

Enterprise Management Incentives (EMI)

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Contents

- Introduction
- What is an EMI option?
- Using EMI options
- The EMI framework
- Qualifying for EMI
- Are the tax advantages worthwhile?



Introduction

The enterprise management incentives (EMI) arrangement provides a popular tax advantaged share option for employees.

Briefly:

- EMI options are relatively quick to grant.
 - Any number of employees can participate at any time.
 - Each EMI option holder may only hold options over shares of a value (at grant) of up to £100,000.
 - A company may grant EMI options over shares with a total market value at grant of up to £3 million.
 - Companies with gross assets exceeding £30 million, or which carry on certain businesses, cannot grant EMI options.
 - Some companies cannot grant EMI options because of their ownership arrangements or group structure.
 - There are very significant potential tax advantages for option holders.
 - EMI options can solve the employer's national insurance contributions (NICs) problem.
 - The employing company may get a tax deduction when an EMI option is exercised.
 - EMI options could be granted over a class of share created specially for EMI purposes (for example, non-voting shares).
- The board selects employees and grants options to them to acquire shares in the company within a defined option period (option agreement and board minutes).
 - The grant of each EMI option is notified to HM Revenue and Customs within 92 days (prescribed form of notice).
 - An annual return is submitted to HM Revenue and Customs (prescribed form).
 - The option holder either exercises the options in whole or in part (notice of exercise of option) and acquires shares or allows the options to lapse.
 - In some cases, a written joint election (made between employer and employee) may be needed no later than 14 days after the date of exercise.

What is an EMI option?

An EMI option operates as follows (with reference to typical documentation):

- The company checks it can grant EMI options. This can be confirmed in advance with HM Revenue and Customs.
- The market value of the shares under option (unless they are quoted on a recognised stock exchange) is agreed with HM Revenue and Customs (prescribed valuation form).

Using EMI options

An EMI option provides the option holder with an opportunity to acquire shares at a predetermined price. There will normally be a cost to the option holder (the exercise price) but an option will not usually be exercised unless it is "in the money". EMI arrangements may operate on a selective basis: there is no need to grant EMI options to all employees. Conditions may be attached to the exercise of EMI options (for example, company-wide or individual performance conditions can apply). Discounted options can be granted. A discounted option is where the exercise price per share is set at below the share's market value at the date of grant of the option.

The EMI framework

The overall framework for operating an EMI arrangement is as follows:

- An option must be granted for commercial reasons in order to recruit or retain an employee in a company, and not as part of a tax avoidance scheme.
- The total market value of shares under option at the date of grant must not exceed £3 million (the plan limit).
- The market value of shares under option to any one employee calculated at the time an option is granted must not exceed £100,000.

- The company whose shares are the subject of the option must be a qualifying company (see below).
- The individual to whom the option is granted must be an eligible employee (see below) in relation to that company (and the option must be granted by reason of employment with that company or another group company).
- There must be an option agreement in writing which meets certain requirements.
- The option must satisfy other requirements (e.g. as to the type of shares that may be acquired).
- If the exercise price is set at market value at the time the EMI option is granted, then the exercise of an EMI option within ten years of the date of grant is completely tax free for the participant (with no NICs payable by the employer). If the shares acquired are subject to restrictions which affect their value, then a joint election as mentioned above may be needed to ensure no income tax arises at a later date under the restricted securities tax regime. Such an election is treated as made if the exercise of the EMI option is tax free.
- The shares acquired on the exercise of an EMI option will benefit from capital gains tax (CGT) taper relief, calculated as starting from the date of grant of the option.
- The tax advantages will, in broad terms, cease to be available if there is a disqualifying event.
- A corporation tax deduction is available as a statutory right in respect of certain employee share acquisitions in accounting periods beginning on or after 1 January 2003. This relief should be available when an EMI option is exercised. The relief is not restricted to acquisitions involving EMI. It is mentioned for completeness only in this briefing paper.

