay system can be relatively straightforward. There are several factors that have increased the take-up and rising profitability may well be one of them. It would be quite impossible to put any form of target in place. This is a matter of continuing political judgement on whether this is a cost effective way of giving tax relief.[28]

In its conclusions, the Committee expressed some concern that the effectiveness of PRP, in terms of the Government's initial purpose in introducing the relief, had not been proven:

We note the Department's argument for putting the responsibility for certifying profit-related pay schemes on employers and their independent accountants. However, we shall expect them to reconsider this decision if there is a significant increase in material errors by employers. We note the Department's intention to focus the work of the profit-related pay Unit much more on compliance matters and helping employers avoid mistakes. We look for a reduction in the number of employer errors as a result. We note that the annual cost of tax relief for profit-related pay schemes is now £550 million. We look to the Department to evaluate fully whether the Government's main objectives for schemes are being achieved. We note that the Department are discussing with the Treasury how best to take this forward.[29]

E. Abolishing tax relief for PRP (1996-1997)

The then Chancellor, Kenneth Clarke, announced the phased abolition of tax relief for PRP in his Budget Speech on 26 November 1996:

The tax relief that the Government introduced in 1987 to promote profit-related pay schemes has been a success. It has played a key role in reinforcing the Government's strong beliefs that employees' rewards should depend on the success of the business for which they work. I have always believed, and have argued publicly for many years, that in a modern enterprise economy people's pay should be closely linked to the performance of the business for which they work. The best way for businesses to motivate their staff is to let them share in the rewards of success. I am delighted that tax reliefs have helped to get that idea accepted so widely.

[28] Committee of Public Accounts, *Inland Revenue - Appropriation Accounts 1994-95*, 12 June 1996 HC 217 1995-96 p 10

[29] *op.cit.* p xi

> Tax relief on profit-related pay was always intended to be a pump-priming measure, and it was introduced in very different circumstances. In the 1986 Green Paper, Nigel Lawson said: "There is considerable inertia to overcome, so it might make sense to offer some temporary measure of tax relief." Profit-related pay is now firmly established as part of British businesses' pay policy. It is one of the reasons for our success. More than 3.7 million people are in schemes. Ten years on, the temporary tax incentive has successfully served its pump-priming purpose.
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> I can no longer justify the ever increasing cost of the tax relief to the 22 million taxpayers who are not in profit-related pay schemes. We cannot permanently divide the work force into groups of people who pay different levels of tax on the same earnings depending on whether the firm that they work for is in a scheme or not. The aim of the relief - a widespread use of PRP - has been achieved, and I would rather make faster progress on lower taxes for everybody. We have changed the culture. Good managers in today's enterprise economy no longer need a tax relief to know that pay should be linked to their firm's performance. Pay linked to profits produces it own rewards on the bottom line in a thriving economy.
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> I shall describe to the House how the Government will start to withdraw this special tax relief. I intend to do that gradually, so I must ensure that businesses which need to adjust their pay packages and their sharing of the rewards of success have ample time to make those adjustments. The upper limit of pay attracting the relief will remain unchanged at its present £4,000 until 1998, which means that no one will be affected before then. [Hon. Members: "In time for a general election."] But during the lifetime of a Conservative Government. It will then be progressively reduced until the year 2000, when the relief will be withdrawn altogether.[30]

At this time there were some 14,000 PRP schemes covering over 3.7 million people,[31] for which the cost in tax revenues was an estimated £1,500 million for 1996-97.[32] By comparison, in March 1992 just 718,000 employees were in PRP schemes, at an Exchequer cost of £200 million for 1992-93. Tax relief would be withdrawn over a two year period, commencing on 1 January 1998; so that for profit periods beginning,

- before 1 January 1998, there will be no change in the £4,000 ceiling on relief;
- between 1 January 1998 and 31 December 1998, the ceiling will be reduced to £2,000;
- between 1 January 1999 and 31 December 1999, the ceiling will be reduced to £1,000;
- on or after 1 January 2000, no relief will be available.[33]

