EUROPEAN COMMISSION

Brussels, 13.7.2009
C(2009) 5082 final

SUBJECT: State aid NN 32/2009 – United Kingdom
Enterprise Management Incentives (EMI)

Sir,

1. PROCEDURE

(1) By letter dated 1 July 2007, registered at the Commission on the same day, the UK authorities informed of the above-mentioned measure. By letter of 25 March 2009, the Commission asked the UK authorities for additional information. The UK authorities responded by letter dated 8 April 2009.

2. DESCRIPTION OF THE MEASURE

2.1. Objective of the measure

(2) Enterprise Management Incentives (EMIs) is a tax advantaged share options[1] scheme designed to enable smaller, higher risk growth companies in the UK to recruit and retain qualified employees they need to achieve their growth potential. The companies can provide key employees with a financial reward the value of which is directly determined by business success and which may be taxed at a significantly lower rate than a cash bonus.

[1] An option is a financial security known as a derivative. The value of an option is 'derived' from the value of an underlying asset, such as the shares of a company, currency, raw materials, etc. An option gives its owner the right (but not the obligation) to buy (call option) or sell (put option) a certain asset under option at a pre-determined price (exercise price) during a predetermined period regardless of the development of the asset's market price. Employee share options are (call) options given by a company to its employees as non-cash remuneration for work. The owner of the option has the right to decide if he wants to exercise his option (right) or not. If it is not exercised within an agreed time, it becomes void.

The Rt Hon David MILIBAND
Secretary of State for Foreign Affairs
Foreign and Commonwealth Office
King Charles Street
London SW1A 2AH
United Kingdom

(3) The scheme is part of the UK Government's integrated approach to tackling the SME labour market and capital market failures. The scheme has been under implementation since 2000.

2.2. Legal basis, granting authority, duration and budget

(4) The legal basis is:

(a) The Income Tax (Earnings and Pensions) Act 2003 (Sections 527 to 541, Schedule 5)[2]: provisions related to the general structure of the scheme and income tax relief;

(b) The Taxation of Chargeable Gains Act 1992 (TCGA) at TCGA (Section 238A and Schedule 7D): provisions relating to capital gains tax;

(c) The Social Security Contributions and Benefits Act 1992 (SSCBA92) and Statutory Instrument 2001/1004: provisions relating to National Insurance Contributions.

(5) HM Revenue & Customs (HMRC) is the aid granting authority. Based on the economic forecasts on the use of the EMI scheme and trends in the share value of EMI beneficiary companies, the UK authorities estimate that revenue losses due to tax relief is approximately GBP 210 million annually, of which the annual relief granted to companies amounts to approximately GBP 36 million.

(6) There are no estimates for the total budget. The UK expects that the take-up and use of EMI will continue to grow whilst the scheme reaches maturity. In the longer term, the use of EMI is expected to rise reflecting long-term growth in the value of companies using EMI.

(7) The notification covers duration until 6 April 2018, which is the period during which EMI share options can be exercised. According to the UK, the proposed duration is necessary to ensure the effectiveness of the scheme in supporting its objectives.

2.3. Nature of the aid

(8) EMI options must be granted for commercial reasons to recruit and retain key employees in a company. EMI option with a maximum share market value of GBP 120 000 under options may be granted to a qualifying employee in a qualifying company, subject to a total share value of GBP 3 million under EMI options to all employees[3] . No employee may hold EMI options over shares worth more than of GBP 120 000 with any 3 year period.

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2 Amended by Finance Act 2003, 2004, 2006, 2007 and 2008, and Statutory Instrument 2004/712 and 2008/706.

3 The market value of the underlying shares is taken at the date of grant, which is the price of the shares on any regulated EEA market. Alternatively, the company can ask HMRC to agree a valuation with them before the option is granted or whenever a valuation is required. There are no performance conditions when determining the market value of the shares under option and attached to the exercise of options.

2.3.1. *Standard tax treatment of share options*

(9) Since employee share options are granted as remuneration for work under an employment contract, they fall under the definition of employment income (i. e. income that is given as the remuneration for work under an employment contract). Employment income is subject to personal income tax and social contributions. Normally, the same taxation applies regardless whether the income is given in cash or in kind (e. g. in the form of a financial asset).

(10) Regardless of the price at which the options are granted, the standard UK's tax treatment of employee share options is as follows:

- Grant of option: no income tax or employee and employer national insurance contribution (NIC);

- Exercise of option: income tax and employee and employer NIC (only NIC liability in case of readily convertible assets – see below) on the difference between the market value of the option shares at the exercise date and the total price paid for those shares;

- Sale of shares: capital gains tax (CGT) charged at a flat rate of 18% on the difference between the value realised on selling the shares and the value of the shares at the exercise date (subject to availability of the annual CGT allowance of specific CGT reliefs)

(11) Under the UK's standard tax treatment, if shares acquired under the option are readily convertible assets (i. e. if they are listed on a stock exchange or otherwise tradable), they are treated like employment related income and therefore are subject to employee income tax and employee's and employer's NICs when an employee exercised the option. Profits from the sale of shares acquired by exercising the option are subject to CGT.

(12) However, for shares acquired under the option that are not readily convertible assets (not listed or otherwise tradable), their value is not easily determined and therefore they are not treated like employment related income. Consequently, they do not attract NIC liability under the UK's standard tax system. According to the UK, in the majority of cases, the shares under options granted by SMEs are not listed and therefore are not going to attract NIC liability[4].

