The strange death and resurrection of EMI

Employment Tax OMB Personal tax

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William Franklin considers the recent interruption of the EMI scheme and its implications

Key Points

What is the issue?

The sudden and unexpected interruption of EMI on 6 April was a shock to most people.

What does it mean to me?

It happened because the government failed to secure a timely extension of an existing exemption from the EU State Aid rules. Fortunately, the EU has swiftly agreed the extension until the UK leaves the EU and normal service has been restored but there was an uncomfortable limbo period for over a month.

What can I take away?

However, the complexities of EMI are beginning to create issues on exits, and other arrangements such as CSOPs which have often been overlooked should also be considered.

Since it began in 2000 the UK's Enterprise Management Incentive (EMI) share option scheme has been one of the most popular employee share schemes ever introduced. Thousands of smaller companies in the UK have set up EMI schemes and many tens of thousands of key employees have received EMI share options.

EMI was the brainchild of the then new Labour Government which readily accepted the argument that smaller companies, which have the potential for substantial and rapid growth, would be helped to grow by closely aligning the interests of owners and key employees through employee share options linked directly to the growth in value of the company.

It is a truth universally acknowledged, that smaller and early stage companies are often cash constrained and less able to pay salaries than larger organisations, and the generous use of share options allows these companies to compete with larger organisations for key staff. When structured as EMI, these options can also promote tax parity between owners and employees by giving the participants a broadly similar tax treatment to the founders of the companies when the business is sold.

The number of companies that grow sufficiently for their employees to enjoy substantial gains through some form of sale or other realisation event are only a minority of the companies that make EMI awards. But a significant number do, and few who have been much involved with EMI would argue that it has not contributed significantly to the strength of the UK's smaller company sector (particularly in technology), which is now one of the most important elements of the UK economy.

The tax advantages for employees of being awarded EMI share option gains are considerable when compared with the taxation of cash incentives or non-tax favoured share options. The gains on these are taxed as Income and are subject to Income tax and National Insurance (both Employee's and Employer's) at the individual's marginal rate, collected through PAYE. The gain on EMI options is normally only taxed as Capital where the tax rates are much lower than for Income and payable later under self-assessment.

The value of the tax reliefs for EMI have also generally increased over the years. The gains on the sale of EMI shares now usually only pay tax at the Entrepreneurs Relief rate of 10% ,and companies can usually claim corporation tax relief on the exercise of the share options. Successful EMI options have, therefore, given rise to an overall negative tax rate of about 10%. With such powerful tax incentives it is easy to understand why so many people have come to regard the case for EMI as a 'no brainer'.

The attractiveness of a capital gains tax treatment rather than an income tax treatment has also become more pronounced over the last decade or so as a result of a number of 'stealth tax' increases on the incomes of employees, such as higher National Insurance contributions and the clawbacks of personal allowances, family allowances and working tax credits. These can push up the effective marginal rates for cash bonuses or non-tax advantaged Share Schemes to high levels. For increasing numbers of young workers these factors, plus the ramping up of the Disguised Graduate Income Tax ('DGIT') to an additional 9% on income above the DGIT threshold (as a result of the much higher student fee regime that was imposed a few years ago) can lead to quite dizzyingly high marginal rates and proportions of cash bonuses being taken by the taxman. For such younger employees tax efficient equity incentives are going to become even more necessary if longer term financial incentives for such employees are going to be effective at all. (See the article 'Encouraging growth' in *Tax Adviser* November 2017).

The original introduction of EMI options also involved some other important changes designed to encourage their use. Before EMI all the documentation for any tax advantaged share scheme had to be reviewed in detail and pre-approved by HMRC; hence the curious and rather misleading terminology of ‘Approved Schemes’ for tax advantaged government share schemes. The bureaucracy inevitably slowed down the process of implementing share schemes and added to the costs of implementation deterring many smaller companies from introducing share schemes in the first place. EMI swept away all this costly rigmarole and put EMI from the start onto a self-approval and registration system. This model was subsequently applied by the government to all the other tax favoured share schemes by removing the HMRC approval process.

Share valuation was another area where EMI has led to fundamental changes. The government recognised that confidence in the tax treatment of an EMI option would be essential to encourage the uptake of EMI, and that key to providing that certainty was an agreed share valuation at the date of grant. Therefore EMI included a procedure whereby companies could seek a valuation agreement with HMRC before making the EMI awards. But, crucially, the Government also changed the culture of the share valuation agreement process. In the last century, valuation negotiations with HMRC had often resembled a form of professional trench warfare with HMRC and external valuers leisurely debating arcane precedents and legal and technical points to the bewilderment and frustration of the taxpayers who got caught up in this system. Such an approach would obviously not have been conducive to encouraging the use of equity incentives by smaller companies, as the government wanted, and had to be changed, and was.

