Introduction

The enterprise management incentive (EMI) scheme is designed to help smaller high-risk companies recruit and retain employees and reward them for their commitment to achieving the company's potential. The scheme enables companies to grant highly flexible, tax-advantageous share options to any number of employees. EMI differs from other tax-advantaged schemes as it does not require advance approval from HM Revenue & Customs (HMRC). Instead, a simple notification process applies. However, several conditions must be satisfied and some formal documents are needed.

Qualifying conditions

Both the company and the employee have to satisfy certain conditions for an option to qualify for the EMI tax benefits. The conditions are designed to limit the EMI scheme to its stated targets. In addition, there are conditions imposed on the option itself, limits on the value of unexercised options and an overriding anti-avoidance 'purpose test', which had never previously appeared in employee share scheme legislation.

Qualifying options

The legislation defines a qualifying option as follows:

> "An option is a qualifying option only if it is granted for commercial reasons in order to recruit or retain an employee in a company, and not as part of a scheme or arrangement the main purpose, or one of the main purposes, of which is the avoidance of tax".

This test is not intended to be highly restrictive. Instead it is designed to prevent abuse of the tax advantages associated with EMI options. However, it could, for example, be used to disqualify options granted to relatives of directors where providing an incentive might be a less important motive to granting options than the fact that they have tax advantages. It would also prevent manipulation of the EMI rules or share values in order to artificially enhance the tax benefits.

Qualifying companies

Companies that wish to grant EMI options may be listed or unlisted, although most listed companies, in practice, will not meet the criteria. They do not have to be resident in the UK, but must trade in the UK. They must satisfy five sets of conditions relating to independence, qualifying subsidiaries, gross assets, trading activities and number of employees.

Independence

The company granting options must not be:

- A 51% subsidiary of another company.
- Under the control of another company in any other way.

There must also be no arrangements in existence under which the company could become a 51% subsidiary. Employees of a subsidiary can only be granted options in the parent company.

Qualifying subsidiaries

The company granting options must not have any subsidiaries other than qualifying subsidiaries.

- A subsidiary is defined as a company that the company granting options controls either on its own or together with any connected person.
- A subsidiary qualifies if it is a 51% subsidiary of the holding company or of a 51% subsidiary of it.

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- However, if the business of the subsidiary consists wholly or mainly of holding or managing land and buildings, it must be a 90% subsidiary.
- Further, arrangements must not be in place which would cause any of these conditions to cease to be met.

Gross assets

The company (or group if the company is a holding company) must not have gross assets with a value of more than £30 million at the time an EMI option is granted.

- Gross assets are taken as the aggregate of the balance sheet values of those assets without any deduction for liabilities, based on a balance sheet drawn up in accordance with standard accounting practice and on a basis consistent with any previous accounting periods.
- No account need be taken of intangibles such as goodwill if, as is often the case, they are not shown on the balance sheet.

If share options are issued on a date for which a balance sheet does not exist, it might be necessary to update the immediately preceding balance sheet to show that the value of gross assets remains not more than £30 million. HMRC statement of practice 2/06 outlines how to calculate gross assets for EMI purposes.

Trading activities

The trading activities test differs slightly according to whether the company stands alone or is the parent company of a group.

- A stand-alone company must:
  - Exist wholly for the purpose of carrying on one or more qualifying trades (disregarding any incidental purposes); and
  - Actually be carrying on a qualifying trade or be preparing to do so.
- Where the company is a parent company of a group:
  - The business of the group must not be wholly or substantially that of carrying on non-qualifying activities.
  - At least one group company, not necessarily the one that grants the options, must satisfy the trading activities test for a stand-alone company. ‘Wholly or substantially’ is normally taken to mean more than 20%. However, there must be at least one group company that does not carry on non-qualifying activities.
- A trade is a qualifying trade if it:
  - Is conducted on a commercial basis and with a view to making profits.
  - Does not consist of excluded activities.
- Excluded activities are similar to those under the enterprise investment scheme (EIS):
  - Dealing in land, commodities, shares, securities or other financial instruments.
  - Dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution.
  - Banking, insurance, money-lending, debt-factoring, hire purchase financing or other financial activities.

