SHARE VALUATION FOR SCHEDULE E PURPOSES

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Most of what has been written on the subject of share valuations for tax purposes deals with the hypothetical open market sale basis required for capital gains and inheritance tax. Yet frequently share valuations are required in connection with a Schedule E charge where, depending upon precisely which charging section actually applies, the valuation principles may be subtly, yet significantly, different.

There are a number of separate occasions when a valuation of shares is required in order to quantify a tax charge under Schedule E or to establish whether such a charge arises. The latter point is important, for example, in the context of approved employee share option schemes, when there is no income tax charge provided the option price represents, or is at a discount of not more than a specified percentage to, market value.

The main provisions under which valuations may be required are these:

- TA 1988 section 131 - a director or employee obtaining shares free or for a consideration which is less than market value;

- TA 1988 section 135 - a person realising a gain by the exercise, assignment or release of a right to acquire shares obtained in his capacity as a director or employee;

- TA 1988 section 162 - a director or higher paid employee acquiring shares at an undervalue where the opportunity arises by reason of his employment;

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- FA 1988 sections 78 and 79 - on the increase in value of shares acquired by a director or employee, where the opportunity to acquire the shares arose by reason of his employment, and where, either the shares are in a dependent subsidiary, or the shares are initially subject to restrictions which are subsequently removed etc;

- TA 1988 section 138 - the forerunner of FA 1988 section 79, now applicable only to shares acquired before 26th October 1987;

- TA 1988 section 185 and Schedule 9 - to ensure the exercise price of options meets the conditions for Inland Revenue approval of executive and savings-related share option schemes;

- TA 1988 section 186 and Schedule 10 - to ensure the number of shares allotted under a profit sharing scheme meets the conditions for Inland Revenue approval, and to determine the amount on which tax will be charged in the event of an early release of the shares.

Despite the comparative frequency with which these occasions may arise, the legislation in fact provides no one general valuation basis for Schedule E purposes. In some cases the capital gains tax valuation rules contained in TCGA 1992 sections 272 and 273 are imported. In others, where the legislation is silent, the stamp duty case of *Stanyforth v Inland Revenue* [1930] AC 339 provides some authority for interpreting the concept of value in terms of the open market sale hypothesis defined by the capital gains tax (and equivalent inheritance tax) statutes. There are, however, a number of specific Schedule E valuation provisions, as this article will show.

Any consideration of share valuations under Schedule E must begin with a brief look at the capital gains tax provisions and how they have been interpreted by the courts. The remainder of the article will look in turn at the occasions of charge under Schedule E and how the general rules, as well as any specific provisions, are applied in each context.

The CGT rules on valuation

Section 272(1) TCGA defines market value as "the price which those assets might reasonably be expected to fetch on a sale in the open market". This envisages a willing buyer and a willing seller and an imaginary market in which all the world are potential bidders.

Section 272(3) effectively interprets subsection (1) in relation to quoted securities so that, in the absence of special circumstances, market value is the lesser of the quarter-up quoted value and the average of the highest and lowest deal prices on the relevant date.

Section 273(3) provides that, where a valuation of unquoted securities is concerned, the hypothetical purchaser required by section 272(1) shall have available to him "all the information which a prudent prospective purchaser of the asset might reasonably require if he were proposing to purchase it from a willing vendor by private treaty and at arm's length". The use of the indefinite article ("a prudent prospective purchaser" and "a willing vendor") rather than the definite article means that the personalities and knowledge of the actual purchaser and vendor are ignored.

This legislation has been considered by the courts on numerous occasions. From the many decided cases a number of key points emerge, as follows:

- Where the articles of association place restrictions on the transfer of shares, they are to be valued on the basis that a purchaser would be entitled to be registered, but the shares would then be subject to the same restrictions on further transfers (see *A-G (Ireland) v Jameson* [1905] 2 IR 218).

- The same applies to other restrictions on the freedom of the hypothetical vendor to dispose of the shares in the open market. An ability to sell in the open market is not a necessary condition for there to be a tax liability, although the fact that there is a limited market may be taken account of in arriving at a valuation.

- The existence of a special purchaser who would be willing to pay more than the market price may be taken into account, but that special purchaser's price is not the open market value required by statute (see *CIR v Crossman* [1936] 1 All ER 762).

