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Enterprise Management Incentives: Call for Evidence

Response by the Chartered Institute of Taxation

1 Executive Summary

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity, and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.

1.2 Our detailed response to the call for evidence reviewing the Enterprise Management Incentives (EMI) scheme and whether it achieves its objective of providing support for high-growth companies in recruiting and retaining talented employees is set out below.

1.3 We understand that the government's objective for this call for evidence is to gather more evidence to understand whether the EMI scheme should be extended to include more companies. In particular:

- whether the current scheme is fulfilling its policy objectives of helping Small and Medium Enterprises (SMEs) recruit and retain employees,
- whether companies that are ineligible for the EMI scheme because they have grown beyond the current qualification limits are experiencing structural difficulties (ie in the labour market) when recruiting and retaining employees,
- whether the government should expand the EMI scheme to support high-growth companies and how, and
- whether other forms of remunerations could provide similar benefits for retention and recruitment as EMI for high-growth companies.

1.4 We believe that the EMI scheme is fulfilling its objectives of helping SMEs to recruit and retain employees. For many, it is the 'go to' scheme for employee incentivisation with more and more smaller companies and start-ups being aware of, and using, the scheme. This said, extending the eligibility criteria for EMI to include more companies would assist many companies in growing, especially post-pandemic.

1.5 We think companies that have grown beyond the current eligibility criteria do face significant additional costs in recruiting and retaining employees. Often these companies are not large enough to cost-effectively implement other tax-advantaged share schemes, and cash-flow limitations may restrict their ability to otherwise match remuneration offers from EMI eligible companies or much larger companies. Extending the eligibility criteria would assist these companies in recruiting and retaining employees. Also, in our view, extending the EMI criteria to a wider range of, or larger, SMEs is unlikely to distort existing qualifying companies' ability and smaller SMEs ability to attract and retain employees. Of course, increasing the limits would shift the 'pinch point' at which companies begin to face difficulties in attracting and recruiting employees to a set of slightly larger companies but being larger, they will be more capable of managing the need to offer alternative remuneration incentives to attract and retain employees.

1.6 We recommend that the current EMI scheme eligibility criteria be reviewed, and thresholds increased. Thresholds such as the number of qualifying employees and gross asset value should be increased to reflect inflation and current business needs. Fixing the qualifying point such that the number of employees or gross asset value is set for, say, a 12 or 18 month period, would help companies whose employee numbers or gross assets flex above and below the qualifying limits. Similarly, it will help those companies that grow rapidly during such a period to retain and recruit employees. It would also ease administration as the company (and HMRC) would know whether or not the company qualifies over a particular period.

1.7 We think that the eligibility criteria for other forms of tax-advantaged share schemes could also be reviewed and increased to aid recruitment and retention of employees. Coupled with administrative simplifications these schemes could then become more attractive to SMEs, and especially those that do not meet the qualifying trades requirements or who have recently grown beyond the EMI scheme qualifying limits.

2 Respondent's profile – About us

2.1 ***Questions 1 – 5***

Question 1 – If you are a business owner or manager, what is your business activity, when was your company created, what is the value of your company's gross assets and how many employees do you have?

Question 2 – If you are a business owner have you used EMI? If so, how many employees did you offer it to and why?

Question 3 – If your business does not qualify for EMI, are you using any other tax-advantaged employee share scheme?

Question 4 – Has your company benefitted from other forms of government support, such as R&D tax credits or investment schemes? Where does EMI rank in terms of importance of government support?

Question 5 – If you are responding on behalf of a representative body or think tank, please describe briefly the body, its objectives and its members.

We are responding on behalf of a professional body (the CIOT). Our body, its objectives and number of members are described below.

2.2 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.3 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.4 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.5 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

3 EMI's effect on the recruitment and retention of key employees

3.1 ***Question 6 – To what extent do you agree/disagree that the EMI scheme is fulfilling its policy objective of helping SMEs recruit employees? Please explain your answer.***

3.2 We agree that, generally, the EMI scheme has been fulfilling its policy objective of helping SMEs recruit employees, for most companies.

3.3 In our members' experience, many business owners have heard of the EMI scheme and will raise the idea of using EMI options as a means of incentivising employees. SMEs making use of an EMI scheme generally need to offer share interests to senior hires to be competitive as part of the recruitment process.

