



Valuing Employee Shares

A Parmentier Arthur Seminar

Thursday 25 June 2009

Steve Lygo

Stuart Gilham

Parmentier Arthur Group Ltd

**7 The Waits
St Ives
Huntingdon
Cams PE27 5BY**

Tel: 01480 465522
stuart.gilham@parmentierarthur.com

**90 Long Acre
Covent Garden
London
WC2E 9RZ**

Tel 020 7849 3018
steve.lygo@parmentierarthur.com



Speakers

Steve Lygo – Director

Stuart Gilham - Consultant



1. EMPLOYEE SHARES – VALUATION BASES FOR TAX PURPOSES

Where the value of employment related securities has to be established the basis of valuation will be one of the following:

- “Case law” or “money’s worth” basis for Income Tax
- Statutory open market value as defined by CGT legislation



Employee shares – valuation bases for tax purposes

Which basis is relevant is determined by the section of ITEPA 2003 the charge to tax arises under, either:

- A “general earnings” charge (s.62 ITEPA) = **case law basis**
- “Specific employment income” (special provisions in Part 7 of ITEPA) = **statutory open market value**

Statutory open market value also applies to valuations in connection with:

- EMI options
- HMRC approved share schemes



Case law basis

Applies when an employee acquires shares for less than their market value, unless:

- The shares are “restricted securities” and
- A joint election is made to disregard some or all of the restrictions (*s.431 ITEPA*)

Employee can therefore elect out of the case law basis so that the statutory open market valuation basis applies instead



Case law basis

Tax charge is based on the difference between the actual market value of the shares and what is paid for them

Actual market value is value allowing for any restrictions imposed on the employee who acquires the shares, e.g.

- *The employee is not allowed to dispose of the shares for a specified period or without permission*
- *The dividend, capital or voting rights of the shares are restricted in some way*



Case law basis

The valuation basis derives from old case law:

- *Weight v Salmon (1935) 19 TC 174*
- *Ede v Wilson and Cornwell (1945) 26 TC 381*
- *Abbott v Philbin (1960) 39 TC 82*

These cases involved quoted shares and the application of the principles to unquoted shares has never been tested in the courts



Case law basis

The test of value is the money or money's worth that the employee could realise in the open market for the shares

“Money's worth” means something that is:

- of direct monetary value to the employee, or
- capable of being converted into money or something of monetary value

HMRC view is that an employee receives money's worth even if the shares cannot be sold as cash could be raised against the security of the shares (e.g. a loan) or the beneficial interest rather than the legal title could be sold



Case law basis

The valuation test is **subjective** and addresses the benefit to **the employee** in question

A sale in the open market is **not** assumed

Takes account of all rights and restrictions attaching to the individual employee's shares, for example under the Articles of Association, a Shareholders' Agreement or Investment Agreement

“Fair value” provisions in the company's Articles of Association and/or the price the employee could obtain by selling the shares in a limited internal market may be relevant



Case law basis – relevant information

HMRC's view is that personal knowledge of the employee forms the information base

May be relevant in situations where commercially sensitive information, such as plans for a sale or flotation, is known by the employee

In principle, different employees with different knowledge could have different values attributed to their shareholdings

e.g. Board member, middle manager and junior employee with holdings of the same size could theoretically have different values placed on their shares

HMRC considers this situation will arise very infrequently in practice and that in most cases personal knowledge will not have a material impact on value



Statutory open market basis

Relevant in CGT and IHT cases and to valuations required for all purposes falling within Part 7 of ITEPA 2003:

- *Restricted securities*
- *Convertible securities*
- *Securities with artificially depressed or enhanced market value*
- *Securities disposed of for more than market value*
- *Post-acquisition benefits*
- *Securities options*
- *HMRC approved share incentive plans*



Statutory open market basis

Valuation test relates value to the price the asset could be expected to fetch if sold in the open market (s272 TCGA 1992)

Information relevant to the valuation defined by s273 TCGA as information which would reasonably be required by a prudent purchaser

- buying the shares from a willing seller
- in a transaction at arm's length
- by private treaty



Open market valuation standard

First introduced by Finance Act 1894, now backed by over a century of case law

- Notional sale between willing vendor (i.e. not a forced sale) and prudent purchaser informed of relevant information about company
- Objective and purchaser-orientated
- Asset is offered for sale to the whole world
- Value is the best price on offer from competing bids
- Identity of the actual taxpayer/employee is irrelevant – the transaction is a depersonalised one between notional parties



