Bird & Bird

Enterprise Management Incentive Plan ("EMI")

June 2024

Introduction

The EMI is a tax-advantaged discretionary share option arrangement aimed at small growing companies to help them recruit and retain employees (including executive directors) in the UK. The exercise is generally tax relieved, allowing gains to be taxed as capital on the sale of the option shares at a fixed rate of as low as **10% on the first £1 million of lifetime gains.**

Tax Reliefs

The EMI tax reliefs are very generous. Broadly, there is:

- no income tax or social security on grant;
- no income tax or social security on exercise (assuming the option was not granted at a discount and is exercised within 10 years of grant);
- capital gains tax ("**CGT**") (usually at 10%) on the sale of the option shares with no minimum share holding period; and
- the UK employing company will generally qualify for a corporation tax deduction equal to the gain that optionholders make for the accounting period in which the option is exercised (even if participants are relieved from income tax), and a corporation tax deduction may also be available for operating costs under general principles.

Gains made on the sale of the option shares in excess of the exercise price are generally subject to CGT. Individuals benefit from a CGT annual exemption (of £3,000 for 2024/25), and thereafter gains are subject to CGT at the top rate of 20% (or 10% for individuals with income and chargeable gains below the higher rate income tax threshold of £50,271 for 2024/25).

However, individuals who qualify for business asset disposal relief ("**BADR**") are subject to CGT at the rate of 10% on the first £1 million of lifetime gains. The BADR conditions are easier to meet for shares acquired pursuant to the exercise of EMI options (because the "personal company" test does not apply[1]) and the holding of the option counts towards the two-year share holding period.

[1] The personal company test requires the shares in the issuing company to entitle the holder to at least 5% of voting rights, 5% of the ordinary share capital when tested by nominal value and either 5% of distributable profits and net assets on a winding up, or 5% of the sale proceeds payable to ordinary shareholders on a notional sale of the whole company. It does not apply to shares acquired pursuant to the exercise of EMI options.

If the option was granted at a discount, only the amount of the discount on grant (or exercise, if lower) is subject to income tax on exercise. Certain "disqualifying events" can mean increases in the value of the option shares after the event are also assessed to income tax and the relaxation of the BADR conditions can be lost (see Disqualifying Events, below). Pay as you earn ("**PAYE**") and social security apply, but only to any amount assessed to income tax, and only if the option shares are readily convertible assets ("**RCAs**") on exercise (employer social security can be passed on to optionholders by agreement or election and, if passed on, is deducted from the amount assessed to income tax). Shares will be RCAs if, broadly, arrangements are in place (or are about to be put in place) to create a market in the shares, or certain deeming provisions apply.

Flexibility

There are very few requirements in the EMI legislation relating to the option terms. The main ones are that options cannot be transferred (other than to personal representatives), that options must lapse within 12 months of an optionholder dying, and that it must be clear the option is a right to acquire shares (so cannot contain excessive discretion). EMI options can be subject to time-vesting and/or performance conditions, provided these are set out in the option agreement.

For options granted before 6 April 2024, the tax relief can only be obtained if an online notification is filed with HM Revenue & Customs ("**HMRC**") within 92 days of grant. For options granted on or after 6 April 2024, the grant of an EMI option must be notified online to HMRC by 6 July following the end of the tax year that the grant was made in. The plan needs to be registered with HMRC online before notifications can be accepted.

There is no requirement for options to be granted using a set of plan rules. The option terms can, for example, be contained in a standalone option agreement or an agreement which modifies the terms of an existing plan. Consequently, it is possible to tailor EMI to fit most commercial requirements and to grant EMI options quickly and easily.

Qualifying Companies

To be eligible to grant tax-advantaged EMI options over its shares, a company must:

- be independent;
- have gross assets of £30m or less;
- have only "qualifying subsidiaries";
- carry on only "qualifying trades";
- have fewer than 250 full-time employees; and
- have a permanent establishment in the UK.

In addition, there is an overall "**purpose test**": the option must be granted for commercial reasons to recruit or retain an employee, and not as part of a scheme or arrangement of which the main purpose (or one of the main purposes) is the avoidance of tax.

