

## **FINAL REGULATORY IMPACT ASSESSMENT (RIA) ENTERPRISE MANAGEMENT INCENTIVES**

### **Introduction**

1. This assessment considers the costs and benefits of the new Enterprise Management Incentives (EMI) for introduction in Finance Bill 2000. It considers both the tax and National Insurance (NIC) issues in a single document.

### **Purpose and intended effects of the measures**

2. It is intended to introduce the legislation for the new arrangements in Finance Bill 2000.

3. The Government recognises that one of the main constraints on growth for a small ambitious company is the difficulty of recruiting and retaining the key people they need to help their business succeed and grow.

4. The intention is to introduce new arrangements specifically targeted at small higher risk trading companies. EMI is intended, through tax and National Insurance incentives, to tilt the risk-reward balance to encourage entrepreneurial ambition and focus those incentives where they can be most effective.

5. The new arrangements will be an important step forward in the Government's strategy for promoting innovation and enterprise. The Government wants to encourage high quality managers as well as other key employees to take a stake in the companies which employ them, and share in the risks and rewards of running small higher risk companies.

6. EMI has been designed to be particularly attractive to smaller companies by enabling them to offer potentially valuable equity-based remuneration packages in the form of share options. Feedback from the last

phase of the consultation exercise has indicated that the vast majority of respondents think the proposed measures will be sufficiently attractive both to encourage small, higher risk companies to use EMI and to encourage prospective key employees to accept the potential risk and reward.

### **Benefits**

7. The Government recognises that, in the future, small and growing businesses will supply more of the country's wealth and jobs. By creating the right environment for dynamic and innovative smaller firms to grow, the economy as a whole benefits.

8. EMI will be of benefit to small companies because it will enable them to compete with much larger concerns in the recruitment and retention of key individuals.

9. The benefit for key individuals is the potential reward, made significantly more valuable by generous tax and National Insurance treatment.

### **Compliance Costs**

10. EMI is not compulsory. It has been designed specifically to appeal to small, higher risk companies with growth potential. An advisory group drawn from share scheme experts, business and other interested parties has assisted the Revenue in drawing up the detail of EMI. Several of the members of the advisory group have small company experience.

11. Keeping administration costs to a minimum has been a key feature of the design process. EMI is very flexible, giving companies as much choice as possible. One of the major simplifications for EMI, compared with the existing tax-advantaged share option schemes, is a new, easy notification process. A brief outline of the main features of EMI is shown at Appendix 1.

12. Companies wanting to use EMI will have a certain amount of administration - for example ensuring they qualify, checking the eligibility of key employees, preparing option agreements.

13. Administrative costs for companies setting up a very simple arrangement, using a standard model, are estimated to be relatively low. A straightforward EMI with professional advice might typically cost around £4,000 – including the initial share valuation. Subsequent annual costs depend on administering EMI and whether there are requirements for further share valuations. There will be one-off costs for a company wanting to grant EMI options, and annual recurring costs.

14. Respondents to the consultation document “Enterprise Management Incentives: Draft legislation and commentary” did not identify costs as a significant issue. Where mentioned, concerns about costs were focused on a need for frequent share valuations possibly being expensive for small companies.

15. The Inland Revenue is working on special help and new guidance for unquoted companies to enable them to agree valuations quickly and easily. Where possible, valuations may be agreed for extended periods where there is no substantive change in the company’s circumstances. This will reduce the number of occasions that a valuation is needed.

16. More details of the administrative tasks and estimates of costs are shown at Appendix 2 Tables 1 & 2. The start-up costs will depend on the complexity of the arrangements and are estimated to range from negligible to a maximum of £15,000 per company.

17. When companies grant an EMI option, they incur costs as shown in Appendix 3 Tables 1 & 2. These costs are one-off compliance costs in the year of notification and recurrent (on-going) costs in respect of each year for which companies have used EMI. Assumptions about costs (in a range from low to high) and proportions of companies opting for simple or complex arrangements have been combined with forecasts of the number of companies using EMI by year.

18. The one-off costs shown in Appendix 3 Table 1, are relatively more significant than the recurring costs. In the first year the aggregate compliance costs associated with notification for an estimated 1,100 companies, are estimated at between £6 million and £10 million. As fewer companies notify in subsequent years the one-off costs decline to between £1 million and £2 million in the fourth year. During the first four years the number of new companies notifying EMI option grants is expected to fall from 1,100 at the start to less than 200 in the fourth year.

19. Recurring costs are shown in Appendix 3 Table 2. The number of companies notifying grants of EMI options by the fourth year (taking account of companies whose options lapse or become worthless) is forecast to rise to, and stabilise at, about 2,500. The recurring compliance costs are similarly forecast to rise from the range of £0.4 million to £0.8 million in year 1 to £1 million to £2.5 million in year 4. The widening bands reflect a range of considerations including the uncertainty about how many valuations will be required in later years, since the costs are not proportional to the maximum number of option holders but the turnover of key employees throughout the period requiring a separate valuation for their options.

