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to succeed

Taxing Matters Handbook: Enterprise Management Incentive

A guide to enterprise management incentive
share options schemes



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Note that this guide is an introduction to the EMI share option scheme as it applies since 11 May 2001. It is a general introduction and does not replace the need to take advice in relation to specific circumstances.

Introduction

The government introduced EMI share option schemes to allow 'small higher risk' trading companies to reward their key staff with shares in a tax efficient manner.

The new scheme was designed to be more flexible than previously available schemes and does not, therefore, require prior Revenue approval.

However, employers often wish to agree a share value with the Revenue before granting the option and they must notify the Revenue of the grant of the option within 92 days of its grant.

A tax incentive designed for entrepreneurial companies

Agreeing a share value is often a vital step and need not be an insurmountable hurdle. We usually assist with agreeing that value.

With effect from 6 April 2008 the scheme could apply to shares worth up to £120,000 per employee. To qualify, the employee must work for either 25 hours per week for the company or commit at least 75% of their total working time to it. Part time employees will be counted proportionately.

An employee will not qualify if they control more than 30% of the company's shares.

The employer can issue options up to a value of £3 million of unexercised options.

The employer must be an independent company with fewer than 250 employees. It must trade or be preparing to trade wholly in the UK. Its gross assets must not exceed £30 million. It must not carry on defined activities; broadly, because they are deemed

to be of a lower risk.

The headline benefits are that the only income tax charge on the grant of EMI share options arises if the employee can acquire the shares at less than market value when the company grants the option. And the payout is subject to capital gains tax at 18% and which, with entrepreneurs' relief, if available would be 10% of the gain.

If you are considering a share based reward for any employee, we strongly recommend that you consider an EMI because of its tax benefits and relative simplicity. And we stress the benefits of acting sooner rather than later because our clients who delayed always regret missing the tax benefits.

Overview

An EMI option is the right of an employee to acquire shares in their employer company. To acquire the share the employee has to pay the option price. The option agreement may grant either an immediate right or a delayed right. The delay may be only the passage of time or it may depend on satisfying further conditions. When the delay is satisfied, the option is said to vest. Employers may limit the right to exercise the option to certain circumstances such as a takeover or flotation.

Relevant option

A relevant option must satisfy the following conditions:

1. It must be granted for commercial reasons. Those commercial reasons are to recruit or retain an employee. Seeking to avoid tax will disqualify the option.
2. It must be granted because of the employee's employment with the relevant company. This is normally employment with the company granting the shares but can include employment with a member of the issuing company's group companies.
3. It must not bring the total unexercised qualifying options over £3 million. If it does, those options will not be relevant options. Special rules apply when there was some headroom for the grant of further options but the grant breached that maximum.

Our experience is that an overall intention to save tax within the rules of the scheme is generally not unacceptable.

Employee maximum

How much?

The £120,000 limit applicable to the maximum options that may be granted to employees is based on the market value of the shares of the same class when the option was granted. The calculation applies to the maximum number of shares available under the option. There is a procedure for determining the value.

How long?

The maximum applies for three years from the grant of the last qualifying option. In other words, once the maximum of £120,000 has been met no more options may be granted for three years.

Options granted by any companies in the same group count towards the maximum.

Special rules apply to prevent employers circumventing this general principle.

Which options?

However, options granted by unconnected parties are treated separately. Because of the time commitment rules, problems with the three year period are more likely to arise in the case of employees with sequential employments. That is to say, an employee can have up to £120,000 options (or, as is more likely a mixture including shares exercised as a result of exercising previous options) with each of a former employer and their current employer.

Any unexercised options granted under an approved Company Share Ownership Plan are added to the tally. In other words, once the employee has reached that maximum they can be awarded no more options even if they exercise, or release, some of the options included in that maximum.

Tax treatment of relevant options

What capital gains tax?

Turning income to capital is the alchemy of EMI options.

The principal benefit of an EMI option scheme compared to any other route for providing shares to employees outside a Revenue approved scheme is that capital gains tax applies in place of income tax.

Because the benefit is subject to capital gains tax, it will probably be taxed at the rate of 18%.

Entrepreneurs' relief can reduce the effective rate of tax to 10%.

However, entrepreneurs' relief is subject to further preconditions limiting its availability.

Special rules apply to calculate the amount that the employee is treated as having paid for the shares.

What income tax?

The exercise of the option is also not subject to income tax provided that:

1. the option is exercised within 10 years of its grant
2. no disqualifying event has occurred, and
3. the option is exercisable at no less than the market value of the shares at the time of the grant.

