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Rt. Hon. Rishi Sunak MP
Chancellor of the Exchequer
HM Treasury
The Correspondence and Enquiry Unit
1 Horse Guards Road
London, SW1A 2HQ

25 May 2021

Enterprise Management Incentives: call for evidence

Dear Chancellor

In response to your call for evidence of the effectiveness of the Enterprise Management Incentive, the Employee Share Ownership (Esop) Centre appointed an ad hoc committee, comprising:
Damian Carnell, executive remuneration consultant and co. director
David Craddock, share schemes consultant and author
Colin Kendon, Head of Incentives & Benefits at Bird & Bird
David Pett, tax barrister (and solicitor) and consultant to HMRC and
Malcolm Hurlston CBE, Founder & Chairman of the Esop Centre.

We put together the attached paper for your consideration.

Yours faithfully

Professor Michael Mainelli FCCA FCSI(Hon) FBCS
Executive Chairman, Z/Yen Group Limited
Co-chairman, The Esop Centre

The response of The Employee Share Ownership (Esop) Centre to the UK government's call for evidence in respect of Enterprise Management Incentive schemes

Background:

The share options-based Enterprise Management Incentive (EMI) is the most popular ever UK tax-advantaged employee equity scheme, in terms of company take-up. EMI is a success story predicated on the concept of making risk more attractive to highly motivated pathfinders in small growing companies. Getting more risk takers into the start-up and gazelle type company sectors accelerates economic growth, as now can be seen throughout Europe. EMI user companies pull in highly motivated individuals who create myriad new products and services, often within high tech sectors, which add to commercial reach and value growth among qualifying smaller companies. As their growth accelerates, they tend to develop more R & D resources, take on more employees and expand their sales overseas, as well as within domestic markets.

These EMI companies comprise the ***evolutionary spearhead*** of the SME world, especially young IT companies, whose big hitters eschew a comfortable life in larger companies to risk all in order to transform start-ups and other incubator companies into national or even global success stories. They know that if they get there, their tax-advantaged rewards via EMI options and other incentives will be considerable, whereas if they fail to achieve an Exit for their company perhaps three years down the line, then they stand to lose everything, as their EMI options in most cases will be worth nothing.

There were more than 12,000 small companies ***registered*** as qualifying for using EMI in the tax year 2018-9, according to HMRC statistics, of whom almost 4,000 each year ***award*** EMI options to key individuals within their company workforce. Over the fiscal years 2015-19, a total 117,000 mostly key employees received EMI options, though only 27,000 employees in EMI user companies exercised their options over the same period. *Why this discrepancy?* The fact that half of all EMI option holders may never exercise their options ever is ***not*** a sign that EMI is failing; rather it shows how dynamic this sector of the economy is. Centre member practitioners point out that many key employees who were attracted by the prospect of holding EMI options in a fast-moving high-tech world move on to other jobs after perhaps one or two years and consequently, as per current rules, lose the value of their original options. Those who stay may hold on to their EMI options for years if their employers cannot achieve an Exit (usually a sale) or other change of control. Only a small percentage of these companies go bust, rendering their EMI options worthless. Nevertheless, the evolutionary process informs us that some fall by the wayside for others to triumph.

Tax:

In the fiscal year 2018-19 (*the most recent year for which the statistics are available)* £430m worth of EMI options were awarded, on which the income tax and NICs relief totalled ***£370m***, while the average relievable gain on exercised EMI options for that year was £83,260 per head.

However, there is no statistical base which tells us how much ***more than that*** taxpayers received back from successful EMI user companies in terms of higher national wealth, additional sources of tax on profits, tax receipts from newly created jobs, increased R & D capacity and heightened prestige worldwide as the UK thereby is perceived as a country suited to more internal investment by foreign companies and governments.

Not for nothing is the EMI one of the most generous taxpayer-supported incentive schemes ever created for 'key' employees in the SME sector worldwide, but that does not mean that the UK can't do better still.

