RESPONSE TO EMI "CALL FOR EVIDENCE"

from David Pett, tax barrister

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This paper is a response to the Call for Evidence on EMI Schemes of March 2021.

In addition to responses to the questions posed, suggestions made as to how the existing legislation could be improved are, for ease of reference, brought together in the Appendix on page 18.

Box 3.A Qus 1-5

1. I am a barrister practising as a member of Temple Tax Chambers having, from 1985 to 2017, been a practising solicitor and partner in Pinsent & Co. (later Pinsent Masons) and, from 2009 to 2017, founding partner in Pett, Franklin & Co., LLP. My specialist field is that of employee share schemes and incentives. I am author and co-editor of "Employee Share Schemes", the 2 - volume loose-leaf and online textbook widely used by professional advisers (and HMRC) and a number of earlier publications on the topic.

2. I was a member of the EMI sub-group of the Advisory Group appointed by government in 1999 and asked to devise what became the EMI scheme, and to formulate the detailed instructions to Parliamentary Counsel for what became Sch 14, FA 2000, the brief from government being to develop from scratch arrangements for providing tax-favoured incentives to "*small higher risk trading companies*" (see the Final Regulatory Impact Assessment on EMIs, "the RIA"). We did a good job: the legislation has stood the test of time and remains to a large extent as we settled it in 1999/2000, notwithstanding that it has (supposedly) been reviewed by government on at least 4 separate occasions before now. (So far as I am aware, there has not yet been any case brought before a tribunal or a court in which the issue in dispute with HMRC has focussed upon a provision of the EMI legislation.) Similar tax rules, based on EMIs, were quickly adopted by other jurisdictions, led by Singapore.

3. At the behest of the Inland Revenue officers with whom we had worked, David Cohen (who was on the AESOPs, now SIPs sub-group) and I wrote a "Special Report" published in hardback by Sweet & Maxwell in which I described and commented upon the EMI rules (and which was read and commented upon by officials before publication in 2000). I have since also drafted and published (in "Employee Share Schemes") precedent EMI documentation which has been widely used by companies and their professional advisers.

4. In the past 21 years I have advised hundreds of companies and their professional advisers (including many legal and/or accounting practices, large and small) on all aspects of EMIs, including the structuring of an EMI scheme; the drafting of EMI rules and option agreements; the application of the EMI Code; disputes which have, or might possibly have, arisen with HMRC and company purchasers in relation to whether or not a particular scheme or EMI option is or was compliant with the statutory requirements or whether the correct reporting process has been followed.

5. What follows is based upon my experiences of companies and their proprietors:

- who have, for whatever reason, wanted for commercial reasons, but been unable, to grant EMI share options either because the company did not qualify, or the statutory limits would have been exceeded;

- who have granted options intended to qualify as EMIs, and in relation to which the substantive requirements of Schd 5 were met, but the procedural and reporting/ notification requirements were not met;

- who believed that they have satisfied both the substantive and procedural requirements, but have later been found – typically upon a 'due diligence' exercise rather than an HMRC enquiry – to have perhaps failed to satisfy all of the requirements of Sch 5 or otherwise fallen short in some way so as to give rise to an uncertainty as to whether tax relief is, or will be, due, leading to commercial negotiation over the need for indemnities and/or a withholding of share sale proceeds, etc.

6. Professional rules mean that I am unable to "name names", but every point made below arises from a 'real life' situation which has arisen since 2000.

7. I am also an investor in private companies which have benefitted, in terms of attracting and retaining key employees, from granting EMI options, notwithstanding that not all such companies have been successful. In the ones which have flourished, EMI options have been a key factor – possibly, the most important factor – enabling the company to attract and retain individuals of a calibre which merits a far higher level of cash rewards than the company has been able to pay. The prospect of benefitting, in a tax-advantageous manner, from the exercise of subscription options and sale, of the shares acquired, when the company is sold, has been the single most important factor binding the individual to the company when he or she could earn so much more elsewhere. This is particularly true of those individuals with specialist, and 'hard to find' skills and expertise for whom there is a high demand from companies of all sizes.

Qu 4

8. It is wrong to compare and contrast EMI with R&D credits and EIS/SEIS, as those serve entirely different policy aims. In terms of recruitment of human capital, EMI options are widely considered to be critical and retaining in staff of the right calibre. As time has passed and individuals have become more aware of the EMI Code, so they have come to expect to be granted EMI options as a condition of joining smaller companies. It is seen as a 'quid pro quo' for accepting the risks inherent in joining a start-up or early-stage company.

Box 3.B

Qus 6 & 7:

Does the EMI Scheme help SMEs 'recruit and retain' employees?

9. The EMI regime was originally targeted at "small higher risk trading companies" (see para 4 of the RIA), not "SMEs". EMIs have worked well in fulfilling the original policy objective. It has allowed companies and their proprietors to enable those who contribute their labour to benefit from the growth in value to which they contribute in a manner which is treated for tax purposes in a broadly similar way to that afforded to those who contribute only their capital. This is widely

perceived as 'fair and reasonable'. It has also allowed small companies which are in development stage and reliant upon equity funders for financial support, having little or no income, to offer potentially very attractive awards (in the form of favourably-taxed share option gains) in lieu of more immediate payments of salary and bonuses. Those employees of a successful company who are fortunate to be granted EMI options at an early stage when the shares have an IUMV of close to their nominal value have come to appreciate the benefit of remaining employed by the company until their options vest and they can be exercised and the shares sold. In the case of high-growth companies, this 'carrot' to remain is obviously powerful. Equally so is the ability to release and re-grant options with a lower exercise price if the company 'hits a sticky patch' and needs to rely upon the goodwill of its employees to see it through.

10. In my experience, the scheme ***does*** fulfil the policy objectives of helping SMEs to recruit and retain employees. It is invariably the 'scheme of choice' for those companies which qualify. Attractions, in addition to the relief from income tax/NICs and potentially favourable CGT treatment, include the commercial flexibility afforded by the statutory requirements.

