

Enterprise Management Incentive - the most tax advantageous option scheme ever

The Chancellor introduced EMI in 2000 – at the time it was the most tax advantageous option scheme ever and subsequent changes have seen it get even better. Its main features are as follows:

- (a) Employees may be granted options to acquire shares in a qualifying company.
- (b) Each participant may hold options over shares having a market value of not more than £100,000 at the time of grant.
- (c) Normally, there is no income tax or employee's or employer's National Insurance contributions when an option is granted or exercised.
- (d) A capital gains tax ("CGT") charge arises when shares are sold, but the gain arising will normally qualify for taper relief. This relief will commence from the date when options are granted rather than the date when shares are acquired.

1 What is a "Qualifying Company"?

A Company (which can be quoted or unquoted) will be a qualifying company if:

- (a) its gross assets do not exceed £30 million, or if it has subsidiaries, the group assets do not exceed £30 million;
- (b) the company is not under the control of any other company (and its connected persons) and there are no arrangements under which it could become under such control;
- (c) it does not (together with its connected persons) control any other company save for those companies which are its 51% owned subsidiaries (unless the subsidiary is a property managing subsidiary when the subsidiary must be a 90% subsidiary); and
- (d) the company carries on a qualifying trade wholly or mainly in the UK (but there is no requirement for the company to be resident in or incorporated in the UK) or in the case of a group, at least one company is carrying on a qualifying trade in the UK.

Most trades will qualify, but there are exclusions relating to leasing, financial activities, property development, legal or accountancy services, receipt of royalties or licences (but not where the company created the intellectual property), farming or market gardening, hotels, nursing or residential homes and woodlands.

2 How many options may be granted?

An employee may not hold unexercised options over shares with a market value (as at the date of grant) of more than £100,000. Where an employee has been granted options over shares having a market value of £100,000 (whether or not those options have been exercised or lapsed) he may not be granted further EMI options within three years of the date of the last EMI option which was granted to him. However, due to a quirk in the legislation it is widely accepted that further EMI options may be granted within this period if the previous grant was over shares having a market value of less than £100,000 and those previous options have been exercised.

3 Who may participate?

An employee will be eligible if:

- (a) he is employed to work for at least 25 hours per week or, if less, for at least 75% of his working time – working time includes time spent in self employment; and
- (b) he (and his associates) do not control 30% or more of the ordinary share capital of the company.

There is a limit on the total market value (as at the date of grant) of shares in respect of which unexercised EMI options may exist of £3 million per company.

4 On what terms are options granted?

Generally the company can determine the terms on which options are granted although legislation stipulates some requirements.

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- (a) The option exercise price can be set at a discount or premium to market value, although if the option exercise price is discounted some of the tax benefits of EMI will be lost.
- (b) EMI options must provide that they may not be assigned. If the option permits exercise on death, it must not permit exercise more than one year after death.
- (c) To qualify as an EMI option, the option must be covered by a written agreement specifying:
 - (i) the date of grant;
 - (ii) that it is granted under the provisions of the EMI legislation;
 - (iii) the maximum number of option shares;
 - (iv) the option exercise price or the method by which the price is to be calculated;
 - (v) when and how the option may be exercised;
 - (vi) details of any restriction or conditions attaching to the shares; and
 - (vii) details of any performance requirements.

5 What shares may be used?

The shares must be fully paid up ordinary shares in a company which is not under the control of another company. Redeemable shares may not be used.

6 HMRC notification/approval

There is no approval procedure. Instead to qualify as an EMI option, the employing company must give notice (which must also be signed by the employee) to HMRC within 92 days of the grant of the option in the prescribed form. HMRC will confirm whether or not a company is a qualifying company in advance of the grant of EMI options. This assurance only extends to the company and not, for example, the eligibility of the employee.

Although there is no strict requirement, it will normally be advisable for the EMI company to seek advance valuation of the company's shares prior to the grant of the options. This is to ensure that none of the EMI limits are breached and options are not inadvertently granted at a discount.

7 How is it taxed?

Income Tax – Grant of options

No income tax or National Insurance contributions ("NICs") are payable on the grant of an option.

Income Tax – Exercise of options

Market value options

Where options are granted at an exercise price equal to or in excess of market value at the time of grant, there will be no income tax at the time the option is exercised.

Discounted options

Where options are granted at an exercise price at a discount to market value at the time of grant, there is an income tax charge on the difference between the option exercise price and the market value of the shares at the date of grant.

Disqualifying events

If an option is exercised within 40 days of a disqualifying event occurring, no income tax will be charged as a result of the disqualifying event. If an option is exercised outside the 40 day period income tax will be charged at the time the option is exercised on the amount of the difference (if any) between the market value of the shares immediately before the disqualifying event and their market value at the time of exercise. Disqualifying events include:

- (a) the company becoming a 51% subsidiary of another company or under the control of another company and any other person connected with that other company;
- (b) the participant ceasing to be an employee or no longer being required to work at least 25 hours per week or if less 75% of his working time (as defined) for the group;
- (c) the participant actually ceasing to work at least 25 hours per week or if less 75% of his working time for the group;
- (d) the company ceasing to carry on a qualifying trade.

8 National Insurance Contributions - Exercise of options

NICs will only be chargeable if a charge to income tax applies and where, at the time of exercise, the underlying shares are readily convertible assets. Readily convertible assets include all shares which are quoted or in respect of which there is a market or informal market and shares for which trading arrangements are likely to come into existence i.e. where a sale or flotation of the company is about to occur. NICs are charged on the same amount as is chargeable to income tax. The employer and employee may agree that any employer's NICs are to be borne by the optionholder but this must be specified at the outset.

9 PAYE

If, at the time of exercise of the option, the shares are readily

convertible assets the employer has to account for any income tax and NICs which arise on exercise through PAYE, If the shares are not readily convertible, self-assessment applies.

10 Capital Gains Tax (“CGT”)

On a disposal of shares acquired pursuant to an option, the shareholder will, in principle, be subject to capital gains tax on the difference between what he paid for the shares and the sale proceeds. He will be able to utilise whatever reliefs are available to him, such as losses on other transactions and his annual exemption (which for 2007/08 is £9,200).

In addition, he will be entitled to taper relief. Taper relief is designed to reduce the amount of the gain brought into charge by reference to the period of time assets are held prior to disposal. The rate of taper relief varies depending upon whether the assets are business assets or non business assets. Where the assets are business assets, the effective rate of tax will be reduced from 40% (assuming the tax payer is a higher rate tax payer) to 10% after two years. By contrast where the assets are non-business assets, the effective rate of tax for a higher rate tax payer is only reduced from 40% to 24% after ten years. Where assets are business assets and subsequently become non business assets (and vice versa) an appropriate apportionment is made.

Shares are treated as business assets for so long as the company is a trading company or the holding company of a trading group and either the shares are unlisted or the shareholder is an officer or employee of the group.

In addition and of particular value for EMI optionholders, is that, subject as noted below, shares acquired by exercise of an EMI option are treated for the purposes of taper relief as if they were acquired on the date that the EMI option was granted.

If a disqualifying event occurs before an EMI option is exercised, taper relief in respect of the shares acquired on exercise will run from the date of grant of the option only if the option is exercised within 40 days after the disqualifying event.

11 Corporation Tax

In common with other share incentive arrangements, provided the requirements of Schedule 23 Finance Act 2003 are met a corporation tax deduction will be available in respect of the exercise of EMI options equal to the market value of the shares at the date of exercise less any amount paid for the shares (i.e. the "option spread").

This is a summary only. For further information please contact:

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