

enterprise management incentives

Enterprise management incentives (EMI) options are tax-privileged share options available to small and medium-sized trading companies. Share options are an important tool in recruitment and retention strategies and providing incentives to employees. EMI options are a flexible form of share option which attract substantial tax benefits for employees and the company and can help create the environment for business success. This chapter provides an overview of enterprise management incentive options.

Enterprise management incentives (EMI):

- are available to independent trading companies with fewer than 250 employees and gross assets not exceeding £30 million at the date when the option is granted;
- allow employees to be given tax-advantaged options over shares worth up to £120,000 each at the time of grant;
- ensure that, normally, no income tax or NICs arise when options are exercised; and
- provide that, when the resulting shares are sold, any gain should normally qualify for capital gains tax treatment.

To qualify as an EMI option, various requirements must be satisfied as regards the shares under option, the company

in question, the individual optionholder and the terms of the option.

General requirements

- “Purpose” test: an EMI option must be granted for commercial reasons in order to recruit or retain an employee and not as part of a tax avoidance scheme or arrangement.
- “Value” test: an employee may hold unexercised EMI options over shares up to £120,000 in value measured at the date of grant of the options. When valuing shares for this purpose, any restrictions or risk of forfeiture are ignored. Once an individual has EMI options up to this maximum (whether or not they have been exercised or released) three years must elapse before he/she can be granted another EMI option.
- Overall limit: there is an overall cap of £3 million on the total value of shares as at the date of grant which may be placed under EMI options. There is, however, no limit on the number of employees who may be awarded EMI options.
- Notification requirement: the company which employs the optionholder must give notice in HM Revenue & Customs approved form to the HM Revenue & Customs of the EMI option within 92 days of its grant. This notice must contain a declaration by the company and by the employee that the EMI requirements are met, including the working time requirement.

Qualifying companies

A qualifying company must satisfy the following tests:

- It must be an independent company not under the control of another company (or another company and persons connected with such other company) but may be quoted or unquoted.
- It must have fewer than 250 employees.
- The company's gross assets must not exceed £30 million at the date when the option is granted. "Gross assets" signifies all assets which should be shown on the balance sheet without any deduction for liabilities.
- The company must be carrying on – or preparing to carry on – a qualifying trade and (ignoring incidental purposes) exist wholly for the purpose of carrying on qualifying trade(s). Research and development (R&D) activity from which it is intended to derive a qualifying trade is treated as carrying on a qualifying trade – but preparing to carry on R&D activity is not.

A qualifying trade must be carried out wholly or mainly in the United Kingdom and must not consist wholly or substantially of excluded activities such as:

- dealing in land, commodities, shares, or financial instruments;
- dealing in goods otherwise than by way of ordinary retail or wholesale distribution;
- banking, insurance, and other financial activities;
- leasing or receiving royalties or licence fees – but see the R&D exception below;
- various property-backed trades including property development, farming, running hotels or nursing homes.

Royalties and licence fees attributable to the exploitation of a "relevant intangible asset" created by the trading company (or another company in the group when the intangible asset was created) are not excluded activities. For this purpose "relevant intangible asset" means any asset treated as such in accordance with normal accounting practice, and the definition includes intellectual property created in circumstances where the right to exploit it vests in the company (alone or jointly with others).

The parent company of a trading group can be a qualifying company provided that the group as a whole satisfies these tests and all its subsidiaries are at least 51 per cent subsidiaries.

Eligible employees

To be an eligible employee, an individual must:

- be employed by the company which grants the option or by a qualifying subsidiary of that company;
- be required to work at least 25 hours a week or, if less, 75 per cent of his/her working time (ie, time spent on remunerative work as an employee or self-employed person); and
- not have a "material interest" in the company. Thus, the individual and/or the individual's associates must not own or control, directly or indirectly, over 30 per cent of the company's ordinary share capital or (for close companies) be entitled to over 30 per cent of the assets available to participators on a winding up.