11. Most companies and their investors (individuals and institutional) readily understand the attraction to prospective employees of being able to share in the growth to which they contribute without having to invest their own funds at the outset or be gifted or sold shares on favourable terms and thereby suffer income tax on the benefit and put their cash savings at risk. In principle, share options are the answer, but employment-related securities options are, under general tax rules, charged to tax on exercise regardless of whether the shares can then be sold to pay the tax or the exercise price, putting the optionholder out of pocket and the exercise monies at risk of being lost if the share value falls. It is the relief from tax on any growth in AMV over the option period, coupled with the availability of CGT treatment matching that of 5%+ investors, which means that EMIs can be used to fulfil the commercial objective of affording a real incentive to help develop the business of the company/group. Other tax-advantaged share schemes do not hit this 'sweet spot' for the reasons mentioned further below.

12. Client companies and their investors are particularly appreciative of:

(a) the freedom to set the option exercise price at less than, equal to, or above, the initial market value of the option shares;

(b) the certainty afforded by being able to secure agreement from HMRC SAV to the UMV/AMV of option shares at the time of grant; and

(c) the ability to impose restrictions on option shares such as, for example, an obligation to sell the shares on leaving, 'drag-along' rights, restrictions on the transfer of shares and voting rights (the commercial intention being simply to allow optionholders to participate in capital growth, not have a say in decisions of shareholders).

An original policy objective was simplicity and that EMI be cost-efficient to establish

13. Another original policy objective was that EMI be a relatively simple regime to understand and implement, allowing small companies to establish an EMI plan at relatively low cost (estimated in the RIA to be up to £15,000 per company), in terms of the need to seek external advice, and (as was made known by HMRC officials although not publicised by HMRC in 2000) with a 'light touch' approach by HMRC to enforcement and compliance.

The existence of 'traps for the unwary'

14. In practice, it has become apparent that there are a number of aspects to the regime which have taken effect as "traps for the unwary", and it would be helpful to all concerned if the legislation were to be 'tweaked' to remove these and allow small companies with limited resources to grant EMI options with no fear that an unintended error in the process, reporting or administration will result in a withdrawal of relief from participants notwithstanding that all the substantive requirements of Parts 2-6, Sch 5 have in fact been met.

Consistency of response by HMRC

15. Since 2000, HMRC have helpfully responded to numerous requests for confirmation of technical points arising either generally or in relation to specific named companies or individual option grants. Regrettably, it is understood that HMRC has not retained records of all the views it has expressed on such technical issues which are of general application. Following changes in the previously long-serving and experienced personnel in the Employee Share Schemes team at HMRC, this has led to a waste of time on the part of companies, advisers, and HMRC in having to 're-invent the wheel', sometimes leading to an apparent change in unpublished policy. It would be helpful to all concerned if HMRC were to retain, and publish, a 'rolling database' of their considered opinions on all such technical issues arising from time to time. (Whilst the Share Plan Lawyers Group does retain such a record, this does not always capture the nuances of HMRC's considered opinions.)

Oversight and 'policing'

16. Oversight and 'policing' of the application of the EMI regime to employee share options has, to a great extent, been undertaken by professional advisers as part of the 'due diligence' process in the run up to a sale of the company or another corporate transaction. This has become almost a 'blood sport', with lawyers and accountants vying to find some error in the documentation or compliance which will justify company proprietors being forced to give indemnities or agree to a withholding of part of the sale consideration pending resolution of whether the options do in fact qualify for tax relief and/or the company is exposed to a penalty under Part 8, Sch 5.

Shortcomings in the annual reporting regime

17. The absence of a 'white space' on the annual online EMI share options return by the employer company, which would allow a narrative explanation of complex corporate transactions, means that in some cases it will be difficult for HMRC to assess if all statutory requirements have been met, particularly in those instances in which there is genuine uncertainty as to whether, on balance, the situation did satisfy the statutory requirements and the parties have relied upon legal opinions with which HMRC might take issue.

Differentiating between substantive and procedural requirements

18. There is universal acceptance amongst companies and advisers that if a company does not in fact qualify to grant EMI options, the grantee is not an eligible employee, or that if a share option does not meet the substantive requirements of Parts 2 – 5, Sch 5, an option will not qualify for favourable tax treatment ab initio.

19. However, there is widespread unhappiness at the notion that, whilst all substantive requirements have been met, some error in compliance and/or process on the part of the employer/grantor/EMI company may result in a loss of favourable tax treatment on the part of the employee, particularly when he or she has been induced to join or remain on the understanding that he or she will be granted EMI share options and it is later discovered (possibly only upon 'due diligence') that, in consequence of such an error over which the employee had no control, he or she will suffer tax penalties resulting in a substantial reduction in the net amount of any growth in value realised upon exercise of the options and a sale of the shares.

20. Whilst grantors can protect themselves against liability to the optionholders for any such errors (by including provisions in the option agreements and the employment contracts which limit their liability to make good any tax loss should the option ultimately be found not to qualify), the employee has little or no means of protecting themselves against such loss of relief and reduction in net profit. Investors will not normally agree to 'guarantee' to an employee that any option gain will ultimately qualify for favourable tax treatment, and advisers will invariably counsel their company clients or their shareholders against doing so.

21. Whilst there is a temptation to suggest that "if it ain't broke, don't fix it", it has become apparent that there are ways in which, ***without expanding the range of companies which qualify to grant EMIs or increasing the existing limits***, the EMI Code could be significantly improved so as to remove "traps for the unwary" and ensure that an optionholder who is and remains eligible does not lose valuable tax benefits by reason of some procedural error by the EMI company over which the individual optionholder has no control. I describe below a number of ways in which the regime could be improved for the benefit of companies, employee-optionholders, advisers and HMRC.

Operation of the tax relief following a 'disqualifying event' (s532): bio-tech and other companies with varying employment needs at different stages of product development

22. A small pharma company developing a new drug or medical treatment or procedure will, typically, require employees with different skill sets at the different stages of product development. Perhaps, for example, one set of employees for the original formulation, another for testing and drug trialling, another for seeking regulatory approval; another for marketing and upscaling production. EMI options are perceived to be a good way to attract and retain employees, but the tax regime means that, in practice, it is only those granted options at the late stage of development and who remain employed when the company is sold and the value, to which earlier cadres of employees have all contributed in their turns, is realised who benefit from the favourable tax treatment. This is because cessation of employment is a 'disqualifying event' and, even if the benefit of the option is retained pending a sale of the company, relief is afforded only for growth in AMV up to the time of cessation. In practice this will typically be de minimis at any time before the company has finally succeeded in commercially exploiting the product and only really increases substantially at a late stage before an 'exit event'. This is considered by many o operate unfairly. It means that the grant of share options to employees engaged in early stages of development does not have nearly the same incentive effect as it does for those at later stages.