Qualifying for EMI

Qualifying company

A company can only grant EMI options if it meets certain qualifying conditions at the time the options are granted, including:

- Gross assets must not exceed £30 million.
- The company must be independent, i.e. it must not be a subsidiary or otherwise be under the control of another company.
- Any subsidiaries must be at least 51% subsidiaries (as defined) except if a subsidiary's business consists wholly or mainly in the holding or managing of land (or any property deriving its value from land) it must be a qualifying 90% subsidiary (as defined).
- The company (the group) must carry on one or more qualifying trades (see the Appendix below).
- The trading activities must be carried on wholly or mainly in the UK (at least one company in the group must be carrying on a trade wholly or mainly in the UK).

Eligible employees

The employee must be employed by the company (or a group company). An employee's commitment of working time must amount to at least 25 hours a week, or if less, 75% of his or her working time.

For this purpose working time consists of all time spent on remunerative work as an employee or self-employed person.

Working time includes time which would have been spent on this work except for injury, ill-health, disability, pregnancy, childbirth, parental leave, reasonable holiday entitlement or not being required to work during a period of notice of termination of employment. It also includes work which would have been chargeable to tax had the employee been resident in the UK.

EMI options cannot be granted to any employee who controls (directly or indirectly) 30% or more of the ordinary share capital of the company.

The option agreement

The grantor of the option and the employee must enter into a written agreement which states:

- The date of grant of the option.
- That it is granted under Schedule 5 to the Income Tax (Earnings and Pensions) Act 2003.
- The number, or maximum number, of shares that may be acquired.
- The price (if any) payable on exercise (or the method by which it is to be determined).
- When and how the option is to be exercised.
- Any conditions, such as performance conditions, which affect the terms or extent of the employee's entitlement.

- Details of any restrictions attached to the shares.
- That the person to whom it is granted is prohibited from transferring any of his or her rights under it and, if they permit exercise after that person's death, do not permit such exercise more than one year after death.

Other qualifying conditions

The shares under option must be ordinary shares, fully paid up, and non-redeemable.

Companies may award EMI options over restricted shares. The market value of shares subject to restrictions is determined as if there were no such restrictions for the purpose of calculating the £100,000 individual limit and the plan limit of £3 million.

The option must be capable of exercise within ten years from the date of grant.

Disqualifying events

A number of changes or developments can disqualify an option from EMI relief. There will be a disqualifying event if the relevant company:

- Ceases to meet the independence test.
- Ceases to satisfy the trading activities requirement.
- Converts the option into an option over shares of a different class unless this is a permitted conversion.

There will also be a disqualifying event, if the employee:

- Ceases to be an employee of the company (or a group company).
- Ceases to satisfy the requirement as to the commitment of working time.
- Receives the grant of an HMRC approved company share option plan (CSOP) option if, immediately after it is granted, the employee holds unexercised EMI options and CSOP options in respect of shares with a total value of more than £100,000.

There are other disqualifying events.

Achieving gross assets of more than £30 million is not a disqualifying event.

Restricted securities

The restricted securities tax regime applies to the acquisition of restricted shares and other securities from 16 April 2003.

A typical example of a restriction is a provision in a private company's Articles of Association that requires an employee to sell their shares at less than market value if employment ceases within a specified period of acquiring shares. The definition of restriction is wide and this is only an example.

There is an automatic exemption from this regime for shares acquired on the tax-free exercise of an EMI option. However, as mentioned above, a joint election will be needed to exclude the restricted securities tax regime and ensure EMI tax reliefs on exercise are maximized if the exercise is not tax-free.

Are the tax advantages worthwhile?

An EMI option provides a means of avoiding the income tax charge of up to 40% and employee's NICs of 1% that would usually apply to an employee on the exercise of an employee share option.

The tax-free exercise can take place at any time, no later than the tenth anniversary of the date of grant, providing the option continues to qualify as an EMI option.