The asset

The shareholding is a “bundle of rights” determined by company’s Articles of Association and the Companies Acts

Purchaser buying the right to be entered on the register of shareholders as the owner of the shares

Value reflects benefits and disadvantages of owning “bundle of rights”



The asset

Consequently, open market value of the shareholding should not encompass any extraneous agreements or contracts personal to the individual taxpayer, for example rights or restrictions under:

- Share Purchase Plans
- Shareholders' Agreements
- Contracts of Employment



HMRC view

Historically, HMRC maintained this interpretation in CGT, IHT and approved share schemes

However, HMRC states personal rights and restrictions outside of the company's Articles of Association **are relevant** for valuations under Part 7 of ITEPA

Assumption is that the hypothetical purchaser would be bound by them

Position unclear but HMRC also seems to have changed its mind in CGT and IHT situations

Not seen as a change of policy by HMRC – 1984?



2. OPEN MARKET INFORMATION STANDARD

Objective information standard for statutory open market valuations (s273 TCGA)

Relates to unpublished or confidential information not in the public domain

Information deemed to be available is that which would reasonably be required by a prudent purchaser

Differs from case law basis where the employee's personal knowledge is taken into account



Open market information standard

Assumed that information is provided by the Board of directors and is also available to the vendor

Attitude of the actual Board to information disclosure is irrelevant - test relates to the actions of a hypothetical Board acting reasonably

Shareholding size and financial outlay are key factors

Generally understood that 'smaller' investments (voting power or monetary value) convey entitlement to less information than 'larger' investments

Parameters not defined in statute and only qualified guidance available from case law



Shareholding size

Impact of voting power clear at the extremes (e.g. purchaser of 51% entitled to know more than someone buying 5%)

Large minority holdings less straightforward:

For example, would the purchasers of 5% and 40% interests in the same company be entitled to the same information?

If the 40% purchaser was entitled to know more, would they get as much information as someone acquiring 51%?

If not, what information would they not be entitled to?

Would it make a difference if the 40% interest was the single largest holding in the company?



Monetary value

General presumption that substantial financial outlay will entitle a potential purchaser to more information than a modest investment in the same company

HMRC's *Share Valuation Manual* ("SVM") suggested a £300,000 investment sufficient for access to unpublished or commercially sensitive information

SVM has just been replaced by a new *Shares and Assets Valuation Manual* ("SAVM") which is less helpful

SAVM only says "whatever the cost of the investment, each case should be judged on its merits"



Case law on open market information standards

Most recent case law is from two Special Commissioner cases concerning separate IHT valuations of shares in the same company in September 1987

Caton v Couch [1995] STC SCD 34
Clark v Green [1995] STC SCD 99

Central issue whether information concerning plans to sell the company would be reasonably required by the purchaser

Secondary issue whether unpublished accounting information for the last financial year and current budget would be divulged



Case law on open market information standards

Holdings approximately 14% in *Caton* and 3% in *Clark*

Issues decided on weight of money:

- Potential investment in *Caton* of £1.4m (at 1987 prices) – sufficient that knowledge of sale plans, budget and results would be ‘reasonably required’
- Potential investment in *Clark* £168,000 – not enough for details of sale plans or budget although information about last year’s financial results would be divulged

SVAM states “the values in *Caton* and *Clark* should not be regarded as providing a benchmark by which to determine whether or not particular information should or should not be taken into account”



Impact of confidential information

Potential circularity in the weight of money test, e.g. value of small minority holding may be:

- **Minimal** using only published information (e.g. company has historic trading losses)
- **Significant** if knowledge of, say, an offer to acquire the company or of an important new contract is deemed to be available



HMRC practice

HMRC generally approaches unapproved share scheme valuations assuming full disclosure

HMRC likely to request potentially commercially sensitive information, such as:

- Up to date management accounts
- Budgets, forecasts and profit projections
- Plans to sell or float the company



HMRC practice

If the valuation standard statutory is open market value (ss272 – 273 TCGA) and small minority holdings are involved, ‘full disclosure’ may be incorrect

Where unpublished information could have a material bearing on value, it will be necessary to consider the facts of the case and agree with HMRC:

- The information that should be taken into account
- Its impact on the valuation



Hindsight

Prohibition concerning use of hindsight, e.g. reference to subsequent events or information not available at the valuation date generally not permissible