2.3.2. *EMI tax relief*

(13) EMI provides for an advantageous tax treatment on growth in share value between the dates of option grant and exercise. Presuming the EMI qualifying requirements are met throughout the option period, EMI share options are only taxed at the time of share sale and are only subject to capital gains tax CGT:

- Exercise of option: if the shares acquired under the EMI option are readily convertible assets and are subject to income tax and NIC, there is no income tax for the employee and no NIC for the employee and employer on any

[4] Based on the 2007 independent survey of EMI, only about 10% of companies using EMI are listed, thus subject to NIC liability.

financial gain (the increase in the value of shares acquired) made on the exercise of the option, provided the exercise price is fixed at or above market value at the time the EMI option is granted.[5] This provides a potential saving to the company of 12.8% of the value of any financial gain made by an employee which would otherwise be subject to employer's NICs as employment related income. If the shares under the EMI option are non-readily convertible assets, there is no income tax for the employee under the EMI;

- Sale of shares: when shares obtained on exercise are sold, the employee will be liable for CGT on the taxable gain (the difference between the value of the shares realised on sale and the exercise price).

2.4. EMI qualifying criteria

(14) In order to qualify for the EMI tax relief, both the grantor company and the employee option holder must fulfil certain qualifying criteria. Provided the legal qualifying conditions have been fulfilled, the EMI status is accorded automatically upon the grant of options. The employer must notify HMRC after the grant of the option certifying that the option agreement satisfies the legislation and the option holder has to certify that he satisfies the working time requirements.

2.4.1. Qualifying companies

(15) The company whose shares are the subject of EMI options must be a qualifying company at the time the options are granted:

- The gross assets must not exceed GBP 30 million at the date of grant;
- The company must have fewer than 250 full time-equivalent employees;
- The company must be independent;
- The company must carry on qualifying trades that are trades carried on a commercial, profit making basis and excludes leasing, financial activities and property development as well as coal mining, steel and shipbuilding sectors also excluded.
- The company must have an establishment[6] in the UK;

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5 If EMI options are granted with an exercise price less than fair value, then income tax and employer and employee NICs is payable. However, the tax is not payable until the options are exercised. The taxable amount will be the difference between the exercise price and the lower of the actual market value at the date of exercise and the actual market value at the date of grant.

6 For the purpose of the measure, the term includes UK resident companies established in the UK and foreign companies with a permanent establishment in the UK. The term "permanent establishment" is based on Article 5 of the OECD Model Tax Convention on Income and on Capital (2003), which means a fixed place of business through which the business of an enterprise is wholly or partly carried on, including a place of management, a branch, an office.

(16) According to the UK authorities, the gross asset and employee limit effectively ensures that the qualifying companies meet the SME definition[7]. Gross assets of no more than GBP 30 million and employees less than 250 fulfils the EUR 43 million balance sheet limit and the employee limit of 250 under the Community SME definition. The gross assets figure used in the UK legislation is broadly equivalent to balance sheet total. Gross assets would exceed balance sheet total by the amount of an enterprises "current" liabilities.

(17) The UK authorities further claim that enterprises in difficulties within the meaning of the Community Guidelines on State aid for rescue and restructuring undertakings in difficulty (the RR Guidelines)8, are excluded due to EMI's inherent safeguards against being used by companies in difficulty. If a company is in difficulty, the value of its shares is likely to fall, thus it is unlikely to be accepted by employees as a suitable remuneration. Besides, employees will exercise their share options only if the value of underlying shares increases, which effectively excludes the possibility of granting the aid to undertakings in difficulty.

2.4.2. Qualifying employees

(18) Qualifying employees must be employed by the qualifying company (at least 25 hours a week). They must have no material interest in the company, which is controlling 30% or more of the ordinary share capital of the company. The option holder must remain employed by the company or its group at all times during the duration of the option. On employee resignation and termination, in case the option has not yet been exercised, the EMI tax relief will no longer apply[9]. There is no limit on the number of employees who may participate in the EMI (subject to an overall limit of GBP 3 million on the value of shares under option).

2.4.3. Qualifying options

(19) The shares under option may be quoted or unquoted and must be ordinary shares, fully paid up and non-redeemable. The option must be capable of exercise within 10 years from the date of grant. After 10 years have elapsed, the EMI tax benefits no longer apply to the exercise of any outstanding options. There is no statutory minimum period before EMI shares can be exercised.

2.5. EMI operating modalities

(20) EMI offers flexibility and it can be designed in such a way as to meet a company's specific requirements and business objectives. EMI can be used by both unlisted and listed companies alike and either for targeted grants to specific key employees or on a wider (even all-employee) basis. Terms of options shall be agreed in a written agreement.

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[7] OJ L 124, 20.05.2003, p. 36.

[8] OJ C 244, 1.10.2004, p. 2.

[9] The employees however will have 40 days to exercise the options after he has left the company and keep the tax relief. If they do not exercise their option within 40 days, the EMI tax relief would not apply for gains for time after they left the company.

(21) Employees whom the company selects to participate are granted options over shares in the company and become option holders, paying a fixed price if they do decide to buy the shares (exercise the option). Unlisted companies would have to establish the market value of shares to be put under option before EMI and agree with HMRC on the market value before the option is granted.

(22) The amount of EMI options awarded is the result of bargaining by SMEs and employees. Both commercial actors will have to negotiate on the exercise price (in most cases the exercise price will be close to the price of the underlying share at grant) and the amount of shares under option to be awarded. While employees will have preferences for greater remuneration, employers will have an incentive to minimise the costs.