Suggestion: that the tax rules be changed so that, if the company allows an ex-employee to retain the benefit of an option granted as an EMI, tax relief should be given on a time-apportionment basis, rather than by reference to the AMV of the option shares at the time of cessation of employment.

23. So, if an optionholder held employment throughout, say, 6 months and the period from grant to exercise was 4 years, relief from income tax and NICS on the gain realised on acquisition of the shares should be available on 1/8th of the gain in AMV over the option period. Under existing rules, if there were no growth in AMV at the time of cessation, such an optionholder would not be entitled to any relief.

The 10-year limit in s529(2)

24. This caused difficulty for many EMI companies after the 2008 financial crash, and it is difficult to see what purpose is served by removing the tax benefits if the option is not exercised within 10 years of grant. I am aware of at least a dozen or more companies who, having granted 'exit-only' EMIs, found themselves unable to be sold within the time-scale first envisaged. Optionholders were put in the invidious position of either (according to how the option agreements were drafted) losing the benefit of the options, or having to exercise in circumstances in which option shares could not be sold to fund the exercise price and any tax charged on the 'discount on grant'. If fresh options were granted, there was then no relief from tax on the growth in AMV which had accrued over the period since grant of the original options.

Suggestion: remove altogether the 10-year limit on the availability of tax relief.

Substantive requirements in Parts 2 – 6, Sch 5

25. The EMI legislation was originally targeted at "small higher risk trading companies". It now appears from the document that it is aimed at "SMEs" i.e. small and medium-sized enterprises. This begs the question of whether it is appropriate to relax the qualifying criteria so as to allow independent companies which fall within the definition of a medium-sized company in s465 CA 2006 (or other primary or secondary legislation or regulations). In any event, it would be helpful if a clear and consistent definition of a qualifying company is adopted.

The individual statutory limit

26. The £250,000 individual limit is generally accepted by clients as fair and reasonable given the policy intent of encouraging participation in growth in value of small companies. Insofar as companies wish to provide individual employees with benefits above this limit, they will typically do so by awards of 'unapproved' share options, so-called 'growth shares' and/or joint share ownership awards. None of these qualify for favourable tax treatment and, insofar as 'growth shares' and JSOP awards seek to secure CGT treatment for future growth in value, they do so (assuming they are correctly drafted and implemented) in a manner which is entirely consistent with the structure of Part 7, ITEPA 2003.

The "3-year" rule

27. The "3-year rule" in para 6, Sch 5 is not seen as a problem as companies granting EMIs to an employee will invariably do so over shares with an IUMV which is just under the £250,000 limit so as to avoid altogether the restriction on the grant of fresh EMIs within the next 3-years if, for example, the share price falls and the company wishes to invite optionholders to cancel and be re-granted options at the lesser price.

The overall £3m limit

28. There appears to be little or no policy reason for the overall £3m limit in para 6 and I would question whether any purpose is served by it? If the company believes it appropriate to afford share-based incentives to employees, what purpose is served by restricting in this manner the number of employees to whom options may be granted? If the company otherwise qualifies to grant EMIs, it should be free to grant options to any, or all, eligible employees subject to the individual limit.

29. It seems counter to the policy objective of wanting "small, innovative companies across the UK to reach their growth potential" (per para 1.1 of the Call for Evidence) to restrict in this way the extent to which company proprietors may choose to dilute their own economic interests by limiting the value of shares over which EMI options may be granted. Insofar as the existing overall limit restricts the ability of the company to grow in value, there is no loss to HMT in removing the limit and thereby enabling greater growth in value to be generated.

Suggestion: remove the £3m overall limit on the grant of EMIs by a single company.

Qualifying companies

The 'independence requirement' (para 9)

Extend participation to companies owned by private-equity investors?

30. Small, potentially high-growth, companies which are majority owned by private equity houses investing in portfolios by providing seed/venture/'start-up'/development capital, are disadvantaged, when compared with truly 'independently-owned' companies in not qualifying to grant EMI share options. It is not clear why, as a matter of principle, an exception has been made for companies which are majority-owned by a employee-ownership trust, but not for those companies which are majority-owned by a private equity portfolio investor. It should be possible to define a corporate fund investing in multiple companies, and to do so in a manner which ensures that only those companies under the control of a genuine private-equity investor qualify to grant EMI options. There is already an exception for EOT-owned companies, so this would not be the only exception to the general rule requiring independence.

Employee-owned companies (owned by a trust which is not an EOT)

31. A trading company which is majority owned by a corporate trustee of an employees' trust cannot qualify to grant EMI options if the sole corporate trustee is itself owned by the trading company (or a holding company of a trading group). It is not uncommon for employee-owned companies established before the EOT legislation was introduced in 2014, to be structured in such a manner. If the trust has a sole corporate trustee, the second limb of the 'independence' requirement will not be met (as the trading company or its holding company will be under the control of another company – the corporate trustee). Further, if the corporate trustee is a guarantee company, the "qualifying subsidiaries" requirement will not be met as the guarantee company is not a "subsidiary". The exception afforded to EOT-owned companies should be extended to any company (assuming it otherwise qualifies) which is under the control of a company acting as trustee of a trust (being a trust within s86 Inheritance Tax Act 1984) for the benefit of employees of the trading company or group and which is itself either wholly-owned and controlled by the trading company (or other member of the trading group) or is 'independent'.

David Pett, Temple Tax Chambers

Suggestion: amend the independence requirement so that, in relation to shares held or owned by a trust, the company is not to be treated as being under the control of a company by reason only of that company holding only shares in a fiduciary capacity.

Companies owned by 50:50 joint ventures

32. A company ("ACo.") owned as to exactly 50:50 by two other companies acting together to exercise control of ACo. by way of 'joint venture' cannot grant EMI options because "in relation to [ACo.], such joint venture parties will be taken to be connected with one another and therefore the second limb of the 'independence requirement' will not be met. It is unclear why a company such as ACo. should be excluded from qualifying to grant EMI options.

Suggestion: amend para 9, Sch 5, to allow a company jointly owned by two companies, neither of which has control of the company wishing to grant EMI options.

