CHAPTER 38

ENTERPRISE MANAGEMENT INCENTIVES (EMIs)

38.1 Introduction

ITEPA 2003, s.527 -541 & Sch 5

EMIs are very similar to company share option plans in the way that they operate in that they enable the employer to **reward selected employees with tax favoured share options.** The rules dealing with tax charges and PAYE deductions on EMI shares are contained at Sections 527 to 541 of ITEPA 2003. The approval procedures and the general rules regarding the operation and administration of an EMI are given in Schedule 5.

The key difference between the two, is that EMI schemes are incentive arrangements which enable small trading companies to attract and retain their staff. "Normal" company share option plans are typically aimed at larger companies, many of which are quoted on the stock exchange.

An EMI scheme is very simple to operate because **no advance approval is required from HMRC.** All other approved share schemes require the documentation to be sent to HMRC before the scheme can be operated. Instead, under an EMI, the **company will enter into an option agreement with each individual employee.**

The company will notify the details of the option agreement to HMRC within 92 days. HMRC thereafter has the right to raise any queries about the scheme within 12 months. ITEPA 2003, Sch 5 Para 44 & 46

EMI schemes are popular with small companies. As we shall see, EMIs are more flexible than normal company share option plans and the rewards available to employees are potentially much greater.

Latest statistics indicate that over 2,500 companies granted EMI options in 2008/09.

38.2 Operation of the scheme

A company will grant options to an employee. The share options give the employee the right to buy shares within a specified period at a fixed price. In order to qualify for favourable tax treatment, the options must be exercisable within 10 years of grant. ITEPA 2003 s.529

Within 10 years the employee will exercise his option and will buy shares in his employer company at their agreed option price. In most instances there will be no tax on the exercise of the option. We can draw similarities here with the company share option plan.

The only tax usually charged on the employee will be **capital gains tax** when the employee eventually **sells his shares**.

38.3 Qualifying conditions

A company may only grant options under an EMI scheme if it complies with certain conditions. Essentially EMI companies are **small trading companies**. The qualifying conditions for an EMI company are very similar to those used for Enterprise Investment Scheme purposes.

The company **must be a trading company**. The company must **carry on a qualifying trade** and all trades will qualify unless they are strictly prohibited or excluded. As we saw in the chapter on the Enterprise Investment Scheme, financial, legal, farming, property development and certain other trades are specifically excluded. ITEPA 2003 Sch 5 Paras 15&16

The total **gross assets of the company cannot exceed £30 million.** An EMI company will generally be an unquoted company although certain small quoted companies could offer EMI options to their employees if they are small enough to qualify. ITEPA 2003 Sch 5 Para 12

The total value of shares over which EMI options are held cannot exceed £3 million. ITEPA 2003 Sch 5 Para 7

The company must have less than 250 full-time employees. ITEPA 2003 Sch 5 Para 12A

Finally the **company must not be controlled by another company**. This essentially means that the company cannot be a subsidiary of a parent company. ITEPA 2003 Sch 5 Para 9

There are also certain qualifying conditions attaching to the employees and to the shares. An EMI scheme is not an "all employee" scheme. The company can invite **selected, full-time employees** to participate in the scheme. By "full-time" we mean the employee must devote at least 25 hours a week to the company. ITEPA 2003 Sch 5 Para 26

Employees with a "material interest" in the company **cannot participate** in the scheme. For EMI purposes, a director or employee will have a **material interest if he** (together with associates) **controls more than 30% of the share capital of the company.** ITEPA 2003 Sch 5 Para 29

The maximum value of shares (valued at the date of grant) over which an employee holds options cannot exceed **£120,000**. This is more generous than the maximum ceiling of £30,000 used in company share option plans. However, the £120,000 limit applies to the value of shares over which options are held under both EMIs and Company share option plans. Therefore, if the employee already holds unexercised options over shares valued at grant at £30,000 under a company share option plan, he can only be granted options over shares worth £90,000 under an EMI. ITEPA 2003 Sch 5 Para 5

EMI options **must be exercisable only within 10 years** from grant. The window of time in which an employee can exercise his EMI options, therefore runs from the date of grant to 10 years thereafter. There is nothing in the scheme rules to prevent an employee from exercising options in the first 3 years. ITEPA 2003 s.529

Finally, an element of the tax advantages is lost if the company grants options at a discount. As we shall see later, if an employee has the right to buy shares for less than their market value at the date of grant, there will be an income tax charge when the options are exercised.

38.4 Tax implications

There is never a tax charge on the grant of an EMI option.

