



# Valuing Employee Shares

**A Parmentier Arthur Seminar**

**Thursday 17 June 2010**

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## Valuing employee shares

1. Restricted and unrestricted market value
2. Valuation bases for tax purposes
3. Information
4. Minority valuation – concepts
5. HMRC's valuation approach
6. The role of HMRC Shares & Assets Valuation



# 1. Restricted and unrestricted market value

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

The 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

e.g. deferred or “flowering” shares



## Restricted securities

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

Restrictions of 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

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 OC Enterprises issued new non-voting B shares while founders keep original Ordinary shares with voting rights; non-voting status of B shares is not a restriction

However, if OC Enterprises 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 s.431 ITEPA (2003) 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 more or be taxed on a higher value than the shares (subject to restrictions) are worth when acquired

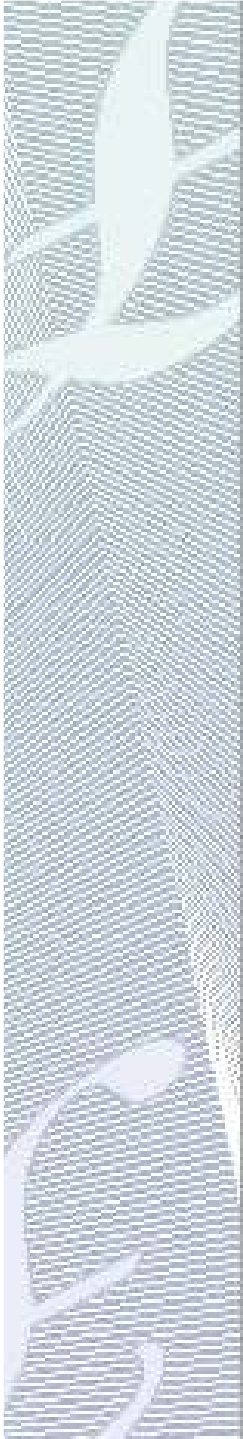


## Two (or more) values?

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 ("UMV"), reflecting the intrinsic 'commercial' value disregarding restrictions
- Value subject to some but not all restrictions

EMI options require both actual market value and UMV to be agreed



## Unrestricted and restricted market value

Restricted (actual) market value reflects:

- Minority status
- Unmarketability
- Size and/or qualitative differences in comparison with quoted 'comparables'
- Any relevant restrictions (e.g. pre-emption at forfeiture provisions)

Unrestricted market value reflects:

- Minority status
- Unmarketability
- Size and/or qualitative differences in comparison with quoted 'comparables'



## 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 of 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



## 2. 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:

- “Money’s worth” basis for Income Tax
- Statutory open market value as defined by CGT legislation

General presumption is that “money’s worth” value will be the same or higher than UMV value



## 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 2003) = **“money’s worth” basis**
- “Specific employment income” (special provisions in Part 7 of ITEPA 2003) = **statutory open market value**
- Statutory open market value also applies to valuations for EMI options and HMRC approved share schemes



## “Money’s worth” basis

Applies when an employee acquires shares for less than 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 2003*)

Employee can therefore elect out of the “money’s worth” basis so that the statutory open market valuation basis applies instead

**NB** this may not be so in all circumstances as HMRC’s guidance manual states: “*where the UMV is seemingly **less** than money’s worth value, the case should be referred for advice*” (SVM 109030)



## “Money’s worth” 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



## “Money’s worth” 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 could be sold rather than the legal title



## “Money’s worth”

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



## Statutory open market basis

Relevant 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 (s.272 TCGA 1992)

Information relevant to the valuation defined by s.273 TCGA 1992 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



## Open market valuation standard

Share rights are defined by Company's Articles of Association

Open market value of the shareholding does not allow for any extraneous agreements or contracts personal to the individual, for example rights or restrictions under:

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



## Open market valuation standard

Supreme Court decision in *Grays Timber* distinguished between rights in Articles of Association and entitlement under separate agreement

- Taxpayer received higher price than other shareholders when company sold
- Reflected provisions in a shareholders agreement, not Articles of Association
- Taxpayer considered to have received more than market value for the shares sold
- Excess treated as employment income under Chapter 3D of Part 7 ITEPA 2003 and taxed at income tax rate



