

Growth Shares

June 2024

Introduction

Growth shares are a special class of shares created (usually) by unlisted companies to provide equity incentives to management and key employees. They reward participants for the growth in value of the company above a "threshold" or "hurdle" which is specified on issue. Growth shares generally allow gains to be taxed as capital in the hands of participants and are used as a tax-efficient alternative to options, where tax-advantaged options cannot be utilised.

Most unlisted companies which do not meet the conditions necessary to grant tax-advantage share options or who wish to offer incentives to non-employees (such as consultants and non-executive directors) should consider structuring their equity incentives using growth shares. This paper sets out how these arrangements work.

Typical Arrangement for an Unlisted Company

Suppose Company A wishes to incentivise a new manager by awarding her 3% of its issued share capital. Company A has 100,000 ordinary shares in issue of 1p nominal value each with an estimated market value of £10 per share (ignoring minority discounts and valuing the company as a whole at £1 million). The value is benchmarked by reference to a recent external investment in which the investor paid £10 per ordinary share (we appreciate investors are more likely to acquire preference shares, but to make this example simpler, we assume here that they acquire ordinary shares).

If the manager acquired 3,000 ordinary shares, she would need to pay market value of £30,000 for them or otherwise trigger an income tax charge (and possibly social security, depending on the circumstances) on the difference between the market value of the shares and the amount paid. The upfront cash costs would make the award of ordinary shares unattractive. Company A could instead lend the subscription monies or issue the shares on deferred payment terms but, in either case, the manager would be required to take a real commercial risk, which is also unattractive.

The arrangement could instead be structured using growth shares as follows:

- The articles of Company A are amended to create a new class of growth shares of 1p nominal value each with no rights other than to participate in sale proceeds on an exit (or distributions on a winding-up) pro-rata with ordinary shares, but only after ordinary shares have received a hurdle amount of £10 per share.

- The new manager is required to enter into a subscription agreement which requires her to pay a premium subscription price of (say) 30p per share for the growth shares. The growth shares are issued fully paid, so the manager has no further obligation to pay for the shares.
- The subscription agreement contains a vesting schedule and a call option which gives the company a right to purchase unvested shares for 1p each if the manager leaves for any reason, and a right to purchase vested growth shares at fair value (or 1p should the manager resign, be dismissed for cause or breach non-compete obligations post-cessation).
- The manager is required to make an election, pursuant to section 431(1) of the Income Tax (Earnings and Pensions) Act 2003, to pay income tax on the "unrestricted market value" of the growth shares (which is, broadly, the value of the shares for tax purposes ignoring the vesting and forfeiture conditions) within 14 days of acquisition.
- Company A takes professional valuation advice to the effect that the upfront "intrinsic" value of the growth shares is no more than par (because any rational purchaser would likely be expected to pay £10 less for the growth shares with a hurdle of £10 than ordinary shares, and nothing material has occurred since the recent investment which would affect the value of the company). In other words, if Company A were sold for £1 million just after the manager received the growth shares, they would not receive any of the sale proceeds so the growth shares have no "intrinsic value" as at the date of acquisition. The premium subscription price reflects any "hope" value attaching to the growth shares.
- The manager declares the receipt of growth shares in their tax return and their tax inspector accepts the growth shares have a market value of no greater than the subscription price, so there is no income tax to pay as a result of making the election (as the manager paid market value for the shares).
- Three years later Company A is sold for £10 million. There are 100,000 ordinary shares in issue and 3,000 growth shares held by the manager. The first £1 million of sale consideration is paid to the holders of ordinary shares and the remaining £9 million is paid pro-rata to ordinary and growth shareholders. The manager receives $\text{£9 million} / 103,000 = \text{£87.38}$ per growth share or £262,136 in total. All gains are taxed as capital at the top rate of 20% so the manager pays capital gains tax ("CGT") of £52,247, ignoring annual exemptions.

Note: the hurdle has a real economic effect, as the manager does not receive the first £10 per ordinary share, so any rational purchaser would likely be expected to pay £10 per share less for growth shares with a £10 hurdle than they would pay for ordinary shares. The arrangement is commercially similar to an option to acquire ordinary shares at a £10 strike price, but is more tax efficient than a non-tax advantaged option.