(23) Individual performance conditions (length of service or profit targets reached) can be attached and EMI options can therefore be used as powerful incentives. Having turnover or profit as the trigger for exercise is that employees do not actually become shareholders, but the motivation to grow the business still exists because the growth of the business will be reflected in the value of their shares on sale.

(24) The value of the financial reward to employees, and therefore the amount of the aid, is directly determined by business success. There is no obligation to exercise the option. An employee would only choose to exercise it when the market value of the shares on exercise is greater than the cost to exercise the option and acquire the shares.

3. ASSESSMENT

3.1. Existence of State aid

(25) In order for a measure to fall within the scope of Article 87(1) EC Treaty, four cumulative criteria must be met:

- the aid must be granted by the State or through State resources;
- it must confer an advantage on certain undertakings;
- the advantage must be selective in that it is limited to certain undertakings;
- it must be capable of affecting competition and trade between Member States.

(26) The measure involves State resources as the tax advantages granted under the EMI scheme is the income tax and NIC revenues foregone.

(27) The exemption from employees' income tax and employee NIC obligations concerns private individuals who are not undertakings, and therefore Article 87 (1) EC does not apply to them. As for an advantage granted to qualifying companies under the scheme, Article 87 (1) EC applies, as explained below.

(28) The measure confers economic advantage to qualifying SMEs. Firstly, the qualifying companies whose shares under the option are readily convertible assets[10] will receive the NIC relief when their employees exercise EMI options and acquire the underlying shares. The relief from employer NIC obligation confers direct advantage to those companies, as it mitigates the tax charges which are normally included in the budget of an undertaking when taxing employment related income.

(29) Secondly, the EMI scheme may confer an economic advantage to all companies offering tax advantaged EMI options because it enables the beneficiary companies to grant options for a lower amount of underlying shares than under a standard tax treatment in order to provide the same level of post-tax rewards from share options to their employees. The value of such advantage is directly determined by business success and only when employees decide to exercise their options.

(30) The measure is selective because it applies only to qualifying SMEs with maximum gross assets of no more than GBP 30 million and employees less than 250, carrying out qualifying trading activities, as described above.

(31) When aid granted through State resources strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade the latter must be regarded as affected by that aid[11]. Given that the measure concerns the companies that have a permanent establishment in the UK, the Commission is not able to exclude the possibility that the scheme may involve services provided on a cross-border basis, or undertakings involved in trade between Member States[12]. Accordingly, there is a risk that the aid could affect trade between Member States.

(32) Consequently, the Commission can conclude that the measure constitutes State aid to qualifying companies within the meaning of Article 87(1) of the EC Treaty.

3.2. Legality

(33) The Commission notes with regret that the UK already implemented the measure without notifying it in advance. Therefore, the UK authorities did not respect their standstill obligation under Article 88(3) of the EC Treaty.

4. COMPATIBILITY ASSESSMENT

4.1. Compatibility under Community State aid legislation

(34) Article 87(2) of the EC Treaty lists certain types of aid that are compatible with the EC Treaty. In view of the nature and purpose of the notified scheme, the Commission considers that the subparagraphs (a), (b) and (c) are not applicable to the measure in question, nor have the UK authorities argued that this may be the case.

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[10] Any company established in the UK (see point 15 of the decision) with NIC liability will benefit from the measure.

[11] Case 730/79 Philip Morris Holland v Commission [1980] ECR 2671, paragraph 11, and Case C-303/88 Italy v Commission [1991] ECR I-1433, paragraph 17.

[12] Cf. Judgement of the European Court of Justice of 03.03.2005 in Case C-172/2003, Haiser, Rec.2005, p.I-1627, paragraph 35.

(35) Article 87(3) of the EC Treaty specifies other forms of aid, which may be regarded as compatible with the common market. In view of the nature and purpose of the notified scheme, the Commission considers that the subparagraphs (a), (b), (d) and (e) of Article 87(3) are not applicable either.

(36) Consequently, the Commission has decided to assess the compatibility of the aid in question with the common market on the basis of the derogation provided in Article 87(3)(c) of the EC Treaty, i. e. whether the aid scheme in question aims to facilitate the development of certain economic activities, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

(37) In assessing whether the exemption provided for in Article 87(3)(c) can apply, the Court of Justice has consistently held that Article 87(3) "gives the Commission a discretion the exercise of which involves economic and social assessments that must be made in a Community context"[13]. For certain forms of aid, the Commission has defined how it will exercise these discretionary powers, in the form of block exemption Regulations or by frameworks, guidelines or notices. Where such secondary texts exist, the Commission must follow them in its assessment of aid measures.

(38) The Commission examined the measure in light of the General Block Exemption Regulation (GBER)[14], which consolidates into one text and harmonises the rules previously existing in favour of SMEs, research, innovation, regional development, training, employment and risk capital in five separate Regulations and enlarges the categories of state aid covered by the exemption. While the EMI measure seeks to address SME, employment, risk capital and labour market objectives, as defined in GBER, the Commission, however, notes that the EMI scheme, by the nature of its objective, does not meet the conditions of GBER.

(39) Therefore the Commission will examine the EMI measure directly upon the basis of Article 87(3) of the EC Treaty, having regard to Community policies in respect of employment and labour markets, risk capital provision and recruitment of highly qualified personnel in SMEs.