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- ➢ Leasing, apart from some chartering of UK-registered ships.
- ➢ Receiving royalties or licence fees, except that royalties and licence fees are ignored where they arise from intangible assets created by the company carrying on the trade or by another company in the same group.
- ➢ Providing legal or accountancy services.
- ➢ Property development, farming, market gardening or forestry or timber production, except that property used by the company or group for its own trade is ignored.
- ➢ Operating or managing hotels, nursing homes or residential care homes or property used as such.
- ➢ Providing facilities for a connected business that carries out excluded activities.
- ➢ Shipbuilding, coal and steel production (for options granted after 21 July 2008).

- Non-qualifying activities are broadly:
  - ➢ Excluded activities, as listed above.
  - ➢ Any activities carried on otherwise than in the course of a trade.

UK permanent establishment

The UK permanent establishment condition applies in relation to options granted on or after 16 December 2010. It is met if the company has a permanent establishment in the UK or, where that company is a parent company, any other member of the group meets the trading activities requirement and has a permanent establishment in the UK.

Number of employees

The company must have fewer than 250 full-time equivalent employees.

- The full-time equivalent employee number is the number of full-time employees plus a just and reasonable fraction for each part-time employee.
- In the case of a parent company of a group, the group must satisfy this condition.
- Directors are included. Employees on maternity or paternity leave are not.

HMRC regards a full-time employee as one whose standard working week is at least 35 hours. A person working, say, 21 hours a week would be regarded as 0.6 of an employee. However, a person working more than 35 hours a week would only be regarded as one full-time employee.

The employee

Employees must meet three conditions:

- They must be employed by the company granting the options or a qualifying subsidiary (the ‘employment requirement’).
- They must work for the company (or group) at least 25 hours a week or, if less, for at least 75% of their total working time (which includes any time as a self-employed person) (the ‘commitment to working time requirement’). Working time includes reasonable holidays, sick leave and parental leave, but not meal breaks.
- They (and their associates) must not hold more than 30% of the company’s shares (the ‘no material interest requirement’). Unexercised EMI options are not counted.

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Limits

Two limits are imposed on the value of unexercised EMI options in existence at any time.

In both cases, the value of the shares is taken by reference to the market value of the shares at the time the option was granted.

- An employee may not hold unexercised qualifying options with a value of more than £120,000.
  - ➢ Any excess will not qualify for the tax advantages, but will not jeopardise the tax-advantaged status of the initial £120,000.
  - ➢ Once the employee has exercised some options and dropped below the £120,000 limit, further qualifying options may be granted three years after the previous grant of a qualifying option.
- The total value of shares in the company, in respect of which unexercised EMI options exist, must not be more than £3 million.

The option

Although there are four specific requirements that the option or the underlying shares must meet, they are more flexible than under other employee share schemes.

- The shares must be ordinary shares of the company, which are fully paid up and not redeemable. However, they can be of a special class, or be subject to restrictions or special provisions, and need not have voting rights.
- The option must be capable of exercise within ten years. It may also remain exercisable after ten years, but the tax benefits are lost if the option is not exercised within ten years of its grant.
- The terms of the option must be agreed in writing. The agreement must include:
  - ➢ The date the option is granted.
  - ➢ The fact that it is granted under the provisions of Schedule 5 to the Income Tax (Earnings & Pensions) Act 2003.
  - ➢ The number or maximum number of shares that may be acquired.
  - ➢ The exercise price or method by which that price is to be determined.
  - ➢ When and how the option may be exercised.
  - ➢ Any conditions, such as performance conditions, which affect the terms of the option. There are no specific restrictions on the nature of such conditions.
  - ➢ Any restrictions attaching to the shares.
  - ➢ Any circumstances in which the shares acquired by the employee may be forfeited.
- The option cannot be assignable to any other person, although its terms may allow exercise for up to one year after the employee's death.
- There are no restrictions on the price payable for the shares on exercise of the option. In particular, it does not have to be market value at the date of grant, although a lower price will give rise to some income tax when the option is exercised.

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Taxation

Generally, no income tax charge arises on the grant or exercise of a qualifying EMI option. However, a capital gains tax (CGT) liability may arise if the shares are subsequently sold for more than the price paid for them. In detail, the tax benefits are:

