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Restrictions on shares acquired under EMI options

By Catherine Gannon

Enterprise Management Incentives (EMI) option plans offer significant tax advantages to both employees and employers. EMI is therefore the currency of choice for many employers seeking to incentivise and retain their employees.

Typically, employees are offered options over ordinary shares in the employer company but often there will be restrictions on such EMI options. For example, employers need to consider how to deal with departing employee shareholders or EMI option holders. This is commonly addressed by imposing restrictions on the shares acquired upon exercise of EMI options – often by compulsory transfer provisions. The right to transfer shares acquired can be restricted and leavers can be required to sell their shares back to the company at par value.

Other restrictions such as drag along provisions are also commonly used to ensure that employee (minority) shareholders cannot hinder a company sale. In some cases the shares acquired under EMI option will be restricted as to non-voting or non-dividend bearing.

What can be achieved to protect tax relief?

There are rules and regulations attaching to EMI options that need to be remembered. One harsh aspect of the UK legislation is that if the rules are breached the option will lose its tax beneficial position.

Restrictions must be contained in the EMI option agreement

The EMI legislation requires that any restrictions applying to the shares acquired upon exercise of the EMI option must be contained in the EMI option agreement. In the past it was sufficient to simply state that the shares are subject to any restrictions in the articles of association and many companies have done just that. However, this practice is no longer acceptable since HMRC issued new guidance in August 2016. The new EMI code requirement is that details of the restrictions (as opposed to mere reference to them in the articles) must be contained in the EMI option agreement.

What details of restrictions need to be included in the EMI option agreement?

All restrictions that affect the value of shares acquired upon exercise of EMI option should be included in the EMI agreement. Some restrictions may have very minimal or no impact on the value of the shares but it will be wise for companies to include all possible relevant restrictions to avoid any later issues regarding the value of shares acquired upon exercise of EMI option or worse any doubt over the validity of the EMI option.

To comply with HMRC's guidance the EMI agreement must describe the restrictions. The actual wording or effect of each relevant restriction should therefore be set out in full (usually in a schedule) in the EMI agreement.

Alternatively the EMI agreement can refer to a particular article containing the restriction in the company's articles or the clause in the shareholders agreement. It is important to note however, where the restrictions are incorporated by reference to another document the EMI agreement should include details of the title and date of such document and list the particular clauses covering the restrictions. The referenced document must also be attached to the EMI agreement.

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Validity of the EMI options where restrictions are not described in the agreement

EMI options granted before the most recent guidance was issued in July 2016 are not impacted. HMRC will only look at the guidance in place at the time of grant. However failure to provide proper summaries of the restrictions in options granted after July 2016 could lead to a disqualification and denial of EMI advantageous tax treatment.

How punishing is HMRC?

Disqualification from tax relief is an extremely punishing result. But in some cases that is what will happen. The EMI code requirement aims to protect the EMI option holder. The intention is that the EMI option holder should be fully aware of the nature of the shares being acquired upon exercise of the EMI option. In some cases failure to describe the restrictions seems to make no difference if, for example, the EMI option is an exit only option and so almost by definition the restriction will not be relevant to the EMI option holder. Disqualifying the EMI options will be tax perverse.

We believe that HMRC will not disqualify an EMI option for failure to draw attention to a trivial restriction. At a meeting with the Share Scheme Expert Group of the Quoted Companies Alliance on 17 February 2018, HMRC confirmed that they were not aware of any options being disqualified because the company failed to draw restrictions to the attention of the option holder.

The common interpretation of HMRC's guidance is that it is not fatal to the tax advantages if the restrictions are not fully described in the option grant documentation, as long as there is evidence that the restrictions have been otherwise brought to an EMI option holder's attention at or near the date of option grant. If EMI option holders can confirm that they were fully aware of the restrictions that should be enough to satisfy HMRC.

Best approach

Still, it is important that companies get it right. Ensuring that all possible relevant restrictions are flagged and correctly described will help to avoid later questions over the validity of the EMI options. For example, on a due diligence exercise in advance of a corporate transaction. Investors may argue that the description may have been insufficient or incorrect and ask for specific indemnities or retentions.

If in doubt as to whether the EMI option agreement complies with HMRC's requirement to provide details of restrictions, companies should seek the EMI option holder's confirmation in a separate document that they were aware of the restrictions set out in the articles of association or shareholders agreement (and the separate document should list what these restrictions are) at the time of entry into the EMI option agreement. It doesn't take long to draft but could save a lot of grief.

Catherine Gannon *is unusual in being both a solicitor and a chartered tax adviser with substantial tax and financial experience gained in the accountancy profession prior to becoming a lawyer. As a lawyer, Catherine worked at leading international law firms before setting up Gannons – a niche commercial law firm – nearly 20 years ago.*

The firm specialises predominantly in the law relating to employment, company and tax focused on the SME market. Catherine has advised on many company acquisitions, investments and sales. "Get to the point and make it quick" is her motto.