Enterprise management incentive schemes: some common pitfalls

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While enterprise management incentive schemes can provide substantial benefits for option holders, diligence exercises can uncover a range of issues leading to increased costs or even disqualification.

Key Points

What is the issue?

This article highlights some common pitfalls that we see on diligence exercises for enterprise management incentive schemes. They can result in some unpleasant surprises arising for buyers and sellers.

What does it mean to me?

A diligence exercise should always include a review of option agreements and plan rules to ensure that all of the statutory requirements have been included to assess the validity of the EMI options.

What can I take away?

As the company grows, care needs to be taken when approaching the relevant thresholds to ensure that any options issued under an EMI scheme qualify for the tax advantages on offer.

In the midst of the ‘Great Resignation’, and strong competition for talent, it has become key for businesses to look at different methods of retention for key members of staff and to attract new senior team members. Enterprise management incentive (EMI) schemes are not new, and we assume here that readers are familiar with the EMI benefits and qualifying conditions. In our experience, EMI comes up a lot on due diligence exercises (it is the most popular HMRC approved share plan). With the potential upside for individual option holders – namely, beneficial tax treatment on exercise and on any capital growth – come a raft of potential stumbling blocks for both the company and for the option holders themselves.

In this article, we want to highlight some common pitfalls that we see in diligence exercises. Although these may not be deal-breakers in isolation, they can result in some unpleasant surprises arising for buyers and sellers.

Tax valuation

It is often overlooked that having a valuation agreed with HMRC is not an absolute requirement in order to establish an EMI scheme (or another HMRC approved share scheme). Whilst it is strongly advisable to do so, thereby avoiding unwelcome surprises for employees down the road, sometimes it simply may not be possible to wait for HMRC’s typical four week turnaround time (although it is possible to agree a valuation post-grant).

Of course, getting the grant and exercise prices right for the options is key in order to ensure that company and individuals do not breach the scheme limits (a £3 million company limit and £250,000 individual limit) to avoid any unexpected income tax liabilities arising for employees. Carrying out a valuation exercise to determine the actual market value and unrestricted market value of the shares

under option can help to ensure that the company has fulfilled its obligations to operate payroll on a reasonable and best estimate basis. As EMI is one of the few areas where HMRC will engage with taxpayers upfront, it is worth businesses taking advantage of the opportunity.

If a company does go down the route of agreeing a valuation with HMRC, there is a time limit to the validity of that agreement. Under normal circumstances, EMI valuations are valid for 90 days from the date of agreement, and options would normally be granted in that window. HMRC has extended the validity to 120 days as a temporary measure whilst businesses cope with the Covid-19 pandemic. In line with the unwinding of some other temporary Covid-19 measures, this is likely to revert back to 90 days shortly.

The key issue with EMI tax valuations arise where discussions around a potential exit are taking place alongside options being granted. Such conversations should be disclosed to HMRC, along with any explanation as to why they should not impact the valuation to be agreed with HMRC if that is the case.

Discounts

In addition to the above, a tax valuation is important as the company needs to ensure that options granted to employees are not done so at a discount (unless there is a commercial desire for the company to do so), again at the risk of creating unnecessary and unexpected tax liabilities for the employee. This can be a nasty surprise for an employee who finds that any discount on the option is taxed via payroll on exercise, as if it were employment income. In other words, only a proportion of future exit proceeds would be taxable at the (typically lower) capital gains tax rates.

Where there is a discount, the employer would also be subject to the usual employment taxes, including the rising rates of NICs – another potentially unexpected cost.

HMRC notifications

On top of the scheme itself needing to be registered with HMRC within 92 days of being established, a notification of each grant of options also needs to be made within 92 days of the options being granted.

Once the options are exercised and shares are held directly by the individuals, don’t forget that the annual ERS returns also need to be made by 6 July following the end of each tax year. Failure to make timely notifications means that the relevant tranche of EMI options would lose their tax advantages, once again giving rise to potentially significant unexpected income tax liabilities for the employee.

Evidencing the submissions retrospectively can be problematic and is likely to be questioned on a due diligence exercise. Those making submissions should therefore always remember to take screenshots of the confirmation screens and keep them on file for future requirements!

A common solution for businesses that miss the initial 92 day registration window for the notification of grants to HMRC is for options to be cancelled and reissued. Whilst there are not any immediate tax consequences of this, there is a risk that the validity of the valuation agreement with HMRC would have expired, and the valuation of the shares may have increased. In these circumstances, a fresh valuation may need to be sought and agreed with HMRC, coming at additional cost to the business.

