

# Tax and Employee Benefits Law Update

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## Enterprise Management Incentive Options — Tax Efficiency with Strings

Many companies, especially those in the technology and biotechnology sectors, have granted their employees enterprise management incentive (EMI) options. This is one of the most tax-efficient ways in which companies can provide employees with an equity interest. EMI options offer the prospect of a 10% capital gains tax rate, as compared to the traditional 40% income tax rate (plus national insurance) for standard non-qualified options.

Since the Treasury is offering significant tax breaks, it is perhaps inevitable they have put in place technical rules that may result in the loss of this relief. This publication is intended to highlight some of these rules and provide practical examples of when they are a real problem.

The EMI legislation lists a series of events, known as disqualifying events, which can cause considerable loss of tax benefits. The commencement of capital gains tax taper relief from the grant of the option is the main tax benefit of EMI options. It is because of this that the capital gains tax rate reduces from 40% to 10% over the two years following grant. If a disqualifying event occurs and the EMI option is not exercised within 40 days of that event, **all** taper relief will be lost. Income tax and national insurance (employer and employee) relief will also be lost, at least in part.

### DISQUALIFYING EVENTS

Given the potential for significant tax loss, it is vital to be aware of the disqualifying events in advance so that, where possible, plans can be made to address the issue.

#### Leaving Employment

Perhaps the most common disqualifying event is leaving employment. Often, option plans enable employees to exercise options

beyond 40 days after leaving their jobs (e.g., within three to six months). Those ceasing employment who plan to exercise options may well be better off exercising within the 40-day “EMI period” rather than at the end of the run-off period permitted under their option rules.

#### Employees Ceasing to Meet the Working Time Requirements

To receive EMI options, individuals must (i) be current employees of the company and (ii) work at least 25 hours per week or, if less, commit 75% of their working time to the business. A disqualifying event will result if these requirements are not met.

An employee who moves from full-time to part-time, and has several part-time jobs, may find it difficult to meet the working time requirements. Difficulties may also arise if employees go on sabbatical and either leave employment (in which case leaving constitutes a disqualifying event) or, whilst remaining employed, cease to commit the appropriate period of working time to the business.

#### Grant of Approved Options

EMI options are limited to £100,000 per person. This limit is aggregated with the £30,000 approved option limit. Combining both tax qualified plans does not allow £130,000 of options to be provided — only £100,000. Therefore, if an employee has been granted £90,000 EMI options, an approved option grant of £20,000 would be a disqualifying event.

#### Company Becoming a Subsidiary of, or Controlled by, Another Company

EMI options can only be granted by independent companies. A disqualifying event occurs if the company ceases to be independent. This is easy to spot if the company is acquired. However, there are

*Loss of tax benefit following leaving employment*

**Loss of tax breaks  
following alteration of  
share capital**

a number of less obvious circumstances. Examples include where an investor buys over 50% of the company's issued (not fully diluted) share capital or a right to acquire over 50% of issued share capital (e.g., because of a convertible loan or share warrant). There are possible ways to prevent this from causing a disqualifying event, but steps must be taken in advance. Such steps add complexity since they can involve changes to share rights.

These rules also apply where a new holding company is imposed on the group. Subject to some specific requirements, it is often possible for option holders to exchange their options for replacement options over shares in the new holding company and carry forward the EMI relief.

### Company Ceasing to Meet the Trading Activities Requirements

EMI options are designed to encourage entrepreneurs. As a result, certain types of businesses — such as financial services and property development — cannot grant EMI options. If a company, having previously qualified, starts an excluded activity (anywhere in the world), then a disqualifying event may occur. Such changes of direction are perhaps unusual.

However, there is also a requirement that at least one company within the group trades wholly or mainly in the UK (the EMI tax benefits are intended to encourage activity in the UK). Difficulties can arise if the UK company opens a non-UK branch. This would be a disqualifying event if the non-UK business outweighs the UK business.

### Altering the Terms of Existing Options

Any amendments to existing options that increase the value of shares under the option or result in the EMI requirements ceasing

to be met will be a disqualifying event. An example is where a restriction on the shares set out in the option agreement is lifted. Difficulties can also arise where terms are altered in favour of the option holder. HM Revenue & Customs can construe this as a new grant, causing taper relief to re-commence.

### Altering Share Capital

Alterations to a company's share capital cause difficulty if, as a result, the value of the shares under option increases. For example, if a company's articles are altered to remove a requirement that all shares held by leavers are sold the shares may increase in value. If so, a disqualifying event would occur.

### Share Conversions

If the shares subject to EMI options are converted to a different class, a disqualifying event will occur. This can be problematic where shares are being re-designated.

## CONCLUSION

EMI options are flexible, easy to grant and provide very valuable tax relief. However, there are a number of events that can result in inadvertent and significant tax loss. It is vital that companies consider the impact on their EMI options of matters such as capital reorganisations and conversion of shares. It is also important that employees are aware of the potential for losing tax benefit if, for example, they leave their employment. Many companies prepare an explanatory booklet that outlines the potential loss of tax benefit and the general terms of the options. This can help employees gain a better understanding of their options. It also helps to protect the company from criticism for failing to point out these pitfalls.

FOR MORE INFORMATION ON THIS OR OTHER TAX AND EMPLOYEE BENEFITS MATTERS, CONTACT YOUR USUAL WILMERHALE LAWYER, OR:

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