# Incentives and rewards

Employment Tax | OMB



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*Charlotte Huntley* provides a refresher on EMI Scheme conditions, looking at the associated benefits and potential pitfalls involved

## Key Points

## What is the issue?

Enterprise Management Incentive Schemes (EMIs) are a popular way of recruiting, incentivising and rewarding key employees. EMI schemes are often seen as a ‘no brainer’ as they result in favourable tax treatment for both the employee and the company but it is vital to understand the conditions to ensure that the schemes are properly structured for maximum tax benefit and the correct advice is given.

## What does it mean to me?

For advisers primarily dealing with owner managed businesses, EMIs are a well promoted and often used scheme. It is important that advisers have a full understanding of the conditions as overlooking the detail may lead to the failure of the EMI scheme and result in unexpected tax charges for clients.

## What can I take away?

This article intends to provider a refresher of the requirements and advantages of EMI schemes and also highlight the potential pitfalls that advisers need to be aware of.

In order for an option to qualify for EMI status, the company, the employee and the option itself need to meet certain conditions. As a brief summary the main conditions are:

## The company:

- Must be a trading company with assets of less than £30 million and less than 250 full time equivalent employees
- Must have a permanent establishment in the UK
- Cannot be controlled by another company; with the caveat that the option can be held in the holding company of a trading group where the employee works for the subsidiary trading company
- Prohibited trades include the legal and finance sectors, farming and property development
- A maximum of £3 million of shares can be held under option

## The employee:

- Must work 25 hours a week for the company, or 75% of their working time must be spent working for the company
- Cannot participate if they hold more than 30% of the shares before the grant of the option

## The option:

- Shares must be fully paid up, non-redeemable, ordinary share capital
- Must be capable of being exercised within 10 years
- The terms of the option must be agreed in writing between the company and the employee

The full conditions can be found in ITEPA 2003 Schedule 5.

## Why are EMIs such a good option?

EMIs offer generous tax treatment and historically HMRC have operated a light touch approach.

HMRC will pre-approve EMI valuations prior to the issue of the option. This provides certainty to the employee as to the cost of acquiring the shares.

The grant of the option is tax free and there will be no income tax or national insurance implications for the employee when the option is exercised, provided that the option was not granted at a discount. This is a key benefit of EMIs and differentiates them from unapproved share option schemes. Similarly there should be no PAYE or national insurance obligations for the company on the exercise of the option, provided the option was not granted at a discount.

The employee will be able to claim entrepreneur's relief on the disposal of the shares provided that the options were granted at least 12 months prior to the disposal and he has worked for the company for at least 12 months prior to the disposal.

There is no requirement for the employee to hold at least 5% of the company shares in order to claim entrepreneur's relief if the shares are acquired on or after 6 April 2013.

The company will obtain a corporation tax deduction, equal to the market value of the shares less any amount paid for the shares by the employee, in the accounting period in which the employee gains beneficial ownership of the shares.

The employee will obtain an income tax deduction for interest paid on monies borrowed to finance the purchase of the shares if the company is a close company. If a close company lends the employee the money to buy the shares, then this loan will be exempt from a taxable benefit charge.

# Pitfalls

As outlined above, EMIs are an attractive option for qualifying companies and employees.

As is so often the case with tax however, there are potential pitfalls and issues which all parties, including advisers, need to be aware of.

# Tax charge on exercise

If the option is granted at a discount then then an income tax charge will arise on exercise. This will be equal to the difference in the lower of the market value of the shares at grant or market value at exercise less any amounts paid.

This will be reportable via self-assessment and the income tax due on 31 January following the end of the tax year in which the options are exercised.

However, if the shares are readily convertible assets then PAYE must be operated by the company and both primary and secondary national insurance contributions will be due.

A readily convertible asset is one for which a market is available. When dealing with unquoted companies the most common scenario where this will be an issue is if there are arrangements in place for the company to be sold and many EMI options are granted on the proviso that they will only be exercisable in the case of a company sale.

The company must account for the income tax due under PAYE regardless of whether they are able to recover that tax from the employee. If the company does not recover the tax from the employee within 90 days of the end of the tax year in question then a taxable benefit charge will arise based on the PAYE paid on behalf of the employee. This will be reportable on Form P11D and is subject to Class 1 National Insurance Contributions.

# Disqualifying events

The legislation lists the following disqualifying events:

- The independence test is no longer met
- The company no longer meets the trading activities requirement
- The employee is no longer eligible (e.g. his working hours are reduced below 25 per week or the 75% equivalent)
- The terms of the option change
- There is an alteration to the company's share capital
- There is a conversion of shares
- A CSOP option is granted which takes the option holder over his £250,000 limit

If the employee exercises his EMI options more than 90 days after a disqualifying event then an income tax charge will arise on the excess of the market value at the date of exercise over the market value immediately before the disqualifying event. This could result in an unexpected tax charge for the employee.

It is therefore vital that both the company and the employee are made aware of this issue and that the adviser keeps abreast of any company or employee changes which may impact the status of the EMI.

A specific issue is the working time requirement for employees. In particular it is necessary to keep ongoing, up to date records, regarding employees to ensure that any unnecessary tax charges can be avoided.

## Company reorganisations

This is an important area for advisers dealing with owner managed businesses as changes in company structure can impact the validity of EMI options.
If a reorganisation meets certain criteria then it will be classed as qualifying and the EMI option benefits can be retained.

A qualifying reorganisation is broadly one where the acquiring company makes a general offer to acquire all of the shares of the target company.

A qualifying share exchange is where the shares in the acquiring company mirror those in the target company. The consideration must wholly be in the form of new shares with equivalent rights and be issued to shareholders in proportion to their shares in the target company.

If the company reorganisation meets the qualifying requirements, then the holder of an EMI option can release his option rights in exchange for equivalent options over

shares in the acquiring company. This replacement option must be granted within six months and the acquiring company must meet the independence and trading tests. The employee must be a qualifying employee in relation to the new company.

The effect of these provisions is that it is possible to put a new holding company on top of an existing group without losing the benefits of an EMI option. However, almost all other share exchanges involving an acquisition by a new company will not qualify.

## Administration

There are strict, administrative requirements which need to be met in respect of EMI schemes.

EMI schemes need to be registered with HMRC via the online Employment Related Securities service.

The company must then notify HMRC within 92 days of the options being granted. If this deadline is not met then the options will not be treated as EMI qualifying.

For every option granted there must be a written agreement between the company and the employee specifying:

- The date of the grant and that the options are granted under the provisions of the EMI
- The number of shares under the EMI option
- When and how the option is to be exercised.

Finally, the company must file an annual online return by 6 July following the end of the tax year. If the return is submitted after the deadline then late filing penalties are chargeable.

## Conclusion

Even when taking into account the potential issues and pitfalls surrounding an EMI scheme, the benefits of an EMI mean that this will still be the preferred option for many owner managed businesses.