Anti-abuse provisions:

In common with most tax favoured share plans; the EMI tax legislation includes many anti-abuse provisions to ensure that tax benefits do not accrete to constructed situations where the true economic intention does not apply fully or at all.

Unsurprisingly, this adds considerably to the complexity. While it may be effective in reducing tax loss, the main effect may well be to lessen the adoption of these complex arrangements, particularly as the punishment for breach is often loss of tax favoured status for employees, who are not responsible for the breach in the first place.

Instead, we suggest that this complex approach is ditched in full for the new EMI. Yet it remains important that tax benefits accrue only to legitimate cases; and so a different anti-abuse mechanism is needed.

Within the body of our wider reply several examples of simplification are cited. But we also suggest a broad principle that any new EMI plan adopted "primarily for the purpose of tax reduction" rather than the creation of genuine capital growth in an enterprise should be disallowed. This is a principle-based test, not a detailed rules based one. It does allow tax to be a purpose; just not the main one.

Any past gains for an EMI plan failing that test will remain tax favoured for employees; but the past tax and NIC loss must be repaid by the employer directly as a corporation tax surcharge (or similar mechanic). Governance mechanics within the ownership structure should mean that this is incapable of abuse by the company's directors for their personal tax purposes.

Fintech Gazelles & Unicorns:

The danger of the UK being *left behind* in the new technology race is very real: the number of fintech start-ups in the EMEA global region alone in February this year was **9,311**, the rate having almost *tripled* over the last ***three*** years. Within the same time span, the number of fintech start-ups in Asia-Pacific had more than doubled to **6,129** and similarly, the rate had doubled in the Americas to **10,605**. The pace of technical development initiated by such gazelle companies is staggering. Yet financial services companies are barred from using the UK's EMI incentive scheme, as are leasing companies and subsidiary companies, even if they are not really controlled by their foreign owners. These exclusions and others need to be reviewed urgently. Fintech receives more than 20 percent of all venture capital in Europe, yet venture capital funded companies are excluded from EMI participation.

Also of concern is the **£3m** limit on the value of all outstanding EMI options at any one time in a user company. This limit should be scrapped (*see detailed proposals below*), as it serves no useful purpose. Worse still, this arbitrary limit sabotages the wish of some EMI user companies to award EMI options to a ***wider range of staff***, not just to half a dozen high-fliers. As *Index Ventures* points out, staff morale and loyalty improve considerably if ***all*** full-time employees in SMEs are awarded share options and EMI could be the vehicle for that concept to take root in qualifying smaller companies.

Restrictions on EMI use continue to pose problems for the medium and longer-term, as competition intensifies. In Germany alone there were around 12,000 start-ups of all kinds last year and the rate of growth is explosive – 22 percent per annum within the **EU**. The European mainland, formerly years behind the UK and the US in supporting and nurturing start-ups, now has the momentum - backroom ideas have grown into quoted companies valued at tens of billions, creating hundreds of thousands of highly-qualified new jobs each year. Two million EU employees work in tech start-ups, up ***43 percent*** in the last four years; by far the fastest growing and most resilient job creation engine, according to the European Start-ups project. Its report predicts that up to 3.2m people will be employed in European tech by 2025. Hence the significance of EMI in terms of UK economic policy, for those countries with start-up-friendly legislation will be the ones to benefit from the resulting innovation and economic growth. This will be especially important in the post-Covid economic recovery.

The founders of 500 European start-ups backed the launch of the *EU Start-up Nations Standard,* which seeks a pan-European solution to address the needs of start-ups and all member states are urged to implement this new Standard, designed to fuel the next generation of successful tech giants to compete with powerful global tech hubs in the US and China. The European Commission called out the treatment of stock options as one of the key policy areas in need of change. If implemented, *start-ups will no longer be hamstrung by an inability to use stock options effectively to attract and retain world-class talent,* it added. ***Hence the obvious need for much more EMI, rather than less of it.***

Conclusions:

What this Esop Centre paper shows is that although EMI has proved itself as a formidable fuel for gazelle-type company growth in the UK since its inception almost 20 years ago, *it has serious structural and operational issues* which are preventing hundreds, if not thousands, of additional companies from using it in order to promote *their* own gazelle-type growth.