Some Additional Features

Suppose Company A recruits another manager a year after recruiting the first manager, and offers him a further 2,000 growth shares when the value of the ordinary shares has increased to £15 per share. The articles of Company A allow the hurdle applicable to the growth shares to be specified by the board at the time of issue. So the board awards the second manager 2,000 growth shares with a hurdle of £15 per share. The hurdle is specified in the subscription agreement, which contains otherwise similar terms to the subscription agreement of the first manager.

The ability for the board to set different hurdles each time growth shares are issued avoids the need to amend the articles to create new classes of growth shares with different hurdles each time fresh awards are made. Putting the vesting and leaver provisions in the subscription agreement rather than in the articles means these arrangements remain private and flexible (they can be different for each participant if required).

¹ Note: In our experience, HMRC generally take the view that growth shares have a "hope" value over and above the "intrinsic" value when compared to ordinary shares. Consequently, it may be necessary to set the subscription price at a premium to nominal value to reflect the hope value. We have set the subscription price at 30p per share in this example, which means the manager is required to pay $30p \times 3,000 = \text{£900}$. It is assumed that HMRC will accept that the premium subscription price reflects the hope value. In practice, the hurdle and the acquisition price should be confirmed by a professional valuer.

The subscription agreement should contain a power of attorney ("**PoA**") which appoints (say) the founder of Company A as attorney on behalf of the participants. The PoA allows the founder to sell the growth shares to a third party purchaser upon an exit being achieved so 100% of Company A can be sold easily to a purchaser without invoking drag rights or obtaining the sign-up of participants. The PoA also authorises the attorney to consent to the variation of class rights on behalf of participants.

The legal title to the growth shares can be held by a nominee to keep the identity of the beneficial owner private, if necessary.

These additional features can be used to minimise most commercial objections to awarding shares as opposed to options.

Valuation and Self-Assessment

If the growth shares are acquired at an undervalue when they are readily convertible assets ("**RCAs**"), the employing company will be obliged to operate pay as you earn ("**PAYE**") and social security for the PAYE month in which the shares are acquired, based on its "best reasonable estimate" of the tax due. Shares will be RCAs if, broadly, there are arrangements in place (or about to be put in place) to create a market in the shares, and will be deemed to be RCAs if the company is a subsidiary of a company which is not listed on a "recognised stock exchange". It is necessary for the employing company to take valuation advice so as to set the hurdle applicable to the growth shares at such a level to minimise any income tax charges arising on acquisition. Since 6 April 2016, HM Revenue & Customs ("**HMRC**") have withdrawn the facility to agree share valuations after the event, so it is advisable for companies and participants to retain a contemporaneous valuation in order to be able to deal with subsequent queries from HMRC. If the shares are not RCAs, any income tax will be payable by the participant through self-assessment. In these circumstances it is still advisable for the employer to take professional valuation advice to determine where to set the hurdle, and to pass this to the participants to assist them when preparing their tax returns.

In either case, HMRC will only agree share valuations in advance if the growth shares are being placed under an Enterprise Management Incentive ("**EMI**") or Company Share Option Plan ("**CSOP**") option (see our EMI and CSOP factsheets in these respects). As such, we strongly advise obtaining a professional valuation from an independent third party expert if there is any doubt as to the valuation of the growth shares on acquisition.

Growth Shares and Business Asset Disposal Relief

Since 29 October 2018, it has generally ceased to be possible to structure growth shares with less than 5% economic rights so as to allow participants to benefit from business asset disposal relief ("**BADR**"). Prior to that date it was possible (and common) to structure growth shares so as to qualify for BADR.

The advantage of BADR is that capital gains is taxed at a fixed rate of 10% (up to a lifetime limit of £1 million) compared to the top rate of CGT of 20% for higher and additional rate taxpayers. A separate factsheet is available on BADR which outlines the conditions that must be satisfied, the key ones being that in the 24 months prior to disposal:

- the company must be a trading company or the holding company of a trading group;
- the individual must have been an employee or office-holder; and
- the company must be the individual's "personal company" (see below).

