

EQUITY FOR EMPLOYEES

Enterprise Management Incentive (EMI) Share Option Schemes

Business asset taper relief can reduce gains on the disposal of shares in private trading companies to give an effective tax rate of just 10% after only 2 years. That means that shareholdings remain a very attractive mechanism to reward employees in private companies. The attractiveness of shares is enhanced when one considers that shares in new companies often have little value at the outset so that shareholdings can be provided relatively inexpensively to the employee and, providing appropriate elections are made, future tax exposure under the restricted securities legislation can be avoided.

However, from a company perspective equity participation at the outset for employees is not necessarily desirable because directors will not wish to give them parity in voting rights and dividend rights with existing shareholders.

Options are an attractive alternative to equity. Companies can often obtain a corporation tax deduction for the benefit and do so without some of the complications of a direct equity holding. Government approved EMI schemes are especially attractive and it is these schemes that this note addresses.

An EMI option is granted under a Revenue approved scheme and offers important tax advantages to the employee that are not available with unapproved options.

EMI options, like many share options and equity participation, are often used where an exit is anticipated so as to provide a mechanism for realising value. However, with judicious use of an employee benefit trust it is also possible to create an internal market for the shares which enhances their attractiveness even where an exit is not anticipated.

CONDITIONS THAT MUST BE MET BY THE COMPANY

To qualify, the company must be an independent company carrying out a qualifying trade, with gross assets not exceeding £30 million;

An independent company is one which is neither a 51% subsidiary of, nor controlled by, another company. At the time the options are granted there must not be any arrangements in place by virtue of which independence might be lost;

A company with subsidiaries can only qualify if the subsidiaries are 51% subsidiaries of the holding company;

A company is not a qualifying company if it has a property managing subsidiary which is not a qualifying 90% subsidiary of the company.

A qualifying trade must be carried on. A qualifying trade is one carried on wholly or mainly in the UK with a view to the realisation of profits, with the following activities specifically excluded:

- ▶ dealing in land, commodities, shares, securities or other financial instruments;
- ▶ dealing in goods other than in the course of a trade;
- ▶ banking, insurance, debt factoring and other financial activities;
- ▶ leasing;
- ▶ receiving royalties or licence fees;
- ▶ legal or accountancy services;
- ▶ property development;
- ▶ holding, managing or occupying woodlands, any other forestry activities or timber production;

- ▶ farming or market gardening;
- ▶ operating or managing hotels, nursing homes or residential care homes; and
- ▶ the provision of services or facilities for a business consisting of any of these excluded activities carried on by another person.

Companies which operate in other jurisdictions through separate subsidiaries should remain eligible but those which extend their business overseas through branches or divisions must be careful that they do not fall foul of the qualifying trade test.

CONDITIONS THAT MUST BE MET BY THE EMPLOYEES

To be eligible for EMI options, employees must be employed by the company or group for at least 25 hours per week or, if less, for at least 75% of their working time, where 'working time' includes time spent in self-employment as well as employment. This means that great care must be taken when Executive Directors become Non-Executive taking on roles elsewhere.

Employees, who, together with their associates, have a material interest in the company, where 'material interest' is defined as more than 30% of the ordinary share capital, cannot participate.

CONDITIONS APPLYING TO SHARES

The shares must be fully paid up ordinary shares, so that the employees have a right to share in the profits of the company, and redeemable and convertible shares cannot be used for EMI; the shares can be listed or unlisted.

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CONDITIONS APPLYING TO THE OPTIONS

To qualify, options must be issued for commercial reasons to recruit or retain employees, and not be part of a tax avoidance scheme;

Each employee can hold options over shares worth up to £100,000 at the time of grant;

Once options with a total value of £100,000 have been granted to an employee, no further qualifying options can be granted to that person within three years of the grant of the last qualifying option, irrespective of whether the earlier options have been exercised;

Options held under a Company Share Option Plan (CSOP) are treated as unexercised options under EMI, so that, for example, it is not possible to hold £100,000 of options under an EMI at the same time as £30,000 of options under a CSOP; and

The total value of shares in a company over which unexercised options exist cannot exceed £3 million.