Assuming there was **no discount** on the shares at the date of grant – i.e. if the option price is the same as the market value of the shares at the date the option was granted – there will be **no tax when the options are exercised.** ITEPA 2003 s.530

If, however, a discount is offered to the employee at the date of grant – i.e. the price at which the employee can purchase the shares is less than their current market value –there will be an income tax charge on the exercise of the options. ITEPA 2003 s.531

In **all** instances, there will be a **capital gains tax** liability on the employee on the ultimate disposal of the shares.

38.5 Income Tax at exercise

An income tax charge will only be levied on exercise if the options were originally granted at a discount. This means that the market value of the shares at the date of grant of the option exceeded the employee's option price.

The way in which we calculate the income tax charge on the exercise of EMI options, is slightly different to that under company share option plans.

Income tax on exercise (only if discount @ grant):

Lower of:		
(i)	MV of shares at grant	X
(ii)	MV of shares at exercise	X
		X
Less: option price		(X)
"Employment income"		X

In the majority of instances, the market value of the shares at the date of grant will be lower than the value of the shares at the date the employee exercises the options. There could obviously be exceptions to this if the share price goes down.

Tax and NIC under PAYE needs to be applied at this point only if the shares are readily convertible assets. This is unlikely to be the case for EMI companies.

Illustration 1

EMI Ltd grants options to Mr Employee in December 2001. The options give Mr Employee the right to buy 40,000 shares at £2.50 each. The market value of the shares at the date the option is granted is also £2.50. Mr Employee can exercise his options until December 2011.

Under an EMI, there will never be a tax charge at the date that the options are granted. Assume that Mr Employee exercises his options and duly purchases the shares in July 2010 and the market value of the shares at this point is £4.50. As with approved company share option plans, there is no tax on the exercise of the option. There will only be a tax charge on exercise, if the options were issued at a discount in the first place. This is not the case here.

The only tax in this scenario will be capital gains tax when Mr Employee sells his shares.

Illustration 2

Changing the numbers very slightly, assume this time that Mr Employee has a right to buy 40,000 shares for £2.00 each.

The company is granting an option to an employee at a discount of 50p per share. Even though the options are granted at a discount, there will never be tax on the grant of an EMI option. The only time an income tax charge will arise is on the exercise of the option.

Assume that Mr Employee exercises his options in July 2010, and duly purchases 40,000 shares at £2.00 each. The market value of the shares at this point is £4.50.

Because the options were originally granted at a discount, there will be tax on the exercise of the option. The tax charge will be based on the market value of the shares at the date of grant, or the market value of the shares at the date of exercise, whichever is the **lower**. In this case, the value of the shares at the date of grant is lower, so we use the figure of £2.50. The income tax charge will therefore be:

40,000 x (£2.50 – £2.00) = **£20,000**

38.6 Capital Gains Tax

There will also be a capital gains tax charge when Mr Employee eventually sells the shares. The capital gain is simply the difference between the sale proceeds and the CGT base cost. The CGT base cost is the amount actually paid for the shares, plus any amount charged to income tax on exercise.

CGT base cost:	£
Amount paid for shares	X
Add:	
Amount charged to income tax at exercise	X
	X

In cases where the charge on exercise is based on the market value at grant, i.e. where the share price has increased in value between grant and exercise, the CGT base cost will effectively be the market value at grant.

Illustration 3

Assume the same facts as in Illustration 2.

Mr Employee exercised his EMI options in July 2010, therefore his base cost will be:

	£
Amount paid for shares (40,000 x £2)	80,000
Add:	
Income tax on exercise	20,000
CGT base cost	100,000

Note that this is the market value of the shares at grant, i.e. £40,000 x £2.50

He sells the shares immediately for £4.50 each. His capital gain is:

	£
Sale proceeds (40,000 x £4.50)	180,000
Less: CGT base cost	(100,000)
Capital gain	£80,000

Example 1

Little Trade Ltd awards options under an Enterprise Management Incentive to Mark, an employee, in January 2003.

The options give Mark the right to buy 20,000 shares at £3.50 each until January 2013. The shares were valued at £4.50 in January 2003.

Mark exercises 15,000 options in March 2011 and sold the shares immediately for £4.25 each.

Calculate the amount charged to income tax on Mark in 2010/11.

Answer 1

"Employment income" at exercise:

			£
Lower of:			
(i)	MV of shares at grant	£4.50	
(ii)	MV of shares at exercise	£4.25	
ie £4.25 x 15,000 options exercised			63,750
Less: purchase price (15,000 x £3.50)			(52,500)
Income tax charge 2010/11			**£11,250**