A participant who acquires shares tax-free may have a CGT liability, but this will only arise when the shares are sold.

The first £9,200 (2007/2008) of all chargeable gains in a tax year are exempt from CGT. Taper relief is likely to apply to reduce the effective tax rate depending on the number of complete years since the date the EMI option was granted. This is an important EMI tax advantage. Normally, an individual has to own the shares themselves for the required number of years before the shares qualify for taper relief. Maximum taper relief should be available after only two years and means an effective CGT rate of 10% for higher rate taxpayers.

No employee's NICs are payable on the grant of an EMI option. NICs are also not payable on the exercise of EMI options, if the exercise is (income) tax free. If the option is a discounted option, the discount is subject to income tax and, depending on the

circumstances, NICs on exercise. Market value for this purpose does take restrictions into account.

As well as tax advantages to employees, there is a very important tax advantage for the employer. In the case of an unapproved option, the employing company will usually face an employer's NICs charge when an option is exercised. This charge is currently 12.8% (without limit) of the difference between the exercise price and the market value at the time of the exercise of the shares acquired. This liability is unquantifiable at the outset and is a major concern for many companies. In contrast, under the EMI provisions there is an exemption from NICs whenever an EMI option is exercised (except as regards any discount).

If a disqualifying event occurs, shares acquired by the exercise of the option are qualifying shares (for the purpose of the enhanced taper relief) only if the option is exercised within 40 days of that event.

How we can help

The Equity Incentives team at Field Fisher Waterhouse can advise on whether or not EMI options are possible for your company. We can help you decide whether or not it is worthwhile establishing an EMI arrangement or whether another form of equity incentive is better suited. We can prepare all the documentation and deal with the notifications process. We can assist with other aspects of implementing an EMI arrangement.

Appendix

Excluded activities for EMI purposes

The following activities are excluded activities. A company which includes these as a substantial part of its trade (substantial can be taken as comprising 20% or more of the trade) would be a non-qualifying company:

- Dealing in land, in commodities or futures, or in 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.
- (Most) leasing activities or receiving royalties or licence fees provided that if, in broad terms, the royalty/licence fee relates to a relevant intangible asset created by the trading company or the parent company or a qualifying subsidiary of the company; the company will not be disqualified simply by reason of receiving such income.
- 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.

In addition to the main excluded activities:

- R&D counts as carrying on a qualifying trade if a qualifying trade will derive from it, but preparing to carry on R&D does not count as preparing to carry on a qualifying trade.
- The provision of facilities for another business which carries on a non-qualifying trade can be an excluded activity.



Who are we?

For further information, please call the Equity Incentives team on +44 (0)20 7861 4717 or contact:



Graeme Nuttall
e: graeme.nuttall@ffw.com



Mark Gearing
e: mark.gearing@ffw.com



Grant Hamilton
e: grant.hamilton@ffw.com

As a member of the HM Treasury employee ownership advisory group, the head of our team, Graeme Nuttall, helped HM Revenue and Customs develop and introduce the share incentive plan (SIP) and the enterprise management incentives arrangement. He also drafted the Employees' Share Schemes Bill, a successful private member's bill enacted as the Employees Share Schemes Act 2002 that increased the tax effectiveness and democracy of SIPs.

The Field Fisher Waterhouse Equity Incentives team has substantial experience in all aspects of employee benefits, including equity incentives. We have particular expertise in advising on creating and sustaining employee ownership solutions for a variety of businesses.

Through our German and Belgium offices and our other overseas affiliated and associated offices we advise on international share plans.



www.equityincentives.co.uk

Our Equity Incentives website is a valuable information source on different types of employee share and share option plans and includes a number of briefing papers, case studies and other helpful information.

Field Fisher Waterhouse LLP 35 Vine Street London EC3N 2AA
t. +44 (0)20 7861 4000 f. +44 (0)20 7488 0084 info@ffw.com www.ffw.com

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