Granting options outside the EMI scheme would, probably bear income tax. However, income tax is not charged on the grant of an EMI share option.

If the option is exercisable at less than market value, the difference is subject to income tax when the option holder exercises the option. This compares favourably to the grant of an option on similar terms but outside the EMI scheme regime when the income tax would be chargeable on the grant of the option. And that income tax charge would be based on the market value at the time of the grant whereas the charge under the EMI scheme is reduced by any fall in the market value of the shares between grant and exercise of the option. In other words, an EMI defers the tax charge and bases it on the fair value.

Employers should pay particular attention to the potential national insurance contributions liability.

The grant of an EMI option carries no national insurance contributions liability.

Special provisions apply to options granted to employees who are not UK resident.

Disqualifying events

If a disqualifying event happens and the option is not then exercised within 40 days, subsequently exercising the option will trigger a tax charge.

A disqualifying event happens if:

1. the company issuing the option becomes a 51% subsidiary of another company or becomes controlled by another company, *although the substituted option provisions explained further below may assist in these circumstances*
2. the company issuing the option ceases to satisfy the definition of a qualifying trading activity
3. the company issuing the option qualified because it was preparing to carry on a trade and either that preparation ceases or the trade does not commence within two years of the grant of the option
4. the employee ceases to satisfy the definition of an eligible employee. If an employee fails to meet the working time requirement (of 25 hours a week or 75% of their working time), a disqualifying event is deemed to happen at the end of the relevant tax year
5. the terms of the option are varied so that either the market value of the underlying shares increases or the statutory requirements of a qualifying EMI option scheme are no longer satisfied
6. the underlying share capital is varied in certain ways
7. the underlying share capital is converted to shares of a different class, although this is subject to certain exceptions
8. the employee is granted options under a Company Share Ownership Plan with the same employer so that the total options exceed £120,000 in value.

Employers should never lose sight of the potential for triggering a disqualifying event by oversight.

Relevant companies

The company issuing the options must satisfy the following conditions:

1. The company must be independent. This means that it must not be either a 51% subsidiary of another company or controlled by another company. Nor are any arrangements permitted that would allow the company to become such a subsidiary or so controlled.
2. Its subsidiaries must qualify as explained further below.
3. Its gross assets must not exceed £30 million. For parent companies, this limit includes the 'consolidated' group assets.
4. The company or its group must satisfy the trading activities test (see page 7).
5. The company and its wider group must have no more than 250 employees.

However, the company may be either quoted or unquoted and need not be UK resident.

Qualifying subsidiaries

If the company issuing the options has subsidiaries, then the parent must hold at least 51% of the shares in its subsidiary and no other person must control the subsidiary. Nor may there be any arrangements to breach those conditions.

However, the subsidiary's winding up or going into administration or receivership does not breach these conditions. Arrangements for the sale of the subsidiary do not disqualify it from granting EMI options.

The exception for arrangements to wind up or sell the company are both subject to the proviso that the arrangements are for commercial reasons and not part of a tax avoidance scheme.

Property management subsidiary

As an exception to the general rule for subsidiaries, a parent company must own at least 90% of any property-managing subsidiary. A property-managing subsidiary is one that satisfies the other requirements of a qualifying subsidiary but carries on the business of holding or managing land or any property deriving its value from land. The 90% condition applies to: issued share capital, voting power and beneficial entitlement to assets.

Disregarded group activities

Certain activities of a group are disregarded when assessing whether a parent company qualifies. These activities are:

1. Group treasury that is to say holding shares or securities in members of the group and making loans to them
2. Group property that is to say holding and managing property used by other members of the group for qualifying trading purposes
3. Incidental activities of a company otherwise meeting the trading activities test.
4. Nonqualifying activities for the purposes of identifying qualifying groups means excluded activities and nontrading activities.

Qualifying trade

The company issuing the options must exist only to carry on one or more qualifying trades. However, incidental or insignificant purposes can be overlooked. Holding and managing property that is used by the company for a qualifying trade is also disregarded. This is a matter of checking its founding documents (its memorandum and articles of association). The company must also be either carrying on that trade or, at least, preparing to carry on.

If the company issuing the options is the parent company of a group, then the activities of the group must satisfy the relevant test. That is to say that the consolidated business of the group must not include a substantial proportion of nonqualifying activities and at least one company must satisfy the trading activities test for single companies.

A substantial proportion is generally accepted to be more than 20%.

What is a qualifying trade?

A qualifying trade:

1. Must be carried on wholly or mainly in the UK
2. Must be run on a commercial basis with a view to making any profits
3. Must not consist of any excluded activities except to an insubstantial extent

This definition extends to research and development intended to lead to, or benefit, a qualifying trade. However, preparing to carry on such research and development does not qualify. The resulting trade may be carried on either by the company or a member of its group.

