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Chartered Accountants

A guide to long term incentive plans

March 2018

The purpose of the long-term incentive is to retain and motivate top talent to drive the business forward.

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EMI SHARE OPTIONS

EMI share option schemes are designed both to recruit and retain employees and to motivate them to achieve a successful exit.

Over recent years we have seen an increasing number of SMEs looking to retain key staff and increase the level of engagement with the company's overall strategy, through the use of long term incentive plans (LTIPs). One of the most popular LTIPs is the Enterprise Management Incentive (EMI) scheme.

This guide outlines the key parts of an EMI scheme and explains some of the tax benefits. We have also included a fictional case study to illustrate how a plan might play out.

AN OVERVIEW

EMI share option schemes are designed both to recruit and retain employees and to motivate them to achieve a successful exit. The scheme allows the company to grant tax-effective incentives to employees known as Enterprise Management Incentive (EMI) options.

The statements in this guide are based on the law at the date this is published. Tax and company law change frequently and you should not rely on this guide. Professional advice should be taken ahead of any scheme implementation to ensure that both the company's and employees' circumstances make the scheme suitable.

You need to ensure that amongst other things the company qualifies for the scheme with reference to its independence, its size and its activities, and that employees qualify with reference to their tax residence and the amount of their working time that is committed to the company.

WHAT IS A SHARE OPTION?

An option is a right to acquire shares in a company at a future date for a specified price.

An employee does not have to pay anything when an option is granted. However, they do not actually become a shareholder until they exercise the option and pay the Exercise Price. Once they have exercised the option, they will become a shareholder and be entitled to all the rights of a shareholder, such as the right to vote at shareholder meetings and to receive dividends on shares. In some cases it may be desirable for the options to be held over a different class of share to those already in issue.

Employees will not normally be able to exercise their option until an exit occurs (see below) and/or they have reached a milestone in respect of, for example, length of service or attainment of stipulated performance criteria.

WHAT HAPPENS WHEN AN OPTION IS GRANTED?

Employees will be sent two copies of an Option Agreement. The Option Agreement will set out the principal terms of the option.

Those agreements are signed and witnessed with copies retained by both the employee and the company.

The grant of options must be notified to HMRC with 92 days of the agreements being signed.

It is advisable, prior to the Exercise Price being specified in the Option Agreement, for HMRC to be approached with a view to obtaining their agreement to a proposed market value for the shares to be put under option. This provides a degree of certainty over the tax position on an eventual exercise and sale.

Once HMRC are notified of the grant of EMI options by a company, it creates an expectation that an annual return will be completed and submitted in respect of each tax year by 6 July following the end of the relevant tax year. That annual return will report any lapsed options (see below) and any options that have been exercised by employees.

HOW DO EXIT EVENTS WORK?

The type of exit most often seen is a Share Sale. This is where a new owner takes over the company by buying a controlling interest in its shares. If this happens employees may be allowed to exercise their options. The Board of Directors of the company would be responsible for making sure employees get sufficient notice and sufficient time to exercise their options ahead of a sale completing.

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The new owner is likely to want to acquire the shares from the employees, and if that's the case, the Option Agreement should compel employees to sell even if they don't want to (a 'drag along' clause). However, the new owner (if it's another company) may also offer employees the opportunity to exchange their existing option for a new option over its shares.

The other types of exit that might be considered are an asset sale whether the company sells all of its trade and assets to another party, leaving a shell company with, perhaps, a large sum of cash; and a listing where the company's shares are placed on a stock market. This guide only covers a share sale style of exit.

Where there is a time-based exercise event written into the Option Agreement, let's say five years on from the date of the Option Agreement, the mechanics work the same way as for an exit.

HOW OPTIONS ARE EXERCISED

Employees must complete and sign an exercise notice (in a set format which the company should supply) and return it to the company, stating how many shares they wish to acquire. Often the company will only allow the employees to submit one exercise notice so the number of shares on the notice will generally be whatever the full entitlement of the employee is.