4.2. Compatibility of the scheme directly on the basis of Article 87(3)(c) of the EC Treaty

(40) In order to determine compatibility under Article 87(3)(c) of the EC Treaty, the Commission has to perform a balancing test weighting positive effects in terms of a contribution to the achievement of well-defined objectives of common interest and negative effects on trade and competition in the common market. The Commission has established the balancing test based on economic principles and composed of three steps:

1. Is the aid measure aimed at a well-defined objective of common interest?

2. Is the aid well designed to deliver the objective of common interest i.e. does the proposed aid address a market failure or other objective? In particular:

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13 Case C-169/95 *Kingdom of Spain v. Commission* [1997] ECR I-135. See also C-730/79 *Philip Morris v. Commission* [1980] ECR I-2671.

14 OJ 9.8.2008 L 241

– is the aid measure an appropriate instrument, i.e. are there other, better-placed instruments?

– is there an incentive effect, i.e. does the aid change the behaviour of firms?

– is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?

3. Are the distortions of competition and effect on trade limited so that the overall balance is positive?

4.3. Addressing a well-defined objective of common interest

(41) The Commission assessed whether the objective pursued by the measure contributes to the achievement of one or more of the objectives of common interest identified in Article 87(3) of the EC Treat, which can be understood either in terms of its contribution to efficiency, thus allowing to remedy a market failure, or in terms of equity (welfare distribution). Contributions to efficiency would be analysed in assessing market failures.

i. Objective of common interest

(42) The Commission notes that the EMI measure has a defined objective to which is to enable smaller, higher risk growth companies in the UK to recruit and retain qualified employees they need to achieve their growth potential through tax advantaged employee share options. The measure aims at increasing market efficiency in the UK by facilitating the efficient matching of labour resources to the economic needs of small high-growth businesses in order to increase their productivity and growth.

(43) The Commission recognised that shortage of skilled employees adversely impacts innovation and growth by restricting small companies' abilities to explore the productive potential of innovation and ideas. This has been perceived as a critical constraint on company growth, as acknowledged in the renewed Lisbon Strategy the Integrated Guidelines for Growth and Jobs[15]. The Commission acknowledged the need to promote a more entrepreneurial culture and create a supportive environment for SMEs.

(44) The Commission report “Employee Stock Options: The Legal and Administrative Environment for Employee Stock Options in the EU”[16] emphasises the importance of employee share options as a mechanism for attracting and retaining employees to small growth companies and in fostering entrepreneurship. Facilitating the recruitment and retention of employees in small companies with tax advantaged employee share options, which corresponds to the objectives of the EMI scheme, is indeed an objective of common Community interest.

15 http://ec.europa.eu/growthandjobs/pdf/integrated_guidelines_en.pdf

16 European Commission, Enterprise Directorate General, “Employee Stock Options: The Legal and Administrative Environment for Employee Stock Options in the EU”, June 2003, page 20

ii. Market imperfections

(45) In assessing how the measure contributes to efficiency and remedies a market failure, the Commission examined the presence and magnitude of market failure in the UK. According to the economic theory and empirical evidence presented by the UK, the market failure underpinning the rationale for the EMI intervention stems from both capital market and labour market failures, each explained by asymmetric information, agency and adverse selection problems.

(46) The Commission notes a number of economic studies provided by the UK showing the difficulties for SME to compete in the labour market and attract qualified personnel, especially as concerns executive, marketing, sales and management skills, adversely affects the overall level of innovation, productivity, growth and job creation in the economy[17].

(47) Empirical evidence[18] provided by the UK shows the recruitment and retention difficulties faced by companies in the UK. SMEs account for a disproportionate share of hard-to-fill vacancies and skill-shortage vacancies[19]. The extent of the recruitment problems becomes smaller as the size of the company increases.

(48) Low numbers of applicants and uncompetitive remuneration packages are two of the most important reason why SMEs face recruitment difficulties in the UK[20]. Even where there are other factors leading to difficulties in recruitment, such as lack of the right skills, qualifications or experience, these factors are indirectly due to the level of remuneration.

(49) According to the economic theory provided by the UK, small high growth companies are often at a competitive disadvantage to larger firms in terms of their ability to offer an economically efficient level of remuneration benefits. Due to rapidly expanding business needs, SMEs tend to be cash constrained and have limited assets or reserves to offer competitive remuneration packages to employees.

(50) Besides, SMEs have difficulties in obtaining external funding. This is especially the case where funding is sought for purposes other than tangible assets, such as for staffing purposes. Due to the asymmetry of information, it is difficult for the external finance providers to estimate additional productivity improvements from remunerating employees in SMEs.

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17 M Institute's "Empowering Medium Enterprises" 2006, D.J Storey, "Understanding the Small Business Sector", Routledge, London, 1994. Pages 155-156. M Institute's "Empowering Medium Enterprises" 2006

18 The UK's Employer Skills Survey (in 1999 & 2001) and its successor the National Employer Skills Survey (in 2003, 2004 & 2005).

19 As for Hard-to-fill vacancies, reasons often include skills-related issues, but can simply involve such aspects as poor pay or conditions of employment, or a remote location. Skill-shortage vacancies are those hard-to-fill vacancies which result from lack of candidates with the required skills and qualifications of work experience.

20 The National Employer Skills Surveys and Chartered Institute for Personnel and Development (CIPD)'s 2007 Recruitment, Retention and Turnover report

(51) An information asymmetry between the employee and the employer may also result in the lack of an effective matching of people to vacancies. Employees are typically risk-averse and find it hard to assess the future prospects of a small risky employer, even if its prospects for the future are positive. This may disproportionately deter them from considering opportunities in any smaller high-risk businesses. The economic theory shows that employees are significantly more likely to choose large employers and SMEs face disproportionate staff shortages[21].