One damaging example of EMI's shortcomings is the result of its own success: some user companies are reporting that as they've grown beyond one or more of the scheme's limits (*e.g. the Gross Asset Value limit of £30m, or that it now employs more than the maximum 250 people*) they no longer qualify and thus can no longer award EMI options to recent hires or, worse still, they have to stop awarding new EMI options to those employees who received a first batch only a year ago. *This is a recipe for a poisonous workplace atmosphere created by reward 'discrimination'* between certain employees and others in high-growth companies.

However, clearly, it would be counter-productive to abolish all limits on EMI user qualification, for to do so would mean that there would be no longer any incentive for pathfinders to leave their comfort zones of relatively safe jobs with larger companies in order to activate their own projects with a few other colleagues, without knowing whether their business plans will succeed or not.

The UK government should do more to facilitate high growth in small pathfinder companies and in the SME sectors generally. Such reforms, as outlined below, would consolidate and improve the UK's standing as a country which offers substantial tax reliefs and other incentives to reward expertise, initiative and risk, which are all intrinsic to the impressive growth rate of these gazelle-type companies.

The Esop Centre's Vision: The Future EMI

Expanding EMI:

EMI works for companies, stimulating productivity and growth for them and the nation. Before this paper turns to the detail of the call for evidence, there is a question worth posing – "why shouldn't enterprise management incentives apply to all companies of all sizes at all times?" The objective of the call for evidence is "to understand whether the EMI scheme should be extended to include more companies". 'Universal EMI coverage' would turn the entire UK into a hothouse for innovation and growth.

Universal EMI coverage would create a more inclusive market economy. Universal EMI coverage would accelerate ‘levelling up’, making employee share ownership a British norm without the rules of workers’ councils or other procedural mechanisms. The economic benefit of technology accrues mainly to capital; and at the same time there is an ongoing and accelerating erosion of conventional jobs. Share incentives help spread this social good more fairly and so assist with the levelling up agenda. Share incentives also play an important part in providing wealth and savings in retirement, at a time when many companies are cutting back on the pension cost alongside reduced tax allowances for retirement savings. ISAs and LISAs are welcome; but more is needed. Broad based EMI would help in this respect.

Universal EMI coverage would simplify the EMI scheme enormously, reducing bureaucracy and paperwork. Universal EMI coverage would render the ‘state aid’ strictures moot. Universal EMI coverage would simplify regulation, effectively little if any regulation would be needed.

The only ‘con’ to universal coverage might be cost. The EMI cost to the exchequer is most likely to be incurred in an efficient free market way; rather than any tax revenue provided directly by way of industrial support to specific companies or industries. Furthermore, the cost will be incurred directly only on success; whereas some interventionist spending is directed at saving jobs in failing sectors; which may have some success but ultimately that may act only as a break on the speed of transition as economic forces work themselves out.
However, as noted in the first chapter, there is no “statistical base which tells us how much more than that taxpayers received back from successful EMI user companies in terms of higher national wealth, additional sources of tax on profits, tax receipts from newly created jobs, increased R & D capacity and heightened prestige worldwide”. Any cost of extending EMI tax status relates only to capital gain, by definition. The gains in point will reflect growth in profit and jobs. The extra corporation tax on extra profit, the extra income tax and NICs on extra jobs and the extra CGT due on the higher capital value of the company overall should exceed the direct cost by a very considerable margin. Your own officials are well placed to model the full outrun effects.
Arguably, the statistical shoe on the other foot is that there is no statistical base that shows universal EMI coverage couldn’t be self-funding or provide aggressively high returns.