The employee's entitlement may be calculated with reference to specified performance criteria. There are no rules as to how to apply such criteria but you would need them to be attainable and transparent for them to properly motivate staff.

The employee must also pay the Exercise Price. This is the price for each share as set out in the Option Agreement, multiplied by the number of shares they wish to acquire.

Where there is an exit and a third party is going to immediately buy the shares from the employees, payment is normally made by way of a deduction from their eventual sale proceeds, and the solicitor acting for the selling shareholders will usually facilitate that.

If any Income Tax or National Insurance Contributions (NICs) are due in relation to the exercise (see tax considerations below), where there is an exit the company may require a deduction to be made from the employee's sale proceeds. Alternatively, the employee may have responsibility for settling the tax themselves.

The company may require employees to sign additional documents, such as tax elections, or a shareholders' agreement, or any documents that may form part of the exit process.

WHAT HAPPENS IF AN EMPLOYEE LEAVES?

If an employee either gives or receives notice of termination of employment, their right to exercise their option should be suspended. If their employment is terminated at the end of their notice period, or if they cease to be an employee in any other circumstances, their option will lapse. However, this position may be overridden where an employee is held to have been unfairly dismissed.

If an employee leaves after they have become a shareholder it is likely that the company will wish for the employee to sell their shares either to other existing shareholders or to company itself. The company can make this so by including automatic transfer provisions in the company's articles or in a Shareholders' Agreement – 'good' and 'bad' leaver situations can also be contemplated.

HOW DO OPTIONS LAPSE?

There are various circumstances which can give rise to an employee's option lapsing. These include:

- an attempt to transfer, assign, or create a charge or mortgage over the option;
- the passing of the tenth anniversary of the grant date (this as per the legislation on EMI schemes);
- the death of the employee, albeit there

is some relaxation in the legislation for the employee's personal representatives to exercise an option on the employee's behalf, assuming the agreement allows it;

- if the employee leaves the company as explained above; or
- if the employee becomes bankrupt or makes a voluntary arrangement with creditors.

WHAT ARE DISQUALIFYING EVENTS?

If a Disqualifying Event happens, this may have an adverse effect on the tax treatment of EMI options.

There are several kinds of Disqualifying Event, most of which relate to the company (eg. a loss of independence, or a change of activity), and are therefore outside of the employee's control. For this reason the Option Agreement may allow for an exercise of the option upon a disqualifying event occurring.

Disqualifying Events also include ceasing to be an employee of the company or a failure to attain the working time commitment required by the legislation.

TAX CONSIDERATIONS

Upon the grant of the option: No tax or NIC is payable when options are granted to the employees. The employees do not have to report the grant of the option to HMRC themselves, but it will be reported to HMRC by the company.

Upon the exercise of EMI option: Where an Exercise Price for the shares is at least as much as the market value at the time of the option being granted, the employees do not have to pay any tax or NIC when they exercise their options. If the Exercise Price for the shares is below that market value then tax and (where shares are treated as being readily convertible to cash – ie. just before a sale of the whole company) NIC will be payable.

If any Income Tax arises employees exercise their options, how tax is assessed and collected depends on whether the shares are deemed readily convertible assets (RCAs) at the time of exercise.

This will be the case if a sale of the company to a third party is imminent.

If the shares are RCAs, any Income Tax will be collected through the PAYE system and employees' National Insurance will be payable. If the shares are not RCAs, the Income Tax is paid by way of a Self Assessment tax return, and no National Insurance is payable. Employees may require some guidance from the company in these areas.

If the shares are RCAs when the options are exercised, the company will be required to pay Employer's NICs. The current rate of Employer's NICs is 13.8%. Some option agreements require the employees to compensate the company for employer's NICs in relation to the employee's particular option exercise.