(52) There is also an issue of attractiveness of employment in SMEs compared to large companies. Large companies have better reputation, offer more opportunities for a career and more attractive remuneration package, as well as job security. Working for an SME inherently involves a greater risk to an employee's job security, which is likely to increase the size of the remuneration package on offer to attract key employees.

(53) There also are agency problems between the employer and employees, reducing the willingness of employers to get external financing for the purpose of employee remuneration. The problem of 'moral hazard' and the lack of an incentive aligning mechanism could discourage the company from looking for external financing for remuneration purposes, as the finance obtained by the SME and invested in staff may not provide the return required by the lender.

(54) According to the economic theory, smaller firms can be less successful in achieving the level of worker discipline comparable to larger ones[22]. As a result, SMEs might be unwilling to offer a higher salary, closer to that paid by large firms. Even if SMEs get external financing to increase salaries paid, if there is no incentive aligning mechanism, the employee might not improve his/her work effort and the extra pay will not be likely to encourage the employee to any greater effort.

(55) Considering the above, the Commission can conclude that the UK authorities have demonstrated, with references to the economic theory and empirical evidence for the UK, that smaller companies in the UK are unable to offer competitive remuneration to employees compared to larger ones. The UK also explained market imperfections linked to the asymmetry of information, agency problems and adverse selection explaining the efficient matching of labour resources to the economic needs of small businesses. The Commission can therefore conclude that SMEs carrying on their business activities in the UK suffer from the capital and labour market failures, which justifies public intervention both at the SME and employee level.

iii. Rationale for employee share options

(56) The Commission took into consideration the economic justification provided by the UK that the use of performance-based instruments, such as employee share options, paid on top of a fixed cash salary, could form an important part of the

[21] G. Akerloff, "The Market for Lemons: Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, 84, 1970, pp. 488-500.

[22] R.G. Ehrenberg, R.S. Smith, 'Modern Labor Economics: Theory and Public policy', 8th edition, Addison-Wesley, 2003, p.373. Financial Times, David Blackwell, May 15, 2007: an article documenting the incentive pay gap at smaller firms.

overall remuneration and enhance the abilities of smaller companies to attract the necessary staff. Granting cash bonuses relies on having the necessary cash, which may be an issue for a cash-constrained smaller growth company. In contrast, share based payments require the company to award ownership rights to the employee, which do not impose any immediate cash constraints.

(57) Share options have a strong effect on retaining employees, since they are motivated to create share value, as the benefits of exercising the option materialise upon the growth in share value. The potential future value of the share options can outweigh the current salary differential between smaller and larger companies. This method is preferred to a direct cash handout because a share option award, via its incentive aligning properties, minimises the potential of moral hazard present in cash-based support.

(58) The UK authorities referred to a range of academic literature showing a positive relation between the use of share-based remuneration and productivity when used as part of a wider package of measures[23]. An econometric study that HMRC commissioned Oxera to carry out as part of the evaluation of tax-advantaged employee share schemes in the UK found a positive productivity effect amongst companies using employee share schemes, confirming the positive relation identified in wider literature[24].

(59) However, employee share options are less often used by SMEs[25] due to a number of market inefficiencies. According to the Commission report[26], share based payments require the company to award ownership rights to employees which constitutes an (opportunity) cost for the company, as the existing owners forego a proportion of their ownership stake and the future income associated with that ownership, which is especially the case for fast growing young companies. SME owners may be unwilling to see their ownership diluted to the degree required to secure the employee's services. Besides, an initial value of an SME may not be sufficient to accommodate the requirements of the prospective employee[27].

(60) Similarly, employees who accept remuneration in the form of share options make an investment decision, similar to equity investment because the benefit of the share options does not materialise immediately (compared to cash-based remuneration), but rather in the future when there is growth in the share value. Investing in SMEs is risky and the future value of the option is uncertain. Therefore, employees hired by SMEs tend to be less inclined to accept this form of remuneration.

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23 A. Bryson, R. Freeman, 'Doing the Right Thing? Does fair share capitalism improve workplace performance?' WERS 2004 Grants Fund. DTI, Employment Relations Research Series No. 81.

24 Research Report 33 on the HMRC website: http://www.hmrc.gov.uk/research/index.htm .The study did not include EMI, as EMI had only recently been introduced when work started on the survey, but found that other tax-advantaged employee share schemes could be effective in raising productivity

25 Estimates show that only less than 5% of SMEs in the EU use employee share options.

26 European Commission, Enterprise Directorate General, "Employee Stock Options: The Legal and Administrative Environment for Employee Stock Options in the EU", June 2003

27 E. g. a company worth only GBP 100,000 cannot offer GBP 200,000 worth of shares in a remuneration package

(61) Economic attractiveness of employee share options also depends on the economic and legal environment that may not be sufficiently conducive to encourage their wider use. Taxation may introduce an additional element of risk for employees, given that employment-related taxation applies regardless of whether the income is given in cash or in kind. This has liquidity consequences as, at the time of granting or exercising an option, the employee still has no cash earnings from the option and the cash for the tax payment has to come from somewhere else. Therefore, treating employee share options as any other employment income makes this type of remuneration less attractive for employees compared to cash salary.

(62) The Commission can therefore conclude that by aiming to enhance the economic efficiency of employee share options, especially by introducing a more attractive taxation regime, the EMI scheme has the potential to correct the labour and capital market inefficiencies and allow reaching the objective of common interest. Given that the market failure underpinning the use of employee share options relates to both the capital and labour market failure in the UK, any public intervention aimed at enhancing the economic attractiveness of this remuneration instrument concerns both SMEs in the UK and their employees.