- No income tax is charged on the grant of an EMI option.
- On exercise of a qualifying option within ten years of its grant, no income tax is charged where the exercise price is not less than the market value of the shares at the date the option was granted.
- If the exercise price is less than the market value at the date of grant, income tax is charged at the time of exercise on that discount less any amount that the employee paid for the grant of the option.
- Any gain on the eventual disposal of the shares is subject to CGT. The annual exemption (£10,600 in 2011/12) is deducted from a person's total gains in the tax year, and the balance at either 18% (basic rate) or 28% (higher rate). The base cost of the shares is the amount paid for them under the option (including anything paid for the grant of the option). Any amount on which income tax was charged when the option was exercised also forms part of the cost.
- A disposal will only qualify for CGT entrepreneurs' relief if the employee holds at least 5% of the ordinary shares and voting rights (not just options) in the company for at least a year up to the disposal, which will rarely be the case. The relief reduces the tax rate to 10% on gains up to the lifetime limit, which is set at £10 million from 6 April 2011.
- If an option is disqualified (see the separate topic 'Enterprise management incentive share options') any increase in market value of the shares between the dates of grant and disqualification of the option remains exempt from income tax.

Example 21.1 – EMI share options

EMI options are granted over 20,000 shares at an exercise price of £4 a share, which is their agreed market value at the time.

Four years later, the company is floated at a share price of £15.

The employee exercises options over 10,000 shares and immediately sells the shares.

The employee has to pay £40,000 (10,000 × £4) on exercising the option and receives £150,000 (10,000 × £15) on selling the shares, making a profit of £110,000 (ignoring costs).

After deducting the annual exemption of £10,600, the employee (who is a higher rate taxpayer) pays tax of £27,832 ((£110,000 − £10,600) at 28%).

If the option had not qualified under the EMI scheme, the employee would have had to pay income tax on £110,000 upon exercising the option, whether or not the shares were then sold. With higher and additional rates of income tax at 40% and 50% respectively compared with a higher rate of CGT of 28%, the tax advantages of the EMI scheme are clear.

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Procedure

Unlike most other tax-advantaged share schemes, there is no prior approval process under the EMI scheme. Instead a notification process exists. Companies granting EMI options must also file an annual return (form 40) with HMRC.

HMRC notification

For an option to qualify, it must merely be notified to HMRC within 92 days of being granted. This notice must:

- Be given by the employer company (not necessarily the company granting the options, where the employee works for a subsidiary).
- Be in the required form.
- Be supported by a copy of the option agreement.
- Contain a declaration by the employee that they satisfy the working time requirement.
- Contain a declaration by a director or the company secretary of the employer company that to the best of their knowledge:
    - ➢ The EMI requirements are met.
    - ➢ The information provided is correct and complete.
    - ➢ HMRC form EMI1 can be used for notifying the grant of options. Form EMI1 can be downloaded at www.hmrc.gov.uk/shareschemes/emi/appendix1.htm. The form incorporates the employee's and company declarations.

The notice should be sent to:

HMRC Revenue and Customs
1st Floor, Ferrers House
Castle Meadow Road
Nottingham
NG2 1BB

Advance assurance

Companies can obtain advance assurance in writing that the Inspector of Taxes is satisfied that the company will meet the qualifying requirements when the options are granted. It is not a requirement to obtain advance assurance, but doing so will reduce uncertainty over whether the option will qualify and, where necessary, enable a company to address any problems before it is too late.

- This opinion is not binding on HMRC. Circumstances might change, and the company might not in the event qualify. HMRC has stressed that whether the requirements for qualification will in the event be met is a question of fact that cannot be known for certain in advance.
- The advance assurance does not cover any other aspect of the EMI conditions, such as whether an employee is eligible.
- To obtain an advance assurance, the company should contact the HMRC Small Company Enterprise Centre and supply all the information that might be relevant, including accounts, the memorandum and articles of association, and details of all trading activities for the company and any subsidiaries.

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HMRC enquiries

HMRC can open an enquiry into an option at any time within one year and 92 days of the grant of the option.

A longer period is allowed if HMRC discovers that any information given in, or supplied with, the notice of the option was false or misleading.

- An enquiry is the only means by which HMRC can establish whether the option qualifies under the EMI scheme.
- If HMRC does not open an enquiry within the permitted period, the option automatically qualifies under the EMI scheme.
- The limited procedure for obtaining advance assurance that the company will qualify under the EMI scheme means that employees cannot be certain that tax relief will be available until one year and 92 days have elapsed or HMRC has concluded its enquiries.
- The procedures for completion of an enquiry and appealing against an adverse HMRC decision are similar to those under self-assessment generally.

Share valuation

The tax relief hinges on the market value of the shares at the time the option is granted.

It is not necessary to establish that market value at the time of the grant, only at the date when the option is exercised.

However, most companies and employees will wish to know the market value at the outset in order to establish the extent of the income tax benefit.

