

# The Share Valuation Implications for Employee Share Scheme

David Craddock was introduced to Chartam readers in the Summer Edition through his article, *The Case for Employee Share Ownership*. In his book, *The Tolley's Guide to Employee Share Schemes*, David expounds in detail on the interface between employee share schemes and share valuation, the accepted share valuation methodologies and how the English courts interpret their application in the context of minority interest rights.

## THE CHALLENGE FOR THE PRIVATE COMPANY

For the private company, the use of the share valuation methodologies is pivotal to determining the price at which minority interest transactions take place within its employee share scheme arrangements, whether through determining the market value on the grant or exercise of options or on the sale of shares to an employee share trust or, possibly, an employee sale back to the company through a purchase of own shares.

The challenge on valuation for private companies embracing employee share schemes is that for the grant of options or gift of shares a value must be determined in circumstances where typically no cash changes hands. There is, therefore, no cash transaction at arm's length to act as a reliable indicator of value with the inevitable consequence of having to rely on the application of the share valuation methodologies that are known to be recognised by HMRC Shares & Assets



Valuation office. Crucial, though, is that these methodologies – the earnings basis, the assets basis, the share trading basis, the offer basis and the dividends basis – are applied in the context of the scenario envisaged by Section 272(1), TCGA 1992 in which the “market value” means “the price which those assets might reasonably be expected to fetch on a sale in the open market”.

For all practical purposes, “market value” or “actual market value” or “statutory open market value” (the terms are interchangeable) is the best price that could be expected for the asset (shares or otherwise) on a sale at arm's length in the open market between a hypothetical willing seller and a hypothetical willing buyer on the basis that both are equally informed about the company, its activities and the market within which it operates and that both the willing seller and the willing buyer are acting for self-interest and gain. In other words, the valuation methodologies are surrogate positions designed to act as the best means of representing the transaction in the open market between the hypothetical parties. It is important to emphasize, therefore, that the valuation methodologies must always be applied with this overriding principle in mind – the hypothetical transaction – in order to withstand any subsequent challenge from HMRC.

Furthermore, there is a fine distinction that must be observed for robustness in a defence to a challenge from HMRC. This came to light in *IRC v Gray* (Executor of Lady Fox) [1994] STC 360, RVR 129, CA in which the judgement stated that “... although the sale is hypothetical, there

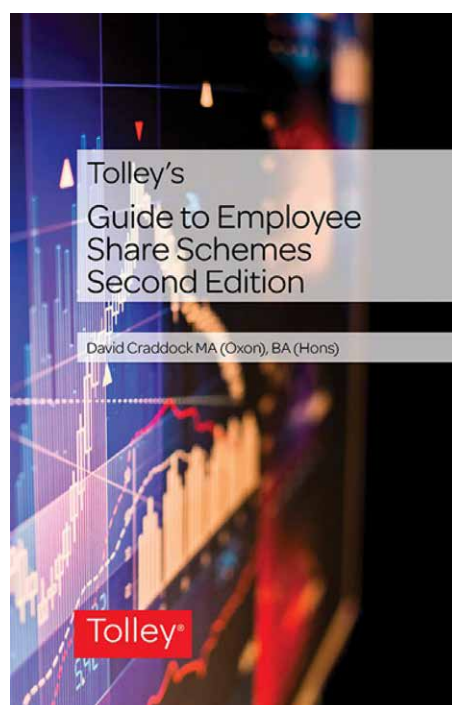
is nothing hypothetical about the open market in which it is supposed to have taken place”. The best interpretation of this statement is that the determination of value must assume a transaction in the real world that accounts for the real facts of the economic parameters that prevail at the time rather than any form of hypothetical assessment of the economic situation. The real assessment of the economic situation must be distinguished from the hypothetical sale. In this context, the actual vendor must be assumed to be a prudent man of action.



## THE MAXIMISATION OF THE DEFENCE POSITION

Although the pre-transactional valuation check from HMRC Shares & Assets Valuation office continues to be available for the tax-advantaged employee share schemes (previously called tax-approved schemes), with effect from 31st March, 2016, the long-standing procedures for securing agreement from HMRC Shares & Assets Valuation office under both the Post-Transaction Valuation Check (“PTVC”) and the PAYE Health Check were withdrawn. The responsibility, therefore, lies with the company to secure a robust valuation position in advance of the transaction prepared by a reputable independent share valuation practitioner.

Although the case law on share valuation is known in tax circles for its entertaining story-lines, the conclusions from the cases are very instructive indeed and, when properly applied, will maximise



the potential of the defence position in the face of an HMRC challenge.

The summary of the key assumptions that emerge from the case law are as follows:

- (1) The determination of the valuation must be anchored into the facts of the case applied within the context of the hypothetical transaction.
- (2) The parties to the transaction, both the seller and the buyer, although they are both assumed to be hypothetical, are also assumed to be willing.
- (3) Although it must be assumed that anybody from anywhere in the world can offer themselves as a potential buyer and make a bid for the shares, the assumed credibility of the purchaser is paramount to the valuation withstanding scrutiny.
- (4) The application of the principles is predicated on the assumption that all the preparations for the sale have been made in advance.
- (5) The best price must be assumed to be the best price that the buyer would pay rather than the best price that the seller would ask.
- (6) The valuation must always give due recognition to market comparisons and, within that analysis, any special purchaser arrangements of significance.
- (7) The sale is hypothetical even though the economic situation that prevails in the open market at the time is real.
- (8) The valuation must be determined as at the valuation date without the benefit of any aspect of hindsight or judgement in the light of subsequent events.



- (9) The restrictions contained within the Articles of Association must be taken into account and the authority of the Articles of Association must be upheld.

### **"THE DETERMINATION OF THE VALUATION MUST BE ANCHORED INTO THE FACTS OF THE CASE APPLIED WITHIN THE CONTEXT OF THE HYPOTHETICAL TRANSACTION."**

In summary, the requirement for private companies to establish robust positions on value is greater than ever. The disclosure to HMRC Employee Shares and Securities Unit is through "the Form 42 electronic equivalent" with a declaration of value and, with regard to sales above market value, a judgement call is required by the company

on whether the sale proceeds are in excess of market value and whether, therefore, entries are required.

The value decisions that support the disclosure must be sound and, with that, an acute awareness of how to apply the principles is paramount. David Craddock is one of those rare practitioners who is expert both in employee share schemes and in share valuation and understands the interface between these two disciplines: the complexities, the challenges, the methodologies and the inherent subtleties that provide the basis for a sound robust valuation position capable of withstanding HMRC scrutiny.

#### **DAVID CRADDOCK**

David Craddock Consultancy Services



**David Craddock Consultancy Services**

**Specialist in Employee Share Ownership and Reward Management**

**Management Buyouts, Share Valuation and Investment Education**

Please feel free to contact David Craddock who will be very pleased to discuss with you your employee share scheme initiative

Telephone: **01782 519925**

Mobile: **07831 572615**

E-mail: **d.craddock@dcconsultancyservices.com**

Please also see the website of David Craddock Consultancy Services as follows:

**[www.davidcraddock.com](http://www.davidcraddock.com)**