Universal EMI coverage would direct investment where it would do the most good, releasing the information asymmetries held by employees for public benefit. Government would not be picking winners and losers by sector, by size of organisation, or by region. Box 3.D: questions 16 to 18, start from an assumption that the EMI scheme needs to be restricted in some way, for reasons that are unclear. If this assumption is questioned, then those questions themselves may be moot. We would encourage greater boldness in questioning what purpose restricting EMI qualification serves.

Practicalities and Recommendations

1. Remove or replace the 92 Day Reporting Requirement

Paragraph 44(1) of Schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA**") requires that for an option to be a qualifying EMI option, notice must be given to HMRC by the employing company within 92 days of grant. The circumstances in which HMRC permits reasonable excuse claims are very limited.

EMI is aimed at smaller companies many of which cannot afford to take professional advice and consequently do not realise how strictly HMRC enforces the deadline. Many miss the deadline assuming options can be notified late resulting in loss of tax relief.

Companies who do report within the deadline using HMRC's online reporting system are often unaware of another trap – namely that it is necessary to obtain a screen shot at the time the report is made (because it is not possible to re-enter the website and obtain one later). This often results in companies being unable to prove options were reported in time.

We recommend that the requirement to notify HMRC within 92 days of the date of grant be removed and replaced with an annual reporting requirement (similar to CSOP and other tax qualifying plans). The 92-day deadline is burdensome and it is unclear what benefit it provides compared to annual reporting. Moreover, the penalty of failing to meet the 92-day deadline is harsh because it penalises participants who have no control over the reporting process.

Should it be felt necessary to continue to require employing companies to notify within 92 days we recommend the consequence of failing to do so should be a fine for the employer rather than loss of tax relief.

Finally, it is vital that HMRC's website is improved to allow employers to re-enter and obtain proof of notification (whenever it is required to be made).

2. Remove or replace the Working Time Declaration

Paragraph 44(5) of Schedule 5 of ITEPA deals with the contents of the notice (referred to above) which the employer is required to retain, and produce to HMRC, if requested. It includes a requirement that the option-holder has signed a written declaration that they comply with the working time requirement. Employers are required to retain a copy of the declaration and to give a copy to the individual within 7 days of it being signed.

The requirement to give a copy of the declaration to participants within 7 days is often overlooked and it is unclear what the impact is of failure to comply. Failure to obtain a declaration at all results in the option not qualifying for tax relief.

We recommend the requirement to obtain a declaration from participants is removed and so (by implication) the requirement to provide a copy within 7 days. We consider it should be sufficient for the legislation to require the working time commitment to be satisfied (as is the case with many other requirements in Schedule 5).

If it is thought necessary for participants to continue to provide a declaration we recommend it is required to be made on the notice of exercise when the option-holder will be able to confirm that they met the condition from grant to exercise. This seems to us to be a more logical time to make the declaration rather than on or within 92 days of grant.

Note: we are also recommending (see below) the working time requirement should only be met for the first 3 years after grant. If this recommendation were to be accepted and participants were to be required to make a declaration in the notice of exercise, they would need to declare they met the working time requirement for the first 3 years from grant rather than for the whole life of the option.

3. Remove or provide further guidance on the Notifying of Restrictions

Paragraph 37(4) Schedule 5 ITEPA requires that the option agreement must contain details of the restrictions applying to the shares under option that could make them restricted securities. HMRC has issued further guidance that in practice this requires the employing company to ensure that the employee is in a position to understand the nature and effect of the restrictions. As a result, the employing company must make the employee aware in a meaningful way and identify the individual restrictions; it is not sufficient to refer the employee generally to a document that contains the restrictions. Failure to appropriately notify and/or make the employee aware of the restrictions will result in the option not being an EMI qualifying option, although HMRC has stated it will take into account evidence that the restrictions have been otherwise brought to a participant's attention in a meaningful way.