Companies controlled by an individual who holds some shares through a corporate body or corporate trustee

33. A 'trap for the unwary' is the situation in which an individual, or husband and wife, have a controlling interest in the company, but a part of their controlling interest is owned indirectly through a family investment company or a family trust with a corporate trustee. It would be helpful if the legislation were to make clear that provided the company is ultimately controlled by one or more individuals, it does not matter that such control is partially exercised through a company (so as to reflect what is understood to be the unpublicised approach taken by HMRC).

Suggestion: amend para 9, Sch 5, to make clear that the independence requirement is met notwithstanding that a controlling individual shareholder exercises such control and ownership wholly or partly through a family investment company or family trust with a corporate trustee.

The "qualifying subsidiaries requirement": interests in JV companies

34. There are many jurisdictions in parts of the world where, post-Brexit, the government is keen for 'UK Limited to do business', but where local legal or cultural conditions mean that the market can be accessed only through the UK company entering into a 50:50 joint venture with a locally-owned company. There is some doubt, and HMRC has not been consistent in giving rulings on the point, as to whether participation by the EMI company, or a qualifying subsidiary, in such a 50:50 JV company (of which neither party has control) would mean that no EMI options can then be granted because the JVCo is (so it is – wrongly, in my view, argued) a "subsidiary", but not a "qualifying subsidiary". [The point turns on whether the opening words of s993(7) ITA 2007 mean that that sub-section applies only to determine if the EMI company is itself under the control of other companies acting together, not in relation to its own connection with a JV partner.] Given the policy of encouraging trade with such other jurisdictions (e.g. China, Indonesia and some African countries), it would be helpful if the legislation put beyond any doubt that participation in such a JV does not disqualify a company from granting EMI options.

Suggestion: amend para 10, Sch 5 to provide that s993(7) ITA 2007 does not apply in relation to a company (or a qualifying subsidiary) for the purpose of determining if it is connected with a joint venture partner.

The £30m gross assets requirement

35. In my experience, this has been widely understood and accepted, although if government wishes to expand the number of companies which qualify to grant EMI options, an increase, to say £50m, would achieve this. Alternatively, qualifying companies could be defined by reference to the Companies Act definition of a “small or medium-sized company” and the gross assets test removed.

36. If, as suggested, there is a case for folding the CSOP regime into the EMI regime, it would then be appropriate for there to be a differential as between SMEs and larger companies, expressed in terms of different individual limits on the grant of tax-favoured discretionary share options (perhaps an IUMV of £250,000 for EMI options and an IUMV of, say, £50,000, for options granted by non-EMI qualifying companies).

Suggestion: It would be helpful if, in the light of recent decisions of the First- and Upper-tier Tax Tribunals, published guidance on:

- what are “*activities carried on otherwise than in the course of a trade*” (per para 14(5)(c),;
- given the comments of tribunal judges, what should now be taken as “substantial”; and
- what is “significant” as that term is used in paras 13(2)(b) and 14(5)(b).

Excluded activities (paras 16 -23)

37. Clients are generally accepting of both the need for, and the scope of, the “excluded activities”. In terms of “excluded activities”, it would be helpful if HMRC would publish details of those trades which fall on or close to the borderline between qualifying and non-qualifying activities and their opinion as to which side of the line a particular type of activity might lie. So, for example, it is understood that, in the opinion of HMRC whilst insurance underwriting is an “excluded activity”, insurance broking is not. Accountancy services are excluded, but professional services restricted to advising on VAT compliance is not. Whilst professional advisers might not always agree with HMRC’s interpretation, it would be helpful (and reduce costs) if HMRC were to make clear what is their opinion on the eligibility of specific types of activity.

Suggestion: it would be helpful if more guidance could be published on activities which are, and are not considered to be excluded, particularly give the growth in “FinTech” activities and new forms of business involving subscription and hiring services (etc.)

Eligible employees (part 4, Sch 5)

38. In the current market for employees’ services, it is commonplace for individuals to have multiple employments, yet for their services to be vital to the development of a company, however many hours they are committed to devote to that company. Against this background, it is difficult to see why eligibility to be granted an EMI option should be dependent upon commitment of a minimum number of hours or meeting the requirement that the employee to devote at least 75% of their “working time”. The value to a company of the respective contributions made by different employees varies enormously and companies should have the freedom to determine for themselves whether the contribution of a particular employee is worthy of that employee being granted an EMI option.

Suggestion: remove altogether the “commitment of working time” requirement in paras 26 and 27, Sch 5.

David Pett, Temple Tax Chambers

39. As a separate matter, there is a frustration on the part of many hi-tech SMEs, and those others in the 'gig' economy, that the company cannot have a single option plan which allows for options with the same tax advantages to be granted to individuals who provide their services under (i) arrangements taxed under IR35 as if they were employments, or (ii) under 'agency' arrangements (the individual being employed by an agency or an 'umbrella' company), or (iii) simply as genuine self-employed contractors. Likewise, if an employee of another business provides valuable services under a secondment or other arrangement and those services are vital to the successful development of the EMI company, why should such an individual not also be incentivised and/or rewarded with the grant of an EMI option?

Suggestion: extend the scope of eligibility to be granted an EMI option by providing that EMI options may be granted by a qualifying company:

- to any employee of the at company or, if it is a holding company, any qualifying subsidiary or company in which the company or a qualifying subsidiary is a 50:50 joint venture partner);
- any individual who, in relation to consideration for personal services provided to the EMI company (or any qualifying subsidiary (etc.)) is charged to tax as if such consideration is employment income;

- any individual who provides to the EMI company (or a qualifying subsidiary (etc.)) personal services under a contract for services (whether that contract be with the individual concerned or another party), and has done so over a continuous period of (say) at least 6 months.

Requirements relating to options (part 5, Sch 5)

40. Para 35(2) is ambiguous, and this gives rise to uncertainty.

Suggestion: para 35(2) should be redrafted to make clear that:

(a) the shares acquired on exercise of an EMI option must be fully paid-up as to their nominal or par value and,

(b) the price payable to acquire the shares must be paid in full within, say, 14 days after the shares have been issued or transferred and,

(c) for these purposes, it is not sufficient that the optionholder undertakes to pay cash to the issuer/transferor of the shares if that undertaking is not fulfilled within that 14-day period.

41. This allows for so-called "cashless exercise", the exercise price being paid out of the proceeds of sale of the option shares and avoids the confusion caused by the existing wording which does not take account of the fact that an EMI option may be satisfied by a transfer of existing shares.

