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# Growth, Flowering and Convertible Shares

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# What do we mean by “growth share”?

- Special class of management share
  - **Hurdle shares**: designed to allow the holder to share in the company’s growth in value above a hurdle, proportionate to other shareholders, with a similar economic outcome to an mv option
  - **PE-style Management Incentive Plan (MIP) shares** or “sweet equity”: designed to allow the holder to share in a proportion the company’s growth in value once other shareholders have received a specified return on their investment
- These features will generally result in the shares having a low upfront equity value, but a high potential value due to their leveraged nature
- Share class rights set out in Articles
  - Articles and shareholder information publicly available

# Why growth shares?

- Shareholding encourages management to grow the value of their business
- Separate share class to investor shares
- Current investor share value preserved with dilution only once hurdle or investor return has been met
- Can be implemented at any stage of the company's lifecycle
- Mainly used by private companies, and especially PE-backed companies, but can be used by subsidiaries of listed companies
- Employees interest are aligned with shareholders, in particular as liquidity will only be available on an exit (unless a synthetic exit is arranged)

# Why growth shares?

- Tax advantages are available as a result of the (currently!) more beneficial CGT tax rates; can be used where tax-advantaged options are not available or appropriate
- Employees acquire shares upfront and are exposed to the economic risks (albeit limited) and rewards of share ownership – they have “skin in the game”
- Restrictions on shares can mirror those that might apply to an option or other share award, for example, leaver provisions
- Can be used with EMI/CSOP options if company qualifies
- No restrictions on who can subscribe for shares, so not limited to employees

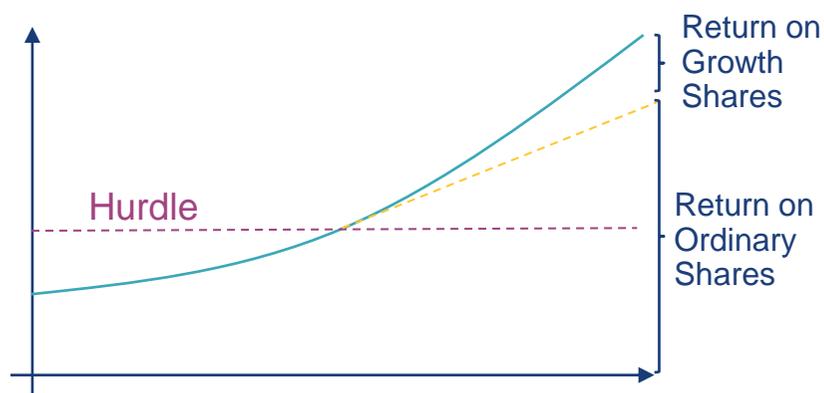
# What is not a growth share?

- PE MIP/sweet equity using preference shares or VC-backed company “alphabet shares”
  - ordinary shares which rank in the waterfall after preference shares or a series of preference shares
  - will share in the value of the company once holders of preference shares have received their capital and, generally fixed percentage, coupon
- Similar economics to growth shares as all value in the company will initially be attributed to the preference shares, resulting in low valuation
- No share class structuring necessary, and leaver provisions generally included in ancillary documentation

# Examples of growth share economics

## Standard Growth Shares

- Ordinary Shares receive all value on a winding-up up to a hurdle value
- G Shares rank equally with Ordinary Shares for value above the hurdle



## MIP Shares

- Ordinary Shares receive all value on a winding-up up to a IRR return on investment
- MIP shares participate in a MIP pool:

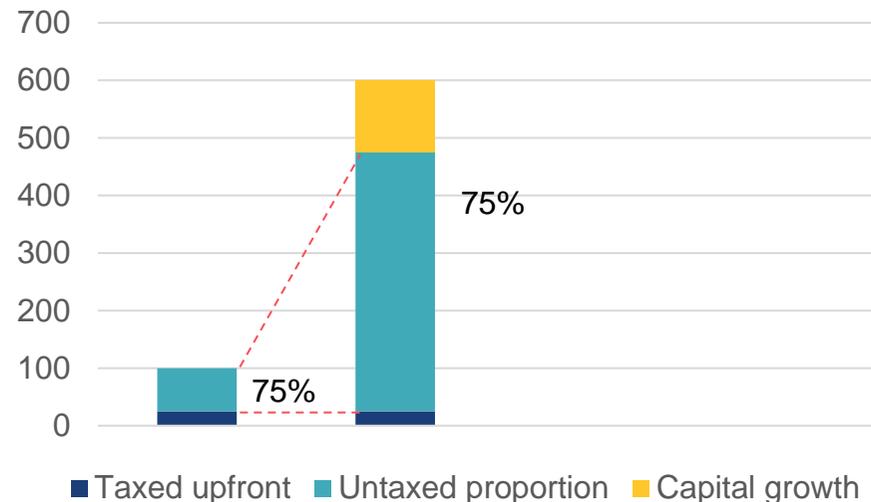
IRR on invested capital	% of equity gain
10%	8%
15%	10%
20%	13%
25%	18%

# How is a growth share taxed?

- As a capital asset, the expectation is for the growth in value to be subject to capital gains tax
- Shares will be *employment related securities*
- Restrictions on shares, for example, leaver provisions or restrictions on sale, with result in the shares being *restricted securities* under Chapter 2, Part 7, ITEPA 2003
- Income tax charges can be avoided if:
  - the shares are acquired for full *unrestricted market value (UMV)*
  - where a lesser amount is paid, the employee enters into a s431 election within 14 days of acquisition and pays income tax on the discount
- Even if full unrestricted market value is paid, a “protective” s431 election is recommended
- Tax position for company should also be considered as limited scope for any CT deduction

# The importance of a s431 election

- Absent a s431 election, income tax on acquisition is paid on any discount to the *actual market value (AMV)*
- Any *untaxed proportion* remains outstanding until a later sale or restrictions are lifted/varied
- Untaxed proportion is the difference between AMV (inc. purchase price) and UMV



- The *untaxed proportion* of the sale proceeds is subject to income tax and NIC

# Inherent terms or restrictions?

- Example growth share terms:
  - shares receive 8% of value above the hurdle
  - shares do not have dividend rights
  - shares do not have voting rights
  - shares must be transferred on leaving
    - at market value for a “good leaver”
    - at the lower of cost and market value for a “bad leaver”
  - shares may not be transferred by an employee without approval of the Board
- Restrictions inherent in the terms of the share (limitations on value, voting and dividend rights) are accounted for in determining UMV
- Leaver and transfer provisions are personal rights, separate to the inherent rights of the share and so are “restrictions” taken into account in determining AMV

# What is a convertible share?

- Shares which:
  - confer on the holder an immediate or conditional right to convert them into securities of a different description; or
  - are the subject of an agreement which either authorises or requires the grant to the holder of such a right if circumstances arise or do not arise; or
  - are the subject of an agreement which makes provision for the conversion of the securities (otherwise than by the holder) into different securities
- A common example would be a preference share which allows for a conversion to an ordinary share if certain conditions are met
- The share does not need to change its name, it is sufficient for the share to accrue additional rights effectively to make it a different share

# How is a convertible share taxed?

- Convertible shares are treated as comprising two parts for tax purposes:
  - the share as a bundle of rights ignoring the conversion right (“*inherent value*”)
  - the conversion right
- On the acquisition of the share, income tax is due on the benefit of any discount to the inherent value of the share (i.e. ignoring the conversion right)
- On conversion, any gain made on the conversion (i.e. the difference between the value of the “new” share after conversion vs the value of the “old” immediately prior to conversion, less anything paid to convert) is subject to income tax
- No Chapter 3 equivalent of a s431 election