- In the absence of any impropriety on the part of the directors, the mere fact that the directors possess information which, if made public, would affect the quoted price, is not a special circumstance within section 272(3) so as to disapply the specific definition of market value for quoted securities (see *Crabtree v Hinchcliffe* 47 TC 419).

TA 1988 Section 131

This section taxes "all salaries, fees, wages, perquisites and profits whatsoever". The courts have interpreted "profits" in this context to mean "something acquired which the acquirer becomes possessed of and can dispose of to his advantage - in other words, money - or that which can be turned to pecuniary account" (see

Tennant v Smith 3 TC 158). This has become known as the doctrine of convertibility.

The section is therefore wide enough to include both gifts of shares and transfers of shares at an undervalue. It is irrelevant in the latter situation that the shares are not received directly and that the opportunity to acquire the shares itself may not be marketable (see *Weight v Salmon* 19 TC 174).

A Schedule E charge arises where the opportunity to acquire the shares derives from the employment, the measure of value in such cases being the difference between the price the recipient could get for the shares and the price he paid for them (see *Weight v Salmon*). In other words, the share valuation necessary to arrive at the amount chargeable under Schedule E requires a hypothetical sale by **that particular** shareholder, so that individual circumstances and actual market conditions **can** be taken into account. Further justification for this proposition is obtained from *Wilkins v Rogerson* 39 TC 344, where the recipient of a suit was assessed on "what he could get for it if he sold it as soon as he received it". Similarly, in *Ede v Wilson* 26 TC 381, it is acknowledged that the taxable value may vary according to the employee's circumstances.

This can influence the valuation either upwards or downwards. For example:

- restrictions over the shares which are personal to the holder, for example in a side agreement or employment contract requiring shares to be transferred at no gain if held by an employee whose employment ceases within a predetermined number of years of the shares' acquisition, are relevant and will **reduce** the share value;

- knowledge which is personal to the holder cannot be ignored; thus favourable information about a company's prospects known only to the directors of the company, in circumstances where a director is acquiring shares by gift or at a discount, may **increase** the share value;

- factors which indicate there is only a small pool of potential purchasers, such as the existence of pre-emption rights and a history of previous sales to a limited group of individuals, will **reduce** the share value.

Arguably, one can distinguish cases where the acquisition of shares derives from the employment (any undervalue is taxable under section 131) from cases where only the undervalue so derives (the undervalue is not taxable under section 131, although it may be taxable under, for example, TA 1988 section 154). This point was an issue in *Tyrer v Smart* 52 TC 533. In most cases, however, the point is academic; the amount of tax payable will be the same.

TA 1988 Section 135

This section deals with both unapproved share options and unapproved exercises within an approved scheme. Under subsection (3), the recipient is taxable on "the difference between the amount that a person might reasonably expect to obtain from a sale in the open market at that time of the shares acquired and the amount or value of the consideration given ....".

The use of "a person" rather than "the person" suggests the type of hypothetical sale envisaged by the capital gains tax definition of market value. The Revenue, apparently, take a different position. In recent correspondence, Shares Valuation Division has put forward the view that, despite the use of "a person", the context of the legislation requires the individual's actual circumstances to be taken into account. Of course, we do not necessarily have to accept that this is right.

There may also be a Schedule E tax charge on the grant of an option where the option is capable of being exercised more than seven years after grant. In this case subsection (5) sets a minimum value for the option right, being the market value of the shares which may be acquired on the date the option is granted, less the amount of the consideration payable for those shares (i.e., the exercise price). Market value for this purpose is the capital gains tax value, the link between TA 1988 section 135 and TCGA 1992 section 272 being found in TA 1988 section 140(3).

Although in theory section 135(5) sets a minimum value for an option right, in practice the Inland Revenue will also treat this as a maximum value, so that a tax charge will only arise if the exercise price is set at a discount to the market value of the shares at the date the option is granted. More complex option valuation methodologies (for example, the Blacks Scholes model) are, thankfully, ignored.

Finally, under this heading, the right, derived from section 137, which exists in some cases to pay a tax charge under section 135 by instalments, depends upon the price paid for the option shares being no less than, or within a defined range of, their market value on the date the option was granted. In this situation the capital gains tax valuation rules are brought into play by section 137 (1)(b).