Option terms

A qualifying option must be:

- over fully paid up, non-redeemable ordinary shares;
- capable of exercise within ten years of grant;
- recorded in a written agreement setting out all its terms; and
- not capable of assignment to any other person.

Several matters (eg, exercise price, earliest date of exercise, restrictions on shares (if any), performance criteria) are left open to the parties to agree rather than being prescribed by legislation.

Tax privileges

Income tax: no income tax arises on a grant and, if an EMI option is exercised within ten years of the grant, no income tax arises on exercise – unless the option has an exercise price less than the market value of the shares at grant. If so, the discount will fall into tax on exercise.

When an EMI option is granted it is necessary to agree with HM Revenue & Customs the value of the shares under option at the date of grant. This valuation can be settled before or after the option is granted and a 'user friendly' valuation form is available to assist the process.

PAYE/NICs: PAYE and NICs will be payable if an income tax charge arises and at the relevant time the shares under option are “readily convertible assets” (ie, capable of realisation in cash at that time or soon afterwards).

Capital gains tax: with effect from 6 April 2008, a single 18 per cent rate of capital gains tax has been introduced and business asset taper relief has been abolished. At the same time, a new entrepreneurs’ relief has come into effect to reduce the capital gains tax rate to 10 per cent on the first £1 million of qualifying capital gains made by an individual during his/her lifetime on or after 6 April 2008. This relief is available to employees/directors on disposals of shares in a trading company (or the holding company of a trading group) provided that, throughout a one-year qualifying period, the employee/director owns at least 5 per cent of the ordinary share capital of the company and can exercise at least 5 per cent of the voting rights in the company. Under the old taper relief rules, the relevant holding period was deemed to run from the date the option was granted but no such provision exists in regard to entrepreneurs’ relief. So, even where an EMI option will result in a 5 per cent stake in the company, the one-year holding period only begins when shares are acquired on exercise of the option.

Corporation tax: companies are generally eligible for a corporation tax deduction equal to the value of any shares issued to employees on exercise of EMI options less any exercise price paid.

Disqualifying events

The tax treatment is affected if a disqualifying event occurs, such as:

- the company coming under the control of another company;
- the company ceasing to carry on a qualifying trade;
- the optionholder ceasing to be an eligible employee;
- any alteration to the company’s share capital which either results in the EMI requirements ceasing to be met or increases the value of the shares under option where the increase in value is deliberate or the alteration is for non-commercial reasons;
- any conversion of the shares to which the option relates into shares of a different class;
- an HM Revenue & Customs approved company share option plan (CSOP) option being granted to an EMI

optionholder resulting in the employee holding unexercised options over shares with a total value exceeding £120,000; or

- any alteration being made to the terms of the option which increases the market value of the shares, or results in the EMI requirements no longer being met.

If a disqualifying event occurs before the option is exercised and the option is not exercised within 40 days of that event, income tax will be payable on exercise on the difference between the market value of the shares on exercise and their market value immediately prior to the disqualifying event. In other words, shelter from income tax is lost for growth in value after the date of the disqualifying event.

Mills & Reeve comment:

EMI options offer generous tax breaks to help attract and retain key employees vital to the future success of a business. There is substantial flexibility to enable companies to establish ‘tailor-made’ arrangements for each key employee awarded an EMI option or to introduce an EMI plan whose rules apply to all EMI optionholders. Specifically targeted at smaller entrepreneurial trading companies, EMI options have become a standard feature among many smaller companies, particularly in the hi-tech sector. When EMI options are granted, companies will need to consider placing restrictions on the resulting shares (eg, compulsory sale if the employee leaves or if there is a takeover) and how best to do so.

This version of LaunchPAD has been prepared while the Finance Bill is passing through Parliament and has been drawn up on the basis that the Bill will receive Royal Assent in the form in which it was initially published. Please note however that it is possible that changes may be introduced before the Bill becomes law.

For more details please contact:

Birmingham: Deborah Clark on 0121 456 8424,

email: deborah.clark@mills-reeve.com

Cambridge: Christopher Townsend on 01223 222387,

email: christopher.townsend@mills-reeve.com