GROWTH SHARE PLAN

Human Capital

Growth shares provide an opportunity for employees and directors to acquire genuine equity in their employing company but in a way that enables them to be rewarded for the real growth in the value of the business that they generate. A Growth share is acquired by the employee which delivers value if the value of the company increases above a set threshold, in a form which is subject to capital gains tax rather than income tax.

How it works

The company creates a new class of share. The share rights given to this new class of share mean that the share benefits from the growth in value of the company in future, but does not benefit from the historic value of the company.

As a result of only benefiting from the future growth in value of the company, the initial value of the growth share is usually much lower than existing ordinary shares.

These shares can therefore be issued or transferred to employees at a low value, resulting in a low issue or purchase price or indeed a low initial tax charge if the growth shares are acquired for no consideration.

The shares can be subject to restrictions on transfer, or forfeiture if specified conditions or targets are not achieved or the employee ceases employment.

The growth in the share value is subject to capital gains tax which is more attractive than income tax that would apply to a cash bonus arrangement or non-tax advantaged share options, offering a significant benefit to employees.

Benefits of growth shares

- The participant becomes a shareholder immediately, aligning interests between existing shareholders and participants.
- Growth shares help preserve the current value for existing shareholders, ensuring that this current value is not diluted.
- The growth in the share value is subject to capital gains tax rules, which are more attractive to employees than income tax treatment that applies to salary and benefits.
- Growth shares can be used with HMRC tax advantaged EMI options, combining their commercial and tax benefits.
- Growth shares are commercially flexible and, when used independently outside of tax advantaged share plans, there is no value cap on growth shares that can be acquired.
- Growth shares can be made forfeitable on employees leaving, with relevant restrictions applying in relation to votes, dividends and other shareholding rights.
- Growth shares form part of the share capital of the company and are therefore governed by the company's Articles of Association and subject to the same provisions as other shares on the sale of the company including tag and drag provisions.

Who can use Growth shares?

Growth Shares are most commonly used by private companies, including start-up

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companies and private equity backed companies where there are substantial growth prospects.

Growth shares are also used by listed companies where the growth shares acquired are generally in the subsidiary of the listed parent.

As Growth shares require a new class of shares to be created, they will not generally be appropriate for use directly over shares in UK listed companies.

For private & listed companies alike, the ability to ring fence the existing value makes the dilutive impact on existing shareholders far less than using 'normal' ordinary shares.

Caution needs to be applied to implement growth shares for EIS companies to ensure that the growth shares do not impact on the EIS tax reliefs but with care, growth shares can be used by EIS companies.

Example

A company is valued at £5m, and a manager is to be incentivised by being given up to 10% of the company.

A new class of share is created which only benefits from capital value in excess of £6m. These growth shares are entitled to 10% of the company value in excess of £6m.

The incentive is to encourage the manager to increase the value of the company, and be rewarded for that.

The growth shares are valued. Due to the £6m 'Hurdle', the value of the growth shares is low and the manager buys growth shares for this low market value.

If the company grows in value and is sold for £10m, the value of the manager's growth shares is 10% of the £4m value above the hurdle, being £400,000. If the company value remains stagnant, or falls, the manager gets nothing.

Personal tax

On award of the growth shares: the employee will pay employment income tax on the value of the shares on the date of receipt less any amount paid for the shares. This would require formal valuation input and, depending on share rights, the tax value could be small. Restricted securities tax elections are required to achieve the desired result.

Disposal of the shares: on disposal, capital gains tax at a rate of 20% should apply (assuming that the whole gain is taxable at the higher rate), giving rise to capital gains tax of £80k. A tax rate of 10% can be achieved if the conditions to claim entrepreneurs' relief are met, which would result in £40k of capital gains tax being payable.

Comparison	Unapproved Share Option	Growth Shares
Income tax and NIC on grant	No	Yes – on (small) value of shares on date of award
Income tax and NIC on vesting/exercise	Yes – on full gain made by employee	No
Tax on disposal	Yes – CGT	Yes – CGT
Corporation tax relief on vesting/exercise	Yes	No

Corporation tax and accounting

There will usually be no corporate tax deduction available for the costs of the arrangement. Subject to auditor agreement, a Growth share plan should result in a FRS 102/IFRS 2 accounting charge based on the fair value of the growth share awards.

Other uses of a Growth share plan

As well as being used for employment reward and planning, growth shares can be used for effective inheritance and succession. Instead of awarding growth shares to employees, those shares can be given to family members, directly or through a trust arrangement, for the next generation.

This has the effect of transferring all or part of the future growth in the value of the company to other family members, whilst the current generation retains the current value. The value of the gift will be limited for inheritance tax purposes. This is particularly useful in cases where a shareholding would not qualify for inheritance tax business property relief (such as shares in investment companies).

Your next steps

BDO can help with all aspects of the design and implementation of your non-qualifying Share Option Plan including participation policy, performance measures, communication and ongoing compliance requirements. Please get in touch with your usual BDO contact or any of our experts listed overleaf.