Enterprise Management Incentives (EMI): Share option scheme

Background
EMI is an HMRC-approved employee share option scheme that offers significant tax advantages to employee and employer when options are granted and later exercised over the employing company's shares.

Overview of share options
Companies that incentivise their employees with the promise of lucrative rewards generally grow faster than those that don't. A share option is an example of such an incentive, which works in the following way.

The employer identifies a key employee and offers the employee the opportunity at a future date to acquire shares in the employer's company. A contract is entered into – the share option agreement – under which the employee has the future right at a fixed price, and subject to certain conditions, to buy shares in the company. It is an option for the employee, and therefore he is free to decide whether or not to exercise it. He can do nothing or he can acquire shares – it's his call. The price to acquire the shares will generally be the market value when the option is granted, but by the date that the option is exercised this market value may have risen significantly. In effect, therefore, the employee acquires shares for far less than they are worth by exercising his rights under an option agreement.

As an illustration, a company may grant an option to a key employee to acquire 10% of its shares when the market value of the shares is £10 each. The exercise price is £10. Some years later, the employee exercises his options when the shares are valued at £50 each. The employee makes a gain of £40 per share. The employer will be happy for this to be the case, because it follows that the remaining 90% of the company has likewise grown in value by £40 per share. Everybody wins.

EMI tax advantages
The tax rules can be seen from continuing the above illustration-

- *Option grant*. The employee is granted the option to acquire 10,000 shares at £10. Although this is a significant step, there is no charge to tax.
- *Option exercise - employee*. The employee exercises the option, pays the £10,000 price to own shares which then have a value of £50,000. There is again no charge to tax on the employee: this is the key EMI tax benefit. This is in contrast to the general tax position outside EMIs where the employee would be subject to income tax on the benefit of £40,000. (For the sake of completeness, it should be mentioned that the employee would be liable to income tax if the option had been set at level below the original market value. Thus, if the shares were acquired at £1, compared with the market value when granted of £10, the difference of £9 would be taxable.)

- *Option exercise - company.* The company would receive a tax deduction of the £40,000, notwithstanding either that the company had not incurred any cost or that the employee is not taxed on this amount.
- *Sale of shares.* The employee would be liable to capital gains tax on a subsequent sale of his shares. The base cost of the shares would be their cost, being the £10,000 paid for them. (Again, for completeness, if the employee had paid a total of £1,000 for the shares and been subject to income tax on £9,000, then two amounts are added together and the base cost likewise is £10,000.) The annual CGT annual exemption would be available, and it is likely that the 10% entrepreneurs' relief (ER) rate would apply, to give a lightly taxed gain.

Commercial overview of EMI options

From the point of view of the employee, the attractions of an EMI option include -

- There is nothing to pay – either for the option or in tax - when the option is granted.
- If the shares do not rise in value then the option need not be exercised, but nothing has been lost.
- If the option is exercised and the original market value is paid, then while the option price needs to be paid, there is no income tax charge.
- When the shares are sold, the gain will be subject to capital gains tax and it is likely that the 10% ER rate would apply.

From the point of view of the company, the attractions of an EMI option scheme include -

- The company can decide which employees should be granted options; this is not an all employee arrangement.
- The market value of the shares can be agreed in advance with HMRC, and so the option terms can be against this background.
- The company can set the conditions for the exercise of the option. This could be the passage of a period of time, individual performance targets or a sale of the company.
- While it is usual for the options to relate to newly issued shares, it is possible to have them exercised against existing shares.
- The option ties in the employee to the company. The option would lapse if the employee leaves with the option unexercised.
- The Articles of Association can provide that an employee shareholder needs to sell shares on leaving employment.
- The Articles can also empower the company to require an employee shareholder to sell shares where there is an agreed sale of the company.
- The option scheme is cash flow positive - the company receives the option exercise amount and a corporation tax deduction when the employee exercises the option. The company could decide - but is not under any obligation to do so - to pay a grossed-up bonus to the employee to fund the option exercise price.

The detailed notes which follow, covering EMI conditions and various other aspects, expand on some of these points.

EMI option conditions

EMI options must comply with conditions under various headings -

- The purpose of the options.
- Company and trade.
- Shares.
- Employees.
- Option terms.
- Other conditions.
- Disqualifying events.

An option that meets all the conditions is a "qualifying option".

Purpose of the grant of options

EMI options must be granted for the purpose of recruiting or retaining employees, and not for a tax avoidance purpose.