A personal company is a company in which the individual holds at least 5% of the ordinary share capital (when tested by nominal value) and 5% of the total voting rights.

In addition, there are two alternative "economic" tests for disposals after 29 October 2018. The individual must be entitled to either (a) at least 5% of the sale proceeds payable to all ordinary shareholders on a notional disposal of the company, or (b) at least 5% of profits available for distribution to all equity holders

and 5% of net assets available to equity holders on a winding-up. The 5% of sale proceeds test is applied on the day of sale and (broadly) treated as met for the prior two years.

Generally speaking, the economic tests make it difficult to structure growth shares so as to qualify for BADR.

Growth Shares and EMI

EMIs are a form of tax-efficient option plan. The tax reliefs are very generous as they generally relieve participants from income tax and social security on grant and exercise and allow participants to benefit from BADR on the sale of the option shares without having to meet the 5% personal company test, and the two-year shareholding requirement also takes the time of holding the option into account. Companies that qualify for EMI should consider granting EMI options as an alternative to growth shares. A separate fact sheet is available on EMI.

There are some circumstances, however, in which it may be preferable to grant EMI options over growth shares. For instance:

- If options are to be exercised prior to an exit, the exercise price can be set at a nominal amount so as to help the cash-flow position of participants (whereas options granted over ordinary shares typically have an exercise price equal to the market value on grant in order to avoid income tax arising on exercise);
- The individual EMI limit of £250,000 can sometimes be restrictive, but it can go further if EMI options are granted over growth shares (which have a lower value on grant than ordinary shares).

Growth Shares and CSOP

CSOPs are another form of tax-efficient option plan that is often used by companies who cannot operate EMI options (either because the qualifying conditions are no longer met or because the conditions could not be satisfied in the first place). At the point of exercise, the spread on CSOP options is generally subject to CGT at 20%.

The grant limit for CSOP options is £60,000 per individual, which can go further if CSOP options are granted over growth shares. The advantage of offering CSOP options over growth shares, rather than an outright subscription of growth shares, is that there is greater tax certainty given that HMRC will agree valuations for CSOP grants in advance. Such valuations can also be prepared at far lower cost than a professional valuation for a subscription of growth shares. This approach has only recently become possible due to the relaxation of the restrictions on the types of shares that can be placed under CSOP option, which took effect on 6 April 2023.

CSOP options also benefit from a corporation tax deduction for the spread when exercised, and leavers are easier to deal with as options can simply lapse with no need to buy back the shares. Furthermore, participants need pay nothing for the grant of the option (the exercise price is only payable when the option is exercised) and so have no risk of a dry tax charge on grant.

Growth Shares and Extending Awards Internationally

In our experience, growth shares can provide an attractive alternative to options in non-UK jurisdictions.

Growth Shares and Consultants

Shares awarded to consultants in exchange for services are taxable in their hands as trading income in so far as the shares are acquired at an undervalue. The upfront income tax charges can be minimised by structuring awards using growth shares allowing gains on sale to be taxed as capital in a similar way to employees.

Growth Shares and AIM Companies

It is possible for AIM listed companies to create a new class of growth shares in an intermediate holding company the economic value of which is generally pegged to the listed share price above a threshold. Once vested, the growth shares can be exchanged for listed shares of the same value which can then be sold in the market. The arrangement replicates an option as it delivers gains above a threshold in the same way as an option, but is more tax efficient than a non-tax advantaged option, as gains on the exchange of growth shares for listed shares are taxed as capital.

It is not generally feasible for companies on the full list of the London Stock Exchange (as opposed to AIM) to use this sort of arrangement as it requires shareholder approval, and the use of subsidiary shares is not recommended by the Guidelines of the Investment Association.

Occasionally, fully-listed companies do implement such arrangements at subsidiary level, with a flip-up to parent company shares on certain corporate events, but any such arrangements need careful consideration and will likely need explaining to shareholders who are generally adverse to complex incentive arrangements and CGT treatment for those they consider already well paid.

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