REWARD; INCENTIVISE; RETAIN - AN INTRODUCTION TO EMI SHARE OPTION ARRANGEMENTS

The JDC Practical Solutions series

JDC Corporate Finance

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About JDC Corporate Finance

JDC is a leading independent corporate finance and advisory firm, with an impressive reputation as experts in our field, providing transaction and related corporate advisory and tax planning services to owner managed businesses.

Our team combines a wealth of corporate finance, corporate advisory and taxation experience, offering our clients a range of services to suit their needs and the needs of their company at all stages of its evolution and development.

We are instructed as advisers for both sell-side and buy-side clients in corporate transactions, including outright and partial disposals to trade and private equity purchasers; acquisition mandates to achieve growth objectives; MBOs/MBIs and minority shareholder exits.

We are also specialist advisers in succession solutions and related planning matters and by offering a tailored approach and working with clients for the long term, we remain the retained advisers of choice to many growing and enterprising businesses.

Our specialist skills, experience and ability to deliver integrated advice in a clear, concise, hands-on and cost-effective manner are the primary differentiators that set us apart from the competition.

About the Practical Solutions series

In this series of guides, Jon Dodge and Tony Longman have reflected on the tax aspects of certain key issues that they have, in their combined professional experience of over 50 years, encountered again and again and know to be of particular concern to owner managers.

This series (by reference to tax legislation current at May 2016) focuses on capital value extraction (with or without a 'third party' sale) from a privately owned business; key planning considerations in securing Entrepreneurs' Relief; issues that might arise on the departure from a business of a retiring or dissenting shareholder; the attraction, retention and reward of key people in a tax effective way and inheritance tax planning in relation to the value of a privately owned company.

We hope that the series will be of value to you and would be delighted to discuss any of the issues raised with you in more detail, on an entirely confidential and no obligation basis.

Jon Tony

ISSUE
OPPORTUNITY
SOLUTION

Most employees value an equity interest in their employing company beyond its monetary value, offering an employer a very cost-effective means of reward … and retention.

How does an employer offer an effective equity interest to retain and attract key staff in the most straightforward, cost-effective and tax efficient way?

There are a number of tax approved share arrangements available but one stands out as offering the greatest value and flexibility for most unquoted companies.

The Enterprise Management Incentive ("EMI") share option offers significant tax advantages to both employee and employer, can be easily tailored to individual requirements and is actively supported through government fiscal policy.

JDC Corporate Finance is a specialist East Anglian based corporate advisory and transaction practice with particular expertise in designing and implementing tax effective strategic plans for businesses and balancing these plans with the personal objectives of the shareholders.

In this guide we have summarised some of the principal features of EMI tax option arrangements and how they benefit, incentivise and retain employees. We would be delighted to discuss these with you in more detail if you believe an EMI scheme might be of benefit to your business.

AN INTRODUCTION TO EMI SHARE OPTION ARRANGEMENTS: THE TECHNICAL ANALYSIS

The Advantages

An employee is granted an option to acquire shares at a fixed price so that he potentially benefits from the future increase in value of the company at a favourable tax rate.

Key characteristics:

- *No tax consequences when the option is granted and potential tax charge @ 10% on the eventual share sale profits after the option is exercised.*
- *Valuable company corporation tax deduction on the exercise of the option.*
- *The option typically lapses if the employee option holder leaves the company, without further cost or complications.*
- *Flexibility: the company can impose restrictions on exercise or impose individual/company performance conditions for vesting of option rights and/or exercise.*
- *Bespoke: the company can grant options with different terms (pricing, exercise conditions, performance conditions etc) for differing employees.*
- *The option can be over an existing class of shares or over a new class.*
- *Relatively low cost to implement and very low ongoing costs for annual reporting.*