It is possible to seek advance clearance from HMRC as to whether a company satisfies the corporate conditions.

Independence

The company cannot:

- be a 51% subsidiary of another company; or
- be under the control of another company (or of another company and persons connected with the other company) without being a 51% subsidiary of that other company.

Arrangements must not exist which could result in the company becoming such a subsidiary or falling under such control.

The independence test prevents companies controlled by one investor from qualifying for EMI, and needs to be considered carefully in borderline cases as it can even exclude venture backed companies if the investors are connected to each other or there are enhanced voting rights that go beyond what HMRC considers commercially necessary.

A company is a 51% subsidiary if more than 50% of its "ordinary share capital" (when tested by nominal value) is owned directly or indirectly by another company. A company is under the control of another if (broadly) that company is able to secure that the affairs of the company are conducted in accordance with its wishes by means of the holding of shares, possession of voting power or by virtue of powers conferred in the articles or in some other document.

Gross Assets

The company's gross assets cannot exceed £30 million at the time of grant. Gross assets are normally as shown in the company's balance sheet (or in the consolidated balance sheet in group situations).

Qualifying Subsidiaries

A company is not a qualifying company unless all its subsidiaries are qualifying subsidiaries at the time of grant. A subsidiary for these purposes is any company that the company controls either on its own or together with any person connected with it.

A company is a qualifying subsidiary if it is a 51% subsidiary of the holding company, no other person (other than the holding company or another of its subsidiaries) has control of the subsidiary, and there are no arrangements in place by virtue of which these conditions would cease to be met.

This test frequently causes difficulties in 50:50 joint venture ("**JV**") situations where the company will be treated as acting together with its JV partner to control the JV. In these circumstances, it is often necessary to alter the share capital held by the company in the JV so that it holds more than 50% by nominal value (whilst retaining only a 50% economic interest), in order to ensure the JV is a qualifying subsidiary.

Qualifying Trades

A trade is qualifying if:

- it is conducted on a commercial basis **with a view** to profits; and
- it does not consist wholly or substantially of the carrying out of "**excluded activities**" (see below).

The trading activities requirements for a **single company** are that the company:

- disregarding any incidental purposes, exists wholly for the purpose of carrying on one or more qualifying trades; and
- is carrying on a qualifying trade or preparing to do so.

For a **group**:

- the business of the group must not consist wholly or as to a substantial part of carrying out non-qualifying activities; and
- at least one group company must be carrying on a qualifying trade or preparing to do so.

A trade will not qualify if one or more excluded activities together amount to a substantial part of it (HMRC says "substantial" is more than 20% of the trade). Excluded trading activities are:

- dealing in land, commodities or futures, or 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;

- leasing (including letting ships on charter, or other assets on hire) or receiving royalties or other licence fees;
- providing legal or accountancy services;
- property development;
- farming or market gardening;
- holding, managing or occupying woodlands, any other forestry activities or timber production;
- operating or managing hotels or comparable establishments, or managing property used as a hotel or comparable establishment;
- operating or managing nursing homes or residential care homes, or managing property used as a nursing home or residential care home;
- providing services or facilities for a business carried on by another person if:
  - the business consists to a substantial extent of excluded activities, and
  - a controlling interest in the business is held by a person who also has a controlling interest in the business carried on by the company providing the services or facilities; and
- shipbuilding, coal and steel production.

There are various exclusions/exemptions, of which two key carveouts are:

- the receipt of royalties and licence fees, where the amounts received can be attributed to the exploitation of *relevant intangible assets.* A relevant intangible asset is one, the greater part of which (in terms of value) has been created by the company carrying on the trade, or by another company in its group. Intangible assets are defined in line with normal accounting practice; and
- certain financial services that are regulated only by the UK Financial Conduct Authority.

Fewer than 250 full-time equivalent employees

The company must have fewer than 250 full-time equivalent employees at the time of grant. For these purposes, an employee includes a director but excludes an employee on maternity or paternity leave or students on vocational training.