However, evidence of subsequent transactions in the company's shares **may** be relevant to valuation (*IRC v Stenhouse's Trustees 1992 STC 103*)

Weight to be given to such evidence is a question of fact and opinion



Hindsight

In *Stenhouse's Trustees* the Court envisaged subsequent transactions being used as “a check or sounding board for a conclusion reached” by a primary valuation approach

Suggests although a subsequent event was not a certain outcome (or even foreseeable) at the valuation date, it may be relevant

Impact will depend on circumstances



Example – Clear Edge Telecoms

- Company floats June 2010 at price equivalent to £140m for 100%
- Unrestricted market value of shares issued to employees in May 2009 must be agreed with HMRC
- Company's tax advisers valued the employee shares at the time using a company value of £40m



Example – Clear Edge Telecoms

Scenario 1: Float not under consideration in May 2009 and no preparatory work undertaken

Scenario 2: Decision to investigate possible IPO taken in January 2009; preliminary discussions held with merchant banks and indicative price range £80m - £180m suggested

Scenario 3: Merchant bank appointed and decision to float taken before May 2009 with target date of April 2010; price range £100m - £130m

What is the relevance of IPO for the purposes of subsequently agreeing share value at May 2009 with HMRC?



Example – Clear Edge Telecoms

Company not certain to float in any of the scenarios

HMRC might argue that float more likely than not in *Scenario 3* based on how matters turned out

Steps taken to prepare the company for a possible float in *Scenarios 2* and *3* might be relevant for a “general earnings” valuation under s.62 ITEPA (case law basis) if employees were aware

In practice HMRC’s view of proposed £40m company value would probably be coloured by float price



Example – Clear Edge Telecoms

Although no steps taken in *Scenario 1* to prepare Clear Edge for IPO, HMRC would probably argue that the £140m float price provides a guide to company value in May 2009 (e.g. is it feasible that Clear Edge increased in value by £100m in one year?)

Merchant bank advice in *Scenarios 2* and *3* may be more relevant to the valuation in May 2009 than the actual float price

Doubtful that this information would be “reasonably required” (s273 TCGA) unless the purchase price was very substantial



3. RESTRICTED AND UNRESTRICTED MARKET VALUE

FA 2003 introduced concepts of “restricted securities” and “restricted interests in securities”

Intention was to create an Income Tax charge where some form of benefit or value passed to an employee, over and above the normal commercial growth in the value of the company’s shares

Statutory open market value (as defined in s272 TCGA) is the basis of value for the “restricted securities” rules



Restricted securities

Employee shares are “restricted securities” if they are subject to restrictions and those restrictions reduce market value

Legislation divides restrictions into three broad types:

- Where there is a risk of forfeiture and the employee will receive less than market value if required to sell
- Where there are restrictions on the employee’s freedom to retain or dispose of the securities or to exercise rights
- Where the disposal (or retention) of the shares or the exercise of a right may result in a disadvantage



Relevant restrictions

Examples of typical restrictions include:

- Pre-emption rights
- Compulsory transfers on cessation of employment
- “Bad leaver” provisions
- Lock-in periods
- Restricted dividend rights



Relevant restrictions

Lack of voting rights is not a relevant restriction if an intrinsic characteristic of the shares, as defined by the Articles of Association

For example, employees in Snoutman Enterprises issued new non-voting B shares while founders keep original Ordinary shares (normal voting rights); non-voting status of B shares is not a restriction

However, if the company has only one class of share and the employee's right to vote is restricted this constitutes a restriction on the shares



Relevant restrictions

Restrictions may be contained in the Articles or imposed under any “contract, agreement, arrangement or condition”, e.g. in:

- Shareholders’ agreement
- Employment contract
- Incentive plan rules
- Share sale and purchase agreement



Two (or more) values?

Employer and employee may jointly elect under s431 ITEPA to disregard some or all restrictions in order to benefit from CGT treatment when the shares are ultimately sold

‘Concession’ comes at a price

Employee will pay or be taxed on a value that is higher than the shares (subject to restrictions) are actually worth when acquired



Two (or more) values?

The same shares may have to be valued on a number of different bases:

- Actual market value, i.e. value subject to whatever restrictions apply under the Articles of Association, shareholders' agreement, employment contract etc
- Unrestricted market value, reflecting the intrinsic 'commercial' value disregarding restrictions
- Value subject to some but not all restrictions



Two (or more) values?