The current requirement to notify the participant of restrictions is far-reaching and overly burdensome on employing companies. Under Schedule 5 ITEPA a restriction must be notified if it reduces the market value of the shares. Arguably this catches even the most common market standard provisions in articles of associations such as the requirement that a transferee must enter into a deed of adherence.

We propose that the requirement to notify employees of the various restrictions in the option agreement is removed.

Alternatively, if this requirement were to remain, guidance should be issued that it is acceptable for employing companies to cross-refer participants to the relevant documentation as opposed to being required to summarise the restrictions. Additionally, failure to notify employees should result in a fine being imposed on the employing company rather than loss of tax relief. The current legislation penalises participants for the company's compliance failure.

4. Amend the Disqualifying Event Rules for eligible employees who are leavers

Section 535(1) ITEPA provides that it is a disqualifying event if an option-holder ceases to be an eligible employee (by ceasing to meet the working time requirement).

Companies who wish to treat leavers as good leavers for commercial reasons are put in a difficult position by this rule. They often allow good leavers to retain their options with the result that all increases in the value of the option shares from cessation to exercise do not qualify for tax relief. Alternatively, companies allow good leavers to exercise within 90 days of cessation (in order to preserve the tax relief) but that often requires participants to fund the exercise price when there may be no liquidity in the shares.

We recommend the working time requirement is limited to the first 3 years from the grant of the option so that participants who leave thereafter are not disadvantaged by loss of tax relief on future gains (and are not forced to exercise their options in order to preserve it). We therefore propose that ceasing to meet the working time requirement should not be a disqualifying event under section 535(1) provided that the relevant employee has met the working time requirement for the previous three years.

The three-year period is in line with the CSOP legislation which does not penalise leavers in the same way as EMI.

5. Remove completely the £3million limit

Paragraph 7 of Schedule 5 ITEPA provides that the total unrestricted market value of subsisting qualifying options (measured at the grant date) must not exceed £3million. Once the relevant company has reached the overall limit, any further options cannot be qualifying EMI options (although capacity may later be freed-up due to option lapses).

When EMI provisions were first introduced there was a limit of 15 participants which was later removed but the £3million limit has remained in place and has not been increased.

In practice companies that make broad-based EMI awards can contravene the limit which is often over-looked resulting in somewhat arbitrary loss of tax relief for participants who are unlucky enough to be granted options while the limit was exceeded.

The limit serves no real useful purpose, and we therefore propose that it should be removed.

6. Increase gross asset test to £75million from £30million

Paragraph 12 of Schedule 5 ITEPA states that for a company to qualify it must not have gross assets in excess of £30million. Since the introduction of EMI in 2000 the limit was increased once (in 2002) from £15million to £30million. UK retail prices have increased by 66 percent since 2002, so on that basis, the GAV limit should be raised to at least £50million, to bring it back to its 2002 level in real terms.

We accept there is still a need to distinguish smaller growth companies and that the gross assets test is a simple way to achieve that objective. Nonetheless the limit has remained unaltered for nearly 20 years so propose that it is increased to £75million.

7. Introduce a *Green Exception* for leasing companies

Paragraphs 13 and 14 of Schedule 5 ITEPA require that a company must be carrying on a qualifying trade or preparing to do so in order to be a qualifying company for EMI purposes. In order to be carrying out a qualifying trade the activities of the company must not consist of certain excluded activities which are set out in paragraphs 16 to 23 of Schedule 5 ITEPA. Under paragraph 16(d) leasing is an excluded activity.

Leasing will play an increasing part in carbon reduction in the future. A typical example is leasing clothes as an alternative to the "buy and throw away" culture. *Tier Mobility* hire electric scooters as a green transport alternative and were denied EMI status because HMRC considered the primary activity was one of leasing.

We recommend an exemption to the leasing prohibition where the activity meets a carbon positive test.