In group situations, employees of all qualifying subsidiaries are included even if these are outside the UK. The test is a snapshot, not an average, so borderline companies with seasonal employees may qualify by careful timing of option grants.

A full-time employee is not defined in the legislation but is taken by HMRC to mean at least 35 hours per week excluding lunch breaks and overtime. An employee who works more than 35 hours per week is taken to be one full-time employee. It is necessary to add to the number of full-time employees a "just and reasonable" fraction for each employee who is not full-time.

Permanent Establishment in the UK

There is no requirement for the company to be UK incorporated or resident in the UK, but it must have a permanent establishment in the UK. In group situations, there must be at least one group company which meets the trading activities requirement and has a permanent establishment in the UK. This requirement can be met by having an office in the UK.

Eligible Employees

An individual is eligible if they are an employee of the company or one of its qualifying subsidiaries at the time of grant, they satisfy the **commitment of working time** requirement and they do not have a **material interest**.

The commitment of working time requirement is that the employee must work at least 25 hours per week on average for the company (or its 51% subsidiaries), or 75% or their working time if less. Periods of absence are ignored for specified reasons such as reasonable holiday, garden leave, ill health, pregnancy, childbirth, maternity and paternity leave and parental leave.

The material interest test is (broadly) that an employee cannot be granted an EMI option if they (and their associates) beneficially own or have the ability to control more than 30% of the ordinary share capital of the company (or more than 30% of assets on a winding up, in the case of a close company). The EMI option itself does not count towards the limit, so if an individual (with associates) beneficially owns 20% of the ordinary share capital (for example), it would be possible to grant them an EMI option to acquire a further 20% without breaching the limit. Complex rules attribute holdings of associates for the purposes of the test.

Limits

An individual may not hold unexercised qualifying options to acquire shares worth more than £250,000. There is also a limit of £3 million on the total value of unexercised qualifying options. Market value for the purposes of these two limits is the CGT value at the time of grant ignoring restrictions (known as the "**Unrestricted Market Value**").

Option shares must be fully paid up (shares are not fully paid up for these purposes if they are subject to an undertaking to pay), and not redeemable.

It is possible to grant options over a newly created class of (say) growth shares to make the £250,000 individual limit go further for these purposes. It is also possible to impose restrictions on the option shares so, for example, optionholders may be required to enter into a power of attorney authorising the attorney to exercise the option and sell the option shares to a purchaser on an exit.

Exercise Price

Options can be granted at any exercise price or for a nil exercise price. Options are usually granted at a price equal to the market value at the time of grant in order to prevent any income tax or social security charges arising on exercise. Market value for these purposes is the CGT value, taking account of restrictions (known as the "**Actual Market Value**").

Option Grant Process

HMRC will agree share valuations in advance of the grant of EMI options, and it is usual practice to obtain prior agreement so as to avoid granting the option at a discount and to reduce the risk of tax disputes on a future funding round or exit. HMRC will usually agree a valuation window of 90 days during which the option may be granted. HMRC will also agree valuations at any time up to 12 months and 92 days after the options have been granted.

Options may be granted by agreement, which must contain prescribed information such as the grantor, grant date, the maximum number of shares that may be acquired, the exercise price (if any) or how it will be determined, when and how the option may be exercised, and any performance conditions.

The grant must be notified to HMRC online by 6 July following the end of the tax year of grant, for option grants after 5 April 2024. The plan also needs to be registered with HMRC online before notifications can be accepted. HMRC do not generally accept any excuses for late notifications.

Disqualifying Events

The EMI legislation prescribes certain "disqualifying events" which have no effect if the option is exercised within 90 days of the event. If the option is exercised later, however, the increase in the market value of the option shares from the time of the event to exercise is subject to income tax (and **PAYE and social security contributions** if the shares are RCAs at the time of exercise). The relaxation of the BADR conditions may also not apply.

There are broadly two types of disqualifying events: those which relate to the company, and those which relate to option-holders.