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30 HC Deb 26 November 1996 c 165

31 Inland Revenue press notice, *Tax relief for PRP to be phased out*, 26 November 1996

32 HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, July 1996 p 10

33 Legislation to this end was introduced under section 61 of the *Finance Act 1997*.

Under these provisions, the Revenue did not approve of any PRP scheme if it provided for payments to be made only for profit periods beginning on or after 1 January 2000.[34] Any PRP scheme which was still registered on 31 December 2000 lost its approval on that date. The last possible profit period for which PRP could be paid free of income tax was one starting on 31 December 1999 and ending on 30 December 2000.

At this time the Labour party supported the withdrawal of tax relief: during the Committee stage of the Finance Bill when this measure was discussed, Dawn Primarolo MP, now Paymaster General, quoted Kenneth Clarke's view that the Government could not continue to "divide the work force into groups of people who pay different levels of tax on the same earnings depending on whether the firm that they work for is in a scheme or not," before saying, "that is absolutely right: it is only surprising that it has taken so long for the Government to discover that."[35] Following the General Election, the Labour Government did not change its position on the issue; for example, during Treasury Questions in October 1997, Alistair Darling - then Chief Secretary - stated that the Government "believe that profit related pay should be taxable, like bonus pay and other, similar forms of remuneration."[36] In his response TUC general secretary, John Monks, said "PRP has been a large loophole, with some people gaining considerably while others, for example public sector workers, lost out. The Chancellor is right to phase out this tax relief."[37]

Critics of tax relief for PRP argued that most companies were attracted to PRP as a means of subsidising their wage bill, and that once relief was withdrawn, companies would stop using it as a method of remuneration. In January 1997 the *Financial Times* reported Allied Domecq Retail - a pub and off-licence company which provides a salary sacrifice PRP scheme to 40,000 of its 45,000 employees - intended on keeping PRP until late 1998, but thereafter was unlikely to replace PRP with another incentive scheme to cover most of its employees.[38]

Some business leaders were disappointed by the decision to do away with tax relief for PRP. The CBI's human resources director was quoted in the *Financial Times* as saying, "there is a danger the Chancellor has thrown the baby out with the bathwater."[39] The impact on small businesses was thought to be minor; as a spokesman for the Forum of Private Business noted, "[PRP] has proved too burdensome and clumsy to install."[40] Even so some companies made extensive use of PRP - such as John Lewis and Whitbread - and at the time argued that the Government should simply tighten the criteria for scheme approval. The deputy chairman of John Lewis, David Young, admitted "a great number of recently introduced PRP schemes have been cynically devised to get tax relief on ordinary pay," but went on to argue, "there should be

[34] With effect from 19 March 1997 (the date for the *Finance Act 1997* receiving Royal Assent).
[35] HC Deb 22 January 1997 c 999
[36] HC Deb 30 October 1997 c 1014
[37] "Sharing ethos is discarded", *Guardian*, 27 November 1996
[38] "Misused tax break scheme is abolished", *Financial Times*, 4 January 1997
[39] "Lament as last orders are called on popular scheme", *Financial Times*, 27 November 1996
[40] *ibid.*

enough clever people in the Treasury to be able to discriminate between genuine PRP and artificial schemes that are only notionally linked to profits."[41]

Specific mention was made of the PRP scheme operated by the John Lewis Partnership, when this legislation was debated in the House. Both Dawn Primarolo MP, and Ian Pearson MP who also spoke for the Labour party, were sympathetic to members of the Partnership, though they did not discuss the possibility of continuing to provide tax relief. Mr Pearson commented, "I have sympathy for any [John Lewis] employees who will lose out as a result. I do not think that we can ignore the widespread abuses of the scheme. That is why the Chancellor was fundamentally right to take his decision."[42]