The Disadvantages

- *Only available to qualifying companies (must be trading and below a certain size regarding gross assets and number of employees).*
- *The value of shares subject to the option at the time of grant must not exceed £250,000 for any one employee.*
- *The total value of shares subject to all unexercised EMI options is subject to an overall cap of £3m.*
- *The option holder must meet an 'employment' test.*
- *The option holder must not be connected to the company (broadly having a 30% interest, ignoring the EMI option).*
- *The option cannot be granted over shares in a subsidiary.*
- *Tax approved EMI status is lost if the option is not exercised within 10 years.*
- *The grant of options can impact on the presentation of accounts.*
- *It can be difficult to achieve a tax efficient disposal of the shares post exercise unless the company is sold or is subject to a flotation.*

Tax Implications At Grant

No tax charge when the option is granted.

By using a new class of growth shares for EMI it is possible to create an enhanced level of return or to provide a greater incentive to the option holder. Growth shares have enhanced rights that provide for a substantial increase in value if certain company performance hurdles are met.

HMRC offer a pre-transaction valuation service to provide certainty as to the value of the shares at the time the option is granted. This provides certainty as to compliance with the £250,000 limit and the tax consequences on exercise and subsequent sale. In most cases, the valuation will include a substantial minority discount to reflect the size of the holding, making the option more attractive to the employee if this 'depressed' value is used for the exercise price.

The gross asset and number of employees tests are taken as a 'snapshot' at the time of grant so it is often possible to meet the tests with careful timing where a company might not otherwise qualify.

Tax Implications At Exercise

A tax charge arises when the option is exercised on an amount equal to the difference between the market value of the shares at grant and the exercise price. In consequence most options have an exercise price based on market value at grant although the price can be set either higher or lower if desired.

Typically, EMI options are granted with restrictions that delay the exercise of the option until a sale of the company. The employee, on the day of the company sale, effectively acquires his shares and immediately sells them, enjoying the uplift in value with a potential low rate of 10% tax.

The 10% tax rate is achieved if the qualifying conditions for Entrepreneurs' Relief are met. The most onerous conditions are relaxed for EMI shares, in particular it is not necessary to meet a 5% voting requirement and the 12 month ownership condition starts on grant of the option.

Exercise should result in a corporation tax deduction based on the difference between the value of the shares at the time of exercise and the value of the shares at the time of grant, regardless that there is no commercial cost to the company - often an incredibly valuable relief for the business owner.

Interested? Please call or email us to find out more.

OUR SPECIALIST SERVICES

Acquisitions

Whether a first time purchaser, a serial acquirer or an MBO/MBI team, we have the knowledge and experience to assist in all aspects of the acquisition process including:

target searches • target appraisal • valuations • funding • due diligence • negotiation • deal structuring • integration strategy.

Business Growth

Through our business growth services we provide external advice or hands-on interim management support to a wide range of clients. Our services include:

business plans • financial projections • refinancing • tailored MI • non-exec services • cash flow management • development strategy • turnaround.

Disposals

We specialise in advising on full, partial or structured exits, retirement sales, divestments and equity release. Our services include:

pre-sale advice and preparation • information memoranda • contacting targets • negotiating and structuring the deal • advising on post deal issues • accelerated M&A.

Reorganisations

The restructuring of a company or a group of companies involves financial, structural, strategic and tax based considerations. We are specialists in:

financial restructuring and refinancing • de-mergers • divestments • succession planning • capital extraction including company purchase of own shares.

Private Equity

We are very well connected to many private equity and venture capital funds and focus on matching the best placed investor to the right deal. We can help with:

pre-investment preparation • deliverable deal structures and IRR models • investor profiling • business plans and sensitised financial models • leading management presentations • negotiating the deal • project management • advising on post deal issues.

Specialist Tax

Understanding the tax planning opportunities and avoiding tax traps and pitfalls is at the core of all our planning work. We are specialists in:

all aspects of transaction tax • corporate reconstruction • share option arrangements • investment and reinvestment relief • tax effective income extraction • tax effective capital extraction • inheritance tax planning • specialist tax clearances.

CONTACT US

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