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A Practical Guide to EMI Options

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Implementing an Enterprise Management Incentive (EMI) options scheme is a strategic move that demands careful planning. This guide delves into the nuanced landscape of EMI options, offering comprehensive insights into their benefits, detailed implementation steps, restrictions, operational mechanics, and distinctions between EMI options and actual shares.

EMI options – Facts and figures

To enrich your understanding, let's first explore key facts and figures about EMI options:

PREVALENCE AND ADOPTION	**Growing popularity**	EMI options have witnessed a steady increase in popularity among UK businesses. As of the latest available data, over 15,000 companies have implemented EMI schemes, showcasing the widespread adoption of this incentivisation tool.
	Diverse sectors	EMI options are not confined to specific industries. They have been successfully adopted across diverse sectors, including technology, finance, manufacturing, and service-oriented businesses.
TAX ADVANTAGES	**Business Asset Disposal Relief (formerly known as Entrepreneurs' Relief)**	One of the key attractions of EMI options for employees is the potential eligibility for Business Asset Disposal Relief (formerly known as Entrepreneurs' Relief) on capital gains. This relief can significantly reduce the tax burden on gains arising from the sale of EMI-acquired shares.
	Corporation tax deductions	Employers also benefit from EMI schemes through potential Corporation Tax deductions. This tax-efficient structure can enhance the overall financial appeal of EMI options.
EMPLOYEE OWNERSHIP AND ENGAGEMENT	**Alignment of interests**	EMI options are lauded for aligning the interests of employees with the long-term success of the company. By offering a stake in the business, employees are more likely to feel a sense of ownership and commitment to achieving organisational goals.
	Motivational impact	Studies indicate that companies with employee share ownership structures, including EMI options, often experience higher levels of employee motivation, leading to increased productivity and innovation.
OPERATIONAL DYNAMICS	**Vesting periods**	Vesting periods for EMI options typically range from one to three years. This time frame allows companies to set performance targets and incentivise employees to contribute to the company's growth over the medium term.
	Exercise windows	The exercise window, during which employees can convert their options into shares, is a critical aspect of EMI schemes. This window may be influenced by specific events, such as a sale or listing of the company. It is important to ensure that exercise windows are carefully thought through to ensure that the administrative burden of issuing shares upon exercise of the EMI options is limited.
OWNERSHIP LIMITS	**Individual limits**	As of the latest update in 2022, individuals participating in EMI options are subject to an ownership limit of £250,000. This limit ensures that the scheme remains inclusive and accessible to a broad spectrum of employees.

Understanding EMI options

What are EMI options?

EMI options represent a unique form of share options granted to employees, entitling them to acquire shares in their employer's company at a predetermined price. This mechanism is designed to mutually benefit both employers and employees by fostering a shared sense of ownership and commitment.

Benefits for employers

Talent attraction and retention
EMI options serve as a potent instrument for talent acquisition and retention. By offering employees a stake in the company's success, businesses cultivate a deep sense of ownership, aligning the interests of the workforce with the overarching goals of the organisation.

Tax advantages
A significant allure of EMI options lies in the favourable tax treatment they receive. This not only benefits employees but also presents employers with an opportunity to optimise their tax liabilities, making EMI options a financially savvy incentive.

Motivation and performance
EMI options can serve as powerful motivators, aligning employee performance with the company's overall success. The prospect of financial gain through share ownership incentivises employees to contribute to the company's growth and profitability.

Key features of EMI options

Exercise price
The exercise price of EMI options is predetermined and usually set at the current market value of the shares at the grant date. This price forms the basis for calculating the gain when options are exercised. Commonly because the share subject to the EMI options will be a minority interest and have various restrictions applied to them, the exercise price will be at a substantial discount to fair value.

Whilst the exercise price is set when the EMI options are granted and does not change, payment of the exercise price only occurs when the EMI option is exercised. If exercise of the EMI option is as part of an exit, then any consideration payable to the employee as part of the sale of their shares, due to them being under the EMI option, may be used to pay the exercise price, meaning that the employee does not need to raise the funds themselves.

Vesting period
EMI options often come with a vesting period, during which employees must meet specified conditions, such as tenure or performance targets, before the options become exercisable.

Sometimes vesting periods mean that the EMI options are protected following an employee ceasing to be employed, meaning that they can still exercise that proportion of the EMI option subject to restrictions within the EMI option legislation.

Exercise window
Employees can exercise their EMI options during a specified exercise window. The exercise window may be influenced by events such as a sale or listing of the company.

Sometimes the structure of the EMI options will be such that the vesting period and the exercise window work together, or are practically the same thing.

Steps for implementing an EMI options scheme

Seek professional advice

It is important to engage legal and financial professionals with specialised expertise in EMI schemes at an early stage. Their guidance is critical for ensuring compliance with HMRC requirements, addressing legal considerations, and optimising the overall structure of the scheme.