### **Other Costs**

20. Businesses are not expected to be affected by any additional or indirect costs. There are no additional costs for individuals. There will be a cost to Government for developing, monitoring and enforcing the new arrangements. However that cost is expected to be minimal.

### **Consultation**

21. Consultation on EMI has been extensive and successful, enabling the Inland Revenue to respond to constructive points of detail about the draft legislation published in November 1999. One respondent commented "*We would...like to commend HM Treasury and the Inland Revenue for the manner in which the consultation process was established and taken forward. This has resulted in draft proposals that....when enacted will make a positive difference to the ability of companies to attract and retain employees.*" More

details about the results of the consultation process are shown at Appendix 4 Table 1.

22. The consultation process also benefited from the formation of an advisory group to work with the Inland Revenue on the detail of EMI. The EMI sub-group met on 9 occasions to discuss and develop the design of the new arrangements. As a result of the input from the advisory group and comments from the first consultation document issued in March 1999, several important changes were made to the design of EMI including the increase in the number of key employees from 6 to 10. To increase the impact of this measure the Chancellor has announced a further increase to 15 key employees. More details about the advisory group are shown at Appendix 4 Table 2.

23. As part of the process the Inland Revenue has also worked closely with ProShare, a not for profit organisation which promotes wider responsible share ownership. Through ProShare the Inland Revenue has been able to consult a wider audience, and incorporate their ideas and suggestions into the design.

### **Summary**

24. EMI should lead to productivity benefits for the economy as a whole, as small companies with potential for higher growth find it easier to recruit and retain the kind of employees who should enable them to realise that potential.

25. The Chancellor wants 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.

26. One-off compliance costs are expected to be between £6 million and £10 million for the first year, based on 1,100 companies notifying options. Recurrent costs for the first year are likely to be less than £0.8 million, and still under £2.5 million in year 4 when some 2,500 companies will have option grants. Further details of these costs are in Appendix 3.

27. There is an impact on small companies in terms of administrative and running costs. The estimated start-up costs will range from several hundred to £15,000 per company depending on the complexity of the arrangements. But the Government believes these small administrative costs are wholly proportionate to the benefits the companies will accrue from operating EMI

### **Monitoring & Review**

28. Companies wanting to use the EMI will not require Revenue approval. Instead a simple notification procedure is proposed with an annual return giving details of employees with outstanding EMI options. The Inland Revenue will issue guidance to help companies to comply. The notification procedure and the return form the basis for the compliance regime. Sanctions for non-compliance are also proposed.

29. The sanctions will take the form of the Inland Revenue having the power to decide that the options do not qualify for reliefs. Penalties for the late submission of the annual return will also apply, but it is expected that only a very small number of companies will be affected.

30. Progress in implementing the new arrangements will be reviewed in March 2002. A full review of the success of the EMI policy is due to take place during 2005.

### **COMMENTS**

Comments on this Regulatory Impact Assessment are welcome and should be sent to:

Richard Lambert

Capital and Savings Division Room 138

New Wing

Somerset House

Strand

London WC2R 1LB

or by e-mail to [Richard.V.Lambert@ir.gsi.gov.uk](mailto:Richard.V.Lambert@ir.gsi.gov.uk)

## Appendix 1

### An outline of the main features of EMI(paragraph 11 in the main RIA text)

- Flexible arrangements where companies can tailor each individual option to an individual key employee;
- No rules about when options may be exercised (although options must be exercised within 10 years of grant to obtain tax and NICs reliefs) or about the price at which options must be granted and no requirement for prior approval. Companies will have to notify the Inland Revenue within 30 days of grant that an option has been awarded;
- Companies must be small – with gross assets of not more than £15 million. Companies can be unlisted or listed;
- Companies must be independent – not under the control of any other company and carrying on a qualifying trade wholly or mainly in the UK;
- Individuals, whether they are new recruits or existing employees, must work for the company for at least 25 hours a week, or if less than 25 hours, for at least 75% of their working time, to qualify for EMI;
- An employee will be able to hold at any one time, options over a maximum of £100,000 worth of shares valued at the date the options are granted. An employee who has been granted options up to this maximum and then exercises some or all of the options may 3 years after the date of grant of the last option be granted further EMI options within this limit;
- Options may be granted only to 15 employees at any one time in each qualifying company;
- No income tax or national insurance will be chargeable on either the grant or exercise of the options if the exercise takes place within 10 years of grant of the option and the exercise price is the market value of the shares at the date they are granted;
- If the options are granted at a discount, the discount is taxed as normal;
- Restricted shares and shares subject to forfeiture are allowed, but will be subject to the normal tax rules;
- For shares acquired under EMIs, the business assets holding period for taper includes the period from the date of the grant of the option;
- Companies will have corporation tax relief on the costs of setting up the options, and there will be no charge to employers' national insurance.

