Establishing an EMI Plan

Level of Benefits

1. An EMI plan offers the potential for considerable tax benefits – if all requirements are met, the effective tax rate for employees on the total gain made can be as low as 10%. For further details, see here.

2. To illustrate the effect – and ignoring any potential corporation tax relief – the following example illustrates the effect with a gain of £100,000 where the cost of the employer NIC charge is transferred to the employee

EMI	£	£	Non EMI	£	£
Gain before tax		100,000	Gain before tax		100,000
Less:			Less:		
Income Tax	0		Income Tax	45,000	
Employee NICs	0		Employee NICs	2,000	
Employer NICs	0		Employer NICs (after income tax relief)	7,590	
CGT on sale	10,000		CGT on sale	0	
Total Tax		10,000	Total Tax		54,590
After tax receipt		90,000	After tax receipt		45,410

Note: Calculations are based on the optionholder being an Advanced Rate taxpayer (i.e. 45% income tax charge)

3. This illustrates a tax saving of 44.59% for the individual option holder – an almost £45,000 difference on gains of £100,000.

EMI Risks

4. EMI was intended, and is often marketed, as an easy, straightforward way for SMEs to reward their employees. It can be implemented at low cost with standard documents and with little reference to the individual requirements of each company and its employees.

5. This is a very attractive approach for small companies – why spend extra money on advisers' fees if you can get the same benefit much more cheaply?

6. The problem is: it's not as easy as it seems, and if there are problems, you may not find out until a due diligence exercise taking place years down the line. Despite the intention to keep it straightforward, numerous complex requirements have to be satisfied in order for the reliefs to be obtained. It has been suggested that EMI plans reviewed in the course of transactions (or on a compliance check by HMRC) are found to be deficient in a high proportion (75% +) of cases.

7. So instead of tax benefits, there can instead be substantial risks and costs if plans are created to fall within EMI which fail at the point of realisation.

8. If the employer has contractually agreed to deliver EMI options – with the benefit of tax relief – a failure of the options to qualify may result in the employer covering the cost. As that would result in a further taxable benefit, the resulting costs would need to be "grossed up". Taking the example above, with the cost of the

lost relief being £44,590 for a 45% (+2% NICs) tax payer, this could result in an additional cost to the employer of £95,742.

9. This is calculated as:

Bonus to Compensate	=	£44,590
Grossed up at 47%	=	£84,132
Add: Employer NICSs	=	£11,610
Total Cost		£95,742

Grossed Up amount calculated as:
Amount to be grossed up: £44,590

Grossing Up	=	£44,590 ÷ (1 – 0.47)
	=	£84,132

10. So the cost of correcting a failure to establish qualifying EMI options can be very expensive indeed.

Pett Franklin Approach

11. The combination of the complexity of the legislation and the consequences of a failure to comply mean that adopting a "cheap and cheerful" approach to implementation is fraught with risk.

12. We look to charge a sensible fee for EMI as we understand many smaller companies are cash flow constrained, but we understand there are low-cost providers out there and unfortunately, we can't meet their prices while still delivering an acceptable standard of service. If your provider claims to be able to deliver EMI on the cheap, before taking the risk, it's worth asking them:

    a. Does my company qualify for EMI and will you check the trading, independence and controlled subsidiaries requirements?
    b. Which of our employees will qualify for EMI?
    c. Do your costs include agreeing a share valuation with HMRC?
    d. Will you help me notify the grant of options to HMRC to make sure they aren't disqualified?
    e. Can we talk about different circumstances in which our employees should be able to exercise their options?

13. If your provider can't answer these questions, think carefully about whether any saving on fees is worth the risk – for some companies, we understand it might be, but we hope this helps you make a more informed decision.

14. Our own belief is that establishing any form of share plan, but particularly EMI, requires care and rigour. That implies:

- Careful planning at the design stage to make sure you have the right plan for your company.
- A detailed understanding of the requirements for obtaining relief.
- Proper documentation designed to reflect both the legislative requirements and the specific commercial objectives of the plan, prepared efficiently by experienced advisers.
- Valuation advice leading to an agreement with HMRC on the value of the shares subject to the EMI options.
- Consideration of the possible events affecting the Company, particularly on exit, and how they may impact on the continued operation of the plan and options granted under it.