By definition unrestricted market value higher than restricted market value

Value ignoring some restrictions therefore lies somewhere in between

NB: Unrestricted market value is **not** synonymous with whole company value

Unrestricted market value still reflects minority status (where appropriate) and fact that shares are unquoted even if transfer and other restrictions are disregarded



Standard discounts?

HMRC has stated that it will not agree a standard set of discounts to cover commonly encountered restrictions

Partly reflects HMRC's traditional aversion to "assisting in tax planning"

Also practical reasons due to myriad potential combinations that could apply

Necessary to decide on the facts of each individual case how individual restrictions, e.g. forfeiture or transfer restrictions, impact value



4. MINORITY VALUATION – CONCEPTS

Employee share scheme valuations typically involve small minority holdings of 10% or less

Value per share of a minority shareholding generally less than a majority interest

Value differential recognises:

- Benefits of voting control to majority shareholder (relevant to issues such as day to day management, strategic direction, Board composition, directors' remuneration and dividend policy)
- The limited influence a minority interest conveys, transfer restrictions and “unmarketability” generally



Impact on value

Minority shareholdings generally valued either:

- on lower profit multiples and/or higher dividend yields than a marketable quoted entity or
- at a discount from the pro rata value of the company

Value differential often termed a “minority discount” although in practice the discount usually sweeps up unmarketability as well

Composite discount approach changes with the need to consider the impact of individual restrictions on value and assign discounts to each



Majority and minority holding values

Often no direct connection between the “discounted” minority value and “control” value because arrived at on different bases

Control value derived from market value of company (broadly value on a trade sale) allowing for notional profit assuming discretionary overhead costs (e.g. group management charges, directors’ remuneration) at market rates

Minority value usually reflects the company’s actual profits, as the minority shareholder cannot access underlying profits

The effective minority discount from control value can be very high



Example – Date Knight Consulting

Employee-owned consulting company which distributes the bulk of profits as special bonuses, paid in addition to normal performance bonus

Substantial company, comparable in size to publicly quoted competitors

Board accepts that reward structure would have to change if it decided to pursue an IPO or if the company is sold

Average price/earnings ratio (P/E ratio) of quoted consulting companies is 15

Date Knight Consulting – relationship between minority and control values

	Minority value	Control value
Profit after tax	£750,000 ¹	£6,000,000 ²
Shares in issue	500,000	500,000
Earnings per share	£1.50 ³	£12.00 ³
Comparable quoted P/E ratio	15.0	15.0
Discount for lack of open market, say	30%	-
Value per share	£15.75	£180.00
<i>Effective discount from control value</i>	<i>91.3%</i>	

Notes: ¹ Actual profit

² Notional profit after adding back special bonuses

³ Profits after tax divided by number of shares in issue



5. THE ROLE OF HMRC SHARES AND ASSETS VALUATION

HMRC's specialist Shares and Assets Valuation office ("SAV") responsible for valuing private company shares for UK share scheme and tax purposes

SAV's role is to advise and assist the Inspector – cases referred to SAV by other HMRC offices

Question of whether restrictions reduce share value (and hence whether a share is a restricted security) theoretically a matter for the Inspector not SAV



Risk assessment

SAV often consulted informally to advise Inspector on reasonableness of taxpayer's value, e.g. when the Share Scheme pages of a self assessment tax return have been completed

If SAV considers the value proposed is realistic no further action taken

Where the taxpayer's value is not acceptable, Inspector may instruct SAV to agree a value

Decision taken on a 'risk assessment' basis bearing in mind the estimated tax at stake

Agreed value usually arrived at following information gathering by HMRC and then negotiation



Other situations

SAV may also be involved in the following:

- Agreeing value in advance for the purposes of granting options under approved share schemes
- Considering the “best estimate” of value for the operation of PAYE
- Post transaction valuation checks (‘PTVC’) to enable the taxpayer to include an agreed value in a self assessment tax return
- Exceptionally, pre-transaction rulings on value



Share options

Priority is given to EMI and other share option cases

In 'approved' cases SAV aims to agree values within 14 days of receipt so that options can be granted

Contrast to 'mainstream' CGT and IHT valuations which may take 1 – 2 years to resolve



PAYE

SAV offers a 'PAYE Healthcheck' so employers can check if estimated value represents the "best estimate"

SAV considers formal agreement of value is not feasible within the time limit for operating PAYE

