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Enterprise Management Incentives

Enterprise Management Incentives (EMI) are tax advantaged share options designed to help small, higher risk, companies recruit and retain employees with skills that will help them grow and succeed. They are designed to reward employees for taking a risk by investing their time and skills in helping small companies achieve their potential.

The scheme allows a company to grant key employees the right to purchase shares at some given time in the future, often subject to meeting performance targets or conditions. Once such conditions are met, the employee can exercise their right and purchase the shares, which are usually below market value or at nil cost. There is no income tax on the grant of the options and often no income tax when the options are exercised.

There are certain conditions which the company and the employee must meet in order to qualify for the scheme:

Company conditions

Independence test
The company must not be a 51% subsidiary or otherwise under the control of another company.

Qualifying subsidiary test
When the company (the parent) has subsidiaries, all the subsidiaries must be qualifying subsidiaries. That is, the parent must own at least 50% of the share capital, have 50% of the votes, 50% of assets on the wind up and 50% of profits available for distribution.

Gross asset test
The value of the company's (or group of companies) gross assets must not exceed £30 million at the date the EMI options are granted.

Employee number test
The company must have a maximum of 250 full time equivalent employees.

Trading activities test
The company must exist wholly for the purpose of carrying on a qualifying trade. A trade is a qualifying trade if it is:

- Carried on wholly or mainly in the UK;
- Conducted on a commercial basis with the view to realisation of profits;
- Does not consist wholly or mainly in the carrying on of excluded activities (excluded activities are as per the Enterprise Investment Scheme).

Employee conditions

Employment test
A person is only eligible for EMI options if they are an employee of the company (or any one of the group companies).

Commitment to work time test
An employee will only be eligible if they:

- Work at least 25 hours a week in the company; or
- If less, work at least 75% of their working time in the company.

No material interest test
A person will not be an eligible employee if they have a material interest in the company. Material interest means:

- Beneficial ownership of directly or indirectly more than 30% of the ordinary share capital;
- Where the company is a close company (controlled by five or fewer shareholders), the possession of or entitlement to acquire rights that would give 30% of the assets if the company were to be wound up, and make them available for distribution among the participators/shareholders.

Value of options
The combined value of unexercised options held by the employee must not be more than £250,000.

Terms of options

Type of share that can be acquired
The options must be over shares which:

- Form part of the ordinary share capital of the company;
- Are fully paid up;
- Are non-redeemable.

Period of option
There is no minimum term of an option, however, it must be capable of being exercised within 10 years of being granted. If the option is not exercised within this period then the income tax relief is no longer available.

If there are any conditions assigned to the exercising of the option, these must be able to be met within the 10 year period.

Terms of option to be agreed in writing

The option must be in the form of a written agreement between the company granting the option and the employee. The agreement must include:

- The date the option is granted;
- That it is granted under ITEPA 2003 Schedule 5 (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 the price is to be determined;
- When and how the option may be exercised;
- Any conditions affecting the term and extent of the employee's entitlement (if applicable);
- Details of any restrictions on the shares.

How the scheme works

Granting the right to purchase shares

There is no income tax or national insurance contributions payable on the grant of the options.

The options may be granted at an exercise price which is less than the market value of the shares at the date of the grant. When this happens, the amount of the undervalue at the date of grant (or gain at exercise if less) will be liable to income tax at the time the option is exercised.

If the shares are readily convertible assets (readily convertible into cash i.e. by way of sale), there will also be an NIC charge on the same value.

Exercising the right to purchase shares

There is no income tax charge in respect of gains accruing on the exercise of the qualifying option if the option was granted at a price of at least market value at the date of grant. This amount is normally agreed with HMRC prior to granting the option.

However, income tax may be charged on the gain if exercise occurs after a disqualifying event.

If shares are granted at less than market value at the date of grant (for example at £nil), the gain chargeable to income tax is:

- The amount of the discount (market value at grant less price paid); or
- If less the market value at date of exercise less the price paid.

No part of the increase in the value of the shares between grant and exercise is subject to income tax. It is only the discount from market value at the date of grant which would be subject to income tax. For example, if the option is granted at nil consideration, the income tax charge is simply on the market value at the date of grant (or exercise if less).

In order to avoid unnecessary surprises at a later date, it is advisable to agree the market value of the shares at the date of grant with HM Revenue & Customs.

Capital gains tax

When the shares are sold, they will be chargeable to capital gains tax on any gain arising on their disposal.

The gain chargeable is the proceeds received from the disposal less the price paid for the shares plus any amount chargeable to income tax. Put simply, this is the difference between the sale price and the market value of the share on the date the options were granted.

Entrepreneurs' relief is available if the individual is an employee at the date of sale and the shares are acquired through EMI share option, as long as the combined period of ownership of the options and the shares is at least 12 months.

Providing that shares are acquired through an EMI scheme, there is no minimum percentage holding required to qualify for entrepreneurs' relief.

Withdrawal of EMI relief

The following are considered to be disqualifying events:

1. Loss of the company's independence (i.e. becoming a 51% subsidiary).
2. The company ceasing to meet the trading requirements.
3. The employee either ceasing to be employed or ceasing to meet the hours of work requirements.
4. Any change in the term of the option which increases the market value of the shares under the option.
5. Any alteration in the share capital which affects the value of the shares, or the creation, variation or removal of a right, or arrangement relating to the shares without prior approval from HM Revenue & Customs.
6. Conversions of the shares subject to the option.
7. The employee is granted an option under the share option plan which takes the value of the options over £250,000.

8. The total value of the shares in respect of which unexercised qualifying options exist must not exceed £3 million. An option will not be a qualifying option if the limit is already exceeded at the time when it is granted. If the grant causes the limit to be exceeded, it will not be a qualifying option so far as it relates to the excess, apportioning pro-rata if more options are granted at the same time.

If a disqualifying event occurs and the option is exercised within 40 days of the disqualifying event, full income tax relief on exercise remains available.

If the options are not exercised until after the 40 days, the amount of gain realised on exercise is subject to income tax. Tax is payable on the market value of the shares immediately before the disqualifying event.

Where the qualifying option has been granted at the market value at the date of grant, tax is payable on the gain in value since immediately before the disqualifying event until the date of exercise.

Where the option has been granted at less than market value, the amount of the gain on the undervalue since grant will be increased by the gain since immediately before the disqualifying event to the date of exercise.

Other considerations

1. There is no requirement to apply for advanced clearance of the share valuation from HM Revenue & Customs – they have 12 months to check the EMI conditions have been satisfied.
2. Once an EMI option has been granted, the company must notify HM Revenue & Customs within 92 days. This is done electronically through the online PAYE registration with HMRC.
3. The company must complete an annual online return advising of any options exercised or lapsed. Nil returns must be submitted if there are no changes.
4. The costs of setting up the scheme are deductible for corporation tax purposes.
5. Complicated rules were introduced in the Finance Act 2003. Under these new rules it will be necessary for the company and the employee to sign a joint election to prevent any income tax charge arising after the exercise of the options.

How can we help?

We can help you apply for advance clearance of the share valuation at the date of grant, register EMI options with HM Revenue & Customs and complete the annual EMI options tax return.

For more information please contact:

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