When an employee sells the shares acquired through an EMI option, they may be liable to Capital Gains Tax (CGT). The amount charged to CGT is calculated as follows:

- take the sale proceeds and deduct any costs of sale, such as transaction costs;
- deduct the exercise price paid; plus any amount of which the employee was liable to income tax on exercise of the option; then
- deduct whatever amount of the CGT annual exemption is available (the annual exemption is £11,300 for the 2017/18 tax year).

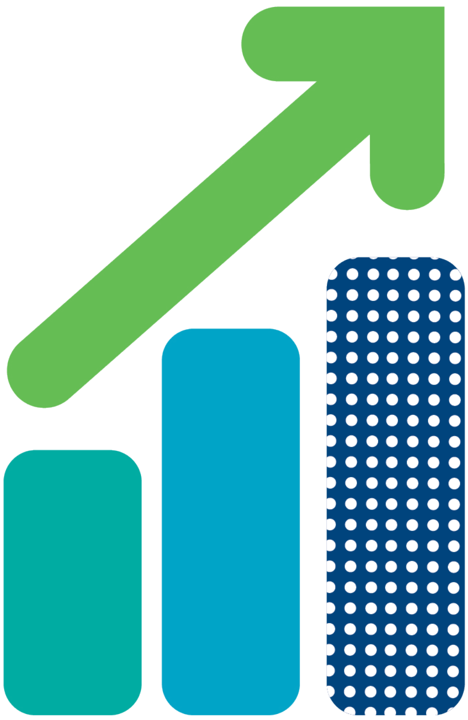
If there are at least 12 months between the date of the option being granted and the share sale, it's possible that the employee will be entitled to claim 'Entrepreneurs' Relief' (ER). ER provides that up to £10 million of an individual's lifetime gains will be taxed at 10%.

ER will not normally apply if an EMI option is exercised following a Disqualifying Event and ER can be lost or restricted if shares are subsequently transferred by the employee.

Any gain that is not covered by ER will be taxed at the normal CGT rate, which currently is either 10% or 20% depending on the amount of other income of the employee for the tax year.

If CGT is payable on the sale of shares, the employee will need to pay this via the self-assessment system. Again, employees may require guidance from the company in this area.

No tax or NIC is payable when options are granted to the employees. The employees do not have to report the grant of the option to HMRC themselves, but it will be reported to HMRC by the Company.



THE EMI SCHEME - A CASE STUDY

In this fictional case study, we illustrate how an EMI scheme may play out.

Bootroom Boys Ltd is a long-established sportswear business. It is wholly owned by a William Shankly, who has led the business to great success but feels it is now time to hand over the baton as the company looks to reach the next level over the next five years or so. There is a strong management team behind Shankly, notably Mr Robert Paisley who is the de-facto Managing Director, and Ms Roni Moran who is the Finance Director. Shankly feels that it is essential for both Paisley and Moran to be retained in the business in order for the five year plan to be delivered, and for Bootroom to be an attractive and saleable asset at the end. Shankly has consulted with his (superb) accountants who have recommended implementing an EMI Scheme.

- In his mind's eye, Shankly feels that the business will be worth circa £10m if they hit the growth and profitability outlined in the five year plan (he recently had an unsolicited offer for the business of £3m which was rejected out of hand) but he's conscious that this may only be the case if Paisley and Moran will remain part of the business post sale, he is therefore aware of the balance to be struck between offering the two of them enough of a potential stake to be exciting, but not so exciting that it is enough money for them to walk away from the business themselves, something around the 5% each mark is what he has in mind.
- Shankly knows the individuals well, and knows that they can be trusted to deliver results so doesn't see a need to apply any performance criteria to the scheme.
- If it transpires that the business isn't sold to an external party after the five year plan period, Shankly has indicated that he would hang on to the business for an indefinite period, and would prefer not to have a shareholder relationship with Paisley and Moran. The ability to exercise options will therefore be limited to an exit event.
- Shankly feels that it's reasonable for there to be a price to be paid for the shares upon exercise, and that a neat solution would be to equate the price to be paid with whatever the market value per share is when agreed with HMRC. This will mean there's no Income Tax or National Insurance to be paid when the options are eventually exercised. This market value will incorporate a substantial minority discount when agreed with HMRC, though the plan is that such a discount will be of no relevance on an exit.