Company and trade conditions

The main company conditions are -

- The company granting the option cannot be a 51% subsidiary of another company or otherwise under the control of another company.
- If the company is a parent company, all of its subsidiaries must be qualifying subsidiaries. This means that the subsidiary must be a 75% subsidiary by reference to voting power, entitlement on a winding up, and profit distribution.
- The company, or group if it is a holding company, may not have total assets on its balance sheet, or consolidated balance sheet, above £30 million.
- The company, or at least one of its subsidiaries, must exist wholly for the purpose of carrying on one or more qualifying trades, and must be carrying on a qualifying trade at the date of grant of the option, or preparing to do so.
- The definition of qualifying trade is similar to that applying for the purposes of EIS investments and, accordingly, excludes trades such as property development, hotels and farming. There are some relaxations in the EMI rules to permit options over shares in companies whose trade involves the receipt of licence fees or royalties from intellectual property that the company has created. Shipbuilding, coal and steel production are excluded trades.
- The company must not have more than 250 full-time equivalent employees.

HMRC will consider an advance assurance request as to whether a company is a qualifying company to grant EMI options.

Shares

The shares over which options are granted must be part of the company's ordinary share capital, fully paid up and neither redeemable nor convertible.

Employee conditions

Points to note on employee conditions are –

- Each option holder needs to be a full-time employee. This means working at least 25 hours a week or, if less, 75 per cent of the employee's total working time including work outside the employment. The employee is required to make and sign a declaration that this commitment is met.
- The employee must not have a material interest in the company meaning, broadly, a shareholding of more than 30 per cent.
- Any number of eligible employees may participate in the scheme. However, no individual employee may hold options over shares with a value of more than £250,000. The value for the purpose of applying these limits is the

unrestricted market value (see below) of shares at the date the option is granted.

Option terms

The terms of the option must be agreed in writing. The option must be capable of being exercised within ten years. The EMI rules allow complete flexibility over the conditions to be met before the options can be exercised.

Vesting period. The option terms will include the vesting period i.e. the duration between the option being granted and the earliest date on which it may be exercised. There is no statutory minimum period, although in practice this is often one year, or three years etc.

Exercise conditions. The employee's ability to exercise the option may be, but need not be, subject to conditions, as the company deems appropriate. Illustrative examples are-

- The employee continues to work for the company for a three-year period.
- The employee or the company meets specified performance targets.
- The company is sold.

Each employee may have individual conditions.

Staged exercise. The conditions need not be all or nothing: the number of options that can be exercised may be subject to a sliding scale. Equally, the agreement may say that options are exercisable in stages over a period.

Other conditions

There are a number of other statutory conditions, including-

- There is a limit of £3 million on the overall unrestricted market value of shares in the company that can be held under EMI option at any one time.
- An option cannot be assignable.
- The grant must be notified electronically to HMRC within 92 days from the date of grant. There are detailed electronic registration aspects with HMRC that must be complied with.

Disqualifying events

If certain events happen before the option is exercised, referred to in the legislation as disqualifying events, an unexercised EMI option will cease to be qualifying. If a disqualifying event does occur, the tax benefits may be preserved by the employee exercising the option within 92 days of the disqualifying event.

The following is a non-exhaustive range of disqualifying events-

- the company becoming a subsidiary of another company or becoming controlled by another company;
- the company ceasing to meet the trading activities requirement;
- the employee ceasing to be a full-time employee of the company;
- a variation in the terms of the option which increases the market value of shares subject to the option;
- an alteration to the share capital of the company designed to increase the value of shares subject to the option or carried out for non-commercial reasons, or which otherwise results in the requirements of the legislation no longer being met.

EMI options: some other points

Some other points are outlined below, under the following headings-

- Share rights.
- Share valuation issues.

- Entrepreneurs' relief for the employee.
- Corporation tax deductions.
- HMRC enquiries.
- Annual returns.

Share rights
The shares over which the employees are granted options may be subject to restrictions. Typically, these restrictions could include-

- Restrictions on the transfer or sale of the shares.
- Restrictions on the ability to retain the shares on ceasing employment.
- Rules governing the rights on a company sale.

The appropriate share rights need to be included in the company's Articles of Association prior to the grant of the options.

Share valuation issues
It is not mandatory for a company to seek HMRC's agreement to the market value of the shares that are to be placed under EMI option, but it is advisable to do so. EMI can be said to have privileged treatment from the Shares & Assets Valuation office of HMRC. Whereas HMRC generally will only give a view on valuation after a transaction has taken place, in the case of EMI options they will agree a market value of a company's shares in advance. This provides certainty to employee and employer of the tax consequences of entering into an EMI option agreement. The company must submit its share valuation application using Form VAL231.

