Enterprise Management Incentives Summary

At a glance

The Enterprise Management Incentive (EMI) is a tax-advantaged share option scheme designed for small/medium companies. A company may grant options to selected employees to allow them to acquire its shares over a prescribed period and provided that certain qualifying conditions are met:

- There is no tax charge on the exercise of an EMI option providing it was granted at market value.
- If the company's share price has increased in value between the time of grant and exercise the uplift is not charged to Income Tax.
- There will be a Capital Gains Tax (CGT) charge when the employee disposes of his shares and proceeds exceed the market value at the date of the grant of the option.

There are Enterprise Relief benefits for disposals of EMI shares acquired after 5 April 2012:

- There is no minimum 5% shareholding requirement in order for shares acquired under an EMI option scheme to qualify for Entrepreneurs' Relief (ER).
- The normal minimum holding period requirement for Entrepreneurs' Relief is modified and includes the period the option is held, so if the option was held for one year (two years from 6 April 2019) the holding period is met.

Tax-advantaged status can be lost if the company:

- Does not set up its EMI within the terms of the legislation.
- Fails to notify HM Revenue & Customs (HMRC) of the grant of an EMI option within 92 days, or
- If a disqualifying event occurs and option holders fail to exercise their options within 90 days.
- The directors need to be aware of the type of events that may disqualify a scheme as they will be able to avoid them if they know what to watch out for.

Overview

An EMI share option scheme works as follows:

- An employee is granted an option to acquire ordinary shares in his employer's company (or a qualifying subsidiary). The price of the shares under option is fixed when the options are granted and notified to HM Revenue & Customs (HMRC).
- Under the terms of the option agreement the employee exercises his option and acquires shares at the price agreed. This is generally at some time in the future, i.e. after the employee has worked for a set number of years or the company is listed on a stock exchange or sold to a third party,
- If the price paid for the shares on exercise of the option is greater than or equal to the market value of the shares at the time that the option was granted there is no income tax to pay on exercise. This is the key tax advantage of EMI: it means that if the company has increased in value between the time of grant and exercise the uplift is received tax-free by the employee.
- If the option is set at a discounted price, there will be an income tax charge on exercise based on the difference between the exercise price and market value at the time of grant.
- If the market value at the time of exercise is less than the market value at grant (i.e. the options are 'underwater'), the tax charge will be based on the market value at exercise.
- Provided that there are no trading arrangements in place the employee will not suffer National Insurance but will pay any tax due on exercise within normal self-assessment time limits.

For example

1. Options offered for free shares

EMI options granted in December 2016 at £nil per share. The share price agreed with HMRC is £100 per share. The company sold in 2019, buyer pays £150 per share.

- The employee will pay income tax and NICs on £100 per share.
- The employee will pay capital gains tax on £50 per share (£150-£100)
- Net proceeds per share £103

If we assume tax rates at 2017/18 levels and that the employee is paying tax at 40%, he will receive net cash of £103 per share (£150 less income tax of 40% and NIC of 2% on £100 and capital gains tax of 10% on £50 - he qualifies for ER). The employer will also pay NICs of £13.80 (13.8% of £100). Employers may ask the employee to bear their NICs cost - this is done by joint election

2. Options offered for shares at market value

EMI options granted in December 2016 at £100 per share, the share price agreed with HMRC at £100 per share, the company is sold in 2019; buyer pays £150 per share

- The employee pays no income tax and NICs on the share award
- The employee will pay capital gains tax on £50 per share (£150-£100)
- Net proceeds for employee £45 per share

If we assume tax rates at 2017/18 levels, the employee will receive net cash proceeds of £45 per share (£150 proceeds, less £100 cost, less capital gains tax @ 10% on £50 of £5).

EMI Conditions

Qualifying Companies

A company can be quoted or unquoted.
It must:

- Be independent (not a 51% subsidiary of another company or controlled by another company or a company and persons connected to it).
- Have gross assets of less than £30 million.
- Have fewer than 250 full-time employees.
- Have only qualifying subsidiaries: a company must hold more than 50% of the ordinary share capital of any companies it acts with; so joint ventures can sometimes be problematic.
- Have a permanent establishment in the UK: a fixed place of business or an agent concluding contracts on its behalf.
- Satisfy the qualifying trade test: must exist wholly or mainly for the purposes of carrying on a qualifying trade or be preparing to do so; a qualifying trade is a trade carried on wholly or mainly in the UK on a commercial basis with a view to profit that does not consist to a substantial extent of certain "excluded activities".
- Excluded activities for EMI are the same as for EIS.

Qualifying Shares

Shares subject to the plan must be fully paid-up, non-redeemable ordinary shares in the company; any restrictions attaching to the shares must be notified to participants in the option agreement/or option agreement linked to articles.

Eligible employees

To be eligible, an employee must work for the relevant company for at least an average of 25 hours per week or, if less, 75% of the employee's working time.

An employee who controls, directly or indirectly, more than 30% of the ordinary share capital of the company cannot be granted an EMI option.

The purpose test

Options must be granted for commercial reasons in order to recruit or retain an employee and not as part of a tax avoidance arrangement.

Limits

The total market value of shares subject to an unexercised EMI option at any time cannot exceed £250,000 from 2012/13 on (£120,000 for earlier years). Market value is measured at the time of grant for these purposes. If the individual has any unexercised options granted pursuant to an HMRC-approved company share option plan, these count towards the limit.

Once the limit is reached, options may not be granted to the individual within 3 years of grant of the last option.

Any number of employees may hold EMI options but the total market value of all shares subject to unexercised EMI options granted by the company or group (measured on grant) cannot exceed £3 million at any time.