Fast forward five years, and sure enough, a US company, Carpetbaggers Inc, have made a £10m offer to buy Bootroom's entire share capital which, despite having some misgivings about the buyer, Shankly has decided to accept. So, what happens now?

What does it mean for the option holders, Paisley and Moran? The numbers are explained on the next page.

BOOTROOM BOYS LIMITED

Valuation for the purposes of granting EMI options

Earnings based approach - Beginning

Year ended		Revenue	EBITDA
31/7/2018	Forecast	8,500,000	900,000
31/7/2017	Actual	7,200,000	720,000
31/7/2016	Actual	6,500,000	600,000

Earnings multiple range	Low	4
(see Note 1)	High	5
Enterprise value range	Low	2,960,000
	High	3,700,000
Equity value range	Low	3,630,000
(see Note 2)	High	4,370,000
Average of equity value range		4,000,000

Value split			
W Shankly	1,000	89.93%	3,597,122
R Paisley	56	5.04%	201,439
R Moran	56	5.04%	201,439
	1,112	100.00%	4,000,000

Minority discount	(see Note 3)	70%
Market value of all shares under option		£120,863
Market value per share		£1,079

Valuation for the purposes of granting EMI options

Earnings based approach - End

Year ended		Revenue	EBITDA
31/07/2023	Forecast	15,400,000	1,800,000
31/07/2022	Actual	14,200,000	1,650,000
31/07/2021	Actual	12,300,000	1,450,000

Earnings multiple range	Low	5
(see Note 1)	High	6
Enterprise value range	Low	8,166,667
	High	9,800,000
Equity value range	Low	9,183,334
(see Note 2)	High	10,816,667
Average of equity value range		10,000,000

Value split			
W Shankly	1,000	89.93%	8,992,806
R Paisley	56	5.04%	503,597
R Moran	56	5.04%	503,597
	1,112	100.00%	10,000,000

Minority discount	(see Note 3)	n/a
Market value of all shares under option		£1,007,194
Market value per share		£8,993

Potential outcome for single employees from the scheme

Capital Gains Tax (CGT) payable	
Sale proceeds	£503,597
Less: Base cost (see Note 4)	-£60,432
	£443,165
Less: Annual exemption	-£11,300
	£431,865
Tax payable (with Entrepreneur's Relief)	£43,187

Income Tax payable	
Market value at date of grant	£60,432
Less: Exercise price (see Note 4)	-£60,432
Amount subject to Income Tax	£ -
Tax payable	£ -

Overall picture	
Sale proceeds	£503,597
Price paid for shares	-£60,432
Income Tax payable	£ -
CGT payable	-£43,187
Net proceeds	£399,979

Note 1 - Earnings multiple range

As a company establishes a record of consistent growth and profitability, it becomes more valuable. This is reflected in an increase in the multiple applied (in this case) to a three year average of EBITDA. This is for illustrative purposes only.

Note 2 - Enterprise v Equity value

Most profitable companies will have cash (or let's say an amount of net current assets) on its balance sheet that is surplus to its short term working capital requirements. Any purchaser would be required to pay for such excess, and in this case we have assumed the amounts to be £670,000 in the beginning, and £1,016,667 at the end so that we end up with nice round numbers!

Note 3 - Minority discount

It is accepted that small stakes in private limited companies do not, in isolation, carry full pro rated value due to the lack of ability to control the company's affairs and the general lack of marketability. Holdings of 5% should justify a discount, from the pro rated value, of at least 70%. This discount would not be of relevance on an Exit as Shankly, Paisley and Moran will be selling to Carpetbaggers Inc on exactly the same terms.