**Table 1      Details of the administrative tasks when using EMI  
(paragraph 16 in main RIA text)**

<b>Likely actions necessary for a company setting up EMI</b>
<ul style="list-style-type: none"> <li>• background research to understand the implications of putting EMI in place</li> <li>• ensuring the company qualifies for EMI</li> <li>• reviewing existing ownership structure and articles of association</li> <li>• obtaining agreement /consent of any existing institutional investors</li> <li>• drafting option agreement and, as appropriate, shareholders' resolutions, board minutes, and checking eligibility of key employees</li> <li>• obtaining SVD agreement to the "market value" of shares under option</li> <li>• notifying the Inland Revenue of option grants</li> <li>• administering the arrangements</li> <li>• submitting an annual return</li> </ul>

**Table 2      Estimates of the cost of using EMI (paragraph 16 in main  
RIA text)**

<b>Cost Estimate of the cost for a company using EMI</b>
<ul style="list-style-type: none"> <li>• simple arrangement without changes to company's Articles, no professional advice, using standard plan: £ several hundred</li> <li>• simple arrangement with professional advice: £3,500 to £5,000</li> <li>• more complex arrangements with professional advice: £8,000 to £15,000</li> </ul>

## Appendix 3

### Details of the overall compliance costs of the new EMI arrangements (paragraphs 17 to 19 in the main RIA text)

**Table 1 One-off compliance costs of companies notifying by year**

		Year 1	Year 2	Year 3	Year 4
<b>TOTAL ONE-OFF COSTS in £M *</b>	LOW	6.0	5.5	2.5	1.0
	HIGH	10.0	9.0	4.0	2.0
<b>Number of companies notifying EMI option grants in year</b>		<i>1,100</i>	<i>1000</i>	<i>440</i>	<i>175</i>

\* One-off compliance costs fall from a high in the first year (still high in the second) indicating that the number of companies setting up EMI for the first time falls after the initiative is first introduced to a steady state which is reached by around year 4.

**Table 2 Recurrent compliance costs of EMI companies by year**

		Year 1	Year 2	Year 3	Year 4
<b>TOTAL RECURRENT COSTS in £M **</b>	LOW	0.4	0.6	0.75	1.0
	HIGH	0.8	1.3	1.6	2.5
<b>Number of EMI companies with notified option grants at end of year</b>		<i>1,100</i>	<i>1,990</i>	<i>2,440</i>	<i>2,500</i>

\*\* Recurrent compliance costs rise over the first four years as the pool of companies using EMI grows over this period until the estimated full year level is reached by around year 4.

**Table 1** Details of the results of the technical note consultation exercise and of the draft legislation document (paragraph 21 in main RIA text)

<p><b>Inland Revenue technical note March 1999</b></p> <p>Feedback from the issue of “Enterprise Management Incentives: A new scheme”</p>	<p><b>Result</b></p> <ul style="list-style-type: none"> <li>■ Responses from 39 sources           <ul style="list-style-type: none"> <li>• 5 from companies:               <ul style="list-style-type: none"> <li>2 from plcs</li> <li>3 from unlisted/AIM companies</li> </ul> </li> <li>• 2 from individuals</li> <li>• 32 from other sources:               <ul style="list-style-type: none"> <li>14 from practitioners</li> <li>16 from representative bodies</li> <li>2 from voluntary groups</li> </ul> </li> </ul> </li> </ul>
<p><b>Inland Revenue document November 1999</b></p> <p>Feedback from the issue of “Enterprise Management Incentives Draft legislation and commentary”</p>	<p><b>Result</b></p> <ul style="list-style-type: none"> <li>■ Responses from 54 sources           <ul style="list-style-type: none"> <li>• 4 from companies:               <ul style="list-style-type: none"> <li>1 from plcs</li> <li>3 SMEs</li> </ul> </li> <li>• 16 from individuals</li> <li>• 34 from other sources:               <ul style="list-style-type: none"> <li>22 from practitioners</li> <li>10 from representative bodies</li> <li>2 from voluntary groups</li> </ul> </li> </ul> </li> </ul>

**Table 2**      **Details of the advisory group (paragraph 22 in main RIA text)**

<p><b>Advisory Group Members</b></p> <p>A 9 strong team formed consisting of</p>		
David Cohen	Norton Rose	<ul style="list-style-type: none"> <li>• inaugural full advisory group meeting with Ministers held on 30 March 1999</li> <li>• 9 EMI sub-group meetings held between 21 April 1999 and 13 December 1999</li> <li>• 2 full advisory group meetings: <ul style="list-style-type: none"> <li>30 June 1999 to agree recommendations before submissions to Ministers on 6 August 1999 and</li> <li>6 October 1999 to review progress</li> </ul> </li> </ul>
Jeannie Drake*	TUC	
John Hampton	BT	
Sue Keast	Bioglan	
Nigel Mason*	Capital Strategies Ltd	
Graeme Nuttall*	Field Fisher Waterhouse	
Andrew Pendleton*	Manchester Metropolitan University	
David Pett*	Pinsent Curtis	
David Tuch	KPMG	
<p>* members of the EMI sub-group</p>		