SAV will not comment on value if PAYE already operated

In complex situations it may not be possible to consider requests before PAYE is due

NB: Healthcheck is non-binding on both HMRC and taxpayer and does not necessarily determine the employee's ultimate income tax liability



Post transaction valuation checks ('PTVC')

No formal procedures in place for PTVC in employee share situations but HMRC will usually consider

Requests for PTVC should be sent to the employee's tax district not SAV

HMRC may seek confirmation that "the valuation does not relate to a transaction which is disclosable under the Disclosure of Tax Avoidance Scheme legislation"

HMRC may decline to undertake a PTVC without giving its reasons



Pre-transaction agreements on value

Generally SAV will not consider value before shares are issued

Exceptionally SAV may agree a pre-transaction valuation check where:

- A substantial number of employees is involved
- The transaction is transparent
- There are no complicating tax or valuation issues

Unlikely these conditions will be met in practice



6. HMRC VALUATION APPROACH

HMRC typically values employee shares using publicly quoted companies operating in the same industry sector as a benchmark

Valuation on a post tax profit basis reflecting the company's "maintainable earnings" and a P/E ratio derived from quoted company share prices

Anticipated income from future dividends also taken into account

Valuation of the company usually not the starting point



HMRC approach

A logical approach as quoted company share prices derived from sale/purchase of small minority holdings and minority status (lack of voting control) allowed for

Method used in most situations unless HMRC considers it would not adequately reflect value in the circumstances of a particular case

For example, where the company is likely to be sold or an IPO is expected

In these situations, HMRC will often start with company value and apply a discount for delay, uncertainty etc



Quoted company comparisons

Finding a quoted company sufficiently similar for a true 'like with like' comparison is difficult

HMRC often uses the average P/E ratio for the closest industry sector instead (e.g. "general retailers" or "media")

However sector classifications very broad and may have little relevance to the company's activities

HMRC approach can result in substantial over valuation



Adjustments to quoted P/E ratios

Quoted company P/E ratios used as benchmark may need to be adjusted for

- Unmarketability (transfer restrictions and lack of public quotation)
- Relative size (most private companies much smaller than quoted companies)
- Dividend policy (private company may not pay dividends)
- Strength of market position (quoted company may be a major player)
- Quality of management (generally better for quoted companies)



Adjustments to quoted P/E ratios

Unless an election to ignore some of the restrictions applies, a single discount is generally made to sweep up all factors

As a guide, unmarketability discount could be 25% - 30% from the P/E ratio of a 'comparable' quoted company before other factors are taken into account

'Typical' range of discounts for small minority holdings is wide, say 25% - 75% depending on circumstances

HMRC methodology – example

Pearl Media Ltd

Year ended 31 March	2007	2008	2009
	£	£	£
Profit before tax	408,000	630,000	700,000
Less taxation	(122,400)	(189,000)	(210,000)
Profit after tax	<u>285,600</u>	<u>441,000</u>	<u>490,000</u>
Earnings per share ¹	2.86	4.41	4.90

¹ Profit after tax divided by 100,000 shares in issue



HMRC methodology – example

Pearl Media Ltd

- Clear upward trend in maintainable earnings therefore HMRC would probably consider £490,000 a suitable maintainable earnings figure
- FTSE actuaries share indices gives a media sector average price earning P/E ratio of 16.66
- A discount of say 70% to take account of Pearl's unquoted status, smaller size, lack of market for shares etc gives a P/E ratio of 5
- Indicates possible value for HMRC purposes in the region of £24.50 ps



Relevance of shareholding size

Larger minority shareholdings likely to be worth more than small minorities (higher value per share)

Reflects additional voting influence, protection this affords and possibilities of Board membership/directors' remuneration

Larger holdings may also give the holder access to confidential information, such as management accounts, IPO plans, trade sale plans which could have a significant impact on value



Restricted market value

Restricted market value represents the ‘actual’ value, i.e. what the shares are worth when acquired

Restricted market value therefore allows for:

- Minority status
- Unmarketability
- Any relevant restrictions (e.g. pre-emption or forfeiture provisions)
- Size and/or qualitative differences between the subject company and the quoted ‘comparables’ used to benchmark



Unrestricted market value

Disregards restrictions (all or some) but should still reflect the following:

- Minority status
- Lack of market/public quotation
- Size and/or qualitative differences in comparison with quoted 'comparables'