3.4 Employment by an SME can be perceived as a greater risk for individuals, so SMEs are disadvantaged where job security and opportunities for career progression are desirable. SMEs cannot match significant equity interests that may be held by the prospective employee in their existing role with larger companies, but the inducement of having capital gains taxed in the same manner as the founders, as capital on a sale, is a balancing factor enabling SMEs to attract the talent required to grow. Equally importantly, tax alignment between key employees/directors and shareholders in itself reinforces the message that everyone is working together as a close-knit team towards a common goal.

3.5 In addition, generally, the base salary that is able to be offered by SMEs will be lower than larger companies and the lure of sharing in equity growth is required for many joiners to justify what will typically be a salary reduction. Consequently, an EMI scheme helps smaller companies to recruit and retain employees that would otherwise be lured away by larger competitors without the requirement to offer big 'cash' incentives.

3.6 A further observable trend of EMI schemes is companies wishing to promote the employee ownership experience and the perceived benefits of engagement of employees with the broader aspects of ownership and responsibility. Many growth companies consider this is a unique selling opportunity to recruit employees.

3.7 ***Question 7 – To what extent do you agree/disagree that the EMI scheme is fulfilling its policy objective of helping SMEs retain employees? Please explain your answer.***

3.8 We agree that the EMI scheme has been fulfilling its policy objective of helping SMEs retain employees, for most companies. For many SMEs, an EMI scheme is all about employee retention. This said, we are aware of more and more instances where an SME would like to use an EMI scheme but cannot as they no longer meet the relevant criteria. Most common instances of this are SMEs who either carry out excluded trades or are too large and therefore fail the employee numbers test or gross assets test.

3.9 In our members' experience, most EMI options are designed such that they will only become exercisable following a significant corporate event such as an initial public offering (IPO), take over or similar. The aim here is to seek to retain talent within an organisation through to these corporate events and beyond to ensure that the business can continue to thrive and grow. Typically, participants' options will lapse on cessation of employment, even for good reasons such as retirement or another 'good leaver' scenario.

3.10 ***Question 8 – To what extent do you agree/disagree that the EMI scheme is fulfilling its policy objective of helping SMEs grow and develop? Please explain your answer.***

3.11 We agree that the EMI scheme has been fulfilling its policy objective of helping SMEs grow and develop, for most companies. However, as noted above, the current qualifying criteria limits (employee numbers and gross assets) do limit the ability for EMI schemes to help some SMEs to grow and develop.

3.12 The recruitment and retention of talent provides a strong basis for stability and growth. We would add that it is the combination of a flexible statutory plan and good management that allows for growth and development of companies. Accordingly, shares schemes, and EMIs with their tax advantages, are a valuable management tool if carefully designed and communicated to participants, creating engagement and loyalty.

3.13 We note that the high prevalence of EMI options being scrutinised as part of due diligence on sales of companies and on an IPO, shows that growth companies have used EMI options.

3.14 ***Question 9 – In your views, what aspect of the EMI scheme is most valuable in helping SMEs with their recruitment and retention objectives? Please explain your answer.***

3.15 The flexibility of an EMI scheme is attractive to growth companies. In particular, the ability to grant options over any share class is compatible with the need for growing companies to be able to offer shares to investors or other shareholders with different rights and obligations to enable fundraising.

3.16 Additionally, the practical approach of HMRC's Shares and Assets Valuation team in agreeing share values generally enables a speedy implementation, and this can be critical in the recruitment process. This said, we are also aware of reports that, pre-pandemic, difficulties were experienced in agreeing valuations methodology for high-growth shares, which has led to plans for schemes being abandoned. We believe that these types of issue could be resolved through ongoing, industry-wide discussion and by agreeing a set of principles on valuation.

3.17 However, we understand that many of the EMI options that are granted are never exercised. This is often due to:

- disqualifying events causing the options to cease to be EMI options, though they may continue to provide capital growth and incentives to the participants, and
- over-ambitious or poorly designed performance/exercise conditions preventing vesting of awards.

