

Bird & Bird

Growth Shares

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.

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 the issued share capital. Company A has 100,000 ordinary shares in issue of 1p 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.

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 National Insurance contributions, depending on the circumstances) on the difference between the market value of the shares and the amount paid. The up-front 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 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 she 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) ITEPA 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 advice to the effect that the up-front "intrinsic" value of the growth shares is no more than par (because any rational purchaser would 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, she 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 her tax return and her 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 £9 million / 103,000 = £87.38 per growth share or £262,136 in total. All gains are taxed as capital at the top rate of 20% so she pays 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 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 award 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).

The subscription agreement should contain a power of attorney 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 power of attorney 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.

¹ Note: 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 is 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 x 3,000 = £900. It is assumed HMRC will accept the premium subscription price reflects the hope value.

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 PAYE and NIC for the PAYE month in which the shares are acquired based on its "best reasonable estimate" of the tax due. 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 avoid or minimise any income tax charges arising on acquisition. Since 6 April 2016 HMRC have withdrawn the facility to agree share valuations after the event so it is necessary 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 to the participants to assist them when preparing their tax returns. 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".

Whether the shares are subject to PAYE or not participants should declare the share acquisition in the white space in their tax return and say they paid market value based on the professional valuation. If HMRC do not query the valuation (or any other aspects of the return) during the 12 month inquiry window for self-assessment, the tax return will be closed.

Growth Shares and Entrepreneurs' 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 entrepreneurs' relief ("**ER**"). Prior to that date it was possible (and common) to structure growth shares so as to qualify for ER.

The advantage of ER 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 fact sheet is available on ER which outlines the conditions the key ones being 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. Either (a) the individual must be entitled to at least 5% of the sale proceeds on a disposal of all the ordinary share capital, or (b) to 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 ER. A separate fact sheet is available on ER.

Growth Shares and Enterprise Management Incentives

Enterprise management incentives ("**EMI**") 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 ER on the sale of the option shares without having to meet the 5% personal company test. 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 Extending Awards Internationally

In our experience growth shares can provide an attractive alternative to options in some jurisdictions - particularly the US.

Suppose Company A (in our running example) recruits a US manager and decides to offer her 3,000 growth shares when the ordinary shares have an estimated value of £20 per share. The Company obtains an IRS compliant professional valuation to the effect that growth shares with a hurdle of £20 have a "fair value" of no more than par. The US manager is required to enter into a subscription agreement (which is substantially similar to the two UK managers) and to pay a subscription price of 1p per share.

The manager makes a so called "section 83(b) election" to pay income tax on the "fair value" of the growth shares (being the value ignoring vesting and forfeiture conditions). Company A does not operate withholding because it takes the view the manager paid fair value for the shares. The valuation means it will be protected from later enquiries from the IRS and exposure to interest and penalties. No income tax or social security arises on issue and all gains are taxed at US capital gains tax rates on sale. The tax treatment is more attractive than had the manager received non-qualifying stock options.

Growth shares can work in a similar way to the US in other jurisdictions too. The key is to ensure the income tax point is on the acquisition of the shares (which usually depends on case law in the relevant jurisdiction - it is not possible to make elections to ensure the tax point is on acquisition in the same way as in the UK and US)

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 up-front 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.

It may also be possible for consultants who acquire growth shares to qualify for the new Investors Relief introduced on 6 April 2016. The investors relief rules allow consultants to qualify provided they receive no more than "reasonable remuneration" for their consultancy services, they hold the shares for at least three years and certain other conditions are met. There is no requirement for consultants to subscribe for the same class of shares as investors and no minimum nominal value or voting requirements (in contrast to Entrepreneurs' Relief). If the conditions are met consultants can achieve a 10% tax rate on capital gains up to a lifetime limit of £10 million.

There is, however, a requirement for the shares to be issued for "genuine commercial reasons" and not as part of a tax avoidance scheme and for the shares to be issued by way of a "bargain at arm's length". It remains to be seen whether HMRC accept growth shares issued to consultants for a nominal amount satisfy these requirements.

Growth Shares & 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.

“They're very professional in a personable and human way. They went the extra mile to hit the deadlines, and we knew they had our interests at heart.”

Chambers UK, 2019

Warning

Content is for general information only and is not intended to constitute or contain legal or other advice. If you require assistance please seek specific advice from a member of the team.

Other Fact Sheets Available:

[Company Share Option Plans](#)

[Discretionary Share Option Plans](#)

[Employee Share Markets](#)

[Entrepreneurs' Relief](#)

[Enterprise Management Incentive Plans](#)

[Long Term Incentive Plans and Deferred Bonus Plans](#)

[Share Incentive Plans](#)

This document gives general information only as at the date of first publication and is not intended to give a comprehensive analysis. It should not be used as a substitute for legal or other professional advice, which should be obtained in specific circumstance.

For more information please contact:

Colin Kendon

Partner

Tel: +442079056312
colin.kendon@twobirds.com



Andrew Rink

Associate

Tel: +442030176946
andrew.rink@twobirds.com



Desiree De Lima

Associate

Tel: +442074156067
desiree.delima@twobirds.com



Stuart Rose

Associate

Tel: +442030176810
stuart.rose@twobirds.com



twobirds.com

Abu Dhabi & Amsterdam & Beijing & Berlin & Bratislava & Brussels & Budapest & Copenhagen & Dubai & Dusseldorf & Frankfurt & The Hague & Hamburg & Helsinki & Hong Kong & London & Luxembourg & Lyon & Madrid & Milan & Munich & Paris & Prague & Rome & San Francisco & Shanghai & Singapore & Stockholm & Sydney & Warsaw

The information given in this document concerning technical legal or professional subject matter is for guidance only and does not constitute legal or professional advice. Always consult a suitably qualified lawyer on any specific legal problem or matter. Bird & Bird assumes no responsibility for such information contained in this document and disclaims all liability in respect of such information.

This document is confidential. Bird & Bird is, unless otherwise stated, the owner of copyright of this document and its contents. No part of this document may be published, distributed, extracted, re-utilised, or reproduced in any material form.

Bird & Bird is an international legal practice comprising Bird & Bird LLP and its affiliated and associated businesses.

Bird & Bird LLP is a limited liability partnership, registered in England and Wales with registered number OC340318 and is authorised and regulated by the Solicitors Regulation Authority. Its registered office and principal place of business is at 12 New Fetter Lane, London EC4A 1JP. A list of members of Bird & Bird LLP and of any non-members who are designated as partners, and of their respective professional qualifications, is open to inspection at that address.