4.4. Well designed to deliver the objective of common interest

(63) An aid measure is considered necessary and proportional when it constitutes an appropriate instrument to achieve the identified objective of common interest, when it has an incentive effect on the beneficiaries and when it does not introduce unnecessary distortions of competition.

i. Appropriate instrument

(64) State aid can only be justified by the appropriateness of the instrument of public intervention to meet the public policy objective and contribute to common interest objectives.

(65) The UK acknowledged that the best policy response would be to address the market failure directly, i.e. reduce the presence of information asymmetries and adverse selection issues. The UK seeks to improve the efficiency of labour markets and information provision through general measures, including corporate governance and accounting standards. However, this is hard to achieve practically and cost-effectively with targeting.

(66) The UK has a number of fiscal schemes aimed at addressing access to finance market failures, such as Small Firms' Loans Guarantee (SFLG) and the venture capital schemes (Enterprise Investment Scheme, Venture Capital Trusts and Corporate Venturing Scheme)[28]. These measures, however, do not address the nature of problems underpinning the recruitment and retention issues faced by SMEs.

[28] State aid NN42a/2007 and NN42b/2007, approved by the Commission on 29 April 2009.

(67) According to the UK, tax relief could enhance the economic attractiveness of share options. While the value of share options first of all depends on the general economic climate and business growth prospects, tax relief may also increase their economic attractiveness both for an employee and employers. It may change the perception of employee share options, as it enhances the post-tax rewards for employees and it allows employers to provide the same level of employee remuneration through the provision of less value of shareholding under options.

(68) Recognising the importance of tax-incentivised employee share options, the UK has introduced a number of general fiscal measures aimed at encouraging the wider use of employee share options in all companies. The UK has a general tax advantaged share option scheme available to all companies under Company Share Ownership Plan (CSOP). It offers preferential tax treatment of options over shares of GBP 30 000 per employee, with minimum holding period of 3 years. There are the all-employee schemes such as Share Incentive Plans.

(69) However, none of these measures specifically target SMEs where the market failure is most severe. The CSOP does not specifically target the problems of small high risk companies: it provides lower option value than EMI, has limited tax benefit period and entails further limitations, such as minimum holding period and no possibility of granting options at discount. Moreover, Share Incentive Plans are rarely attractive for most unquoted companies.

(70) According to the UK, selective public intervention, such as the EMI scheme can improve the ability of small companies to offer competitive remuneration package and compensate for some of the imperfect information and adverse selection problems identified above. The EMI scheme is specifically targeted at small companies and their employees that suffer from the market failure in the UK. By offering preferential tax treatment of share options, the scheme improves their economic attractiveness for SMEs and their employees. The results of the EMI evaluation survey[29] demonstrate that EMI can have positive effects on recruiting and retaining key employees and improving the company's performance.

(71) Given the above, the Commission finds that the UK authorities established and demonstrated the rationale for using selective instrument, such as the EMI scheme. The UK authorities introduced a number of policy tools, such as regulatory, corporate governance and accounting, alongside the EMI scheme, to address the above identified market failure. Besides, the UK has general tax advantaged share measures, such as CSOP. However, well targeted tax incentives are needed to address SME-related market failure. The Commission report[30] also emphasises the role of special tax incentives to promote the broad-based use of employee stock options, especially targeted at small growth companies.

(72) In sum, the Commission considers the EMI measure to constitutes an appropriate instrument, complementary to other policy instruments aimed at addressing the above identified market failures.

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[29] "Enterprise Management Incentives (EMI) Evaluation Survey: Use of EMI and its perceived impact", 2008.

[30] European Commission, Enterprise Directorate General, "Employee Stock Options: The Legal and Administrative Environment for Employee Stock Options in the EU", June 2003

ii. *Incentive effect*

(73) State aid must change the behaviour of a beneficiary undertaking in such a way that it engages in activity that contributes to the achievement of a public-interest objective that (i) it would not carry out without the aid, or (ii) which it would carry out in a restricted or different manner.

(74) According to the UK, EMI options increase the amount of post-tax remuneration available to an employee, thus increasing the attractiveness of remuneration to employees and provides an incentive for employees to join and remain in the SME. While the potential benefits arising from EMI options only crystallise if an employee ultimately exercises their EMI option and only if there has been market growth in the value of the shares between grant and exercise, nevertheless granting the EMI options *per se* creates incentives to employees. Besides, given that the EMI tax advantages are lost on employee resignation and termination, employee would have an incentive effect to remain in the company.

(75) The UK authorities explained that the EMI scheme has an incentive effect on SMEs as it reduces the amount of underlying shares under the option that an SME would have to provide to give the same post-tax reward to employees, thus enabling SMEs to provide a more competitive overall remuneration package that otherwise would have only been possible through the provision of greater shareholding value under the option. According to the UK, options over GBP 3 million of shares per company can be granted to employees under EMI, compared to options over GBP 5.2 million of shares without EMI to achieve the same post-tax returns to employees under the UK's standard tax treatment.

(76) According to the UK, it is the increased post-tax rewards to employees and not the employer NICs reduction *per see* which enhances the economic attractiveness of EMI options for SMEs. First, cases where SMEs are able to benefit from the NIC advantage (whose shares are readily convertible assets) under the EMI are rare, as stated above. Secondly, in those cases where employers' NICs relief applies, the actual benefit to employers may actually be lower as it is a common practice for employers to transfer their NIC liability to the employees, who can then obtain income tax relief.