### 3. Information

#### **“Money’s worth” 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

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



## Open market information standard

**Objective** information standard for statutory open market valuations (s273 TCGA 1992)

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

Parameters not defined in statute and limited guidance available from case law



## Shareholding size

HMRC position is broadly summarised as follows:

Holding size:

- 50% and above - all information disclosed to purchaser
- 25.1% - 49.9% - “fairly full” disclosure especially where valuation holding is the largest or joint largest
- 25% or less - no hard and fast rules, although the more influential the holding, the more likely it is that unpublished information will be relevant



## Monetary value

Substantial financial outlay will generally entitle a potential purchaser to more information than a modest investment in the same company

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

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

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



## 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

An unresolved conundrum!



## HMRC practice

HMRC often 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 1992) and small minority holdings are involved, ‘full disclosure’ likely to 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

General prohibition concerning use of hindsight, to exclude information not available at the valuation date

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

Court envisaged subsequent transactions being used as “a check or sounding board for a conclusion reached” by a primary valuation approach

Suggests a subsequent event may be relevant even if not foreseeable at the valuation date



## Example – LHC Telecoms

- LHC 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 – LHC 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

Is the IPO relevant for the purposes of agreeing share value at May 2009 with HMRC?



## Example – LHC 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 2003 (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 – LHC Telecoms

Although no steps taken in *Scenario 1* to prepare LHC 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 LHC 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” (s.273 TCGA 1992) unless the purchase price was very substantial



## 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
- 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



## 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 – Glitter 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

## Glitter Consulting – relationship between minority and control values

	Minority value	Control value
Profit after tax	£750,000 <sup>1</sup>	£6,000,000 <sup>2</sup>
Shares in issue	500,000	500,000
Earnings per share	£1.50 <sup>3</sup>	£12.00 <sup>3</sup>
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: <sup>1</sup> Actual profit

<sup>2</sup> Notional profit after adding back special bonuses

<sup>3</sup> Profits after tax divided by number of shares in issue



## 5. 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

**NB** Valuation of the whole company usually **not** the starting point



## HMRC approach

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

e.g. 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. "consumer goods" or "media")

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

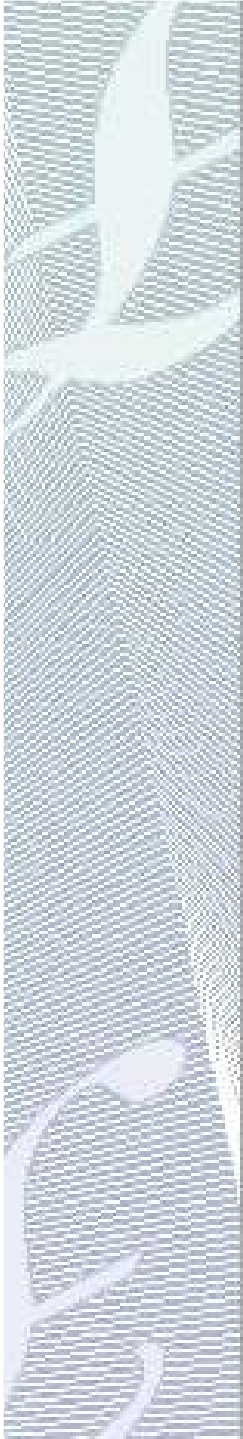
HMRC approach can result in substantial over valuation



## 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

### Shoes of Justice Ltd

Year ended 31 March	2008 £	2009 £	2010 £
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 <sup>1</sup>	2.86	4.41	4.90

<sup>1</sup> Profit after tax divided by 100,000 shares in issue



## Example - Shoes of Justice Ltd

- Clear upward profit trend and HMRC would probably consider £4.90 a suitable maintainable earnings figure
- FTSE actuaries share indices gives a consumer goods sector average P/E ratio of 15.0
- A discount of say 70% to take account of S of J's unquoted status, smaller size, lack of market for shares etc gives a P/E ratio of 4.5
- Indicates possible value for HMRC purposes in the region of £22.05 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



## 6. 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) is a matter for the Inspector not SAV



## Risk assessment

SAV often consulted informally to advise Inspector on reasonableness of taxpayer's value

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

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

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

Agreed value usually follows HMRC information gathering and 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

SAV gives priority to EMI and other approved share option 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