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Growth Shares: Helping your Business Thrive

Many companies decide to retain and motivate employees by allowing them to acquire shares in the company. While arguably the most well-known employee share scheme is the Enterprise Management Incentive (EMI) scheme, there are other options allowing companies to incentivise staff while providing a number of tax advantages. This article will focus on one of these alternatives, growth shares.

What are Growth Shares?

Growth shares refer to a special class of share capital which is designed to allow the holder to benefit only from growth in the value of the company.

Key Characteristics of Growth Shares

Below are the typical characteristics of growth shares that are distinct from other types of shares:

- **Valuation Hurdle**: A valuation hurdle means that holders will only participate in growth above the defined hurdle, expressed as a value of the company. For example, if the hurdle rate is set at £1.50 per share, the holder will only participate in the growth once it exceeds the hurdle rate. This means the shares are worthless until the hurdle is achieved and the existing shareholders are not diluted from a financial point of view.

- **Entitlement to capital:** Holders of growth shares do not usually have the right to receive proceeds on a sale or winding up of a company until a certain amount has firstly been paid to holders of ordinary shares.
- **Entitlement to income:** Regarding income, growth shares may either come with no dividend rights, or a right to a proportion of any dividend that is paid, with such proportion based on the value which the growth shares as a class represent.
- **Voting rights:** Growth shares do not typically carry voting rights. Despite this, some growth shares give voting rights to allow the holder to qualify for business asset disposal relief.
- **Leaver provision:** Such provision is incorporated into the agreement as it forces an employee to sell their shares on termination. It will specify whether an employee is a good or bad leaver. If the employee is a bad leaver, they would usually be required to sell their shares lower than the current market value or the original cost.
- **Conditions**: Holders of growth shares are generally required to fulfil certain conditions to benefit from them, such as remaining employed for a certain period or achieving specific performance targets.

Why Should I Issue Growth Shares?

Any share scheme will have its own pros and cons, but below are some advantages associated with growth shares, which include but not limited to the following:

- **Maintaining shareholding:** From an existing shareholders' perspective, their shareholding is not diluted when growth shares are issued, whilst it would be diluted on issue of ordinary shares. This means that there is some reassurance from existing shareholders that their shareholding is preserved.
- **Lower market value:** At the time growth shares are acquired, the market value is much lower than that of an ordinary share, which makes it much more affordable for employees to invest in.
- **Income tax treatment:** As growth shares are usually structured to ensure there is a low value on the date of acquisition, they are acquired at relatively low or even nominal value with little or no income tax and NICs payable at the time of acquiring the shares.
- **No time limit:** The good news is that unlike EMI share options which must be exercised within 10 years of the grant, there is no time limit with growth shares. This is particularly ideal for companies that are not planning an exit event within the next 10 years.
- **Flexible Terms**: Companies are free to tailor their terms of issuing growth shares based on their milestones. As growth share schemes are discretionary, they do not have to be offered to all employees and therefore there are no restrictions as to who can and cannot participate.
- Before you set up a growth share plan, it is also important to consider the following issues:

- **Suitability:** Growth shares are usually only suitable for private companies that are able to have more than one class of ordinary share capital. This makes growth shares unsuitable for public companies due to the listing or stock exchange rules which restrict the complexity of share capital structures.
- **Set-up costs:** It is important to exercise caution when setting up growth share plans to ensure there are no unwanted income tax liabilities under various employment income tax charging provisions. This involves the need to obtain expert valuation and to review and make necessary amendments to the company's existing articles of association and other documents.
- **Potential for growth:** Adopting a growth share plan may not be justified unless there is a real prospect that the company can achieve growth.
- **Corporation tax relief:** There is no corporation tax relief on the set-up costs of a growth share plan, nor on any profit made by the growth shareholder when they sell their shares.

If you wish to issue growth shares to your employees, there are a number of matters to be considered, such as assessing the company's potential for growth, obtaining expert valuation and amending the existing articles of association. While this sounds rather complicated, our highly experienced team at Farringford Legal are here to advise and help set up a growth share plan for you.

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