The market value for this purpose is the value of a holding of the size covered by the option agreement, which will take account of-

- The number of share over which options are to be granted. For instance, if an employee is to be granted options shares, which would amount to 1% of the company, the valuation is of a shareholding of that size, which will be reflected in a suitable minority discount to the prorated value of the whole company.
- The restrictions under which the shares are to be issued, as outlined above. These restrictions reduce the market value of the shares. When a share valuation application is submitted to HMRC, the company must provide two share values for clearance – an unrestricted market value and a restricted market value.

Entrepreneurs' relief for the employee
As noted, a key tax benefit of EMI options is that no income tax liability arises when the employee exercises the option, provided he pays at least the market value prevailing at the time of the grant of the option. On a subsequent sale of the shares, the employee will be subject to capital gains tax, based on the difference between the sale price and the amount paid on the exercise of the option. Under standard capital gains tax rules the gain would be taxed at 18% or 28% depending on the circumstances.

Entrepreneurs' relief (ER) generally allows a 10% rate of CGT on a sale of shares in unquoted trading companies where the seller has held at least 5% of the company and has been an employee or director for at least one year prior to the sale.

The general ER conditions are significantly relaxed where shares are acquired after 6 April 2013 from the exercise of EMI options, as follows-

- The 5% ownership requirement is waived.

- The one-year period runs from the grant of the option, and not the date of the acquisition of the shares.

These provisions will allow may employee shareholders to enjoy the 10% ER rate of capital gains tax on a sale of their shares.

Corporation tax deduction
The employing company will generally be eligible for a corporation tax deduction when the employee exercises the options. The deductible amount will be the rise in the value of the shares between the issue and exercise of the options.

The rules allowing the corporation tax deduction are generous- the company has not incurred a cost, nor has the employee been taxed on the rise in the value of the shares.

HMRC enquiries
HMRC may open an enquiry into a notification of the grant of EMI options or into an employee's declaration of working time commitment. The enquiry notice must be issued within twelve months of the end of the 92-day notification period. If HMRC discovers that a notification is false or misleading there is no time limit to open an enquiry.

An enquiry remains open until HMRC gives notice that the statutory requirements are either met or not met. Both the employer and the option holder have the right of appeal.

If HMRC do not open an enquiry, the option is deemed to have met the statutory requirements.

Annual returns
An online annual return must be filed within three months of the end of the tax year, including such information as to enable HMRC to determine the tax liability of any employee. The information must be provided in a prescribed HMRC format. Incorrect returns must be amended without delay.

The reporting regime is easy and straightforward, but there are penalties for the unwary!

Legislation
- ITEPA 2003 Part 7 s527-538
- ITEPA 2003 Schedule 5 Parts 1-8.

Commentary
- Simons Taxes E4.543-553.
- HMRC Manuals ESSUM57100-57900.
- HMRC Manuals CG56440-56449

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Appendix

Case study

Company A operates a manufacturing business. It has three key full-time employees, X, Y and Z. All the shares in company A are currently owned by members of family B.

The family wants to grow the company with a view to an open market sale. With this in mind, the Board decide to offer share incentives to the three key employees. They are advised by their accountants to offer EMI options.

The company submits a VAL231 share valuation clearance application to Shares & Assets Valuation at HMRC. The application encloses newly amended Articles of Association that include employee shareholder restrictions. It also encloses a share valuation report, valuing the whole company at £100 a share. The shares to be placed under EMI option to X, Y and Z amount to 3% of the diluted share capital, giving each of the key employees 1%. The company seeks HMRC agreement to a discount to the whole of company value of 75%, to reflect small, uninfluential minority holdings. It proposes an unrestricted market value of the EMI shares of £25 and a restricted market value of £22.50. HMRC agree the valuations, and the options are therefore granted, with an exercise price of £22.50.

The terms of the option agreement state that exercise is only permitted in the event of a third party sale of the company at a price of at least £150 per share. The effect of this is to incentivise the three employees to (a) grow the value of the company's shares and (b) position the company for an open market sale.

Eighteen months after the grant of the EMI options, a US company expresses interest in acquiring company A. It offers £200 per share and the Board accepts. The EMI options are exercised by the three key employees and the shares acquired are immediately sold to the US acquirer.

The employees each make a gain of £177.50 per share (being £200 less £22.50) and this is fully subject to capital gains tax at 10%, leaving them with £159.75 per share (being £177.50 less 10% CGT). For each of the three key employees, this represents a 710% gain on their initial option in the EMI agreement to acquire shares at a minority valuation of £22.50.

Company A receives a corporation tax deduction of £177.50 for each share acquired under EMI option by each of the three key employees.