Excluded activities

These are:

1. Dealing in: land, commodities or futures, or in shares, securities or other financial instruments
2. Dealing in goods unless that is the company's ordinary trade of wholesale or retail
3. Banking, insurance, money-lending, debt-factoring, hire purchase finance or other financial activities
4. Leasing, receiving royalties or license fees
5. Legal or accountancy services
6. Property development
7. Farming or market gardening
8. Forestry activities or timber production
9. Operating or managing hotels and similar establishments such as guesthouses and hostels, if the person has an estate or interest in the property
10. Operating or managing nursing homes or residential care homes, if the person has an estate or interest in the property
11. Providing services or facilities for any of the above to a connected business
12. Shipbuilding, steel and coal production.

**Most
companies
qualify to grant
EMI options**

Relevant employees

The option holder must satisfy the following conditions:

1. They must be an employee of the company issuing the options or one of its qualifying subsidiaries

2. They must work for at least 25 hours per week on average or for no less than 75% of their working time. These limits are judged by the relevant contract to hours. Working time includes any remunerative occupation and therefore includes self-employment.
3. They must not have a material interest in the company or any of its subsidiaries. Their interest includes beneficial ownership (in most cases, and including any right to acquire shares other than those under an EMI scheme) or control whether direct or indirect and includes that of their associates. Further special conditions apply to so-called close companies that is to say those under the control of five fewer participates.

Relevant contract terms

The option must satisfy the following requirements:

1. The option shares must be fully paid-up shares. This is not the case if there is any undertaking to pay cash to the company at a future date.
2. The shares must be part of the ordinary share capital of the company issuing the options. They must not be redeemable more capable of becoming redeemable.
3. The option must be capable of being exercised within 10 years from the date the grant. If the exercised depends on satisfying further conditions, the option satisfies this requirement provided that the condition may be satisfied within that 10-year period.
4. The option must be in writing containing the following details:
 - the date of the grant
 - confirmation that it is issued under the relevant legislation
 - the number of shares to be acquired or the maximum number
 - the price or a pricing mechanism, if any
 - the date and mechanism for exercising the option
 - any preconditions to exercising the option
 - details of any restrictions apply to the shares

An EMI agreement is a legally binding document that needs to be carefully drafted.

The rights under the option must not be assignable.

The option may be made exercisable up to one year after the death of the option holder.

These are the bare minimum. Clients are often best advised to provide a more extensive agreement to cover other circumstances and liabilities.

Employee benefit trust

Employers often see the benefit of establishing an EBT

An EBT is not a formal requirement for setting up an EMI option. But they are a convenient and lawful mechanism for the employer to pump prime a market for the shares. This can benefit option holders and also existing shareholders. Once established for the EMI use, an EBT often finds other uses.

To set up an EBT the employer needs to identify trustees.

Substituted options

If a company (the “new employer”) obtains control of the company issuing the options, it may, in certain circumstances, agree with the option holder to issue substituted options in return for the original options. Equivalent provisions apply when the new employer obtains control following certain insolvency procedures or a qualifying exchange of shares.

The new options are, generally, treated as granted at the same time as the original options.

Successive substitutions are permitted.

In the case of a takeover, retaining employee loyalty is important and careful handling of the EMI scheme significant.

Notifying the Revenue

The company issuing an EMI option must notify HMRC within 92 days of the grant using a prescribed form. Failing to give proper notice disqualifies the option. HMRC have a procedure for inquiring into the grant of option.

Revenue returns

Companies with outstanding options at any point in a year are obliged to make return of that information before 7 July following the end of that tax year.

Next steps

We prefer to work through the various issues with clients rather than follow a set procedure.

To proceed with an EMI , an employer needs to check whether it has the power to grant the options, whether it qualifies and the general operating criteria for the scheme.

We can assist with these preliminary enquiries and make the relevant amendments, if necessary.

We can provide a checklist if that is helpful.

The next stage is to prepare the relevant documents: the agreement, letter to staff, options certificate and exercise letter.

We don't just prepare the documents but can provide a commentary, a user's guide.

We are particularly focused on achieving useful performance criteria.

The employer will need to decide whether to agree a share value with the Revenue. In our experience, they probably will.

We can usually assist with agreeing that valuation.

The options need to be granted and the performance criteria monitored, where relevant. The vesting of the options needs to be recorded. Finally, exercise of the options should be correctly performed and recorded.

The granting and existence of options needs to be reported and the continued qualification of the EMI needs to be monitored.

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