SHARE VALUATION: THE CONUNDRUM OF *HOLT v HOLT*

Peter Vaines[1]

The valuation of shares in private companies is a regular source of professional interest to tax practitioners, because in any transaction involving shares (and some which do not) the value of the shares will be important in determining the charge to tax. Unfortunately and all too frequently, valuations for fiscal purposes have little or nothing in common with valuations in the real world, because of the multiplicity of fictions which have to be resorted to in connection with the various taxes. This can be a matter of acute frustration to those inexperienced in fiscal valuations, because commercial plans which are made on a perfectly sensible basis can come to grief (to a greater or lesser extent) when the technical tax concepts relating to share valuation come to be applied.

The description of the process of share valuation being undertaken in "a dim world peopled by the indeterminate spirits of fictitious or unborn sales" (per Danckwerts J in *Holt v IRC* [1953] 1 WLR 1488) illustrates the artificial nature of the process, and it is frequently necessary to engage in lengthy correspondence with the Shares Valuation Division on the various artificial concepts to be used in a particular valuation, long before any consideration is given to the value of the actual shareholdings involved. There can be arguments about the precise characteristics of the hypothetical vendor and the hypothetical purchaser. There is often a difference in opinion about which accounts should be used for the basis of the valuation and precisely what information would be available to the purchaser (see for example *Lynall v IRC* [1972] AC 680 and s.273(3) TCGA 1992). The value of the underlying property assets of the company is invariably controversial. Even when one looks at the precise holding to be valued, it may need to be valued as part of a larger holding for inheritance tax on the loss to the donor principle (or by

1 Peter Vaines, Tax Partner, Brebner Allen & Trapp, 180 Wardour Street, London W1V 3AA.
Tel: (071) 734 2244 Fax: (071) 287 5315
Author of *Tax Planning for Expatriates* published by Key Haven Publications PLC and Managing Editor of this *Review*.

reason of the existence of related property) or, for capital gains tax, as being one of a series of disposals. To value a single holding in isolation can sometimes be a rare treat.

A straightforward commercial valuation can be just as difficult as the New Zealand case of *Holt v Holt* [1990] 1 WLR 1250 illustrates. It was not a tax case at all, but one concerned with the division of property on a divorce. The arguments in this case, which appear in other contexts much closer to home, provide a real conundrum to which no doubt different minds will provide a number of different conclusions.

The company owned and operated a farm in New Zealand. There were 1,000 shares of NZ$1 each, divided into 999 'B' shares and 1 'A' share. The single 'A' share carried 10,000 votes, and the 'B' shares carried 1 vote each. However, in all other respects each share ranked equally, and this was obviously of particular relevance in connection with entitlement to dividends and any surplus arising on liquidation. So the 'A' shareholder and the 'B' shareholders had conflicting but complementary interests. Only the 'A' shareholder could authorise a dividend or put the company into liquidation, but he could not benefit from doing so. Only the 'B' shareholders were entitled to the company's assets, either by dividend or in a winding up, but they were powerless to obtain that benefit. This sounds like the antipodean equivalent of a Mexican stand-off.

To make matters worse, the 'B' shareholders could not realistically sell their shares, because the Articles restricted a sale to other members of the company or a person nominated by the directors. The appointment of the directors was naturally under the control of the 'A' shareholder. This restriction effectively deprived the 'B' shareholders of any opportunity to sell without the consent of the 'A' shareholder. The 'A' share was held by Mr Holt, and the 'B' shares were held by trustees for his children. Unfortunately, but providence being what it is, perhaps inevitably, the marriage failed, and the wife claimed a share in the matrimonial property. It therefore became necessary to value the 'A' share. The differences in valuation bases meant that the wife was able to claim that the 'A' share was worth NZ$800,000 (although for some reason the Court decided that it would "work on" a value of NZ$640,000), whereas the husband maintained that it was worth only NZ$10,000.

In many ways this may be thought to be an ideal share structure - better perhaps than having the shares held in trust, because although the only beneficiaries were the children, and the value could only accrue to them, the father maintained total control over that value without any of the obligations and difficulties which might have interfered with his judgment as a trustee.[2]

Although the combined value of the 'A' and 'B' shares may have been enormous, if they could be valued separately and in isolation, each holding would arguably be worthless; the value of the company would simply disappear, but only of course for the purposes of taxation. It was perhaps this very thinking which persuaded the Court to reach a middle course and to value the 'A' share at NZ$150,000. It could perhaps be said that this is a valuation where common sense prevailed; one's instinct is that the value is fair. But common sense has never been a safe route to a technical answer.

In valuing the 'A' share, the New Zealand Court of Appeal said that the test:

> "... in essence calls for an enquiry as to the value at which a willing, but not an anxious, vendor would sell and a willing, but not an anxious, purchaser would buy."

