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Growth shares: summary

Background and structure

Growth shares are a tax-efficient equity-based arrangement typically used by unlisted companies to incentivise key executives and senior management. Implementation of a growth share arrangement involves amending the articles of association of the company to create a separate class of ordinary shares (growth shares) to those held by current shareholders.

Growth share arrangements are often favoured by unlisted companies which are unable to grant tax-advantaged options, although they can also be used in conjunction with the grant of enterprise management incentive (EMI) options.

The key feature of growth shares is that they only accrue capital/economic value above a specified hurdle. The hurdle will be set at a figure to be agreed before the growth shares are issued, typically at a premium to the current market value of the company. This means that the growth shares will entitle their holders to a percentage of any growth in value above the hurdle and existing shareholders are protected from dilution in respect of the current value of the company.

How do growth shares work?

Since the growth shares only have a right to growth above the hurdle, their value on acquisition by the employees should be relatively low, typically enabling the employees to fund the upfront acquisition cost from their own resources.

From a tax perspective, provided that the participants in the growth share arrangements pay the full market value for their growth shares on receipt of their shares, no income tax should arise on acquisition of the growth shares.

Valuation of the growth shares will be a key component of the implementation of a growth share incentive arrangement. Over recent years, as growth share plans have become more popular, the methodology for valuing growth shares has developed so that HMRC now expects the market value of a growth share to take into account its future "hope value". This means that participants will generally be required to pay a meaningful sum for the growth shares (but significantly less than the value of an ordinary share) or pay income tax on acquisition (if they subscribe for growth shares at a discount to market value).

Vesting provisions can apply to the growth shares and so the arrangements can be structured to mirror the commercial objectives of a share option. Also, leaver provisions will typically apply to the growth shares meaning that a participant can be required to transfer their shares for a specified price if they leave employment (often with differentiation in price for good and bad leavers).

On a sale of the company, the participants in a growth share arrangement will sell their growth shares alongside current shareholders but, as mentioned above, only participate in a percentage of value above the prescribed hurdle.

Any return would, in normal circumstances, be taxable to capital gains tax at a rate of 24% (business asset disposal relief, which reduces the capital gains tax rate to 14%, is unlikely to be available but the participant will have the benefit of the CGT annual allowance).

Example

The example below shows how growth shares can work:

Company A awards 500 growth shares to Employee Z. The growth shares only participate in value once Company A is worth more than £10 million. Company A's valuers determine that the growth shares are worth £2 each. Employee Z enters into a subscription agreement with Company A and pays £1,000 to Company A to acquire the growth shares. No income tax liabilities arise on acquisition of the growth shares.

Four years later, Company A is sold and Employee Z joins with the other shareholders and sells the growth shares. The growth shares are sold for £200 each.

Overall, Employee Z's return is £99,000.

That return is taxable to capital gains tax so Employee Z is liable to pay capital gains tax at 24%.

Company A has no tax to pay.

As a result, Employee Z receives £99,000 in cash and, assuming Employee Z is a higher or additional rate tax payer, pays capital gains tax to HMRC of £23,760 (which may be reduced further by the effect of the CGT annual allowance).

Structured correctly, growth shares align management's risk and interests with shareholders and can act as a powerful incentive.

Contact TLT

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