Providing in the option agreement for a discretion on the part of the grantor as to whether and when an option may be exercised

42. Part 5 leaves open the question of the extent to which the share option agreement may reserve to the grantor a discretion to amend the vesting criteria for an outstanding option and/or bring forward the time when an option may be exercised to take account of changes in

circumstances. This, coupled with some questionable rulings given by HMRC officers in response to companies seeking certainty as to whether or not the exercise of a given option will qualify for tax relief, has led to uncertainty amongst EMI companies and their advisers. This in turn leads to increased work, costs and complexity, particularly at the time of a corporate transaction when certainty as to the tax treatment of outstanding option is essential.

Suggestion: HMRC should publish detailed guidance as to what is, and what is not, in their view acceptable, both as to the terms of the option agreement, and the extent to which the exercise of any discretion reserved to the grantor may affect entitlement to relief.

Company reorganisations (Part 6, Sch 5)

43. The requirements for there to be a "company reorganisation" (so as to allow for the grant of replacement options) are unnecessarily complex.

Suggestion: amend para 39 (2), (4) and (5), so that para 39 simply refers to a situation in which an acquiring company has obtained control of the EMI company, omit para 40, and amend para 42 so that replacement options must be granted (if at all) within the period of 6 months after such acquisition of control.

Notification requirement (Part 7, Sch 5)

44. It is difficult to understand why the notification of grant of an EMI option should not simply be a part of the employer's annual online return, rather than a separate and time-limited requirement.

Suggestion: Amend the EMI Code as follows:

- delete the existing s529(2) (see earlier suggestion re 10-yr time limit) and replace it with provision to the effect that sections 530 -540 only apply in cases in which the grant of the option has been notified to HMRC by the employer either in accordance with para 52 of Sched 5 or, if the option is exercised before the first annual return has been duly made after it was granted, at any time before the end of 30 days after it was so exercised, and (in either case) so as to require, in relation to new grants, a declaration by the employer that the option is a "qualifying option" (defined as suggested below);
- delete para 1(2)(b) and para 44(1);
- define, in para 1, a "*qualifying option*" as an option which satisfies the general requirements of Parts 2 – 5 or is a replacement option;
- delete paras 44(5)(c), (5A) and (6);
- amend paras 57A et seq to take account of these changes.

Suggestion: If the other suggestions regarding the procedural aspects are adopted, omit para 49(1).

The need for a "working time declaration" by the employee

45. Whilst the need for confirmation that an employee satisfies the "commitment of working time" requirement is understood, there is widespread misunderstanding of the need for the employee to provide such certification, particularly following the changes made in 2014 and the move, from a paper, to an online notification of EMI option grant. For example, many companies

seeking to grant EMI options without specialist advice failed to understand the need for the employee to make a working time declaration ("WTD") every time a new EMI was granted to the same employee. Many also failed to understand that, in addition to the declaration made by the employer (para 44(5)), a separate declaration is required to be made by the employee. Whilst this was apparent from the old paper notification, it is not readily apparent from the online process which does not require the involvement of the grantee.

46. It is unclear what purpose is served in requiring an *employee* to make a WTD. The responsibility for ensuring that an employee is eligible to be granted an EMI option should be on the employer. In any event, a failure by the employee to give a WTD should (assuming that the employee does in fact satisfy the "commitment of working time" requirement) result in a penalty on the employer, not a loss of tax relief for the employee optionholder.

47. The existing requirements are counter-intuitive and this leads to unintended failures by companies to ensure that the option is "*notified to [HMRC] in accordance with Part 7*" (per para 1(b)). HMRC officers have asserted that this leads to a complete loss of tax relief.

48. Quite apart from the general power of enquiry by HMRC when the grant of an option has been notified, HMRC also has specific power to enquire into whether the "commitment of working time" requirement has been met (para 46(2).

Suggestion: remove altogether the requirement that the employee make a WTD, and rely upon the declaration of the employer that the grantee does in fact satisfy the "commitment of working time" requirement.

49. In any event, it is wrong in principle that, as a consequence of the 2013/2014 changes, a failure on the part of the employer to comply with the procedural requirements of Part 7 should result in a loss of tax relief for the employee, notwithstanding that the substantive requirements of Parts 2-5 are met in relation to an option. If the substantive requirements are met, procedural failure should be met with a penalty on the employer, not a loss of relief to the optionholder.

Combining CSOPs with EMIs

50. In principle, it is difficult to see why the legislation could not be simplified by omitting Schedule 4 (CSOPs) and extending the form of tax relief which applies to EMI options to options which are granted by larger companies provided that such larger company options ("LCOs"):

- are subject to a lower individual limit (say, £50,000);
- the employee must satisfy the employment requirement and the material interest tests;
- the shares over which such LCOs are granted must be of a class the majority of which are "employee-control shares" or "open-market shares";
- the "exchange of options" regime is the same as that which applies to EMI options (modified as suggested above).

51. Crucially, this would afford the greater commercial flexibility to set an exercise price at less than market value, and not have the availability of tax relief dependent upon the 3-year period between grant and exercise.

52. It would then make more sense for the individual £250,000 and overall £3m EMI limits to be applied only to EMI options, not LCOs.

David Pett, Temple Tax Chambers

Suggestion: combine the EMI and CSOP regimes, with differential limits applying to larger companies not qualifying to grant EMI options. Remove altogether the "requirements as to other shareholdings" provisions in para 20, Sch 4, these being unnecessary now that restricted shares can be used for CSOP options.

Business Asset Disposal Relief from capital gains tax ("BADR")

53. It is considered to be an unfairness that the favourable reduced rate at which CGT is charged on disposal of EMI option shares is lost if the shareholder ceases to be an employee or director before the shares are sold, as this is often a circumstance which is outside the shareholder's control.

Suggestion: amend the BADR rules to entitle a holder of shares acquired pursuant to the exercise of an EMI option in circumstances qualifying for tax relief on exercise, to BADR notwithstanding that the shareholder ceases for any reason to hold office or employment with the EMI company or group.

Box 3.B

Qus 6, 7 & 8

54. From what I have observed of independent SMEs, the availability of EMI options has been a vital tool in allowing qualifying companies and their proprietors to attract and retain key employees and thereby help them to grow. Many individuals who have earned sufficient monies from working for large companies, and who now want a challenge, are very happy to work for lower cash salary and bonuses but have the opportunity to share in the proceeds of sale of the company in a tax-efficient manner.