8. Modify the Independence Test for subsidiaries and PE backed companies

Paragraph 9(2) of Schedule 5 ITEPA requires that a company must not be a 51% subsidiary of any other company, or otherwise under the control of anther company in order to qualify. Moreover, there must be no arrangements in place that could result in the company becoming a subsidiary or falling under the control of another company. If the company ceases to be independent, it is a disqualifying event.

While we appreciate no tax qualifying plan (other than shares for rights) has applied to subsidiaries to date we cannot see any difficulty in principle with extending relief to sub-groups that are run independently on an arm's length basis.

The existing legislation means venture and PE backed companies can cease to qualify for EMI because the investors may be technically connected and therefore treated as controlling the company (even though it is still being funded and run on arm's length terms).

We therefore propose to modify the independence test at paragraph 9(2) by providing that a company must either be independent as currently defined or run independently. This second limb would mean that for a company to be run independently all intra-group transactions must be completed on an arm's length basis. If this amendment were to be accepted, the gross asset test under paragraph 12 of Schedule 5 ITEPA should apply to the granting company and its sub-group rather than to the group as a whole.

The change would allow growth companies to seek wider investment without penalising participants.

9. Remove the 10-year limit on the availability of EMI options tax relief

The 10-year limit on availability of tax relief caused difficulty for many EMI companies after the 2008 financial crash, and it is difficult to see what purpose is served by removing the tax benefits if the option is not exercised within 10 years of grant. We are aware of at least a dozen or more companies who, having granted 'exit-only' EMIs, found themselves unable to be sold within the time-scale first envisaged. Optionholders were put in the invidious position of either (according to how the option agreements were drafted) losing the benefit of the options, or having to exercise in circumstances in which option shares could not be sold to fund the exercise price and any tax charged on the 'discount on grant'. If fresh options were granted, there was then no relief from tax on the growth in AMV which had accrued over the period since grant of the original options.

10. Improve HMRC website

More access is needed to *What if?* scenarios; simple two-way facility for amending mistakes without losing tax protection and publication of regular updated HMRC guidance on EMI issues.

Case Study Examples

EMI Case Study 1: A Company Marketing Software Technologies

(1) The Objective

The objective is to establish strong motivation and incentive for employees to drive the business forward to an exit date.

(2) The Facts

The company is a private company, currently valued at £300,000, with an expected projected value in 5 years' time of around £7 to £10million. The company anticipates fast growth in the development of the company, marketing software technologies to premium clients.

The declared corporate objective to exit in 5 years' time is an ambitious target and in order to realise this ambition the company needs high-calibre software engineers that are difficult to recruit in the marketplace and even more difficult to retain.

(3) The Solution

The solution is to develop a scheme arrangement based on EMI that focuses on the corporate objective of realising value at the expiry of an expected limited life for the company, i.e. the expected time of the exit, with all employees being given the opportunity to share with the founder shareholders in the capital sale.

The option price is set at nominal value only, in order to maximise the benefit of the upside value to the employees at the date of exit and, therefore, maximise the sense of motivation for the employees.

Participation in the scheme is available for all employees, with entry into the scheme subject to a length of service criteria. The share allocations are determined on a tier basis that is linked to the internal grading system. However, the all-inclusive nature of the arrangement recognises that team performance from all levels is required for the achievement of the ambitious corporate objective.

The events that trigger the exercise of the options are restricted to the exit positions of a takeover trade sale or a management buy-out or a flotation on a recognised stock exchange or a sale of the trade and assets of the company.

For any employee who leaves the company for any reason whatsoever, the option lapses on leaving, a feature that is intended to assist in the retention of the quality employees who have been recruited into the business.

(4) The Particular Commentary Features

The scheme is based on an accumulating right to exercise for one-off grants rather than a series of annual staggered grants at different option prices. This feature establishes the option price when the market value of the shares is low.