4 Recruitment and retention of key employees in high-growth companies

4.1 ***Question 10 – Is there evidence to suggest that high growth companies that are no longer eligible for EMI are finding it difficult to recruit or retain employees? Please explain your answer. If your answer is yes, what in your view causes these difficulties and which jobs and kinds of companies are affected?***

4.2 High growth companies no longer eligible for EMI, for example due to employee numbers exceeding the 250 limit or a fundraising that causes the gross assets to exceed £30m, may continue to recruit and retain employees but the cost of doing so rises exponentially. Consequently, whether or not this can be achieved outside of an EMI plan may well depend on a company's ability to obtain additional funding.

4.3 One potential difficulty for companies that have outgrown their EMI scheme is that new joiners and existing employees are accustomed to annual awards through an EMI scheme. The cost and cash flow of continuing to match the staff expectations therefore rises. For example, whilst employees could continue to be given the opportunity to buy shares (outside a tax-advantaged share scheme) the cost might be too much for the employee, and so the company may then have to lend money to the employee to fund the purchase. But this in turn requires compliance with additional Company Law and Consumer Credit Act requirements. In addition, there may well be a tax liability arising for the company under section 455, Corporation Tax Act 2010. The company could instead pay taxable cash bonuses to recruit and retain employees (or to facilitate share purchases, so they can then benefit from future share growth) but this would represent a significant cash flow cost. So all in all if EMI could be more flexible, so that qualifying awards could still be made for more high growth companies, this would be much preferable.

4.4 Breaching the EMI scheme eligibility thresholds leaves few options for some companies. Where a company remains an SME, even if the current limits are slightly breached, the costs of designing, implementing and maintaining a Save As You Earn (SAYE), Share Incentive Plan (SIP) and Company Share Option Plan (CSOP) (which combined might replicate the incentive of an EMI scheme) would be difficult to justify for most SMEs. We are aware that the costs involved in implementing other tax-advantaged share schemes can result in companies just abandoning providing such schemes.

4.5 ***Question 11 – If your answer to the previous question is yes, in your view, would expanding EMI help with these issues? Please explain your answer. If your answer is yes, do you think that other forms of remuneration or employee benefits could achieve similar results?***

4.6 Yes, we do think that expanding the EMI scheme eligibility criteria would help these companies to recruit and retain key employees. See our response to Question 10.

4.7 Other forms of tax-advantaged remuneration or employee benefits could, of course, achieve similar results. People are crucial to the effective running of a business. Persuading those people that there is something in it for them, and for their company, naturally motivates them and makes the company more successful. Profit-sharing gives employees an immediate interest in their company's performance. There are many ways to encourage profit sharing, from 'The John Lewis Partnership' model to the HMRC registered Profit-Related Pay (PRP) scheme of the late 1980s and 1990s. Certainly pay/bonus linked to profit can motivate workers and enable them to share in their employer's success without ratcheting up pay rises which cannot be reversed in less prosperous times and tax incentives can play an important part in this. However, it would be very important to frame any tax incentives so that they are appropriately targeted – this was the problem with PRP, and which ultimately led to its withdrawal.

4.8 ***Question 12 – Are you aware of the other tax-advantaged employee share schemes offered by the Government (CSOP, SIP, SAYE)? Do you use or have you previously used any of these schemes? If the answer is no, please explain why.***

4.9 The CIOT is aware of the other tax advantaged share plans and many of our members will have advised clients on their establishment.

4.10 ***Question 13 – In your view, do the other tax-advantaged employee share schemes offered by the government (CSOP, SIP, SAYE) provide enough support to high growth companies that no longer qualify for EMI to recruit and retain employees? Please explain your answer.***

4.11 We think that CSOPs, SAYEs and SIPs have limited value for high growth companies:

- Given the low upper limits for these share schemes, very high levels of growth would be required to motivate participants to join and remain with an SME. For example, if an individual is granted a CSOP option over the maximum value of £30,000, even 50% growth would give a profit of just £15,000, or £12,000 after capital gains tax. In addition, if that option become exercisable on a non-qualifying takeover within three years, which is very common for a growth company, the gain would be subject to income tax and NICs (employer and employee) payable under PAYE potentially reducing the value of the incentive to £6,811.50,
- CSOPs are not too onerous to adopt, especially for a quoted company, compared with an EMI but for private companies with investors it may not be possible to use a qualifying share class,
- SIPs and SAYEs require companies to employ an administrator/savings provider. Where SMEs have limited administrative staff, appointing an external administrator might be cheaper than hiring an employee to manage the plan but it remains a significant, and off-putting, cost for SMEs, and
- The requirements attaching to SIPs, SAYEs and CSOPs are less flexible than EMI schemes. It is easier for SMEs who might be saving costs by trying to manage such plans in-house to make inadvertent errors and, thus, lose the tax advantages associated with these schemes. The plans therefore move quickly from being a staff incentive to a disincentive.

