



**EQUITY
INCENTIVES
LIMITED**

Enterprise management incentives (EMI)

September 2003

Introduction

The enterprise management incentives (EMI) provisions, introduced in 2000 and modified since then, continue to provide 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 (from 1 January 2002), 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 solve the employer's national insurance contributions (NICs) problem.

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 the Inland Revenue.
- The market value of the shares under option (unless they are quoted on a recognised stock exchange) is agreed with the Inland Revenue (prescribed valuation form).
- 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 the Inland Revenue within 92 days (prescribed form of notice).
- An annual return is submitted to the Inland Revenue (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.
- A written joint election (made between employer and employee) may be needed *no later than 14 days* after the date of exercise (this applies to EMI options, whenever granted, which are exercised from 16 April 2003).

Only an option granted after 28 July 2000 can qualify as an EMI option.

Using EMI options

An EMI option provides the option holder with an opportunity to acquire shares. 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. Conditions may be attached to the exercise of EMI options. Discounted options can be granted.

The EMI framework

- 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 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 will usually be needed to ensure no income tax arises under the restricted securities tax regime.
- 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.

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 (previously £15 million).
- The company must satisfy an independence test i.e. it must not be a subsidiary or otherwise be under the control of another company.
- Any subsidiaries must be at least 75% subsidiaries.
- The company (the group) must carry on one or more qualifying trades (see Appendix).
- 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 work:

- The general earnings from which are taxed as employment income; and
- The profits from which are chargeable to tax under Case I or II of Schedule D.

It 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.

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 the provisions of 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 10 years from the date of grant.

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

Disqualifying events

There is also a requirement to avoid disqualifying events during the life of each EMI option. 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 are also disqualifying events, 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 Inland Revenue 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

A new 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 no automatic exemption from this regime for shares acquired on the exercise of an EMI option. However, a joint election may be made to exclude the restricted securities tax regime and ensure EMI tax reliefs on exercise are maximised. A separate question and answer paper is available to help identify

cases where the restricted securities tax regime applies and therefore a joint election is needed.

Are the tax advantages worthwhile?

An EMI option provides a method of avoiding an 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 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 £7,900 (2003/2004) 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 will be payable on either the grant or exercise of EMI options, unless the option is discounted. An option is discounted if it is granted at an exercise price which is less than the market value at the date of grant. In which case, the discount is taxed as normal (i.e. usually subject to income tax and 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 Equity Incentives can help

We 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.

Who are we?

Equity Incentives has substantial experience in all aspects of employee benefits, including equity incentives. The Managing Director, Graeme Nuttall, is a member of the HM Treasury advisory group which helped the Inland Revenue introduce EMI and the Share Incentive Plan. He drafted a private member's Bill which was enacted as the Employee Share Schemes Act 2002. Through membership of the **Global reward plan group** we implement international share schemes.

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