Briefing Note

GROWTH/HURDLE SHARES

An alternative or supplement to share options

Growth Shares (sometimes also termed hurdle shares) are a separate class of shares which entitle the holders to benefit only in the event of the growth in value of a company.

Whilst Growth Shares can be held by third parties as well as officers or employees of the company, this Insight focuses on the tax issues arising in relation to employment or office holder scenarios. The position in relation to third parties is less complex.

In many cases, a hurdle is set (often in excess of current market value) such that the employees' Growth Shares become entitled to share in all or a proportion of the proceeds on a company sale only once the hurdle is met.

For example, a company has a current value of £5 million and has one class of shares (Ordinary Shares). A new class of shares (Growth Shares) is created and issued, this class can only share in any proceeds over £6 million. Five years later the company is sold for £10 million. The Ordinary Shares receive the first £6 million. The Ordinary and Growth shares receive the balance of £4 million to be apportioned between them.

Benefits of Growth Shares

Growth Shares can provide a number of commercial advantages.

By setting the hurdle at an appropriate rate the Growth Shares should have only a minimal value on issue, so there is little cost for the employees subscribing for the shares. They can, however, enjoy the financial benefits of any increase in value in a tax efficient manner (see below).

As the employees share in any increase in value this provides an incentive for them to work for the growth of the company. This can be done without a cash cost to the company, unlike a bonus arrangement.

The Growth Shares can be non-voting shares so the employees do not participate at Board level with the running of the business. There would normally be in place an agreement that if the employees cease employment the shares are bought back by the company, usually for only a nominal sum.

Tax treatment

Provided the employees pay (or elect to be taxed on) the full unrestricted market value of the Growth Shares (which would usually be low because of the hurdle – see above), then no income tax or national insurance contributions liabilities should arise on the growth in value. Instead the employees would normally pay Capital Gains Tax (CGT) on the profit made on the sale of the shares. CGT standard rate is 20%. Business Asset Disposal Relief (BADR) may reduce this to 10%. (See our separate Insight).

Disadvantages of Growth Shares

It is not normally possible to agree a value for the shares in advance with HMRC. However, it is possible to agree a value where EMI options are to be granted over the shares.

As the employees are usually paying market value for the shares it is not possible for the company to obtain a corporation tax deduction, which is in contrast with EMI options where a corporation tax deduction is available on the market value of the shares on exercise less the amount paid for the shares.

If the hurdle is set too high then it will not operate as an incentive for employees but if it is set too low then the Growth Shares will have value giving rise to a cost to and/or income tax charge on the employee.

Growth shares can be relatively complicated to set up. Their provision involves the creation of a new class of shares and consequent amendments to Articles of Association and specialist valuations. The allotment of the Growth Shares will require shareholder approval and we would recommend a Subscription Agreement and/or a Shareholder's Agreement to cover matters such as good and bad leavers.

Who can use Growth Shares?

Any company can issue Growth Shares but they are ideal for companies that have growth potential; where it is not possible to grant EMI options and/or where the current value of the shares may already be too great for employees to be able to afford to pay full market value.

Due to the fact that Growth Shares require a new class of shares to be created, they are not appropriate for shares in UK listed companies who will need to consider other alternatives.

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