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Osborne Clarke

Growth shares

Where companies or individuals do not qualify for EMI options, an award of growth shares may be the best alternative.

Companies are generally familiar with EMI options and the tax advantages they provide for both employees and the company. However, EMI options are subject to various qualifying requirements (please see our flyer on EMI options for further details here) and the company and/or the recipient may not qualify. While other types of tax advantaged options may be possible (e.g. CSOP or SAYE) these are more restrictive in both size of awards and the terms applicable to the option. Growth shares on the other hand are very flexible and are more tax efficient compared with unapproved options.

What are growth shares?

"Growth shares" is a generic term to refer to a class of share which entitle the holder to participate in the growth in value of a company above a certain threshold or hurdle. Growth shares do not typically participate in the value below the threshold which remains "ring fenced" for existing shareholders. There are many different terms for growth shares including "hurdle shares", "flowering shares" and "ratchet shares", which each have a slightly different emphasis but fundamentally work in the same way.

How do growth shares work?

Growth shares are often intended to commercially replicate an EMI option. As such, participants are not typically required to pay significant amounts to acquire growth shares (as they would for ordinary shares or preference shares if the company has a large enterprise value). Growth shares do not typically carry voting rights or entitle the holders to receive dividends (although they can if required).

As growth shares are a separate class of share, the company's articles of association will require amendment to set out the rights and restrictions applicable to the growth shares. This should include drag and tag provisions, as participants in a growth share scheme will actually hold shares in the company from "day 1" (unlike EMI options where participants only become shareholders on exercise of the option). The articles of association should therefore be drafted to properly protect the company and other shareholders on a corporate sale.

Similarly, participants will generally be required to sign a subscription agreement setting out the terms applicable to holding growth shares for that particular participant. For example, growth shares may "vest" over time, or on certain performance targets being met, with the company having the right to buy-back the growth shares if they are not vested, or if the participant ceases to be an employee or director of the company.

Tax Treatment

Provided the threshold applicable to the growth shares is set at the right level (at some level in excess of the value of the company as at the date the growth shares are issued), participants should not generally be required to pay a significant amount on acquisition and will not be subject to any income tax.

When the growth shares are sold, participants are generally subject to capital gains tax ("CGT") at 10% for basic rate taxpayers and 20% for higher and additional rate taxpayers. Participants may also be able to make use of the annual CGT exempt amount (and any other CGT reliefs) to reduce their tax bill. Growth shares do not typically qualify for Entrepreneurs' Relief (as the 5% voting and nominal value tests are not normally met), but may do in some limited cases, or where the holder otherwise qualifies for Entrepreneurs' Relief because of their existing shareholding.

When are growth shares used?

A growth share plan is typically introduced when the company is looking to introduce an incentive plan which delivers tax efficient gains for participants, but the company does not qualify to grant, or the participant is not eligible to receive, EMI or other tax-advantaged options. Common circumstances where this is the case include:

- the company is too large, i.e. it has more than 250 full-time employees (or their part-time equivalent), or it has gross assets in excess of £30 million;
- the intended participant is not an employee and/or does not meet the working time requirements for EMI (e.g. Non-Executive Directors); or
- the company is not independent because, for example, it is a subsidiary company, or a corporate investor controls the company or it is part of a joint venture arrangement.

Points to consider

- The company's articles of association will need to be amended to set out the rights and restrictions attaching to the growth shares. This will need the approval of holders of at least 75% of the shares and may need additional written consents from investors and/or significant shareholders.
- Participants in a growth share plan hold actual shares (unlike options), so will need to be entered into the company's register of members and will be on the public record. However, a nominee could hold the growth shares on the participant's behalf if it is intended the growth share awards should be kept confidential.
- There are registration and ongoing reporting requirements – an annual return must be made online to HMRC by 6 July in each year.

How can Osborne Clarke help?

At Osborne Clarke we have a dedicated specialist team of incentives lawyers who can advise on all aspects of establishing and operating a growth share plan. They are supported by experts in other disciplines, such as employment, company and financial services law.

Tax is likely to be a critical consideration as is providing for future changes in the life of the company and its employees. Setting up and running a growth share plan involves careful planning, including designing vesting and leaver provisions that meet the commercial requirements of the company, drafting the changes to the articles, the growth share subscription agreements and associated documentation. It is also important to ensure that the threshold is set at the right level.

Summary

- A discretionary incentive arrangement for the benefit of employees, directors and/or consultants – the company can select who will benefit and it is not limited to only employees.
- Ideal for companies who do not qualify to grant EMI options – growth shares are tax efficient compared with unapproved options.
- Flexible arrangements – the terms attaching to the growth shares can be tailored to suit the commercial needs of the company.

If you are considering establishing a growth share plan, please speak to your usual Osborne Clarke incentives contact. Alternatively, contact any of the following members of our incentives team.

These materials are written and provided for general information purposes only. They are not intended and should not be used as a substitute for taking legal advice. Specific legal advice should be taken before acting on any of the topics covered.

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