Note 4 - Exercise price

Most times it is decided to set the exercise price (ie. what employees need to pay for the shares) at the market value agreed with HMRC. This would mean that they would not need to pay any income tax or NIC when they came to exercise the options. This figure then becomes the employee's base cost for the purposes of CGT.

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GROWTH SHARES

If you wish to reward employees immediately through equity, then growth shares may be your preferred solution. Here employees are awarded actual shares as opposed to options over shares.

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These are likely to be ordinary shares in the capital of a company, but they could be ordinary shares with different characteristics to what we might call 'full' shares – specifically they may only enjoy rights to capital where the company is sold above a certain threshold, or they may not have voting rights. Having multiple types of ordinary shares also means that the directors can declare dividends at different levels for the full shareholders and the growth shareholders.

HOW DO THEY WORK?

Take a company which is worth £5m. A new type of growth share might be issued to employees which gives the employees 5% of the overall shares in issue. However, it could be made so that they only have a right to participate in equity value above £5m. The initial value of the growth shares will therefore be very low on award because at the time of issue the equity value all belongs to the 'full' shares. Consequently, the employees do not need to pay very much for the shares and even if they paid below whatever market value was determined at the time of issue, there won't be much Income Tax to pay.

As far as selling this plan to the employees is concerned, they need to think about what happens if the company were subsequently sold for £10m, the growth shares would have a right to 5% of the value in excess of £5m – ie. £250,000. This gain would be subject to the more favourable capital gains tax rules including entrepreneurs relief at 10%.

There may be a need to consider how shares are dealt with if and when an employee leaves ('good' and 'bad' leaver provisions), and perhaps drag and tag clauses on an exit.

All of this can be dealt with in the Articles of Association so no need for a Shareholders Agreement, there is no real interaction with HMRC during this process. Unlike with a share option plan there are no accounting entries to be considered beyond the original issue of the shares.

PHANTOM SHARES

If you do not want to part with equity in your business then there are other options available, one of which is phantom shares. Unfortunately, there are no tax advantages here whatsoever - we are effectively talking about a deferred bonus arrangement.

Unlike normal annual bonuses, the idea is that the employee has to stick around for a set period or until, perhaps, an exit event in order to get their hands on the bonus.

The quid pro quo of no tax advantages is complete flexibility in the way the scheme is designed, and the absence of any sort of reporting requirements to HMRC.

A phantom plan would typically contain the following features:

- payment to an employee being contingent on them remaining in employment and attaining specified individual and/or company performance targets.
- a lump sum cash payment at the end is determined by a notional share price growth from the date of award to the date of exercise.
- a clear and consistent approach to valuing the company so that notional share price growth can be tracked.
- provisions for early payment in the event of a sale or flotation.
- frequent communication with plan participants so that they are aware of the value being created.

The employees will see Income Tax (probably at the higher rates) and national insurance deducted when the pay-out occurs. The employer will also pay National Insurance, the current rate is 13.8%.

Corporation Tax relief will not be available until the pay-out occurs – for arrangements that constitute cash settled share based payments, this is going to correspond with the accounting entries with a lump sum expense booked at the pay-out date.

One extra point to consider is that a potential purchaser is going to have to consider the impact of the bonus pay-out on the company's cash position. Too big an amount could be seen as being a poison pill and turn out to be a deal breaker. It is probably sensible therefore for the company to think about a cap on the overall amount to be paid out from the scheme.

THE NEXT STEP

If you have any questions about long term incentive plans or would like to know how they could work for your business, please contact:

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James Price is a partner at UHY who heads up corporate finance, both in respect of delivering transactions, advisory and valuation services to clients, and in raising the firm's profile amongst the wider business community.

James is passionate about enabling business owners to achieve their long term objectives and is seen as a valued partner in the business journey.

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