Ultimately the EMI scheme needs to be structured in a way that maximises employee motivation, and appropriate advisers can assist with this process.

Establish eligibility

There are certain limits on which businesses can create an EMI scheme, and who can receive them. Appointed advisers will be able to quickly review the requirements to assess whether granting EMI options is possible, and this will avoid wasting time.

Some key criteria is as follows:

Company size
Only companies with gross assets which do not exceed £30 million and that have a staff count below 250 full-time employees on the date of grant of the EMI options, will qualify.

Trading activities
Companies will need to ensure that they engage in qualifying trading activities before they are permitted to issue EMI options. Certain sectors, like investment and property development, face restrictions.

Obtain Board approval

Present proposal to Board for approval
Before spending time and cost associated with implementing the EMI options, it is important to ensure that the proposal is presented to the Board for approval by preparing a comprehensive outline proposal for consideration.

Valuation of company shares

It is good practice to ensure that the shares subject to the EMI options are valued as of the date of grant of the EMI Options, and that this valuation is approved by HMRC. Your professional advisers will be able to assist with preparing the valuation of the shares, subject to the EMI options.

This valuation is crucial for establishing the exercise price for the EMI options. Often because the share subject to the EMI options will be a minority interest and have various other restrictions attached to them, their value will be subject to a substantial discount, meaning that the holders of EMI options will be able to purchase shares at a healthy price.

Draft EMI option agreements

Legal Documentation
Collaborate with legal professionals to draft comprehensive EMI option agreements. These documents should clearly outline the terms and conditions of the scheme, including vesting schedules, exercise periods, and any performance-related criteria.

Dependant on the terms of the EMI options and when they can be exercised, it may be advisable to amend the articles of association of the company to ensure that the EMI options meet the necessary requirements. For example, if the EMI options are over non-voting shares then it may be that a new class of share will need to be created within the articles of association.

Employee Communication
Develop detailed communication materials to educate employees about the EMI scheme. Provide clear information on its benefits, potential risks, and the responsibilities associated with participation. To ensure that the EMI options have the maximum motivational effect, they need to be understood by participants.

Implement robust administration
Establish a robust administrative system to manage the EMI options scheme. This includes tracking option grants, exercises, and maintaining compliance with reporting requirements.

Types of EMI option structures

Vesting and exercise structures

Performance based vesting
In some scenarios, companies may opt for immediate vesting, allowing employees to exercise their EMI options without having to meet specific milestones or performance targets. This structure is often employed to provide immediate benefits and incentives.

Time based vesting
Graded vesting involves the gradual accrual of EMI options over time, typically tied to an employee's tenure and/or performance with the company. This structure ensures that long-term contributors receive increasing benefits, enhancing retention efforts.

Exercise timing structures

Pre-sale exercise
Some EMI structures permit employees to exercise their options before a sale or exit event, subject to vesting criteria having been satisfied. This provides employees with an opportunity to hold actual shares, and possibly to be paid a dividend, if a dividend is paid. It does not necessarily mean that they can sell the shares, or that they are protected if they cease to be an employee.

Exit-contingent exercise
Alternatively, companies may adopt exit-contingent exercise structures, where employees can only exercise their options upon the occurrence of a specific exit event, such as a sale or merger. This may be the case even where vesting criteria has been satisfied.

This structure aligns the financial benefits with the company's overall success, and is particularly popular where the other shareholders have the ultimate aim of selling the business in the medium term.

Exit only EMI options are generally seen as simpler to implement because the holder of EMI options will not become a shareholder until an exit, and at that time they will be required to immediately sell the shares to the purchaser. This means that they do not generally take part in shareholder matters.

Operating EMI options

Vesting and exercise

Vesting conditions
Vesting conditions are pivotal in the EMI landscape, representing milestones or performance targets that employees must achieve for their options to become exercisable. These conditions must be clearly defined in the option agreement to avoid ambiguity.

Exercise process
When an employee decides to exercise their EMI options, the company is tasked with issuing new shares or transferring existing ones. Strict adherence to legal and regulatory requirements during this process is imperative to avoid complications.

Clearly, allowing employees to exercise their EMI Options prior to an exit is more complex than only on an exit because it will mean that the Company will need to ensure that there are appropriate articles of association and shareholder agreements in place, to govern how the shares are held.

Upon exercise of the EMI option, the employee will be required to pay the exercise price set when the EMI options were granted. If exercise of the EMI option is on an exit, then the employee will usually be permitted to allow set off of the exercise price against the consideration due to them, for selling the shares.

Tax considerations:

Gains arising from the sale of shares acquired through EMI options will usually attract Capital Gains Tax. Business Asset Disposal Relief may apply, providing participants with potentially favourable tax rates.