Qu 10

55. The commercial flexibility allowed by Part 5, Sch 5 – compared with CSOP options - is seen as most valuable.

56. So is the ability to secure agreement with HMRC in advance of the grant of EMI options as to the AMV and UMV of the option shares. This affords commercial certainty for both employer and employee as to the anticipated tax consequences of the acquisition of shares on exercise, and if there occurs a disqualifying event.

Qus 10 & 11

57. I am not aware that companies which have grown to a size which means they no longer qualify to grant EMI options find it difficult to recruit and retain employees by reason only of being unable to grant EMI options. Such companies can, and do, face an HR problem arising from having long-serving employees who hold EMI options and employees who cannot now benefit from being granted such flexible and tax-advantaged benefits. Most company proprietors appear to accept that EMI options have a role to play allowing small cash-strapped companies to compete in the employment market with larger companies who can afford to pay greater salaries and cash-based incentives.

58. The individual and overall limits restrict the ability of some SMEs to use EMI options as a tool to attract and retain key staff to the extent they would wish to do so. It is arguable that these limits are unnecessary to protect HM Treasury as:

- if and insofar as growth in value of the company is not achieved, there is no gain on which there would, absent the EMI relief, be a taxable gain; and
- it is for the proprietors of the company to determine the extent to which it is appropriate for them to suffer dilution in their proportional shareholdings by either granting options over their own shares or having the company grant rights to subscribe for new shares. If they choose not to do so, and to retain that 'slice of the cake' for themselves, they would typically be charged to capital gains tax, not income tax and NICs upon the disposal of their greater proportional shareholdings.

59. Other forms of remuneration or benefits do not have similar forms of incentive value as they are not directly related to the value created, or are funded out of that value – whereas (ignoring the accounting rules re recognition of share-based payments) the real economic cost of the issue of shares at a discount is borne by the market, not by the company itself.

Qu 12

60. Yes. These have a place, and the advantages and flexibility offered by a SIP in relation to all employees need to be given more widespread publicity. Given that, until a company is sold (when SIP shares can typically be sold entirely free of tax), an employee who leaves may be required to forfeit 'free' shares and sell back on a 'no-gain' basis 'partnership' shares, there need be "no skin off the nose" of other shareholders (in the sense that the only 'cost' of doing so is that of dilution borne by the other shareholders by the issue of new shares to employees – and this may be outweighed by the enhanced growth resulting from the goodwill engendered by the awards) in awarding shares to all employees under a SIP.

61. CSOPs are perceived as inflexible and, given the individual limit of £30,000, of limited benefit. AS suggested above, there would be merit in rolling CSOP into the EMI scheme and providing differential limits for larger companies so as to preserve the relative advantages offered by the existing EMI scheme for small companies.

62. SAYE schemes remain popular amongst large employers only (I suggest) because of the familiarity of employees with the way they operate. Given the nil bonus rates and the fixed option periods, as well as the administrative costs of the savings contracts, and the need to extend participation to all eligible employees, they are of limited appeal to those high-growth companies seeking to attract and retain key employees.

Qu 13

63. No. The CSOP is too inflexible. Those companies which are not, or no longer, eligible to grant EMI options typically consider instead issuing 'growth shares', subject to a s431 tax election, and/or issuing shares into the joint ownership of the individual employee and trustees on terms whereby the individual is entitled, when eventually the shares are sold, to the future growth in value (typically above a premium to the initial UMV of the jointly-owned shares), with the balance being due to the trustee joint owner ("JSOP awards"), again subject to s 431 elections being made. Such arrangements are entirely consistent with the scheme of the legislation, which allows for the

employer and employee to elect for the employee to pay, or be taxed at acquisition on, the UMV of the shares, and for future growth in value then to be taxed as capital gain.

64. Companies and their proprietors are generally accepting of the principle that selected, or all, employees should either pay, or pay tax on, the market value of shares acquired by reason of employment. What 'sticks in the craw' is the idea that, just because shares are acquired as an employee, the future growth in value of those shares should be taxed as employment income rather than on the same basis as applies to other investors. The existing tax regime allows for this to be avoided (by making a tax election and either paying for the shares a price which ignores restrictions, or paying tax up-front by reference to the unrestricted value of the shares), but the mechanisms for doing ('growth shares' and JSOPs) so are widely perceived as too complex.

65. An alternative is for employees to be made loans to acquire shares for full value, the loans being repaid on sale of the shares, or (which is similar in effect) for shares to be issued to employees on the basis that the agreed subscription price is left outstanding unpaid until the shares are sold. Annual charges to tax on employment-related beneficial loans (or under Chapter 3C, Part 7 ITEPA) are avoided if the employee qualifies for 'interest relief' on a loan to acquire shares in the company (being a 'close company'), but this applies only to those employees and directors involved in the group-wide management. It is also widely perceived to be unfair that employees – who invest their labour and personal skills – are at risk of a fall in value of the shares. Many would assert that, unlike outside investors, employees – or, at least, selected 'key' employees - should be entitled to benefit from 'upside' growth without being at risk of loss if the company fails. For them, such failure involves a 'double-whammy' of loss of employment as well as loss of the investment in shares. This alone justifies a tax regime which, within limits, allows for selected, or all, employees to benefit from growth in value taxed in the same way as would an outside investor, but with no adverse tax consequences arising from a form of 'stop-loss' arrangement.

66. This could be achieved to a limited extent by bringing the CSOP regime into line with the EMI scheme, but with differential limits for larger companies (see 52 above).

Section 431 tax elections

67. There is a case for simplifying the s431 tax election process so that, for example, it an "opt-in", rather than an "opt-out", the tax consequences of making a s431(1) election becoming the default position if an election is not made.

Suggestion: amend the regime for making tax elections under s431 so as to provide for an election under s431(1) to be deemed to be made in relation to "restricted employment-related securities" unless the employer and employee elect for it not to apply.

68. The question assumes that it is possible to differentiate between "*high growth companies which no longer qualify for EMI*" and other types of company which, whilst not being "high-growth", are nevertheless competing in the same market for skilled employees. It is difficult to see how any tax-advantaged scheme can differentiate in its eligibility criteria between such types of company – or, indeed, why it should.

Qu 14

69. By combining the CSOP regime with the EMI regime and providing for differential limits according to the size of the company (see 52 above).