Standard Terms

- Options must be non-transferable, must be capable of being exercised within 10 years of grant and may not be exercised more than a year after death.
- Options may be granted at any exercise price or for a nil exercise price.
- The main terms of the option must be specified in an option agreement.

Bespoke Terms

These are scheme terms that are individual to each scheme and not laid down by legislation. They will cover vesting, and ensure that share options will automatically vest on the occurrence of a sale to a third party or listing on the AIM or recognised stock exchange.

Vesting may be purposefully delayed: an employee will not be permitted to take up their options until they have completed x number of years of service. Alternatively, there could be other performance conditions included, but the more of these the more complex the drafting.

Restrictions

When the underlying shares are subject to restrictions this may affect the tax and NICs payable. Restrictions will also affect share valuation.

Tax and NIC treatment of an EMI option

Grant

No Income Tax or National Insurance Contributions (NICs) are payable on the grant of an EMI option provided exercise takes place within 10 years from grant and there has been no disqualifying event.

Exercise

- No Income Tax or NIC are payable on exercise if the option was granted with an exercise price greater or at least equal to the market value of the option shares at the time of grant.
- If a nil cost or discounted EMI option is granted, Income Tax will be payable when the option is exercised on the amount by which the market value of the shares at the date of grant (or, if lower, at the date of exercise) exceeds the exercise price.
- Where shares are readily convertible assets, Income Tax will be collected under PAYE and both employers and employee's NICs will be due.
- The definition of a readily convertible asset is wide. It covers arrangements where an employee may sell for cash.
- If a NIC liability arises, the company and the option holder may agree that the employee should bear the liability for the employer's contributions.
- Any increase in the value of the shares between the date of grant and the date of exercise is not charged to Income Tax irrespective of whether the option was granted at a discount or not conditionally exempt from IHT (usually properties designated of national interest).

Disqualifying Event

- The Income Tax and the NIC relief are partially lost if an option is not exercised within 90 days (40 days prior to 17 July 2013) of a disqualifying event.
- Income Tax and NIC are charged on the amount by which the market value of the shares at the date of exercise exceeds the market value immediately before the disqualifying event.
- The Income Tax charge is limited to the growth in value after the disqualifying event. In the case of a nil cost or discounted option, this charge is an addition to the charge on the discount.
- A disqualifying event occurs when the company fails to fulfil any of the following qualifying conditions:
    - The company loses its independence: the company is controlled by another company, or another company and a connected person.
    - The company's trading activities change to include restricted activities, or it mainly trades abroad.
    - The option holder ceases to be an employee.
    - The employee's working hours reduce to less than 25 hours per week or at least 75% of their working time.
    - Changes are made to the terms of the option.
    - The share capital of the company is altered.
    - The company's shares are converted.
    - A further grant of share options that takes the option holder over the £250,000 2012/13 (£120,000 in earlier years) limit.
    - Shareholders depart leaving an EMI option holder with more than 30% of the share capital.

Tax traps: buy-outs and private equity

- If another company invests in the EMI company it may fail the independence test as it may fall under the control of another company.
- Some investors, e.g. private equity, may amend a company's articles so that they contain provisions allowing the investor to take control if financial performance is not up to standard. This again can fail the independence test.

Qualifying Reorganisations

The independence test will also be failed if a new holding company is inserted under a share for share exchange.

Although this is a disqualifying event, EMI benefits can still be retained if:

- The options are exercised within 90 days, or
- In the case of a 'qualifying reorganisation', the acquiring company grants a replacement option within 6 months.

A 'qualifying reorganisation' can include:

- Making a general offer to acquire all the shares of the EMI company,
- A share for share exchange where the shares in the acquiring company mirror those in the EMI company.

A number of conditions which the replacement options and reorganisation must met are included in Part 6 ITEPA 2003.

Sale of Shares

On the disposal of the shares acquired under an EMI option, CGT may be payable on any gains made, calculated by deducting the "base cost" of the shares from the net sale proceeds.
The "base cost" of the shares is their exercise price and any amount assessed to Income Tax on exercise. Tax is paid at CGT rate on gains after a deduction of the annual exemption and losses, if available.

Corporate Tax Deduction

The company will receive a Corporation Tax deduction on the exercise of options granted under an EMI plan, provided that certain conditions are met. The relief is given for the accounting period in which the EMI option is exercised on the difference between the market value of the option shares on the date of exercise and the exercise price.

Checklists

This is designed to show you the main stages in setting up an EMI scheme or plan.

- Review that the company, its activities and the shares being offered will qualify for EMI.
- Agree qualifying activities with HMRC, via advanced assurance.
- Draft up and agree the terms of the option, these should set out vesting conditions, set restrictions etc.
- Draft up and agree to the scheme rules with the company.
- Make necessary changes to the Articles.
- Ensure Board approval of any amendments to articles and pass necessary resolutions.

- Value the company and agree a valuation with HMRC (this will consider vesting conditions, minority holdings and restrictions applicable to the shares).
- Pass resolutions to issue shares, adopt new articles and approve the EMI terms.
- File resolutions and amended articles with Companies House.
- Grant of option (executed as a deed between company and employee)
- Notify HMRC: for options granted from 6 April 2014 use HMRC's PAYE portal (accessed via PAYE online).
- End of year file your online EMI return on HMRC's online portal as above.
- Employee to notify HMRC on exercise.

The above summary is based on legislation and guidance published as at 17th May 2019. The summary is intended to provide a general guide and individual advice should be sought about your specific circumstances.