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ENTERPRISE MANAGEMENT INCENTIVE

Many companies see the provision of an equity stake in the business as an important element in the incentivisation of key management and staff. In turn those working in the business see an equity stake, no matter how small, as something worth striving for.

However, providing shares to employees can be fraught with difficulty, and onerous tax charges, such that great care is needed.

There are a number of schemes for providing shares to employees which are approved by H M Revenue & Customs ("HMRC"). One of the most flexible, and therefore perhaps most useful, is the Enterprise Management Incentive scheme ("EMI").

There are strict guidelines which have to be met which means that an EMI scheme is only possible for certain smaller companies. However, if all the conditions are met an EMI scheme can be a very rewarding initiative for both the company and the participants.

This briefing note looks at the important issues, some planning points and a few of the pitfalls.

The benefits of an EMI scheme

The main benefit of the scheme is that employees can acquire shares in the company without incurring an income tax liability and can participate in the increased value of shares at capital gains tax rates. In addition neither the award of the options nor the exercise of the options gives rise to a national insurance liability which is advantageous to both the employee and the company.

The employer will hopefully be able to use an EMI scheme as a mechanism to tie in to the business key employees who are working together with the owners to maximise the equity value of the company. The employer will also get a corporation tax deduction when the options are exercised.

Suitability

The use of an EMI scheme is particularly attractive for companies which are seeking:

- To align the employees' interests with those of the company and other shareholders to ensure growth;
- To lock-in key employees in the medium term;
- To encourage tax efficient share ownership and enable employees to access ER on their share ownership; and

- To provide a total remuneration package which is competitive and will attract key employees to the business.

The conditions to be met

There are a number of conditions which need to be met by both the company and the individual. The EMI legislation also sets out what needs to be included in the formal documentation.

The main conditions are:

The company:

- must be independent and not under the control of another company. Thus in a group situation an EMI scheme can only be in respect of shares in the parent company;
- must meet certain conditions with regard to the nature of its trade;
- have fewer than 250 employees;
- have gross assets less than £30 million;
- only have qualifying subsidiaries;
- can only issue options to the value of £3 million. This is by reference to the value of the shares at the date of grant; and
- must not grant options to any one individual in respect of shares with a value of more than £250,000.

The individual:

- must work at least 25 hours per week in the company or a group company, or if not, 75% of their available time.

The EMI option scheme formalities

The agreement, which must be in writing, must state:

- the date the option is granted;
- that it is granted under the provisions of the relevant EMI legislation;
- the number, or maximum number, of shares that may be acquired;
- the price (if any) the employee will pay to acquire the shares, or the method by which that price will be determined;
- when and how the option may be exercised;
- any conditions (including performance conditions) affecting the terms or the extent of the employee's entitlement; and

- any restrictions on the shares. If the shares are subject to a risk of forfeiture, the agreement must contain details of the conditions. Shares are subject to risk of forfeiture if the interest in shares that may be acquired is only conditional within the meaning of the relevant tax legislation.

The option must:

- be in respect of fully paid up shares which are not redeemable;
- be capable of exercise within 10 years;
- have terms which are agreed in writing; and
- be a right which is non-assignable.

The mechanics

The employee is awarded options over shares in the employing company, or if a group, in the parent company. The EMI option agreement will specify what conditions must be satisfied before the option can be exercised and will set out the earliest date on which the options may be exercised. The options must be capable of exercise within 10 years.

When the conditions are satisfied the employee can exercise the option paying the agreed price (if any). The employee then owns the shares and will be subject to capital gains tax when the shares are sold.
The EMI option can have an exercise price which is less than the market value of the shares at the date the options are granted but this will affect the income tax position, as detailed below.

HMRC's input

The value of the shares at the date of grant should ideally be agreed with HMRC before the scheme is implemented. This is the only input which is required from HMRC.

An annual return is required in respect of the EMI scheme once implemented. HMRC may also ask questions in connection with the scheme once it is in place.

HMRC will also give advance clearance that a company's activities do not fall within the excluded activities in the EMI legislation.

Tax consequences of a qualifying option

The employer will usually qualify for a corporation tax deduction when the employee exercises the options equal to the difference between the exercise price and the market value of the shares on exercise.

Income tax and NIC

No income tax or NIC liabilities arise on the grant of the option.

Where the exercise price is at least equal to the market value of the shares at the date of grant, no income tax arises on the exercise of the option if exercised in an approved manner.

If the options have been granted at a discount, there is an income tax charge on exercise based on the lower of the market value at grant or at exercise less the exercise price and any amounts paid by the employees for the grant of the option.

If a disqualifying event occurs, as defined in the legislation, the option holder has 90 days to exercise any unexercised options to retain the tax benefits. Otherwise an income tax charge will arise based on the increase in market value from the date of the disqualifying event.

For companies which are listed, or where there is a market for the shares, income tax will be collected through PAYE and there will also be a NIC liability.

Capital gains tax

A capital gains tax liability will arise when the employee disposes of the shares. The chargeable gain will be based on the sale proceeds less the price paid to exercise the option and the amount on which any income tax liability arose on exercise. The foregoing is subject to the special rules for share cost 'pooling' where the employee also holds other shares in the company.

A capital gains tax rate of 10% is available, due to the availability of Entrepreneurs' Relief, on EMI share disposals by an employee. For disposals made on or after 6 April 2013 a minimum 5% shareholding is no longer required, provided the option was granted at least 12 months before the disposal date.

Administration

There are a number of very important issues which need to be addressed as part of the introduction of an EMI scheme.

One, as mentioned above, is the need for formal documentation. One other is the need to notify HMRC of the grant within 92 days of the grant. A simple requirement but one which can be missed by the most diligent of clients and advisers.

How Friend can help

We can:

- confirm that all the necessary legislative provisions are, or can be, met;
- prepare draft scheme rules and customise these as applicable for finalisation and implementation;
- prepare any supporting documentation which may be required;
- obtain advance assurance from HMRC on the qualifying status of the company, if required;
- obtain HMRC agreement on the valuation of the shares at the award date; and
- deal with all HMRC reporting requirements and HMRC enquiries if relevant.

If you have any questions in connection with this briefing please contact Simon Littlejohns, Tax Partner, on 0121 633 2007 or your usual contact at Friend.

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