Disqualifying events are:

- the company ceasing to satisfy the independence test;
- the company ceasing to meet the trading activities test;
- the employee ceasing to be an eligible employee because:
  - they cease to work for the relevant company or within the group; or
  - they cease to satisfy the working time commitment;
- any alteration to the option:
  - to increase the value of the underlying shares; or
  - so that the requirements of Schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 are no longer met;
- any non-qualifying alteration to the share capital of the company;
- a non-qualifying conversion of shares from one class to another; and
- the grant of options under a CSOP which would (when added to unexercised EMI options) take the aggregate market value of the shares subject to such options (measured at the date of grant) to over £250,000.

Re-Organisations

On a company re-organisation, option holders may be granted replacement options over shares in the new holding company, which continue to qualify for tax relief if certain conditions are met. The normal EMI conditions must be met when the replacement options are granted, save that the new holding company need not satisfy the £30 million gross assets test or the 250 full-time employee tests. The 10-year period during which options may be exercised in a manner which qualifies for tax relief runs from the date of grant of the original (rather than the replacement) option. The total exercise price of the original and replacement options must be the same as must the value of shares under option, so it is normally necessary to agree that is the case with HMRC. The replacement options must be granted by agreement (or evidenced by a later agreement) and the replacement option grants must be notified to HMRC by 6 July of the tax year following the grant of the replacement options.

EMI in Practice

There are broadly three types of companies that use EMI, namely:

- UK private companies;
- US companies extending plans into the UK; and
- UK listed companies.

Private Companies

UK private companies often introduce "exit only" plans, so called because options can only be exercised on or immediately prior to an exit being achieved. Leavers may lose their options whatever the reason for leaving, or good leavers may be permitted to retain their options to exit. Alternatively, private companies introduce “pre-exit plans”, so called because they allow options to be exercised prior to exit in certain circumstances such as within 90 days of leaving (in which case leavers may be permitted to either retain their option shares or be required to offer the option shares for sale).

These types of plan should invariably be structured as EMI plans if the conditions are met, as the tax reliefs are very generous. We recommend participants are required to enter into a power of attorney as a condition of the option grant so that options can be exercised on their behalf on an exit and the option shares can be sold to the purchaser easily without having to operate drag-along rights.

In the normal course of events, options of this sort are granted at market value, so there is no income tax on exercise and all the option gains are taxed as capital at a very attractive rate of just 10% (assuming the relaxed BADR conditions are met). The spread on exercise (i.e. the market value of the option shares at the time of exercise less the exercise price) gives rise to a corporation tax deduction in the hands of the UK employing company for the accounting period of exercise. The deduction is usually treated as a deferred tax asset in completion statements, and it is often possible to persuade purchasers to give sellers credit for the asset so it has the effect of enhancing the purchase price.

US Companies Extending Share Plans to the UK

US companies typically wish to grant options to UK employees at the same time as other option grants to US employees at the same fair value strike price.

The market value of the option shares is usually agreed by submitting the most recent s409A valuation to HMRC and asking them to confirm the strike price is no more than the actual market value for UK tax purposes. There is usually no need to amend the rules of the main US plan or to create a sub-plan if the rules allow options to be granted on modified terms, provided the required EMI option terms are set out in the option agreement.

UK Listed Companies

It is a popular misconception that listed companies cannot qualify for EMI – they can if the relevant conditions are met, though this is rare given the £30 million gross assets test and market opinion is currently against the use of tax-advantaged share plans for executives.

Most listed companies operate long term incentive plans (or performance share plans) and deferred bonus plans all of which involve the delivery of free shares. These plans can be made much more attractive by structuring awards as nil cost EMI options. Such companies may also operate executive option plans which can also be structured using EMI. Separate factsheets on executive options and long term incentive plans for listed companies are available (see below).

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Warning

This document gives general information only as at 1 June 2024 in respect of individuals who are resident, tax resident, and domiciled in the UK at all relevant times and does not take into account any individual's personal circumstances. It is not intended to give a comprehensive analysis. It is not intended to constitute and should not be used as a substitute for legal or other professional advice. If you require assistance, please seek specific advice from a member of the Bird & Bird EIB team.

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