The idea of willing but not anxious parties is not too different from the basis used by the Inland Revenue in this country (see *IRC v Clay* [1914] 1 KB 339). However, it is by no means universally accepted that this is an accurate description of the hypothetical vendor or purchaser. Whether or not the seller is anxious, he still has to sell his shares on the valuation day for the best price he can obtain on the open market. He cannot withdraw his shares from sale until a better offer comes along (*Buccleuch v IRC* [1967] 1 AC 506). It is interesting to consider how else such a vendor should be described. If the vendor knows that he must sell his shares that day, it is difficult to describe him as anything but anxious - what else does being an anxious seller mean? However, maybe the vendor is not anxious because he knows that the purchaser must buy that day. This is the oddest of fictions. Perhaps it would be better to say that both parties are anxious. They are both anxious to do the best deal they can on that day, and their mutual anxiety cancels itself out.

In this case the farm profits yielded only enough to pay the farm manager a reasonable remuneration; accordingly, there was no prospect of any dividend. This seems to have led to the submission that the position of the 'A' shareholder was analogous to a farm manager, but in the Privy Council Lord Templeman felt this was false. His Lordship suggested that the position of the 'A' shareholder was analogous to that of a tenant for life, impeachable for

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2 The 'B' shares were of course in trust, but even if they were not, the same valuation principles would have applied.

waste. He could not sell capital assets and keep the money, he could not commit waste, nor could he allow the farm to deteriorate so as to enhance the profits for his own benefit. The 'A' shareholder had some additional advantages. He could continue to farm the estate as long as he wished, and could transmit that opportunity to his son or to anybody else who found it attractive. However, although those rights were clearly of some value, neither Lord Templeman nor anybody else suggested that they were worth NZ$150,000. In any event, it can be argued that this confuses the rights of the investor and the rights of the management. There is no reason to suppose that an investor would be willing or able to run the farm, and this should not be a characteristic necessarily attributable to a hypothetical prospective purchaser. Of course, there is nothing to prohibit the prospective purchaser from being a farmer (the description "prudent man of business" does not preclude farmers), but if he worked in the business he would expect to be paid the market rate for doing so, and that would seem to take the valuation of the share no further. He would be paying to secure himself a job, and it would be the value of having a job which was relevant; we need to consider the intrinsic value of the share.[3]

However, this is perhaps a diversion, because the point seems not to be reflected in the valuation by the Appeal Court which reached its decision mainly on the basis of the existence of a special purchaser. In this case, the special purchaser was the holder of the 'B' shares. The fact that to the 'B' shareholders the 'A' share would be worth everything (or at least everything the company had) and to any other purchaser the share would be completely worthless, was no reason to disregard the possibility of the 'B' shareholders purchasing the share.

This is the starting point for the 'arbitrage' argument. The existence of a special purchaser will drive the price up, because other purchasers will enter the market in the knowledge that they can buy and make a turn on selling to the special purchaser. However, these other purchasers will want a handsome

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[3] This would seem to follow the comments in *IRC v Crossman* that a purchaser who will pay more for special personal reasons should be disregarded. "I do not think it would be right to appreciate the value of the shares because of this special demand for a special purchase from a particular buyer", per Lord Hailsham.

profit because of the risks involved, and the price will therefore not increase to the price the special purchaser would pay.[4]

Given their mutual stranglehold, the Court concluded that it was obvious that the parties would do a deal. Three alternatives were considered to be available to the 'A' shareholder:

a) he could do a deal with the 'B' shareholders to wind up the company and divide the assets equally;

b) he could sell his 'A' share to the 'B' shareholders for an amount equal to 50% of the assets; or

c) the 'B' shareholders could sell their shares to him so that he would obtain the whole value for himself.

Lord Templeman acknowledged that the 'A' and the 'B' shareholders would naturally have to reach an agreement about the division, but that 50% may not be appropriate. However, the Appeal Court had worked on that basis, and it was a tenable view which he and his brethren in the Privy Council saw no grounds to disturb.

However, this might be taking the arbitrage argument too far. If the 'A' and 'B' shares were in the same ownership, they would be valued on the basis of a combined holding (see *A-G of Ceylon v Mackie* [1952] 2 All ER 775); the vendor would get the best price for his 'A' share by selling it in conjunction with the 'B' shares. But this can hardly apply where the 'A' and 'B' shares are in different ownership. As long as it is necessary to value the one 'A' share in isolation, what would a third party pay for the 'A' share to stand in the 'A' shareholder's shoes and hope that he will be able to do an advantageous deal with the 'B' shareholders? That would be a real gamble; what are the odds of doing a deal with the 'B' shareholders and at what value? A NZ$150,000 bet in these circumstances looks heavy. Some may doubt whether this would really be the act of a prudent man of business? He would be putting himself at the mercy of the 'B' shareholders. If they knew that he had purchased the share for NZ$150,000, they would know why. Human nature being what it is, the 'B' shareholders might take a perverse pleasure in saying

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[4] This seems to be the suggestion in *Glass v IRC* (1915) SC 449, but are such speculators able to be considered? They can hardly be prudent men of business - unless prudent men of business are also speculators. That seems to be a contradiction in terms.