Indeed, the exercise price is likely to be set at the agreed market value.

- The EMI rules provide that:
  - ➢ The market value may be agreed between HMRC and the employer company.
  - ➢ If no agreement can be reached, HMRC may determine the market value unilaterally. The company can appeal.
  - ➢ The company may refer the valuation to the Tax Tribunals (which rule on tax disputes) any time before HMRC makes a determination.
- HMRC has stated that if the shares under option are listed on a recognised stock exchange their market value will be the quoted price. In other cases, companies can offer their own valuation, but HMRC is likely to open an enquiry in order to determine whether it is acceptable.
- A better arrangement is to agree the value in advance with HMRC's shares valuation division.
  - ➢ The shares valuation division has produced a two-page form (form Val 231) for requesting an EMI valuation, which can be downloaded from the HMRC website at www.hmrc.gov.uk/shareschemes/val231.pdf or obtained from:

    Shares and Assets Valuation (SAV) (Share Schemes)
    Ferrers House
    PO Box 38
    Castle Meadow Road
    Nottingham
    NG2 1BB

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- ➢ The completed form has to be submitted with specified supporting documents such as accounts, the company's articles of association, valuation reports and details of recent share transactions and dividends.

- HMRC undertakes to agree share valuations as quickly as possible, but it must be recognised that agreeing the valuation of minority holdings of unlisted company shares can be a protracted process. Any such valuation is surrounded by a great deal of uncertainty.
- HMRC will consider agreeing a valuation for an extended period during which circumstances are not expected to change, in order to reduce the number of valuations needed. This is unlikely to be possible for very new companies.

Annual returns

A company whose shares are subject to EMI options at any time during a tax year must deliver a return to HMRC within three months of the end of the tax year (i.e. no later than 6 July following the end of the tax year). The EMI annual return form (form 40) can be downloaded from the HMRC website (www.hmrc.gov.uk/shareschemes/emi/emi40-2011.pdf).

Information and documentation

Companies will need to produce their own documents for the options and for any performance incentives or other special features. Because the terms of each option might be different from those of any other option, these documents cannot be standardised. Because of this, HMRC has not produced any standardised documentation, in contrast to other share schemes, except for its specimen form for notifying the grant of options.

Guidance on enterprise management incentives can be found in HMRC's Employment Related Securities Manual at section ERSM304000ff at www.hmrc.gov.uk/manuals/ersmmanual/index.htm. Guidance is also available on the HMRC website at www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm.

HMRC can be contacted in relation to EMI queries as follows:

- By email at enterprise.centre@hmrc.gsi.gov.uk,
- By telephone on 0115 974 1250,
- By fax on 0115 974 2954, or
- At the following address:

  Small Company Enterprise Centre
  HM Revenue & Customs
  1st Floor, Ferrers House
  Castle Meadow Road
  Nottingham
  NG2 1BB

Disqualification of options

An option will qualify if it meets all the EMI requirements at the time it is granted. However, there are several events that could occur after the grant of the option, but before its exercise, which will disqualify it from that point on. Disqualification can be avoided if the option is exercised within 40 days of the disqualifying event. Events that occur after the employee has exercised the option do not affect the tax advantages.

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Effects of disqualification

Disqualification results in partial loss of the income tax relief.

- Where an option is exercised more than 40 days after a disqualifying event, income tax is charged on any increase in value of the shares between the dates of the disqualifying event and the exercise of the option. This is in addition to any income tax where the exercise price is less than the market value at the date of grant of the option.
- Any increase in value between the date of grant and the disqualifying event remains free of income tax and liable only to CGT when the shares are sold. Employees should take advice on whether to exercise their options within 40 days of a disqualifying event. As any income tax is payable only on exercise of the option, there is no longer always a clear case for early exercise, but the decision will depend on the circumstances.

Where the terms of the option require certain conditions to be met before exercise, such as performance targets being reached, there could be a proviso allowing exercise within 40 days of a disqualifying event.