On the Conservative benches Peter Bottomley MP asked if the Government might consider protecting tax relief for "those who benefit at low levels," including those at John Lewis, though he acknowledged that the Partnership "had had profit-sharing or surplus-sharing for 70 years and did not introduce the practice because of the tax break allowed in 1986."[43] The then Financial Secretary, Michael Jack, noted that John Lewis "has made it clear that it wishes to continue the scheme" although tax relief was to be withdrawn, the suggestion being that, now that PRP is an accepted part of commercial life, the Exchequer should not continue to subsidise its use.[44] In short, if a scheme is worth doing, it should pay for itself.

In its 1996 *Green Budget*, published before the Chancellor's announcement, the Institute for Fiscal Studies argued that the history of PRP was a cautionary lesson, in the practical dangers that face any government that wishes to use the tax system to change people's behaviour:

> Income tax relief for profit-related pay (PRP) schemes was introduced in March 1987 in order to encourage firms to link part of their employees' wages to the performance of the company. It was hoped that this would bring increased flexibility into the labour market by allowing wages to fluctuate with profits and would provide employees with the incentive to boost the profitability of their firms. But if linking pay to profitability benefits firms by giving stronger incentives to their employees, firms already had an incentive to set up PRP schemes *without income tax relief.*
>
> The only possible case for giving tax relief for PRP schemes was as a temporary measure to overcome firms' and employees' reluctance to try new ideas. After these initial concerns have passed, there is no case for continuing tax relief for PRP. Indeed, this was precisely the reasoning given by Nigel Lawson in his 1986 Budget Speech. He stated that 'there is considerable inertia to overcome, so it might make sense to offer some temporary measure of tax relief to the employees concerned' ...
>
> If PRP was encouraged to promote flexibility in pay and to relate pay to company performance, many new PRP schemes fail on both grounds. Many employees are now

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41 "Firms protest against tax relief cut on PRP", *People Management*, 5 December 1996

42 HC Deb 22 January 1997 c 1008

43 *op.cit.* c 1002

44 *op.cit.* c 1009

guaranteed at least part of the PRP by their employer, so removing the clear link to profitability. There have even been suggestions that employers are offering 'no-redundancy' packages to entice employees to join PRP schemes, which can only reduce flexibility in the labour market. And when essentially non-profit making bodies, such as charities and universities, start jumping on the PRP bandwagon, the need to do something about PRP in this Budget becomes urgent.

> Tax relief on PRP schemes should never have been allowed to get out of hand in the way it has. But every year, the number of employees benefiting from this tax relief increases, making it more difficult simply to abolish tax relief for all PRP schemes. The parallels with mortgage interest tax relief are striking: while the current system of tax relief for PRP should not have been introduced, abolishing the relief immediately would create genuine losers, much as the abolition of mortgage interest tax relief in one fell swoop would. Abolition could even possibly cause redundancies for those employees whose employment relies on the tax subsidy in PRP. At the very least, the Chancellor should tighten PRP rules to make sure that any new PRP scheme is genuinely related to firms' profitability. He could and should probably go further by announcing a phased abolition ...

> The sorry saga of the explosion of PRP schemes serves to remind us of some of the practical dangers of using the tax system to change behaviour. The danger is always that the change in individuals' and firms' financial behaviour dwarfs the desired change in real behaviour, at great cost. [45]

F. Subsequent developments (1997 -)

Since the General Election, the Labour Government has not made any move to reintroduce tax relief for PRP. At the time of the March 1998 Budget the Government announced that tax avoidance legislation would be introduced in the forthcoming Finance Bill, to prevent the exploitation of the transitional provisions for PRP's abolition. A press notice issued at this time gave details:

> **The phasing-out provisions :** The provisions to phase-out the income tax relief for PRP were introduced in the first Finance Act of 1997. They are designed to withdraw the relief over a three year period.