# How is a restricted convertible share taxed?

- Legislation doesn't specifically deal with this situation
- HMRC guidance at *ERSM40030* accepts that shares can be both restricted and convertible
  - no double tax charge “if restricted securities convert into a different type of security”
  - expectation that restricted securities tax regime would be preferred as a result of the ability to enter into an election to “front-load” tax charges
- Without an election, upfront tax is based on AMV and later conversion likely to tax full increase in value to income tax
- Effect of s431 election is to treat the additional rights attaching to the “converted shares” as restrictions on the original shares acquired, such that upfront tax is based on the UMV of the converted shares
- May only be useful if the converted shares have a relatively low UMV at the point of acquisition of the convertible shares

# Is a flowering share a growth share or a convertible share?

- Special class of management deferred share with, for example:
  - limited economic value on winding up
  - no voting or dividend rights
- Shares “flower” or “blossom”, ie gain economic and dividend rights, and receive voting rights on certain conditions being met, often profit levels or other corporate targets
- Often coupled with an equivalent number of ordinary shares ceasing to have rights so as not to dilute value for all shareholders, but only specified investors
- Can be made up of different sub-classes, flowering based on levels of achievement of performance

# Tax risks in structuring flowering shares

- Key question:
  - are there inherent rights in the flowering shares from the outset which are restricted or
  - does the flowering result in new rights (i.e. there is a conversion into a different share)?
- HMRC considers that the flowering generally results in a conversion of deferred shares into ordinary shares, ie shares of a different description
- Rights such as voting and dividend rights were absent from the deferred shares, not simply subject to restrictions
- With growth shares, all relevant share rights are incorporated on acquisition – no new rights attach later, and the leveraged economic value is simply as a result of the capital sharing mechanism included in the Articles

# What are the alternatives?

- Growth shares, flowing shares and convertible shares are mechanisms for delivering value on the achievement of certain hurdles or conditions
- Consider
  - share options, including CSOP and EMI
    - note that growth shares can now be subject to both tax-advantaged option arrangements if the company qualifies
  - Joint Share Ownership, splitting the interests in ordinary shares between the intrinsic value on acquisition and the growth element
  - cash bonus or “phantom” arrangements
- Tax benefits should not be the sole driver of structure

# Is a pre-transaction reorganisation necessary?

- Only certain transactions will require a reorganisation of share capital
  - where the company is acquired by share sale, the purchaser is able to acquire all share classes and effect a post-transaction reorganisation
  - an asset sale or winding up will result in shareholders receiving distributions on shares in accordance with the Articles waterfall, and does not require a share reorganisation
  - a company which is to IPO will generally reorganise share classes into a single class for listing
    - establish clean Listco and effect a share-for-share exchange
    - convert existing shares into shares of a single class
- Partial exit may also require a reorganisation of leveraged instruments into ordinary shares which also assists with applying tag/drag provisions

# Reorganisation of share classes

- Converting 1,000 growth shares of 1p each worth £1 per share into ordinary shares of 1p each worth £10 per share
  - 1,000 growth shares collectively worth £1,000 (*£10 nominal*)
  - consolidate and split into:
    - 100 ordinary shares collectively worth £1,000 (*£1 nominal*)  
*plus*
    - 900 worthless deferred shares of 1p each (*£9 nominal*)
- Maintains aggregate nominal value of shares and avoids capital reduction

# Reorganisation of share classes

- Converting 1,000 growth shares of 0.01p each worth £1 per share into ordinary shares of 1p each worth £10 per share
  - 1,000 growth shares collectively worth £1,000 (£0.10 nominal)
    - consolidate to 100 growth shares of 0.1p each
  - Effect a 0.9p reduction of capital on ordinary shares such that each ordinary share has a nominal value of 0.1p each
  - Convert 100 growth shares of 0.1p to 100 ordinary shares of 0.1p
- Share capital reduction moves into distributable reserve
- Special resolution of shareholders coupled with:
  - a directors' solvency statement, if a private company
  - a court order, if a public company (irrespective of whether or not listed)

# Questions?

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