4.12 ***Question 14 – In your view, how could the government improve the other tax-advantaged employee share schemes to help support high growth companies?***

4.13 We consider that continuing to simplify procedures both for EMI schemes and other tax-advantaged share schemes would support SMEs, reduce their administration requirements and consequential costs and allow management to focus on business growth not administration. The following are suggestions relating to both EMI schemes and other tax-advantaged share schemes:

- Numbers such as the number of employees and gross assets value, can change daily. A simplification would be to fix the qualifying limit as applicable for, say, a 12 month or 18 month period during which the SME could continue to qualify,
- Share valuations of non-quoted shares for EMI options have been agreed for the longer period of 120 days as a result of Covid-19. Valuation agreements for SIP shares have been normally fixed for six months. These are subject to significant changes. A simplification would be to allow values to be agreed for 12 months (this is the US tax approach) or at least six months for all plans. This helps growth companies making multiple annual awards as their employees grow and should save review time for HMRC,
- Remove the requirement to report an EMI option within 92 days. There is no longer the approval process difference between EMI, CSOP and SAYE that was the original justification for the additional

requirement and the grants may be reported on the annual returns through the normal online portal. Whilst there is a reasonable excuse provision, the removal avoids companies making genuine mistakes needing to rely on this. For example, we are aware of instances where an error, resulting in a company not reporting an EMI option at the time of grant, has resulted in significant liabilities for the affected employee, which then leads to loss of trust between employee and employer, potential court actions, knock-on effects in the employer being able to recruit and retain other staff, etc. In addition, it would save HMRC time dealing with errors,

- Remove the requirement that the company set up for PAYE Online and register an EMI or other tax-advantaged scheme with HMRC, before any reporting or notification can be done by agents and allow agents to register the scheme. Similarly, at present, only the company has the ability to close the scheme, when an authorised agent should be able to do this too,
- Review and simplify the excluded activities for EMI options in Schedule 5 ITEPA. For example, hotels and residential care homes have been excluded on the basis that they may be capital intensive businesses, but as they have suffered due Covid-19 this might be reviewed. Computer software and game development companies find the limitations imposed by the restriction on licensing are out of line with common practices where, for example, businesses with intellectual property are bought by other growth businesses such that the exemption for such IP created 'in-house' will not apply. Similarly, while it may be understandable that dealing in land and property development is excluded, given the potentially lower risks of such activities, it is not so obvious why leasing (of cars) or providing legal or accounting services, are excluded activities,
- Relax the meaning of associate within the 'no material interest' test for EMI qualification. This requires that an eligible employee and their associates' combined interest to be below 30% of the shares. While it is right to consider the share interests of a relative, we think it is odd to include the interests of business partners from a separate stand-alone business. We suggest that a narrower definition of connected persons is adopted,
- Relax the 'working time requirement' in the EMI legislation, which requires that the employee's time committed to the company must be equal to or exceed the statutory threshold of 25 hours per week or if less, 75% of their working time, to reflect that working arrangements in the 21st Century have changed, and many more workers have multiple engagements. Such a change is likely to benefit those with family responsibilities, or who are disabled, and have limited time for work;
- For a SIP, reduce the holding period to three years, in line with the three year period for CSOP options and the minimum saving period for SAYE contracts. This encourages broader employee participation, particularly for younger or less financially well-off staff members for whom a five year commitment would be too difficult,
- For a CSOP, to ease the cliff-edge when growth companies grow:
    - (i) remove the prohibition on having an option exercise price less than market value but replace that with an income tax charge on the discount, and
    - (ii) allow options to be exercised on a takeover within three years without the complex conditions imposed by section 524 of ITEPA 2003,
- An increase in qualifying limits to reflect current values (taking account of inflation) and understanding of the meaning of 'SME'. For example, by increasing the EMI gross assets test from £30m (this limit has been in place since 2002) to £50m and employee numbers from 250 (this limit has been in place since 2008) to 350 or, possibly, even 500. This latter change would certainly help many hospitality businesses with high staff levels that are suffering from the combination of Brexit hampering recruitment and Covid-19 recruit the staff they need. Also, the £250,000 limit per

individual can prove a stumbling block to employee recruitment and should be increased. For a CSOP, the £30,000 limit is no longer fit for purpose and to increase that to £50,000 would improve take up.