Disqualifying events

Disqualifying events include certain breaches of the requirements that must be met in order to grant EMI options. They also include some provisions to prevent manipulation of the scheme to gain additional tax benefits. However, the company growing such that its gross assets exceed £30 million is not a disqualifying event, but this requirement must have been met at the time the options were granted. Disqualifying events include:

- The company coming under the control of another company.
- The company ceasing to meet the trading activities requirement.
- The employee leaving the employment or reducing the hours worked below the minimum requirement.
- Certain variations of the terms of the option.
- Certain alterations of the share capital of the company that would increase the value of the shares under option.
- A conversion of shares into a different class, except in certain specified circumstances. In general, where a special class of shares is created for EMI options, a conversion will be a disqualifying event. However, a conversion will often precede a flotation or sale of the company, which is an occasion when employees are likely to want to exercise their options anyway.
- The grant to the employee of an option under an approved company share option plan (CSOP) if, as a result, the employee holds unexercised options under the two schemes of more than £120,000.
- If the EMI option was granted at a time when the company was only preparing to carry on a qualifying trade, the option will be disqualified if the company fails to start trading within two years.

Sale or takeover of the company

Many unlisted companies that grant EMI options will do so with a view to employees being able to realise the value of their shares on a sale or takeover of the company in the medium term. This prospect gives the options a strong incentive element.

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Sale for cash

A takeover may be an ideal opportunity for employees to benefit from their share options by selling their shares for cash. A takeover will in many cases be a disqualifying event and employees may want to exercise their options within 40 days. This will not cause difficulty if the employees are able to sell the shares for cash to be able to pay the exercise price and any income tax liability where the exercise price is less than the market value at the date of grant.

Share exchange

Where the takeover is in exchange only for shares in the acquiring company, the EMI rules allow an exchange of options, transferring the tax benefits to replacement options over shares in the acquiring company (the new shares). The share exchange must meet certain conditions. Additionally:

- The replacement options must be issued within six months of the takeover.
- The EMI rules must be met in relation to the new options except that:
    - The acquiring company need not satisfy the gross assets test.
    - It may have non-qualifying subsidiaries.
- In particular, the acquiring company must meet the rule that the value of unexercised options in existence must not be more than £3 million. This could cause difficulty if both companies have previously granted EMI options to a high value.
- The values of shares and amounts payable by the employee under the old and new options must remain unchanged.

Other points

National insurance contributions (NICs)

Liability to NICs (employer's and employee's) will only arise where there is an income tax liability and the shares are readily convertible assets. Shares are readily convertible assets if they can be sold on a stock exchange or there are arrangements in place that allow the employee to sell the shares for cash.

It is possible for the company and employee to agree that the employee will meet some or all of the employer's NIC liability or for some or all of the employer's NIC liability to be transferred to the employee. Where this occurs, the amount on which the employee is liable to income tax in respect of the share option gain is reduced by the NICs passed on.

Commercial considerations

Despite the tax advantages and incentive effect of EMI options, employers should consider all the issues carefully before granting options:

- Employers should remember that the value of shares can be affected by many factors apart from the efforts of the employees. For example, share values can rise and fall with economic and trading conditions generally. As a result, some employees might become disenchanted with the arrangements.
- From the employer's point of view, 'golden handcuff' arrangements, which tie an employee to a company, can prove expensive if the employer wishes to end a contract prematurely.
- The shares must be easily disposable after the exercise of options. EMI options will be most attractive to companies with a good prospect of flotation or sale in the medium term.

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Legal considerations

A company granting options must ensure that:

- The grant is within the provisions of its memorandum and articles of association.
- The provisions of the Financial Services and Markets Act 2000 are not breached by recommending its shares as an investment.
- The terms of the option do not breach the employee's employment rights.

Personal tax returns

The employee must show all events that give rise to income tax liability on the share schemes pages of the self-assessment personal tax return.

Costs

The Government has estimated that the cost to the company of setting up straightforward EMI options will typically be between £3,500 and £5,000. This includes taking professional advice, checking the eligibility of the company and its employees and agreeing the initial share valuation with HMRC. Arrangements that are more complex could cost up to £15,000. There will also be some annual running costs.

Corporation tax

Companies are entitled to corporation tax relief where an employee acquires shares as a result of exercising an EMI option regardless of when the option was granted. The corporation tax deduction is equal to the market value of the shares when the employee acquires them under the option, less any amount the employee pays for the shares. The relief is given in the period in which the employee acquires the shares. The company's setting up and running costs are also tax deductible.

Tax planning key points

- EMI options are flexible and have significant tax advantages.
- Difficulties can arise on a company takeover, and care must be taken with complex arrangements so that the tax benefits are not lost.
- They have advantages over the approved CSOP in that they are cheaper and simpler to set up, and the value of options granted can be much higher than the £30,000 allowed under the CSOP.
- However, they are targeted at particular types of company and many companies will not qualify.
- Further information can be obtained from the HMRC website at www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.

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