

Enterprise Management Incentives (EMI) share options guide

COMPANIES in the biotech and tech spaces have a constant need to incentivise staff and build motivated teams to prepare them down the line for a sale or investment.

Part of that process should include consideration of equity incentives and the tax implications of granting these share options to employees.

We often get asked about the best ways to manage these Enterprise Management Incentives (EMI) schemes so this factsheet outlines eligibility criteria, the required tests and what happens when options are granted.

1. Background

Within the technology start-up industry, the best-practice approach to provide employee incentives is to grant EMI options where possible. An EMI scheme is an HMRC-approved share option scheme which provides significant tax advantages for the employee.

Provided the options are awarded with an exercise price (the price that the employee will pay to receive their shares) equivalent to or greater than the market value at the date of grant, no tax charge should arise on grant or exercise for either the company or the employee. The spread, being the difference between the exercise price and sale price, is subject to capital gains tax, usually at a rate of 10%.

An added benefit of the EMI scheme is that the value of the shares to be placed under option can be agreed upfront with HMRC, providing greater certainty on tax treatment.

To put a scheme in place you typically need two documents:

- a share option plan, which sets out the general rules of how the scheme works – eg, what happens to an already granted option if someone leaves or the company is sold; and
- a share option agreement for each individual, which specifies how many shares that individual can get if they exercise their option.

Importantly, you cannot change the terms of the option after it is granted, because the tax advantages are removed and the option can result in income tax, PAYE and NI liabilities that are more costly than capital gains tax.

2. Qualifying company requirements

To issue EMI options, a company must meet a number of qualifying tests:

2.1 Gross assets requirement

The value of a company's gross assets must not exceed £30 million at the date the EMI option is granted. If the company is a member of a group of companies, the limits are applied to the gross

assets of the group as a whole.

2.2 *Number of employees requirement*

To be a qualifying company for the purposes of granting EMI options, the company must have fewer than 250 full-time equivalent employees on the date a qualifying EMI option is granted.

This requirement applies to employees of the company and all its qualifying subsidiaries, whether or not the employees are based in the UK. Directors are counted as employees for the purpose of this test.

2.3 *Independence test*

To be an EMI qualifying company, more than 50% of the ordinary share capital must not be owned by another company or “controlled” by another company, or by another company and persons connected with it. This is to prevent any potential manipulation of the controlled company’s share price.

In addition, arrangements must not exist that could result in the company becoming a 51% subsidiary or otherwise being controlled. The 51% subsidiary test is measured by reference to the nominal value of the issued ordinary share capital, in accordance with the Canada Safeway case.

Ordinary share capital, for these purposes, ignores any nomenclature in the articles and includes all shares that have a right to a dividend at a fixed rate but have no other right in the company’s profits.

3. **Eligible employees’ requirement**

Individuals are only eligible to receive EMI options if they are employees of the company whose shares are the subject of the options, or in the case of a group, employees of any qualifying subsidiary of that company.

Directors are classed as employees of a company, and as long as a director meets the criteria set out for employees, as below, they will also qualify for EMI.

3.1 *Working time commitment*

Employees are eligible to receive EMI options if they are required to spend:

- at least 25 hours each week, or
- if less, 75% of their working time,

working as an employee for the company whose shares are subject to the EMI option. The working time requirement is based on the average working time of an employee, so it can apply to an employee on flexi-time whose hours vary, but whose average working time meets the requirements.

In broad terms, this test is designed to prevent an individual being able to have EMI options in two companies at once.

3.2 *Material interest*

An employee is not eligible if he or she has a “material interest” in the company whose shares are under option, or if that company is a parent company, in any group company. A material interest is either:

- beneficial ownership of, or the ability to control directly or indirectly, more than 30% of the ordinary share capital of the company, or
- where the company is a close company, possession of or entitlement to acquire rights that would give 30% of the assets, if the company were to be wound up, and make them available for distribution among the participators.

An employee has a material interest if:

- he or she alone has a material interest in the company;
- he or she, together with their “associates”, has a material interest in the company; or
- any associate of his or hers has a material interest in the company.

If an employee acquires a material interest greater than 30% after he or she has been granted an EMI option, the option held will not be affected but he or she will not be eligible for the grant of any more EMI options.

4. Granting EMI options

Once it has been confirmed that your company is a qualifying company and that the individuals to receive options are eligible employees, the following steps should be followed.

4.1 EMI valuation

The market value of shares can be agreed between the company and HMRC prior to granting the options. In many cases, it should be possible to agree a low, if not nominal, value.

Although not mandatory, it is highly recommended that the valuation is agreed prior to granting the options to prevent any issues on due diligence in the event of a further funding round or an exit.

The EMI options must be granted within 60 days of the date of the letter from HMRC confirming that it agrees with the company’s proposed valuation.

4.2 EMI notification

When a company grants EMI options, it must notify HMRC using the online ERS service within 92 days of the date of grant. Failure to comply with this 92-day deadline will result in the options losing EMI status and could create tax implications for the employees and the company.

4.3 Employment Related Securities annual return (previously an ‘EMI40’ form)

A company that issues equity incentives to employees at any time during a tax year must complete ERS annual returns for HMRC.

Companies are required to make an annual return for each year beginning with the tax year when the first qualifying option was granted and ending with the tax year in which the “termination condition” is met.

A company must therefore make a return for a tax year even if no EMI options were granted, exercised or lapsed in the year (a nil return).

Failure to submit an annual return within the time period set by HMRC will invoke penalties for the company, which will accumulate with further delays to submission or failure to pay the penalties raised by HMRC.

Further information

If you would like to find out more about EMI share options schemes contact Liam Hawkins by email liam@confluencetax.com or telephone **+44 (0)1223 847901**.

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