(77) The UK authorities carried out a survey in 2007[31] to evaluate the impact of EMI. The survey demonstrates that the EMI scheme has a positive effect on recruiting and retaining key employees and improving SME performance. Besides, an econometric study that HMRC commissioned Oxera to carry out as part of the evaluation of tax-advantaged employee share schemes in the UK found a positive productivity effect amongst companies using employee share schemes[32].

(78) Considering the above, the Commission can conclude that the UK demonstrated, including with empirical evidence, that the EMI scheme has a positive effect on recruiting and retaining key employees and improving SME performance. EMI

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31 "Enterprise Management Incentives (EMI) Evaluation Survey: Use of EMI and its perceived impact", 2008.

32 Research Report 33 on the HMRC website: http://www.hmrc.gov.uk/research/index.htm .The study did not include EMI, as EMI had only recently been introduced when work started on the survey, but found that other tax-advantaged employee share schemes could be effective in raising productivity

tax advantages make employee share options economically attractive both for employees and SMEs, which addresses the labour and capital market failure. EMI increases the amount of post-tax reward available to an employee and thereby provides an incentive to join or stay with the SME. Besides, by reducing the value of the options that a company would have to issue to attract a given employee, it enables companies to provide a more competitive overall remuneration package.

(79) Therefore, the preferential tax treatment specifically targeted at SMEs and their employees in the UK is inherent to the objective of the measure, as the measure aims at addressing constraints faced by SMEs active in the UK in recruiting and retaining employees. Consequently, the measure seeks to influence the behaviour of both the SMEs in the UK, so as to encourage them to use equity-based remuneration, as well as their employees to accept the potential risk and reward in this form of remuneration. If the employees have no incentive to accept remuneration in the form of share options, the scheme would not reach its intended objective – to enable SMEs in the UK to recruit and retain employees.

(80) The Commission notes that while the EMI scheme applies to any qualifying employees, the biggest incentive effect is likely to be for highly qualified middle/key management, which is in line with the intended objective of the measure. This is because share options compared to other forms of remuneration, such as cash wages, are generally less important source of income for low-tier employees than to middle/key management. Highly demanded specialist or key managers often expect to receive employee share options as a part of their salary and companies offering them are likely be in a more advantageous position.

(81) Given the above, the Commission can conclude that the EMI scheme, by improving the economic attractiveness of employee share options granted by SMEs in the UK to their employees, provides incentives to the beneficiary companies to recruit and retain employees. It is also an incentive to employees to join or stay with the companies, which addresses the UK-specific market failure and contributes to the achievement of the public objectives.

iii. Proportionality

(82) Aid is considered to be proportionate only if the same change of behaviour could not be reached with less aid and less distortion. The amount and intensity of the aid must be limited to the minimum needed for the aided activity to take place.

(83) According to the UK, the EMI scheme provides the minimums amount of aid necessary to overcome the identified market failures. Firstly, advantage from the EMI tax relief materialises only from the exercise of employee share options, which happens only where share price exceeds the agreed exercise price. Since the advantage from EMI options depends on the growth in the company's share price and financial gain made by employees at exercise, this ensures the proportionality of the aid.

(84) Secondly, the amount of EMI options awarded is the result of bargaining by SMEs and employees with opposite motives, which ensures the aid provided to the minimum necessary. Both commercial actors will have to negotiate on the exercise price (in most cases the exercise price will be close to the price of the underlying share at grant) and the amount of shares under option to be awarded.

While employees will have preferences for greater remuneration, employers will have an incentive to minimise the costs.

(85) Third, the measure is proportionate because the tax relief is granted only to those SMEs and their employees that suffer from the above described market failure, which is the case of SMEs that carry on economic activities in the UK, i. e. with a permanent establishment. It is in the nature of the State aid measure that the employment income tax relief is granted in relationship to the employment for the SMEs that are economically active in the UK. By definition, SMEs which do not carry on economic activities in the UK do not suffer from the market failure and therefore neither those SMEs, nor their employees receive tax relief under the measure in question.

(86) Finally, the EMI scheme has a cap on the value of shares over which options can be granted per employee and per company. Besides, EMI share options must fulfil a number of qualifying criteria (see above), which ensures the aid is well targeted and limited to the minimum needed. The measure is targeted at SMEs that carry on economic activities in the UK and certain qualifying trades which are particularly exposed to the market failure. In contrast, large companies in the UK or companies not active in the UK are not concerned by the identified market failure.

(87) The UK estimated economic advantage to SMEs offered by the EMI scheme, by comparing the value of EMI share options in the case where a company makes full use of the GBP 3 million company-wide EMI limit against the value of share option under the UK's standard tax treatment. Using several option pricing and valuation techniques[33], the estimated difference in share option value may range from GBP 275,000 (under Black-Scholes model) to GBP 584,000 (under the accounting practices), which is a proxy for economic advantage granted to each SMEs.

(88) The UK has also noted that the tax benefit to the employee 'spills over' to the employers in the UK, which, as a result benefits from easier access to workforce. Besides, share options add a factor of motivation to the employee's performance. This represents an additional element of the 'aid spillover' to the employer. However, the extent of these benefits could vary widely depending on specific aspects of each company, therefore it is not possible to quantify them reliably.

(89) In ensuring that the EMI scheme provides the minimum amount of aid necessary to overcome the identified market failure, the Commission first of all notes that the minimisation of aid provided by EMI arises directly from its form. Bargaining by two independent economic actors, employers and employees, has the effect of minimising the aid provided to the minimum necessary and producing the least possible distortion.