TA 1988 Section 162

Where a director or higher paid employee acquires shares at an undervalue "in pursuance of a right or opportunity available by reason of his employment", that undervalue is treated as a beneficial loan. The amount of the loan is the difference between the market value of fully paid shares and the amount paid for the shares at that time. The capital gains tax definition of market value is imported by section 162(10)(d).

The section only bites to the extent that the undervalue is not otherwise included in emoluments (section 162(11)). Rumour has it that the section was originally intended to catch the situation where partly-paid shares are issued to employees, but parliamentary counsel exceeded his brief and extended the section to cover all acquisitions by employees at an undervalue (see subsection (2)). In practice, of course, most acquisitions of shares by an employee at an undervalue will be caught by TA 1988 section 131, but an anomaly emerges because of the different valuation bases used in section 131 and section 162.

Under section 131 restrictions which are personal to the shareholder are relevant and can reduce the share value. Under section 162 personal restrictions are ignored. Arguably, in cases where the share values on each basis are different, a charge could arise under section 131 and an additional charge under section 162. The counter argument is that any charge under section 131 is enough to avoid a further charge under section 162, on the basis that the words "any amount corresponding to it, and representing the same benefit" in section 162 do not require that the amounts which would otherwise be charged twice are identical in amount. This is probably the better view. Certainly, it seems that the Inland Revenue do not take the point at present.

FA 1988 Sections 78 and 79

Both sections tax the increase in value of shares, either as a result of the removal of restrictions (section 78) or during a period specified by the legislation (section 79). Value is defined by section 87(1) as "the amount which the person holding the shares .... might reasonably expect to obtain from a sale in the open market". In other words, the characteristics of the particular employee or director acquiring or holding the shares must be taken into account, but the sale is a hypothetical one. The fact that there is no ready market for shares, or that special circumstances apply in the actual market, should not be taken into account.

TA 1988 Section 138 (applicable only to share acquisitions before 26th October 1987)

The predecessor legislation to FA 1988 sections 78 and 79 provides for a Schedule E charge on the difference in market value of the shares acquired between two dates. Section 140 (3) imports the TCGA section 272 definition as under section 162, dealt with above.

TA 1988 Sections 185 and 186 and Schedules 9 and 10

This legislation deals with approved share option and profit sharing schemes. The conditions for approval require the market value of the shares to be established in order to fix the approved acquisition price or to determine how many shares may be allotted or acquired. Market value is defined for this purpose by section 187 (2) which imports the capital gains tax rules.

It is worthy of note that, unlike the other Schedule E charges, there is some flexibility as to both the date on which market value must be considered and the method of calculating it. For example, the acquisition price may be fixed according to the market value on a date not more than 30 days before the options are granted, and in determining market value an average over a period agreed with the Inland Revenue can be used. This flexibility can be useful to a private company where there is no actual market for the shares, and equally to a public company when it can remove the effect of temporary fluctuations.

Conclusion

The analysis set out above can be tabulated as follows:

Section	Hypothetical purchaser/vendor?	Hypothetical market?
TA 1988 s.131	No, personal characteristics are relevant	No, actual market
TA 1988 s.135	Yes (but Revenue may disagree)	Yes
TA 1988 s.162	Yes	Yes
FA 1988 s.78/79	No, personal characteristics are relevant	Yes
TA 1988 s.138	Yes	Yes
TA 1988 s.185	Yes	Yes, but with (limited) flexibility on valuation date
TA 1988 s.186	Yes	Yes, but with (limited) flexibility on valuation date

There is of course a very real practical problem in that, except in the case of approved share option and profit sharing schemes, the Inland Revenue Shares Valuation Division will not agree a valuation before a transaction takes place, which leads to considerable uncertainty for the parties involved. One possible solution, in order to avoid any tax liability where the intention is that the share transaction should take place at market value, is for the parties to agree a price of "X or such higher or lower value as may subsequently be agreed with Shares

Valuation Division as representing market value", but this, of course, may change the commercial deal.

Finally, whenever a valuation after the event is required, it is particularly important to ensure that the application of the tried and tested valuation principles discussed above is not tainted by hindsight.

The moral must therefore be that anyone valuing shares for Schedule E purposes needs to have all their wits about them!