It should be noted that the initial 92 day deadline for submission of notification of the grants of options is strict. Although there is a reasonable excuse exemption, this requires HMRC approval to be applied, and would need strong reasons in support.

Working time requirement

The EMI rules include a requirement that recipients of options must work for the group for at least 25 hours per week, or 75% of their working time, if less, and will be required to sign a declaration to this effect as part of the acquisition of options at the time. Generally, this is tested retrospectively at the end of each tax year that the individuals work for the group. These declarations should be retained together with the option agreements themselves.

The 75% of working time and 25 hours tests will cater for those working less than full time. However, where individuals hold multiple employments this could taint the qualification for EMI options, and prematurely disqualify the options. An individual holding EMI options in multiple groups is uncommon due to the time commitments required.

A temporary measure was introduced following the Covid-19 pandemic with a concession given to workers who were furloughed or whose working hours were reduced as a result of the pandemic. Between 19 March 2020 and 5 April 2022, the usual working time requirement was relaxed, such that where an individual *would have* met the working time requirement but for the pandemic (i.e. they are usually a full-time employee, but were on furlough/reduced hours), this would not result in a disqualifying event, and they are treated as having met the requirements. Records of any relevant individuals who may have been furloughed should be retained to be provided on any future due diligence exercises.

Control

It is important to remember that the company issuing EMI options must be 'independent' and not under the control of another company at the time the options are granted. This is a test that is often failed with some private equity backed portfolio companies for instance, with control potentially being gained via shares or via the company articles or a shareholders' agreement. EMI options cannot be granted where arrangements are already in place which may lead to a change of control, and therefore care must be taken when granting options in close proximity to a potential deal or when ongoing discussions are taking place.

Where the company later comes under the control of another (e.g. following a majority transaction), this is a disqualifying event. As a result, it is common to see options being exercised before an impending transaction.

Paperwork!

Share schemes of all kinds come with plenty of paperwork for the company and for employees to sign. EMI schemes have certain pieces of information which are statutory requirements to be included in written agreements (including the number of shares under option, the exercise price and when the options may be exercised). A diligence exercise should always include a review of option agreements and plan rules to ensure that all of the statutory requirements have been included to assess the validity of the EMI options. Conditions around discretion over vesting or exercise of options need careful consideration.

Another requirement is that details of any restrictions applying to the shares under option also be made clear to the option holder, as well as the impact of those

restrictions applying. Although any option agreement which does not have the details of the relevant restrictions attaching to the shares is not a valid EMI option agreement, HMRC guidance notes that the option holder can be made aware of the relevant restrictions which apply to the shares instead by referencing to a separate document. Any restrictions must be specifically identified, and any separate documents must be attached and incorporated into the option agreement.

If this information is missing from the plan rules or option agreements, there is a risk of disqualification.

Disqualification… Now what?

Once a disqualifying event occurs, the clock starts ticking, and EMI options should be exercised within 90 days of the disqualifying event to maintain the tax advantaged benefits of the scheme. Disqualifying events are one-way, and there are no means by which to un-disqualify the options.

It is important to note that a disqualifying event only affects the tax treatment of the value arising after the disqualifying event itself. Any value attributable to the period immediately before the disqualifying event will be taxable at capital gains rates, and only any gain from the disqualifying event to the option being exercised would be subject to income tax and NICs (as would a normal non tax-advantaged share option).

The employee would also be unlikely to receive the level of net proceeds that they may have been expecting post-option exercise, so effective communication is key if there have been any disqualifying events.

The future of EMI

On the face of it, EMI option schemes can be a great way to incentivise and attract staff to work for smaller and fast growth companies.

The potential benefits for the employees of participating in the growth of their company, and the ability for companies to have a ‘cashless’ exercise (if the plan permits or amendments can be pre-agreed with HMRC) can be a win-win for all parties.

That being said, private businesses need to tread carefully with EMI option schemes to avoid the pitfalls outlined above. As the company grows, care needs to be taken when approaching the relevant thresholds to ensure that any options issued under an EMI scheme qualify for the tax advantages on offer.

The 2020 Budget included an announcement of a consultation into the future of the EMI scheme, and a call for evidence in the 2021 Budget. Whilst it remains to be seen what will come out of the consultation, it is possible that some of the requirements and thresholds may be relaxed a little in future to allow for a wider range of companies (and therefore individuals) to benefit from the EMI regime.