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[33] As any financial asset, employee share options have a certain value. Given that employee share options are usually non-transferable, the lack of transferability means that the standard valuation models that were developed for marketable options have to be modified in order to use them for the valuation of employee share options. Often, statistical models for valuing tradable options (e.g. the Black-Scholes model) are adjusted to value employee stock options. However, there is no general agreement on the methods for such adjustments and it is still unclear if the results of modified valuation formulas can be considered as correct representations of the value of non-tradable options at grant.

(90) Besides, the Commission notes that the proportionality of the aid is ensured by the fact that the measure is targeted at SMEs established in the UK carrying on certain qualifying trades which are particularly exposed to the market failure. Besides there are a number of qualifying criteria for companies, employees and options, which also safeguards that the measure targets the above identified market failures. Finally, the duration of the scheme is limited in time, as it will apply for nine years.

(91) The Commission also notes that the cap on the maximum amount of aid provided ensures the aid is limited to the necessary minimum. Considering that the maximum amount of aid possibly delivered to any company under EMI is limited to approximately GBP 600,000, this amount is well below the annual risk capital investment tranche of EUR 1.5 million allowed under the GBER[34]. The Commission also notes that in practice, the actual aid amount per company will differ and depend upon the value of options and financial gain made by an employee when exercising an option.

(92) While there are no aid cumulation provisions under the EMI, the Commission notes that the aid under the EMI is not related to any costs that could be eligible for other state aid. The EMI qualifying criteria effectively preclude abuse or cumulation with other aid schemes for the same eligible costs. Overlap between venture capital schemes is limited to ensure that each support is targeted at specific market failure.

(93) In conclusion, the Commission considers the EMI scheme to be proportionate to the nature and magnitude of the market failure that it addresses.

4.5. Distortions of competition and effect on trade

(94) State aid may distort competition and effect trade by having long-term dynamic effects on the incentive to invest and compete, by affecting competition in the product market and the input markets. In assessing the magnitude of the distortions of competition, the Commission focused primarily on the effect that the change of behaviour of the recipient has on competitors and input suppliers.

(95) In assessing whether the change of behaviour of the EMI aid recipient will affect competitors and competitors might reduce their sales and investment plans (crowding out), the Commission noted that the measure is targeted at a well-defined restricted set of companies which typically face difficulties in recruitment and retention of key employees. Larger companies do not suffer from the same magnitude of the market failure and therefore would be able to compete successfully in the labour market by offering competitive packages. Therefore, the EMI is unlikely to discourage investments by larger companies. Besides, any possible distortions of competition in other Member States are minor, as the measure is well targeted to address the UK-specific market failure.

(96) The Commission notes that by increasing the ability of SMEs to offer a competitive remuneration package to employees, the scheme has a potential to promote competition in the labour market and help to improve the efficient matching of labour resource to productive economic activities. This should

[34] OJ 9.8.2008 L 241

increase product market competition, since it will give companies greater potential to develop, market and commercialise their products, and therefore will lead to growth in overall economic productivity.

(97) The Commission notes that the aid characteristics ensure the potential distortions of competition are limited to the minimum. The EMI advantage will only materialise if there is real productive growth and the employee exercises the option and realises a gain, this in turn is likely to facilitate the development of new product and services, which has a positive effect on competition. Given that the maximum aid amount is limited and that the aid is targeted to a well defined purpose, it is unlikely to have any measurable negative effects on competition and trade.

(98) The Commission therefore is able to conclude that the distortions of competition and negative effects on trade are limited.

4.6. Balancing negative and positive effects

(99) Article 87(3)(c) of the EC Treaty requires a balance between positive developments allowed by a given measure and its negative effects on competition.

(100) The positive effects of the aid are directly linked to the change of behaviour of the aid recipients which allows reaching the desired common interest goal. In the case of an efficiency objective, the positive effects can be described in terms of its contribution to remedying a market failure. The negative effects on competition and trade also derive from the change of behaviour of the aid recipient. The significance of the distortion of competition can be assessed in terms of effects on competitors and input suppliers

(101) By enhancing the capacity of small companies to attract and retain employees, the scheme addresses the objective of common interest, it remedies a well-defined market failure and the characteristics of the measure do not entail unnecessary distortions of competition. The Commission therefore considers that the positive effects of the measure outweigh the negative effects in terms of actual and potential distortion of competition and the overall balance is positive.

(102) Accordingly, the Commission concludes that the measure is compatible with the common market pursuant to Article 87(3)(c) of the EC Treaty.

5. DECISION

(103) The Commission regrets that the United Kingdom put the measure into effect, in breach of Article 88(3) of the Treaty. However, it has decided, on the basis of the foregoing assessment, to consider the Enterprise Management Incentives scheme compatible with the common market pursuant to Article 87(3) (c) EC Treaty. It has decided not to raise objections.

(104) The Commission reminds the UK authorities that the reporting conditions described in the Commission Regulation (EC) N°794/2004 implementing Council Regulation (EC) N° 659/1999 laying down detailed rules for the application of Article 93 of EC Treaty have to be respected.

(105) The Commission further reminds the UK Government that all plans to modify these aid schemes have to be notified to the Commission.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:

http://ec.europa.eu/community_law/state_aids/index.htm

Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
State Aid Greffe
B-1049 Brussels
Fax No: +32 2 2961242

Yours faithfully,
For the Commission

Neelie Kroes
Member of the Commission