> The maximum limit for tax-relieved PRP will be reduced for "profit periods" (normally the firm's annual accounting period):
> - beginning 1 January 1998 to 31 December 1998: from £4,000 to £2,000
> - 1 January 1999 to 31 December 1999: from £2,000 to £1,000
> - on or after 1 January 2000: no relief will be available.
>
> The estimated Exchequer yield from these withdrawal arrangements is £200 million in 1997-1998, £800 million in 1998-1999, £1,800 million in 1999-2000, and £3,100 million in 2000-2001.

[45] *Options for 1997 - the Green Budget*, October 1996 pp 41-42

> **Exploitation :** Some employers who already have PRP schemes have attempted to exploit these phasing-out arrangements. They have done so by, for example, setting up a new company to which they transfer their employees. This new company seeks to register a new PRP scheme, whose profit period begins later in a calendar year than the profit period under the old scheme. (For example, it may begin on 31 December, rather than on 1 January under the old scheme.) The employers' purpose is to manipulate the start dates of their businesses' profit periods in order to delay the progressive reductions in the relief for their employees for as long as possible. If this attempted exploitation were successful the potential tax loss to the Exchequer could be very substantial.
>
> **The counter measure :** Under the Budget proposal, an employee, who is in a registered PRP scheme, will be prevented from obtaining a higher tax relief limit for a longer period by becoming a member of another scheme where-
>
> - the employee becomes a member of that other scheme on or after 17 March 1998; and-
> - the profit periods of the two schemes start on different calendar dates.
>
> Employees in schemes which last only one year, where the schemes are replaced annually by fresh schemes starting on the same day and calendar month (that is, schemes whose profit periods are not being manipulated) will not be affected by the proposal.
>
> **Exclusions :** The new rules will not apply where the scheme employer for the two schemes is not the same person or where the scheme employers are unconnected. This exception is intended to ensure that the measure targets the schemes of employers who are attempting the manipulation, leaving employees who change jobs in the normal way, and move between unconnected schemes unaffected.
>
> **The effect of the new rules :** Where the new rules apply, the employee will, in effect, be subject to the PRP limit which would have applied to him or her, either –
>
> - under a scheme with a start date of 1 January or-
> - under the earlier, connected scheme.
>
> If the second alternative is to apply, employers must exercise their choice by notifying the employee. The option of applying the limit for a scheme commencing on 1 January is intended to help employers if, for example, they are unable to find out the start date of the earlier scheme, or if they decide that it would be administratively more convenient to treat all those who join their schemes, from other connected schemes, on the same basis.[46]

These provisions are now set out in section 62 and schedule 11 to the *Finance Act 1998*. They were agreed to without debate at the Committee stage of the Finance Bill that year.[47] This issue does not appear to have been debated in the House since then.

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[46] Inland Revenue Budget press notice IR37, 17 March 1998. The estimated yield of this measure was £5 million in each of the 3 years 1998-1999 to 2000-2001.

[47] Standing Committee E 2 June 1998 c 413

G. Further reading

1. *Profit Related Pay*, Library Research Note 91/27, 8 April 1991

2. "PRP in the 1990s: a survey of 333 employers", *IRS Pay and Benefits Bulletin 360*, September 1994

3. "Spectacular growth in PRP continues", *IRS Pay and Benefits Bulletin 373*, April 1995

4. Inland Revenue, *Profit Related Pay - an Employer Survey*, Inland Revenue Economics Papers: No. 2, 1994

5. "A continuing opportunity", *Taxation*, 14 September 1995

6. IDS Study, *Profit-Related Pay - Study 603*, June 1996

7. Inland Revenue press notice, *Tax relief for PRP to be phased out*, 26 November 1996

8. Debate on clause 62 of the Finance Bill 1997 (HC Deb 22 January 1997 cc 997-1010)

9. "Goodbye to PRP", *CCH Weekly Tax News*, 24 September 1999