Re: SIPs

70. In the case of a SIP, by further amending s498(3) to (5) so as to extend the exemption from tax to any situation in which plan shares are withdrawn from, or cease to be held in, the SIP in anticipation of, or consequent upon a change in ultimate control of the plan company brought about by any means and regardless of the form of consideration received for the disposal of the plan shares. There are examples of 'take-overs' in which the existing exemption is not available because of the commercial terms of the company sale. It seems unfair to participants that the question of whether they suffer tax on a disposal of plan shares on a takeover is dependent upon factors outside of the control of the SIP company.

71. If the accumulation period for savings from earnings into a SIP were extended from 12 months to 3 years, and the limit on the value of shares purchased in a tax year from such savings were increased to match those of the SAYE regime, there would be little reason to retain the SAYE regime as similar (and enhanced) tax and commercial benefits could be offered to all qualifying employees through the use of a SIP. This could produce a reduction in the amount of legislation and, with the combination of CSOP and EMI option regimes, consolidation into two forms of tax-advantaged employee share schemes: one for selected key employees, and one for all employees. This would benefit "high growth" companies as much as it would all other independent companies.

72. The existing tax treatment of SIP shares which are withdrawn from, or cease to be held in, the plan is too complex to explain and certainly too complex for most employees to grasp and understand. The period in which shares must be held in the SIP to qualify for exemption from tax should be reduced, from 5, to 3 years.

Suggestions (re SIPs):

- allow plan shares to be disposed of upon any form of 'change of control' without loss of tax relief;
- extend the allowable accumulation period for savings to 3 years (to match SAYE option savings contracts) and allow savings to be made either with the employer (in a trust account) or with a bank or building society under a certified SAYE savings arrangement;
- simplify the tax treatment so that a single basis of calculating the amount on which a 'clawback' charge arises applies, and provide that such a charge applies only if plan shares are withdrawn from, or cease to held in, the plan within 3 years (i.e. reduce the period throughout which plan shares must be held in the plan to qualify for exemption from tax, from 5 to 3 years).

The attitude of private-equity funds

73. The message received from private-equity funds (and other institutional investors) is that they recognise the importance of employee share incentive arrangements and the value of the tax advantages which they afford. They also accept the need for a special regime for small, high-risk companies needing to offer a 'carrot' to induce key skilled employees to join and remain. Such investors would be more willing to establish such schemes, including forms of 'growth share', JSOPs and other incentive regimes which conform to (and do not seek to take advantage of

perceived loopholes or weaknesses in) the existing tax regime, if only such plans were simpler and available ‘off the peg’ rather than having to be tailored to the circumstances of each company. There is often neither the time nor the budget available to incur the costs of addressing the uncertainties which often still arise in the context of such arrangements.

Suggestion: that HMRC liaise with professional advisers to produce a suite of ‘standard-form’ documentation governing a form of ‘unapproved’ selected-employee form of share-based incentive arrangement (i.e. a form of ‘growth share’ or simple form of JSOP arrangement) which can be easily adapted and adopted by companies safe in the knowledge that the tax treatment of such an arrangement in that form will not be challenged by HMRC.

Share valuation

74. The change in policy of HMRC Shares & Assets Valuation, who now decline to entertain applications to agree share values for income tax and PAYE purposes in advance of share awards other than under a tax-advantaged scheme, and the uncertainty as to the amount on which an employee may suffer a charge to tax on acquisition and in future has meant that many companies and their investors are unwilling to take the risks associated with not knowing in advance what exactly will be the taxable value of the shares, or interest, to be acquired. What HMRC perceived as “inefficiency in the allocation of scarce resources” on their part (because so many such applications were simply agreed without dispute) was in fact a much-valued provision of certainty for companies and employees allowing them to plan and budget for the costs of employee share incentives.

Suggestion: HMRC Shares & Assets Valuation should once again be willing, and suitably resourced, to allow employers to secure agreement, in advance of making ***any*** form of employee share option or other award of shares or share incentive award, as to what is the actual and unrestricted market values of the shares (or interest in shares) both (i) a provisional “health-check” valuation, to allow employers to meet their PAYE obligations, and a definitive and binding agreement for all tax purposes.

Qu 15

75. Very well.

Qu 16

76. I am not aware of significant dissatisfaction amongst company proprietors of the existing eligibility criteria for, or limits on, EMI options. There is widespread acceptance of the fact that EMI options serve a valuable purpose for small companies (as presently defined). The only area of dissatisfaction is the ineligibility of small companies which, although they are managed independently, are owned by private-equity funds and therefore fail the “independence requirement”.

77. There is dissatisfaction at the overall £3m limit, the policy reason for which is not understood (see 28 & 29 above).

Qu 17

78. No. I am aware of companies paying of loans so as to reduce their 'gross assets', granting EMI options, and then taking out fresh loans, and of companies deliberately deferring the hiring of staff so as to remain within the "fewer than 250 employees" limit. In all such cases, these were short-term measures taken to "get under the wire", and did not significantly affect the long-term behaviour of the company or its growth.

Qu 18

79. Yes. Given the original policy behind EMI options, namely "to reward well-qualified individuals who are prepared to take the risk of moving from secure jobs and venture their time and effort to create wealth for the country" (para 25 of the RIA), it would seem to be counter-productive to remove the differential advantages for small companies by extending those same advantages to larger companies. If the question is: where should the line, between small companies qualifying for EMI and larger ones which do not, be drawn, then, apart from the desire on the part of private-equity backed companies to become eligible, the existing criteria – and, in particular, the £30m gross assets and 250 employees tests – feel about right. There has not, to my knowledge, been any real pressure from qualifying companies to increase them. Larger companies should be eligible for similar tax-advantaged treatment of employee share options, but subject to limits which clearly differentiate between the two categories of company.

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APPENDIX

Suggestions made for improving the existing tax-advantaged employee share incentive schemes

1. That the tax rules be changed so that, if the company allows an ex-employee to retain the benefit of an option granted as an EMI, tax relief should be given on a time-apportionment basis, rather than by reference to the AMV of the option shares at the time of cessation of employment. So, if an optionholder held employment throughout, say, 6 months and the period from grant to exercise was 4 years, relief from income tax and NICS on the gain realised on acquisition of the shares should be available on 1/8th of the gain in AMV over the option period. Under existing rules, if there were no growth in AMV at the time of cessation, such an optionholder would not be entitled to any relief.