DISQUALIFYING EVENTS

Each of the following is a disqualifying event in relation to an EMI option:

(a) A loss of independence. If shares are sold to a company that becomes a controlling company then independence is lost.

b) Additionally, if a controlling individual shareholder transfers any of his or her holding of the shares in the EMI company to a corporate trustee of a trust of which he or she is the settler, or any company of which he or she has control, the test of

independence will cease to be satisfied. This is because the EMI Company is then under the control of a company and a person connected with it. We understand that HMRC will not in practice take this point if the individual controlling shareholder retains his control of the company after making such a transfer.

c) Such a loss of independence is not a disqualifying event if it occurs in consequence of a takeover, or interpositioning of a new holding company by way of an exchange of shares.

d) The EMI Company ceases to meet the trading activities requirement.

e) The option holder ceases to be an eligible employee either because he is no longer an employee of the EMI Company, or a qualifying subsidiary, or because he ceases to meet the commitment of working time requirement.

f) The terms of the EMI option are varied so as to increase the market value of the shares under option or such that the requirements of the legislation are no longer met.

g) Any alteration is made to the share capital of the EMI Company which affects the value of the shares under option.

h) The conversion of any of the shares to which the option relates into shares of a different class unless all of the shares of the original class are converted and either immediately before the conversion, the majority of the shares of that class are held by persons other than directors or employees, or the EMI company was then employee controlled by virtue of holding of shares of that class.

THE EFFECT OF A DISQUALIFYING EVENT

If a disqualifying event occurs before an EMI option is exercised, and the option is not exercised within the 40 days, the relief from income tax will be curtailed and the CGT taper relief will be lost altogether.

- ▶ Disqualifying events include the company ceasing to meet the qualifying trading activities requirements and the individual ceasing to meet the working time conditions.
- ▶ Where a disqualifying event occurs before the option has been exercised, the employee has 40 days in which to exercise and retain the tax benefits; and
- ▶ If the option is not exercised within the 40 days, the employee will be taxed on the difference between the market value of the shares at the date of the exercise and their market value immediately before the disqualifying event, in addition to the charge on any discount.

OTHER ISSUES TO BE AWARE OF

Companies must take care when looking to restructure share capital so as not to lose qualifying status and must be careful wherever there is a change in control.

Companies must be aware that any loan notes obtained on exercise of an EMI options only qualify for taper relief from the date of acquisition of the loan note because the loan note is not a qualifying share for the purpose of the legislation.

The acquisition by the EMI Company after the grant of an option of an interest in a subsidiary which does not satisfy the

requirements of being a qualifying subsidiary is in fact not a disqualifying event. However, it would prevent the grants of any fresh EMI options.

If the company is subject to a takeover before the EMI option is exercised, and the option holder releases his EMI option in exchange for the grant of a corresponding right to acquire shares in a new holding company, then the replacement option will be treated for the purposes of both income tax and CGT as if it were the original EMI option.

- a) The option must be exchanged within 6 months from when control passes and any conditions of the offer have been satisfied.
- b) The replacement option must satisfy the requirements of being an EMI option with the exception of the £30m grossed asset.
- c) The total market value of the shares under the old option must be equal to the total market value of the shares in respect of which the new option is granted. In addition, the total amount payable upon exercise of the new option is equal to the total amount that would have been payable upon exercise of the old option.
- d) The grants of a replacement option must be notified to HMRC within 92 days after the date of the grant.

Takeover for these purposes is defined as a situation in which an acquiring company obtains control of an EMI company as a result of making a general offer to acquire either:

- a) The whole of the issued ordinary share capital;

- b) All of the shares of the same class as those for which the option remains;
- c) Obtains control of an EMI company in pursuant of a compromise or arrangement sanctioned by the Court under CA 1985;
- d) Obtains all the shares of the EMI Company as a result of the interposition of a new holding company.

If there is a takeover after the options have been exercised then the benefit of the special taper relief rate will be retained if:

- a) The shares acquired upon exercise of the EMI option are exchanged for shares which are fully paid up, non-redeemable and form part of the ordinary share capital of the company concerned; and
- b) The replacement shares are treated for CGT purposes has the same asset as the original holding.

It is important to note that the taper relief benefit running from the time of the grant will be lost if the shares acquired are subsequently exchanged for loan notes. We understand however that this policy is currently being reviewed by HMRC.

SHARE VALUATION

It is necessary to determine the market value of the shares under an EMI option:

- a) When the option is granted;
- b) Upon the occurrence of a disqualifying event;
- c) Upon exercise of the option will be charged to income tax that arises at that time;
- d) Upon an exchange or rollover of options.

ACTION

If you are interested in implementing an approved share option scheme then please speak, in the first instance, to your usual contact at Dixon Wilson or the authors:

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