FACT SHEET: GROWTH SHARE PLANS

Wedlake Bell

Introduction

Growth shares are a special class of shares created (usually) by unlisted companies to provide equity incentives to management and key employees. They typically 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 or other conditional share awards such as restricted stock units.

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

Main features

- Growth shares typically comprise a separate class of ordinary share 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 those other ordinary shares have received a minimum amount.
- Managers are offered the opportunity to acquire growth shares and will enter into a subscription agreement which requires them to pay the unrestricted market value ("**UMV**") for those growth shares.
- The subscription agreement typically contains a vesting schedule and a call option which gives the company a right to purchase, or at least procure the purchase, of the growth shares if the manager leaves employment before an exit.
- The manager is required to make an election pursuant to section 431(1) ITEPA 2003 to pay income tax on the UMV 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.
- On a subsequent exit, the sale consideration up to the hurdle is first paid to the holders of ordinary shares and then the excess of any consideration will then be allocated between the holders of the growth shares and the other ordinary shares.
- Holders of the growth shares will be taxed under the capital gains tax ("**CGT**") regime on all gains on an exit above the UMV on grant.

Flexibility

Because growth share take advantage of the prevailing differences in tax rates between income tax and CGT regimes, and are not subject to specific qualifying legislation which applies to the four UK tax-advantaged plans, companies can generally implement a growth share plan on whatever terms it considers appropriate to meet underlying business and commercial objectives.

However, given that the rights attaching to growth shares will, at least in part, have to be set out as a new class of ordinary share in the company's articles of association, the prior consent of shareholders will be required to give effect to the introduction of revised articles.

Employee taxation

If the shares are not readily convertible assets ("**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".

Growth Shares and Company Share Option Plans and Enterprise Management Incentives

Company Shares Option Plans ("**CSOP**") and enterprise management incentives ("**EMI**") are each a form of tax-advantaged option plan available to UK tax paying employees. The tax reliefs can be very generous as they generally relieve participants from income tax and social security on grant and exercise and allow participants to benefit from the currently more favourable CGT regime. In the case of EMI plans, business asset disposal relief on the sale of the option shares is also available without having to meet the 5% personal company test, resulting in CGT being charged at 10%. Companies that qualify for EMI or CSOP may consider granting EMI options as an alternative to growth shares. Separate fact sheets on EMI and CSOP are available.

There are some circumstances where it may be especially desirable to grant either CSOP or EMI options over growth shares. For instance, the individual limits of £30,000 in the case of CSOP options and £250,000 in the case of CSOP options can sometimes be restrictive but can go further if such CSOP or EMI options are granted over growth shares (which have a lower value on grant than ordinary shares).

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 Investment Association's principals of remuneration.

Administration and valuation

As with other employee share plans in the UK, there is a requirement to register growth share plans and then make annual filings under HMRC 's employment related securities ("**ERS**") regime.

If the growth shares are acquired at an undervalue when they are 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.

Next steps

Growth share plans are typically bespoke to the company with individual rules and performance targets. Wedlake Bell can help with all aspects of the design, drafting and implementation of your EMI Plan, including communication, valuation and ongoing compliance requirements.

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