Leaving the company – Good and Bad Leaver provisions

When an employee that holds EMI options leaves employment, the EMI option documentation will need to specify what happens to their rights, and whether they are entitled to retain their rights to shares in the company.

Generally whether a holder of EMI options is entitled to retain their rights to shares in the company, and in doing so, exercise their EMI option on their ceasing to be employed, will usually depend on the circumstances of their departure. This is commonly referred to as Good and Bad Leaver.

It may be appropriate for employees to lose all of their rights to EMI options if they leave, but whilst this is simple, it can be seen as unreasonable, especially where the employee has met the vesting criteria.

	Definition	**Exercise period**	**Shares following exercise**
GOOD LEAVER	A Good Leaver is typically an employee who leaves the company under favourable circumstances, such as retirement, disability, or death. In such cases, EMI option agreements may provide for more favourable treatment, allowing the individual to exercise their options under specified conditions. Usually a Good Leaver would be entitled to exercise their vested proportion of the EMI option only, and the unvested proportion would lapse.	Employees who leave for any reason other than death are required to exercise their EMI options within 90 days of their date of leaving in order to ensure that the favourable tax treatment on all gains is maintained. In the event of a death of an employee, their estate will usually have up to 12 months to exercise the EMI Options.	Following exercise of the EMI option following the employees ceasing to be employed, they can either be repurchased by the other shareholders or the company, or be permitted to retain them. If they are retained, usually they will be required to enter into a deed of adherence to the existing shareholders agreement, or to enter into a new one.
	Definition	**Forfeiture**	**Shares**
BAD LEAVER	A Bad Leaver is an employee who departs under less favourable circumstances, such as resignation or termination for cause. EMI option agreements may contain provisions restricting or limiting the ability of Bad Leavers to exercise their options.	In the case of Bad Leavers, EMI options may be subject to forfeiture/lapse in respect of both elements, which are vested and unvested.	If an employee has exercised their EMI options, and therefore holds shares, usually the treatment of the shares would then be dealt with within the shareholders' agreement or under the company's articles of association.

EMI options vs. actual shares

	Ownership structure	Dilution and control	Tax implications	Exit scenarios
EMI OPTIONS	EMI options provide employees with the right to acquire shares at a predetermined price but do not confer immediate ownership; the actual ownership is realised only upon exercising the options. This may make employees feel like they do not have 'skin in the game' when practically the effect is the same. EMI options are attractive for the company in the sense that if an employee leaves employment, then unexercised EMI options simply lapse rather than having to arrange a transfer of shares from the employee.	EMI options minimise immediate dilution for existing shareholders since employees acquire shares at a future date. This structure preserves the current ownership structure and control because employees who hold EMI options do not generally have rights as a shareholder.	EMI options offer favourable tax treatment, with potential eligibility for Business Asset Disposal Relief on capital gains, subject to meeting specified criteria. Generally, the discount which can be applied to the shares subject to the EMI option and the ability to obtain certainty as to that valuation from HMRC in advance, also makes them attractive from a tax perspective.	EMI options often align with exit events, allowing employees to realise the value of their shares upon a sale or merger. On an exit, EMI options that are entitled to be exercised at that point, will be exercised shortly before completion of the exit, and the shares immediately sold to a purchaser. On exercise of the EMI option, the exercise price will be payable but the employee will usually be permitted to set the exercise price against the consideration they receive for selling the shares.
ACTUAL SHARES	Granting actual shares results in immediate ownership, providing employees with voting rights and entitlement to dividends from the moment of issuance. If an employee who holds actual shares leaves employment, then the company will need to ensure that there is appropriate documentation in place to allow the other shareholders, or the company, to repurchase the shares at the appropriate value. If documentation is not drafted correctly, the employee shareholder may not be under an obligation to transfer the shares either when they leave, or on an exit, and this will obviously then be problematic.	Issuing actual shares leads to immediate dilution, as employees become direct shareholders, impacting the overall ownership structure and potentially altering control dynamics. Dependant on the rights of the shares issued to the employee, they may have to be involved in shareholder decision making, meaning increased administration. In order to avoid a tax charge on issue of the shares to the employee, it may be necessary for the employee to acquire the shares for value on day one which may be unattractive.	Actual shares may trigger immediate tax liabilities for employees, especially if the shares have been provided at a perceived discount to actual market value. Dependant on the size of holding, the employee may not qualify for Business Asset Disposal Relief.	Holding actual shares can complicate exit scenarios, as employees may need to navigate the sale or transfer of their shares independently. Ultimately, neither EMI options or actual shares, if structured correctly, should be problematic on a sale, and the employees are generally happy at that time to realise their rewards in the form of cash consideration.

Are EMI options right for your business?

Understanding the landscape of EMI options involves navigating through a series of intricacies, benefits, and operational considerations. By acknowledging the key facts and figures surrounding EMI options, businesses can make informed decisions about their implementation, aligning employee incentives with overall corporate success.

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