Larking Gowen

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# Introduction to growth shares

Growth shares are often used as a tax-efficient share incentive plan to offer share reward in an employing company to senior employees and executives.

## Why use growth shares?

Growth shares are an alternative to Enterprise Management Incentive (EMI) options where the company doesn't meet the necessary conditions for EMI, i.e:

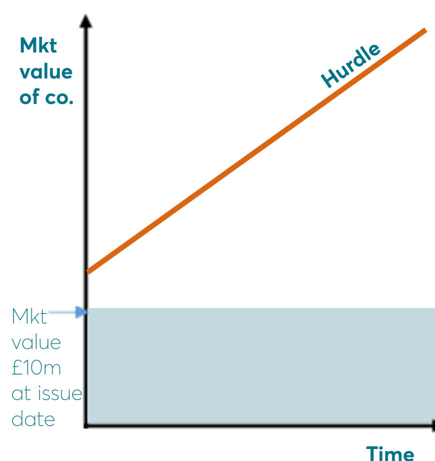
- More than 250 employees
- More than £30m of gross assets
- Company wants to offer shares in a subsidiary
- £250,000 worth of shares isn't enough
- Person to get the share reward is a director not an employee

Growth shares are useful if the owner's commercial objectives are better met by awarding actual shares in a subsidiary to the employee. They're also used in family companies for inheritance tax planning.

Growth shares allow a company to offer shares to its senior employees or directors at a low value. This means the senior employees can invest with a low initial investment requirement. If they are awarded the shares for free, there is a negligible or low value on which they will need to pay income tax and National Insurance contributions (NIC).

The term 'growth shares' is used to mean shares of a special class designed to allow the holders to benefit only from the growth in the value of the company above that at the time the shares are issued (with at most a very limited interest in the value of the company at the time the shares are issued).

For example, if the company is currently worth £10 million, the growth shares would participate in growth only above £10 million. For tax valuation reasons, the hurdle in the growth shares is usually set at a number a little above the company's current market value.




Growth shares are commercially very attractive from a shareholder perspective.

Through the operation of the hurdle, growth shares help preserve current value for existing shareholders.

They also make sure that there is no dilution to the existing value of their shareholdings.

## Setting up a growth share plan

To set up a growth share plan, a company needs to amend its articles of association to set out the distinctive capital, income and voting rights of the growth shares.

A subscription agreement is needed and possibly a 'put option' agreement. It needs to be tailored to any special features of the existing articles of association which the company wants to keep.

The company will need to consider whether any amendments need to be made to the articles for good and bad leaver provisions for employee shareholders; whether any changes need to be made to the pre-emption rights; and whether any drag-along or tag-along provisions need adding.

These changes, and the allotment of growth shares to employees, will be a matter of public record (potentially accessible to all employees) and require shareholder approval, even for the smallest companies.

The company will also need a set of plan rules for a growth share plan and/or a growth share subscription agreement for the awards. If the growth shares are to be awarded subject to performance criteria, these will need to be added to the subscription agreement.

As a result, the adoption of an employee growth share plan may be different to a more typical employee share option plan, share purchase plan or performance share plan, in which the terms are set out wholly or mainly in a self-contained set of plan rules and the individual option, purchase or award agreements (which may also be more or less confidential).

## Reasons for introducing growth shares

The principal reason for introducing growth shares for employees and directors is to give them tax efficient equity incentive and reward. It is considered where the traditional solutions (like EMI options) don't work or fit or where the business owner thinks actual shares in the company are more motivating than options.

Growth shares (like share incentives) are usually considered because of one or more of the following circumstances:

1. The company has had a recent (last three to six months) venture capital or private equity investment.
2. The company is about to go through a growth phase and it needs to keep and incentivise its best staff or its key managers (FD, MD, CEO, Sales Director).
3. The company is bringing in a more 'grown-up' corporate governance structure, and so is bringing in new non-executive directors onto the board.
4. It's in a growth phase and is bringing in new, key employees like a new MD/CEO or a new FD.
5. It's standard practice in that sector, e.g. finance, creative industries, technology, communications and biotech.
6. It's a company in a sector which relies on its skilled managers and technical staff for its growth and profitability, e.g. technology, creative industries, finance, high tech engineering and biotech.
7. It's a family company whose senior family owner-managers are reaching retirement and management skill, capability or appetite isn't there in the next generation.
8. It's a knowledge-based company whose owner-managers are nearing retirement, and to make the company saleable they need a senior team who will be around and motivated to take over the reins.
9. Company proposing to go to an Initial Public Offering (IPO) and which wants to allay its employees' fears that the company will lose its 'family' feel by giving them an opportunity to acquire shares on favourable terms at flotation.
10. UK companies that are obliged to put in share plans if they're caught by the Financial Conduct Authority or Prudential Regulation Authority Remuneration Codes.

The market value of a growth share is much lower than that of an ordinary share. This makes it more affordable for executives to invest, or there's a very low value on which they have to pay income tax.

Existing shareholders' share of ownership of the current value of the company isn't diluted by an issue of growth shares, whereas it would be diluted by an issue of ordinary shares.

## Tax treatment of growth shares

The growth shares will secure the expected tax advantages only if right up to the time when employees dispose of their growth shares:

- there is no change in the tax legislation to impose income tax on the shares' growth in value (which might be done retrospectively if HMRC feel that growth shares are being used for unacceptable tax avoidance); and
- the CGT rate remains low relative to high earners' income tax rates.

**Income tax on acquisition**
There will be income tax on the value of the growth shares awarded. The growth shares can and will be structured so there is little value at award on which the employee/director has to pay income tax and NIC. If there is more significant value, either the employee can agree to pay this value at acquisition or the employer can agree to lend them the money to pay the tax bill, which is then deducted from the ultimate sale proceeds; or the employer can agree to pay the employee a bonus, which, after tax and NIC, is enough to pay the tax bill.

It's very likely that growth shares will be restricted securities, meaning that there can also be an income tax charge on a proportion of the subsequent growth in value of the shares. There are two ways to avoid this:

- make sure that the employee pays at least the full unrestricted market value (UMV) for the securities, measured at the time the executive acquires them; or
- ensure that the employee and employer make a joint election for the employee to pay tax up-front on any discount to UMV.

This results in an increased tax charge at acquisition only, based on the amount (if any) by which the UMV of the growth shares exceeds the amount the employee pays for them. Valuation is, of course, crucial to determining this.

**Tax on disposal: CGT and business asset disposal relief**
Ordinarily, a participant would look to realise the value in their growth shares by selling them to a third-party buyer or to an employee trust, giving rise to a favourable capital gains tax charge only (assuming a section 431 election was made on acquisition). That rate can be as low as 10% where business asset disposal relief (BADR) is available (but note the Budget 2018 restrictions), or 20% otherwise.



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