EMI Case Study 2: An Engineering Tools Testing Company

(1) The Objective

The objective is to introduce arrangements to facilitate the company operating with significant employee share ownership in perpetuity.

(2) The Facts

The company is a private company currently valued at £5million with no plans for an exit in either the short-term, the medium-term or the long-term. The company is a very fast-growing company in the business of providing testing for precise engineering tools. The company recognises the opportunities that are available in the UK and throughout the world for its continuing growth.

The shareholder directors are united in their belief in the employee share ownership ethic for growing their company and have taken the view that they wish to see the shares of the company recycled in perpetuity between employees of successive generations.

(3) The Solution

The solution is based on combining the grant of EMI options with the formation of an employee share trust. The company has chosen to set option prices that are equal to the market value of the shares at the date of grant, with employees being given the opportunity to buy their shares following the exercise of their options. The directors believe that the employees will buy their shares through a combination of bonus monies and their own resources.

The options are granted to all employees, subject to a length of service condition, with all eligible employees offered shares on the basis of a tiered structure that is linked to objective and fair criteria.

The scheme encourages early share purchase by the employees through restricting the opportunity for exercise to the period of three years from the date of grant. The scheme also encourages some retention by not allowing the employees to sell their shares until two years after purchase. Specifically, therefore, the scheme is designed and intended to encourage particular behaviours. The directors believe that the employees will respond positively to these scheme features, provided they continue to have belief in the potential of the company to grow and develop. The on-going communications assume high profile, therefore, for the success of the scheme.

The option exercises are satisfied through the employee share trust purchasing shares from the existing shareholders through the exercise of call options and then dispensing those shares to the employees on exercise.

(4) The Particular Commentary Features

Given that the company is a private company, the employee share trust operates as a surrogate market for the shares in the absence of a recognised stock exchange. The same 20% of the share capital is recycled through the employee share trust adopting a commercial persona and acting as both provider and purchaser of the shares.

The application of recognised share valuation methodologies is used to establish a surrogate value for the shares on a six-monthly basis. The company has taken a definite decision to be proactive in communicating the developing share value to employees on a regular basis.

EMI Case Study 3: A Light Engineering Company

(1) The Objective

The objective is to establish a succession plan for the shareholding of the company, thereby enabling the existing shareholders to diversify their investment portfolio and pave the way for a management buy-out.

(2) The Facts

The company is a private company and has grown steadily over many years. The existing shareholder directors are in their late 50s and are contemplating retirement. The company operates an engineering business that has a long history of successful initiatives in the UK market and overseas. The directors recognise that the company has strong potential for new product development and the capture of new markets. The existing shareholder directors have identified successors within the business, existing managers who as responsible individuals will be able to lead the workforce of some 220 employees into this new era for the business. The directors are, therefore, planning for both shareholder succession and management succession. The existing shareholders want to retain some shareholder interest. However, they also want to realise value for at least some of their shares with a view to diversifying their investment portfolio.

(3) The Solution

The company establishes an employee share trust, initially with a view to enabling the shareholder directors to sell 24% of their combined shareholding and realise actual cash for investment elsewhere.
The company grants EMI share options to key management team members with top-up tax-unapproved share options to take the shareholding of the new management team to 40% in five years' time and to 75% in 7 years' time.
The company has taken deliberate steps to train and to develop its new management team to the level of management that is required to run the company.

(4) The Particular Commentary Features

The existing shareholder directors realise their actual cash return through a capital gains tax transaction with the employee share trust, based on an anti-avoidance clearance from HMRC.
The existing shareholder directors have in the short-term retained control of the company, even control of special resolutions, whilst at the same time ensuring that their investment portfolio is not restricted to shares in their own company.
The statutory corporation tax deduction is a particular attraction to the directors with the company benefiting from relief within its corporation tax computation based on the gain realised by the employees at exercise.
The new management team can envisage a future with their own shares escalating over time and their own opportunity in time for a realisation of value through selling to the same employee share trust.