4.14 One aspect that the Call for Evidence does not consider is the interaction of EMIs with the Enterprise Investment Scheme (EIS). Where high growth companies want to both incentivise senior staff and attract business angel investors through EIS, the interaction of the two schemes (which should be complementary) is particularly fraught and often it is only possible to implement one or the other. While we do not believe employees should be able to use EIS, or that business angels should be allowed EMI options, we think it should be possible to operate both schemes in the same company (for different recipients) and generally speaking that is not the case at the moment. We would therefore suggest reviewing the interactions of tax-advantaged employee share schemes with the EIS. For example, under EIS the shares cannot have any preferential rights over other classes but for EMI it is often desirable to have good/bad leaver provisions. This can mean that the EIS shares would have preferential rights which is not permitted – so it is then either EIS or EMI. This could be resolved by, for example, relaxing the EIS conditions so that the no-preferential rights condition is modified so as not to include EMI shares.

4.15 ***Question 15 – In your view, how does the tax-advantaged employee share schemes' offer in the UK compare with other countries?***

4.16 The UK appears to have a wider range of tax advantaged share scheme than most comparable countries, but the rules are significantly more complex. Inbound companies seeking to replicate awards to UK employees frequently make errors as a result that can unfairly tax UK employees.

5 EMI eligibility criteria

5.1 ***Question 16 – In your view, should the EMI scheme criteria be extended to include more companies? Please explain your answer. If your answer is yes, which eligibility criteria would you change and why?***

5.2 Further to our response to Question 14, we would suggest that the eligibility criteria for an EMI option should be reviewed to reflect current values, inflation, the needs of business post-Brexit/Covid-19 and current business models.

5.3 In our opinion, and as noted above, the excluded activities element of EMI (see ETASSUM52100[1]) is too restrictive. We think the criteria for eligibly activities could be widened. We also think that additional guidance on excluded activities would be helpful. While it may seem simple it is not always obvious what is excluded or when an activity is sufficiently substantial to exclude a company. Requesting advance assurance is possible, however this increases the cost of the professional fees which, for a scheme aimed at smaller companies, is quite a large part of it

5.4 ***Question 17 – In your views, do the current EMI scheme criteria have a distorting effect on companies' growth insofar as the companies try to remain within the scheme's limits? If your answer is yes, could you provide examples or quantitative data to support your views?***

5.5 We are not aware of companies seeking to restrain growth to remain within scheme limits, but two particular incidents have been observed by members:

[1] ETASSUM52100 - Employee Tax Advantaged Share Scheme User Manual - HMRC internal manual - GOV.UK (www.gov.uk)

- Waiting until year-end bonuses have been paid out before awarding EMI options, as a result of which the gross assets of company will have fallen, and
- Waiting until certain employees have been made redundant, for example for seasonal businesses after the end of a season, so that employee numbers fall below 250 enabling qualifying options to be granted.

5.6 This said, we are aware that where a company's number of employees or gross asset value may flex above and below the qualifying limits, these companies have to take a lot of care when deciding when to grant options to ensure that they can qualify under an EMI scheme.

5.7 ***Question 18 – In your view could widening the current eligibility criteria to support larger companies affect smaller companies' ability to recruit and retain employees? Please explain your answer.***

5.8 In our view, a proportionate increase in limits and widening other eligibility criteria to attract more SMEs into using EMI schemes would have minimal impact on larger companies, such as FTSE 100 or FTSE 350 companies, but would significantly support quoted SMEs. In particular, by reducing the additional burden and unnecessary cost of establishing alternative arrangements to encourage employee ownership.

6 Acknowledgement of submission

6.1 We would be grateful if you could acknowledge safe receipt of this submission and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation

26 May 2021