Postlethwaite
EMPLOYEE OWNERSHIP LAWYERS

Growth Shares

An employee share involving growth shares enables employees to acquire shares with a low starting value, their eventual value being linked to the company's future growth.

Growth shares are a special class of shares which mirror the economic effect of an option grant by only providing participants with the benefit of growth in the company's value from the time the shares are issued. The historic value of the company is ignored and the shareholder is only able to participate in the company's growth between the date the shares are created and an eventual sale or flotation of the company. These shares are often called "growth" shares (because the shares only participate in the "growth" in value of the company).

Growth shares could be an alternative to options, for example for a company which is not eligible to grant EMI options, or they could be used as part of an EMI option plan (see below).

How they work

A company has a current value of £5 million. A new senior management team is brought in to run the company and is granted growth shares that entitle them to share in 20% of the proceeds in excess of £5 million. Two years later, the company is sold for £7.5 million in cash.

With growth shares, the senior management team will receive (and share) £500,000 as the proceeds of selling their shares. If they had received the proceeds as compensation as part of a management incentive plan, the £500,000 would be taxed as remuneration. However, as they are receiving the proceeds as holders of growth shares, they are taxed on the basis of capital gains.

The main tax objective is (if the growth shares are acquired directly by participants from the outset or are subject to EMI option grants) likely to be that sale proceeds will be subject to capital gains tax, rather than income tax (and possibly also National Insurance).

Implementation

For companies considering implementing growth shares, once the class of shares is created they may be issued to participants either through a sale of the shares themselves or by way of a grant of options over the shares in the class (or a combination of the two). The tax and accounting implications of each method should be considered, both for the company issuing the growth shares as well as for the participants acquiring the shares or options over the shares.

Purchase of Growth Shares. Purchasers of growth shares may be able to acquire the shares outright for a very low purchase price, as the value of the growth shares at the date they are issued is small (because the shares do not participate in the historic value of the company).

Option Grant. Options may be granted over growth shares in place of a straightforward subscription and in some circumstances this may be an attractive alternative approach. Where the company is eligible to grant EMI options, this can make it much more likely that the capital gains tax rate on selling growth shares will be 10% under entrepreneurs' relief.

We would recommend that advice is sought on valuation before growth shares are issued.

What happens if a participant leaves?

If you want to use your growth share plan to encourage participants to stay with your company, you could:

- *stipulate that growth shares must be sold for nominal value if an employee leaves; or*
- *stipulate that they must be sold on leaving but the price will depend on the reason for leaving (good and bad leaver)*

Issues arising

There are a number of potential issues that should be considered prior to implementing growth shares.

Tax. A growth share scheme does not carry specific statutory tax advantages and the capital gains tax treatment cannot therefore be guaranteed.

EIS. This is relevant to companies which have investors claiming EIS relief. One of the fundamental conditions for investments from individuals pursuant to an Enterprise Investment Scheme (or EIS) is that the class of shares acquired by an EIS investor is the lowest class (typically, ordinary shares). With their limited capital rights, growth shares may rank below ordinary shares and their creation may result in a disqualifying event for EIS purposes. It is still possible to implement growth shares for a company that has received an EIS investment, but such shares should not have inferior rights compared with ordinary shares.

One Off Transaction. Due to the value of the company being determined, and the growth being established, at a specific moment in time, the implementation of growth shares should be considered to be a "one off" transaction. If the company grows in value subsequent to the growth being established, any further issue of growth shares may cause immediate income tax issues. Further, any new grant of options over growth shares may have an impact on the company's profit and loss account. Therefore, if the value of the company has increased since the creation of growth shares, then the company should either increase the price of the growth shares (relative to the growth in value of the company) or create a new class of growth shares (with a revised growth).

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Growth Shares
How it works

Shares of a separate class that only acquire capital value once the company's overall value exceeds a particular threshold.

TAX EFFICIENCY (INDIVIDUAL)	TAX EFFICIENCY (COMPANY)	EASE OF SETTING UP	OVERALL INCENTIVE AND REWARD VALUE
No IT or NICs if shares purchased for market value. CGT on sale of shares.	No CT deduction if shares purchased for market value. No NICs on same condition.	Requires change of Articles to create new class of share.	Simple to explain, little risk, tax efficient – but its value as a reward will depend on how high the hurdle is set.

Other issues

Valuation questions will arise on receipt of growth shares.

If you would like to explore how an employee share scheme might be introduced in your company, please contact us for an initial discussion.

We are happy to meet at our offices without charge or commitment and will be very pleased to hear from you.

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