Surprisingly, given the amount of planning and forethought that went into the original EMI legislation and its practical implementation, one issue the government overlooked was the EU State Aid rules. The meaning and practice of State Aid can be quite wide but rules are intended primarily to deter dumping and governments giving taxpayer support to loss making companies to the disadvantage of other competing companies in the EU. There are many exemptions and the rules have usually been liberally interpreted and lightly enforced by the EU.

The selective nature of EMI by concentrating the relief on smaller companies and excluding some business activities brought it within the State Aid rules but it was not until 2007 that the UK government sought an exemption from the EU which was secured in 2009. This was fortunately granted with retrospective effect by the EU who nonetheless when issuing the exemption recorded their annoyance that the UK had failed to follow the rules and report the State Aid in the first place. But the exemption was time limited and expired on 6 April 2018.

The government had been well aware that the exemption was due to expire and in the Spring 2017 Budget announced it would be seeking an extension of the State Aid exemption, and over the following months, reassuring noises emanated from Whitehall that all would be well. So it was a considerable shock for many (including HMRC) when the government announced in a low key statement only two days before the exemption expired that a continuation of the exemption after 6 April had not been obtained. Furthermore in that statement the government offered no assurance that awards made after 6 April would be valid EMI options and in fact suggested companies might wish to delay granting options until the position was clear. Companies and their advisers were effectively left to work things out for themselves.

The fact that Sweden and Ireland have in the last few years been granted State Aid exemptions for share schemes (albeit less generous than the UK's EMI) targeted at smaller companies offered some significant reassurance that a renewed UK exemption should be obtainable, although this only added to the puzzlement as to why the extension had not already been secured. Fortunately, in early May, the EU swiftly agreed to a continuation of the exemption until the UK leaves the EU but pointed out that the UK had only submitted the formal request for an extension in March 2018.

Despite the casualness over the State Aid issue, EMI has been one of the policy successes of government and it is loss (even if only temporarily) and the legal uncertainty over the status of EMI options that ensued was deeply regrettable. It is hard not to conclude that EMI has been one of the business casualties of the pressures and dislocations that the Brexit process has placed on the machinery of UK government. It remains to be seen whether after we leave the EU, State Aid rules continue to apply.

However, EMI is starting to show its age, and is probably approaching the point where a review of its operation might be needed. The EMI tax reliefs come with a plethora of granular conditions. The rules on independence, the rules that prevent companies with EMI schemes participating in some joint ventures, constraints on making changes to the Articles of EMI companies, working time and employee number requirements, and changes in the mix of the activities of companies with qualifying and non-qualifying trades are just a few of the rules that companies can trip over during the lengthy lifetime of an EMI scheme.

For the majority of EMI schemes these problems are of only academic interest as the companies never achieve a realisation event with gains for the employees. But for the minority that do, where there is an exit the normal due diligence process for transactions is increasingly becoming a challenge. As HMRC, in the new tax digital age, extend the number and scope of their own detailed share scheme reviews such concerns are likely to intensify.

The need for there to be an exit event within 10 years of grant for the EMI tax reliefs to apply may have contributed to some extent to a business culture in the UK whereby successful entrepreneurs prefer to sell and realise value early rather than carry on with the hard slog of building much larger enterprises. However, the widespread cultural preference of owners in the UK for selling rather than holding and growing businesses organically over the long term was well entrenched in the UK before EMI. It is reinforced by so much of the available finance for business being channelled through private equity which invests on five year exit timeframes. But EMI has at least allowed more people to benefit from the UK's early exit culture.

But the clear danger is that, as experience of problems at an exit increases the perception that EMI tax reliefs can be lost will grow and its effectiveness as an incentive diminish.

Radical solutions might then need to be considered. For example, one might remove many of the EMI conditions while mitigating the government's concerns over the loss of tax revenue or the risk of tax abuse by setting an overall lifetime cap for each taxpayer on the quantum of EMI gains that can be taxed at the lower tax rate for capital gains.

There are other alternatives to EMIs that companies might consider. Growth shares and Joint Share Ownership Plans (JSOPs) can also provide for participants a capital gains tax treatment but they are more complex and considerably more costly to implement, and so are not really a practical alternative for most smaller companies.

However, CSOPs as the old Approved options have been renamed, are still on the books and as they are not selective are outside the State Aid rules. They have been rather neglected in recent years with the focus of attention being on the much more generous EMI options and the overall limit on the value of awards that can be granted has not been increased for 20 years. If it had kept pace with inflation or the rise of earnings over the period it would have doubled to about £60,000. The equivalent limit on grant for EMI options is £250,000 and unlike EMI options CSOP option gains do not benefit from the 10% Entrepreneurs Relief rate but have to pay tax at the higher standard rates of Capital Gains Tax.

However, CSOPs are much simpler to implement now that the rigmarole of HMRC pre-Approval has been removed and have far fewer of the granular rules that are now starting to bedevil EMI. CSOPs have the same opportunities as EMI to agree tax valuations in advance with HMRC and if the limit on grants were uplifted to £60,000 and indexed, most start up and early stage companies which would otherwise have used EMI options could still make meaningful awards to most of their key employees with CSOPs.