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EMI employee share options and acceptable discretion

HMRC has recently published guidance on the use of acceptable and unacceptable employer discretion in deciding when shares can be received under Enterprise Management Incentive (EMI) options.

Once an EMI share option - the most tax-favoured and common employee share incentive arrangement in private companies – has been granted, employers regularly exercise some level of discretion to enable shares to be received by employees.

The issue here is that HMRC view the exercise of excessive employer discretion as causing relevant tax benefits to be lost, but its views on where the dividing line between acceptable and unacceptable discretion lies have been uncertain for several years, with rumoured fears of a change of practice.

HMRC's recently published guidance goes a long way to clarifying its position on the most common situations and providing reassurance. It should therefore make both for smoother company sale processes going forward and also enable the drafting of arrangements which can confidently set out where discretion can be given to companies without difficulties arising with HMRC or buyers in due course.

What are EMI options?

EMI share options can be granted to employees by companies/groups with gross assets of less than £30 million, which have 250 or fewer group employees and which are not subsidiaries of, or controlled by, another company.

While this, in practice, means that most quoted companies (due to their size) and most private equity portfolio companies (due to their ownership structure) cannot operate these arrangements, for many other companies and particular start-ups they offer considerable tax advantages. As long as the relevant company is trading/about to trade and does not operate in the finance or property (or certain other) sectors, share options can be granted over shares with a value of up to £250,000. The tax advantage is that when the options are exercised and shares are sold, any gain (being the increase in value of the shares from the time of grant to sale) should normally be subject to capital gains tax at 10%. This contrasts with the usual position with share options, which is that this gain would be subject to income tax and NICs at a much higher overall rate.

What kinds of discretion are seen with EMI options?

While EMI share options give employees the right to receive shares in certain circumstances, the agreement often contains flexibility for the company to give additional rights to an employee, should it exercise its discretion to do so.

Regularly drafted examples of this are:

- While the employee may receive a minimum number of shares as of right on a sale of the company, the company has discretion to allow more shares to be received on that occasion, eg by amending or waiving performance targets or other conditions which have not (or not yet) been achieved or accelerating vesting;
- Allowing a departing employee to retain an option or exercise early (over more than the number of shares which they are entitled to as of right); or
- Giving the company an extremely broad power on a case-by-case basis to allow exercise of options other than on a sale of the company or a leaver situation, without actually specifying what type of event or circumstance that might be, or the number of shares that might be received.

HMRC's concerns and impact on recent deal activity

Tax benefits are only provided by the relevant tax legislation if shares are received under a "right" granted by a company. HMRC's concerns have been that a "right" must specify:

- the number of shares,
- the exercise price payable to acquire the shares, and
- crucially for the issue of discretion, "when" those shares can be received.

If, as has been common, employees have a right to receive shares on a sale of the company, but the company then has the ability to allow the employee to receive more shares on that occasion than are earned by reference to relevant performance conditions which have been set, are those additional shares received under the "right" as granted or a discretionary change to the arrangements?

HMRC's nigh on 5-year silence on making a public pronouncement in this area has led to some companies being cautious about whether to include discretion in their share plans. Where discretion was provided for and used, it also led to individual HMRC clearance applications having to be made (where time was available) or other deal strategies, e.g. retentions, as well as considerable time spent drafting and negotiating risk allocation between the parties to a sale.

This is because the consequence of getting EMI option tax treatment wrong can be so stark. If the options are subject to PAYE and NICs because the relevant discretion was too wide, that will be a deduction obligation for the target company. If the company has instead allowed option gains to be paid gross to an employee believing that the option satisfied HMRC conditions and no deduction was necessary, the target company will be severely exposed. It would have to proceed against the employees to recover amounts due or else pay relevant tax out of its (or rather the purchaser's) own pocket.

HMRC's guidance

HMRC has now published detailed guidance in Employment-Related Securities Bulletin 46 and relevant pages in the Tax-Advantaged Share Scheme Manual. Click here to read the guidance. https://www.gov.uk/guidance/employment-related-securities-bulletin-46-october-2022

In essence, HMRC draws a distinction between discretions which accelerate the *timing* of exercise (which do concern it) and those which affect the *extent* to which the shares which can be received on that occasion (which do not). Timing can either be by reference to a fixed date or dates or by reference to an event occurring.

So long as an option specifies an event or circumstance when an option can or may (at the discretion of the company) be exercised (the "when" condition), then HMRC will generally accept that a company reserving discretion as to the number of shares to be received on that occasion is not problematic (the "extent" condition).

So, assume that if a sale of the company occurs after an option has been held for two years, the employee as of right could only receive 50% of the shares under option. If the company had discretion to allow exercise in full on the sale of a company, then because the "when" (the sale of the company) has already been provided for as a potential exercise right in the option documentation, it would be an acceptable exercise of discretion to allow exercise of up to 100% of the option as HMRC is happy with there being discretion as to the "extent" to which the option is exercised. Similarly, it would be acceptable for a company to reserve discretion as to what happens when an optionholder leaves employment as, again, the possibility of when that exercise occasion can occur has already been referred to.

However, even in these circumstances, HMRC emphasise that discretion to amend/waive exercise conditions must be in the original option documentation. If there is no discretion reserved up-front, then allowing the option to be exercised beyond any entitlement will be a change to it which will probably cause the option to lose its tax benefits. Equally, amending options where there is no discretion to make the change sought will often, unless the change is minor, lead to the option being disqualified.

HMRC also go on to say that a blanket discretion to create extra exercise events is a discretion too far. For example, we occasionally see options allowing exercise on a company sale or leaver situation but also going further to give discretion to permit exercise at the company's discretion in any other case. HMRC view the generality of such a wide provision as meaning that, because no specific exercise trigger is mentioned, an option exercised in this situation would lose favourable tax treatment.

The guidance also addresses other, generally less common, situations.

Action

There is relatively little that can be done to change options which have already been granted and do not already provide flexibility as set out above. This is because making a change now to allow for this would probably be treated by HMRC as losing favourable tax treatment for the option.

However, going forwards when granting options companies should review their EMI documentation for the discretions that are included and:

- Options should now always be drafted expressly reserving the right to allow for full exercise in a sale or leaver scenario. Failure to include this would mean that, where a company did want to allow full exercise on those occasions, it would not meet HMRC's guidance conditions and would fail to achieve tax-favourable treatment.
- We also regularly see performance or other conditions which are set out prescriptively with no ability to be waived or amended. Based on the new guidance, that also seems a hostage to fortune and there should be flexibility reserved to change or relax those as well.
- Finally, if a company thinks that there might be any other occasion when an option might be exercised, it makes sense to mention that event specifically and include a discretion for the company to be able to make that particular occasion an exercise event.

We have experience of some clients not wanting to refer even to the possibility of additional shares being receivable even if targets are not met for fear that employees will just assume they will always receive the full number of shares. This can be a very real concern, but there are other ways of dealing with this. Additionally, the flexibility in the option agreement to allow there to be no tax and NICs payable if those additional shares are receivable seems a price worth paying for this.

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