EMI Case Study 4: A Passenger and Freight Transport Company

(1) The Objective

The objective is to establish a substantive long-term incentive arrangement for the company's senior management.

(2) The Facts

The company is quoted on the Alternative Investment Market with a current value of £18million. The company has a high-level reputation in the business of passenger and freight rail transport and has been awarded numerous prizes for its very high-quality customer service.
The company has some years earlier introduced the Free Shares Module of the Share Incentive Plan together with the Savings-Related Share Option Scheme on an all-employee basis as required by the tax-advantaged legislation. The company now needs to give focus to the introduction of a tax-efficient long-term incentive scheme for its director and executive team in order to meet its retention needs in the face of competitor companies seeking to tempt key performers away from the company.

(3) The Solution

The solution is to establish an EMI scheme with options granted as "nil cost" options, i.e. 100% discount on the market value at the date of grant, with the opportunity for those options to be exercised on the achievement of performance conditions through the transfer of shares from an employee share trust.
At the time the options are granted, the company settles monies into an employee share trust to enable the trustees to purchase shares off the Alternative Investment Market.
The company agrees performance conditions that are linked to criteria based on a particular derivation of Total Shareholder Return that must be achieved for the exercise of options in 3 years' time.
The company makes the decision at the outset that options will be granted on an annual basis so that option lives overlap with up to three live options at any point in time, each with a different outstanding period remaining.

(4) The Particular Commentary Features

The combination of the 100% discount EMI options and the employee share trust replicates the long-term incentive arrangement with an absolute guarantee of no tax or NICs arising at the inception of the scheme.
The staggered option arrangement based on overlapping options assists retention by ensuring that if a director or executive leaves the company then that individual would be making a conscious decision to walk away from value.

These case studies represent real-life companies that have benefited from the ability to recruit and retain, motivate and incentivise their employees, especially at a senior level, through the grant of EMI share options.

Provided by David Craddock, Consultant, Lecturer, Writer and Author of Tolley's Guide to Employee Share Schemes.

EMI Case Study 5: Operation of the tax relief following a 'disqualifying event' (s532): bio-tech and other companies with varying employment needs at different stages of product development

A small pharma company developing a new drug or medical treatment or procedure will, typically, require employees with different skill sets at the different stages of product development. Perhaps, for example, one set of employees for the original formulation, another for testing and drug trialling, another for seeking regulatory approval; another for marketing and upscaling production. EMI options are perceived to be a good way to attract and retain employees, but the tax regime means that, in practice, it is only those granted options at the late stage of development and who remain employed when the company is sold and the value, to which earlier cadres of employees have all contributed in their turns, is realised who benefit from the favourable tax treatment. This is because cessation of employment is a 'disqualifying event' and, even if the benefit of the option is retained pending a sale of the company, relief is afforded only for growth in AMV up to the time of cessation. In practice this will typically be de minimis at any time before the company has finally succeeded in commercially exploiting the product and only really increases substantially at a late stage before an 'exit event'. This is considered by many to operate unfairly. It means that the grant of share options to employees engaged in early stages of development does not have nearly the same incentive effect as it does for those at later stages.

Suggestion: that the tax rules be changed so that, if the company allows an ex-employee to retain the benefit of an option granted as an EMI, tax relief should be given on a time-apportionment basis, rather than by reference to the AMV of the option shares at the time of cessation of employment. So, if an optionholder held employment throughout, say, 6 months and the period from grant to exercise was 4 years, relief from income tax and NICS on the gain realised on acquisition of the shares should be available on 1/8th of the gain in AMV over the option period. Under existing rules, if there were no growth in AMV at the time of cessation, such an optionholder would not be entitled to any relief.

Provided by David Pett, tax barrister.

Professional rules mean that he is unable to "name names", but every point made in example 5 above arises from a 'real life' situation which has arisen since 2000.