2. Remove altogether the 10-year limit on the availability of tax relief.

3. Remove the £3m overall limit on the grant of EMIs by a single company.

4. Amend the independence requirement so that, in relation to shares held or owned by a trust, the company is not to be treated as being under the control of a company by reason only of that company holding only shares in a fiduciary capacity.

5. Amend para 9, Sch 5, to allow a company jointly owned by two companies, neither of which has control of the first-mentioned company, to grant EMI options.

6. Amend para 9, Sch 5, to make clear that the independence requirement is met notwithstanding that a controlling individual shareholder exercises such control and ownership wholly or partly through a family investment company or family trust with a corporate trustee.

David Pett, Temple Tax Chambers

7. Amend para 10, Sch 5 to provide that s993(7) ITA 2007 does not apply in relation to a company (or a qualifying subsidiary) for the purpose of determining if it is connected with a joint venture partner.

8. It would be helpful if, in the light of recent decisions of the First- and Upper-tier Tax Tribunals, HMRC would re-issue published guidance on:

- what are "*activities carried on otherwise than in the course of a trade*" (per para 14(5)(c),;
- given the comments of tribunal judges, what should now be taken as "substantial"; and
- what is "significant" as that term is used in paras 13(2)(b) and 14(5)(b).

9. It would be helpful if more guidance could be published on activities which are, and are not considered to be excluded, particularly give the growth in "FinTech" activities and new forms of business involving subscription and hiring services (etc.).

10. Remove altogether the "commitment of working time" requirement in paras 26 and 27, Sch 5.

11. Extend the scope of eligibility to be granted an EMI option by providing that EMI options may be granted by a qualifying company:

- to any employee of the at company or, if it is a holding company, any qualifying subsidiary or company in which the company or a qualifying subsidiary is a 50:50 joint venture partner);
- any individual who, in relation to consideration for personal services provided to the EMI company (or any qualifying subsidiary (etc.)) is charged to tax as if such consideration is employment income;

- any individual who provides to the EMI company (or a qualifying subsidiary (etc.)) personal services under a contract for services (whether that contract be with the individual concerned or another party), and has done so over a continuous period of (say) at least 6 months.

12. Redraft para 35(2) to make clear that:

(a) the shares acquired on exercise of an EMI option must be fully paid-up as to their nominal or par value and,

(b) the price payable to acquire the shares must be paid in full within, say, 14 days after the shares have been issued or transferred and,

(c) for these purposes, it is not sufficient that the optionholder undertakes to pay cash to the issuer/transferor of the shares if that undertaking is not fulfilled within that 14-day period.

13. HMRC should publish detailed guidance as to what is, and what is not, in their view acceptable, both as to the terms of the option agreement, and the extent to which the exercise of any discretion reserved to the grantor may affect entitlement to relief.

14. Amend para 39 (2), (4) and (5), so that para 39 simply refers to a situation in which an acquiring company has obtained control of the EMI company, omit para 40, and amend para 42 so that replacement options must be granted (if at all) within the period of 6 months after such acquisition of control.

David Pett, Temple Tax Chambers

15. Amend the EMI Code as follows:

- delete the existing s529(2) (see earlier suggestion re 10-yr time limit) and replace it with provision to the effect that sections 530 -540 only apply in cases in which the grant of the option has been notified to HMRC by the employer either in accordance with para 52 of Sched 5 or, if the option is exercised before the first annual return has been duly made after it was granted, at any time before the end of 30 days after it was so exercised, and (in either case) so as to require, in relation to new grants, a declaration by the employer that the option is a "qualifying option" (defined as suggested below);
- delete para 1(2)(b) and para 44(1);
- define, in para 1, a "*qualifying option*" as an option which satisfies the general requirements of Parts 2 – 5 or is a replacement option;
- delete paras 44(5)(c), (5A) and (6);
- amend paras 57A et seq to take account of these changes.

16. If the other suggestions regarding the procedural aspects are adopted, omit para 49(1), Sch 5.

17. Remove altogether the requirement that the employee make a "working time declaration", and rely upon the declaration of the employer that the grantee does in fact satisfy the "commitment of working time" requirement.

18. Combine the EMI and CSOP regimes, with differential limits applying to larger companies not qualifying to grant EMI options. Remove altogether the "requirements as to other shareholdings" provisions in para 20, Sch 4, these being unnecessary now that restricted shares can be used for CSOP options.

19. Amend the BADR rules for capital gains tax to entitle a holder of shares acquired pursuant to the exercise of an EMI option in circumstances qualifying for tax relief on exercise, to BADR notwithstanding that the shareholder ceases for any reason to hold office or employment with the EMI company or group.

20. Re SIPs:

- allow plan shares to be disposed of upon any form of 'change of control' without loss of tax relief;
- extend the allowable accumulation period for savings to 3 years (to match SAYE option savings contracts) and allow savings to be made either with the employer (in a trust account) or with a bank or building society under a certified SAYE savings arrangement;
- simplify the tax treatment so that a single basis of calculating the amount on which a 'clawback' charge arises applies, and provide that such a charge applies only if plan shares are withdrawn from, or cease to held in, the plan within 3 years (i.e. reduce the period throughout which plan shares must be held in the plan to qualify for exemption from tax, from 5 to 3 years).

21. Amend the regime for making tax elections under s431 so as to provide for an election under s431(1) to be deemed to be made in relation to "restricted employment-related securities" unless the employer and employee elect for it not to apply.

David Pett, Temple Tax Chambers

22. HMRC should liaise with professional advisers to produce a suite of 'standard-form' documentation governing a form of 'unapproved' selected-employee form of share-based incentive arrangement (i.e. a form of 'growth share' or simple form of JSOP arrangement) which can be easily adapted and adopted by companies safe in the knowledge that the tax treatment of such an arrangement in that form will not be challenged by HMRC.

23. HMRC Shares & Assets Valuation should once again be willing, and suitably resourced, to allow employers to secure agreement, in advance of making ***any*** form of employee share option or other award of shares or share incentive award, as to what is the actual and unrestricted market values of the shares (or interest in shares) both (i) a provisional "health-check" valuation, to allow employers to meet their PAYE obligations, and a definitive and binding agreement for all tax purposes.

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David Pett

Temple Tax Chambers

24th May 2021