

SHARE STRUCTURES

Growth Shares: Rewarding Key People Without Giving Away Today's Value

What growth shares are, how a hurdle works, and what to settle on valuation, tax and filings before any are issued.

What growth shares are

Growth shares are not a separate legal type of share. They are shares in a new class, created through the company's articles of association, whose rights entitle the holder only to value created above a set threshold, known as the hurdle.

The design answers a common problem. An owner wants a key person, or a child, to share in the company's future. Issuing ordinary shares today would hand over part of the value already built, and may create a tax charge for the recipient. Growth shares pass on the future and leave existing value where it is.

How the hurdle works

The hurdle is a company value, usually set at or slightly above the current market value. On a sale or winding up, the growth shares receive nothing until the proceeds exceed it. Above the hurdle they take an agreed percentage of the excess.

An illustration, before costs and tax. A company is worth £2m. A class of growth shares is created entitled to 10% of any value above a hurdle of £2.5m. If the company is later sold for £5m, the growth shares share in £2.5m of value and receive £250,000. The existing shareholders receive the remaining £4.75m. If the sale price is £2.5m or less, the growth shares receive nothing.

Setting up the class

Creating the class normally takes three documents:

- **Articles.** The new class, its capital, voting and dividend rights, and the hurdle mechanism are written into the articles. This needs a special resolution, passed by 75% of votes cast.
- **Shareholders' agreement.** Leaver provisions, drag-along and tag-along rights and any restrictive covenants usually sit here.
- **Board and shareholder approvals.** The directors need authority to allot, and any pre-emption rights must be disapplied or waived.

Key points

- The hurdle protects existing value. Holders share only in growth above it.
- Value at issue is the central tax question, and HMRC will not usually agree it in advance.
- Holders who are, or will become, directors or employees bring the employment-related securities rules into play.
- A section 431 election, signed within 14 days of acquisition, should be considered for almost every employee or director holder.
- Leaver terms in the articles decide what happens when a holder departs. Decide them before issue, not after.
- Filings must follow: the special resolution, new articles and SH01 at Companies House.

Valuation at issue

The tax result depends largely on what the shares are worth on the day they are issued. If a director or employee pays less than market value, the shortfall can be taxed as employment income. Market value reflects the hurdle, the lack of votes and dividends, and the minority holding, so it is often a small fraction of a proportionate share of the company.

HMRC does not agree the value of growth shares in advance, except under approved schemes such as EMI. A written valuation by a suitably qualified valuer, prepared at the time and kept on file, is the main protection if the value is challenged years later. Where the valuation turns on HMRC practice or judgement, we say so rather than treat it as settled.

Employment-related securities in outline

Shares acquired by reason of employment or directorship are employment-related securities under Part 7 of the Income Tax (Earnings and Pensions) Act 2003. Restrictions on the shares, such as leaver provisions, reduce their value when issued. Without an election, tax on part of the later growth can arise as income, with PAYE and National Insurance in some cases, when those restrictions end.

A joint election under section 431 of that Act, signed by the holder and the company within 14 days of acquisition, removes that risk by taxing the shares on their unrestricted value. It is not sent to HMRC, but it must be kept, and a missed deadline cannot be put right. Companies must also report the shares to HMRC each year through the employment-related securities service, even where nothing has changed.

Leaver, drag and tag provisions

Holders become real shareholders, with statutory rights. The articles or agreement should therefore say what happens if a holder leaves: whether shares must be offered back, at what price for a good or bad leaver, and by when. Drag-along rights let a buyer acquire the whole company; tag-along rights protect minorities if control is sold.

Filings at Companies House

- The special resolution and the amended articles, within 15 days (Companies Act 2006, ss.29 and 30).
- Form **SH01**, return of allotment, within one month of the allotment (s.555).
- Form **SH08**, notice of name or other designation of class of shares, where a new class is named.
- Form **SH10**, notice of particulars of variation of rights, where existing class rights change.
- Updates to the register of members and any share certificates (within two months, s.769).

Before you start

- Who is to receive shares, and are they directors or employees?
- What percentage of growth do they share in?
- What is the company worth, and how will that be evidenced?
- Is EMI available instead? Where it is, it may suit employees better, and options can sometimes be granted over a growth class.
- Are investor or lender consents needed?
- What happens on leaving, death or divorce?
- Does a sale of the company look likely soon? If so, take advice before issuing.

How MTM can help

0161 835 2080
client@mtmlp.co.uk

Practices often bring growth share projects to us through their clients. We draft the articles and shareholders' agreement, prepare resolutions, minutes and section 431 elections, coordinate with the valuer, and make the Companies House filings, in your name or ours. The valuation and tax analysis stay with you and your client's tax adviser.