"Well, well, you have taken a risk, haven't you? You had better stew for a while - or better still, get farming, unless you want to be impeached for waste". Later perhaps they may offer him some money for his shares - but maybe not. It would become a question of who wanted to realise their investment most, and in that situation he who had laid out the NZ$150,000 would seem to be at a bit of a disadvantage.

Another argument against this approach is that it attributes value to the 'A' share which it simply does not deserve. The 'A' share would never be of any intrinsic value. It is the key to the gold; it is not the gold itself. How much therefore is it permissible in valuing the 'A' share on its own in the open market to take into account that there may be a purchaser to whom the 'A' share may be equally valueless but to whom it may unlock the value of some other assets?[5]

Perhaps the most powerful contrary argument comes from the judgment itself. A crucial part of the Appeal Court reasoning went as follows:

> "[As far as the 'B' shareholders were concerned] it is a tenable view that to pay NZ$150,000 in order to receive a net sum of NZ$490,000 (NZ$640,000 minus NZ$150,000) is, on its face, good business when the existing value of the 'B' shares without control must be very substantially less than that sum", per Somers J.

This is obviously a reference to circumstance (c) above, that is to say the 'B' shareholders would sell their shares to the 'A' shareholder. But that is the wrong way round - or at least it is rather convoluted. It is to consider what the 'B' shares are worth to the 'A' shareholder. At best, it is attributing to the 'A' shareholder a value for the possibility that he might be able to buy something which would enable him to do something else, which might provide him with a profit.

But what is more important is the comment that "the value of the 'B' shares without control must be very substantially less than" NZ$150,000. One might suppose that the Court would have been equally content with a proposition that the 'B' shareholders would pay NZ$150,000 for the 'A' share to enable them to make a similar profit. Accordingly, it would follow that the comment would

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[5] This is wholly different from the situation of a purchaser of a 2% holding who already has the other 49%. In that case, by combining the holdings, the 2% itself would become substantially more valuable.

apply equally to the 'A' shareholder, and so the existing value of the 'A' shareholder without any participation rights would be substantially less than NZ$150,000.

This would seem to be the view of Christopher Glover (*Valuation of Unquoted Securities*: Gee & Co), who argues that there is little value in control if it is not linked to equity entitlement. He says:

> "The value of voting shares with no equity entitlement must reflect the value of control and nothing else. But what value has control if it is not linked to equity entitlement. What value is there in managing a business for others. In short, none. The holder of these shares could elect himself to the board of directors and obtain a livelihood from the company. In practice this may count for a lot, but it is well nigh impossible to value this opportunity. To value it as a substantial amount would imply that the income derived from the position of employment exceeded the value of the services provided. The directors would be in breach of their duty to act in the best interests of the company if they charged more for their services than they were worth."

However, it seems clear that in the context of this case, Lord Templeman would not agree.

It may be that the problems here can only be properly solved with the development of a new principle of valuation, which is the corollary of the loss to the donor principle; that is to say, the enhancement of the estate of the donee. However, both are probably necessary, or other opportunities for devaluation would immediately arise. This would solve the other conundrum of valuation, where a 2% holding is sold from a 51% holding. If the purchaser pays what a 2% holding is worth, that does not properly reflect the vendor's loss, and he therefore makes a transfer of value for inheritance tax purposes. If the purchaser pays sufficient to the vendor to compensate him for his loss, that is more than a 2% holding is worth; his estate is thereby diminished and he makes a transfer of value. The Inland Revenue's answer to this is that nobody in their right mind sells 2% out of a 51% holding, so there would always be a transfer of value in these circumstances. That rather begs the question, because the whole point is that a transfer is artificially attributed to the taxpayer in circumstances when he would not have dreamt of making a disposal at all.

A configuration of shareholding as found in *Holt v Holt* might on a different analysis have proved an effective means of depriving each holding of any significant value. It may be thought of as a doorway wide enough for a cart and a lot of horses, which has rightly been blocked by the Privy Council.

But even as it stands the decision is extremely helpful because a good deal of value disappears anyway - and if the 'A' shareholder's rights were to be of only limited duration, that would further reduce the value of the A shares.[6] In that event, the prospects of doing a deal at the levels suggested above would be considerably reduced because the 'B' shareholders would merely have to wait for their money - and on those kind of figures, it would be worth waiting for. This might not cause any evaporation of value overall because the value of the 'B' shares would obviously go up, but that may not matter if the concern is to value only the 'A' shares. The valuation may be more complex, but perhaps this just exposes the difficulties inherent in valuing unquoted shares on a hypothetical basis. In the real world, there would always be a price - but it would never be the same twice. As always, it would depend upon who was buying.

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6 I am grateful to Kevin Prosser for this suggestion.