INCENTIVES THROUGH EQUITY

SHARE PLAN
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Growth Share Plan

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What are growth shares?

Growth shares are sometimes used by companies that wish to allow employees to share in the future growth in the company with existing shareholders but not the accrued value to date. Economically, they are similar to full cost share options although the legal structure and tax implications are very different.

With full cost options, an employee is granted an option to buy shares in the future but at a price (exercise price) equal to the value of the shares at the date of grant. When the options are exercised the employee will enjoy any upside growth above the exercise price. Where a tax advantaged share option plan is not available, any such gain will be liable to income tax and NICs.

Growth shares are a mirror of full cost share options but involve an upfront award of shares. A new class of share is created with capital rights limited to any future increase in company value beyond an initial hurdle, typically set at a small premium to the current value of the company, or else adjusted at an annual compound rate. This means that the growth shares would be worth a fraction of what the shares of the original share class would be worth because they only have 'hope value'. Growth shares are then acquired by employees at day one subject to a risk of forfeiture. If the employee ceases employment within a specified period, shares are forfeited and employees are then required to sell their shares, typically at the lower of the price paid for the shares and what the shares are then worth. In select circumstances, employees who are 'good leavers' will be allowed to sell their shares at fair value, meaning that they can appreciate any gains up to their date of leaving. Unlike share options, any gains realised on a sale would be subject to CGT, not income tax and NICs. The use of growth shares should also produce a lower accounting cost under IFRS2.

Example:

Instead of granting options, X Co decides to issue 11,111 'B' shares. The total number of shares in issue will be 111,111. The B shares will only accrue future value. So, the initial 100,000 shareholding will share in the existing £1m value but the diluted 111,111 shareholding will share in the £5m exit value (less the initial £1m). The gain is the same as the option route

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but subject to CGT and business asset taper relief.
In effect, growth shares provide an equivalent upside to a full cost option but with beneficial tax consequences. They are therefore worth considering whenever a tax advantaged share option plan is not available or, in the case of EMI options, where the financial limits might be breached were a regular class of ordinary share used. There are different ways of designing growth shares and in each case a restructuring of the company's articles of association and any shareholders' agreement will need to be considered.

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Advantages and disadvantages of growth shares

Advantages	Disadvantages
• Can accommodate execs and non-execs in one plan • Low initial cost to participants owing to low initial value of growth shares • Growth in value subject to capital gains tax instead of income tax and NICs • Can convert into PLC ordinary shares • Participants share 20% of the increase in value of the company above the hurdle – same as for all plan models considered • Should be acceptable within AIM rules to create a separate class of growth shares (not tradable on AIM) for the purposes of the plan	• Complex and expensive – requires new class of shares and changes to Articles of Association • No CT deduction for gains subject to capital gains tax in hands of participants • Requires shareholders' approval • Difficult to add future participants – either need to provide for this in the Articles at the outset or make further changes to the Articles (with shareholders' approval) in future • Possible that future participants will have to pay a higher subscription price (or face a higher initial income tax and NICs charge) than those who participated at the start for their growth shares

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Advantages	Disadvantages
• No immediate dilution of ordinary shareholders' interests – equity dilution deferred until growth has been achieved and growth shares are exchanged for ordinary shares	• Need for a professional valuation of the growth shares at the start and prior to exchange for ordinary shares • HMRC will not agree valuations in advance, so some uncertainty about participant's tax position until agreement reached • ABI etc not generally in favour of such plans • Participants at risk if tax rules change

We hope you found this useful, but if you would like further information about growth share plans or would like assistance with establishing a new plan, please contact Share Plan Partners for a FREE consultation.

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