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SHARE VALUATION FOR SCHEDULE E PURPOSES - A REPRISE

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In March 1994,[2] I wrote an article with my colleague Valda Clapham on the subject of share valuations for Schedule E tax purposes. Since then the law has changed in a number of respects, most notably with the introduction of the regime for conditional and convertible shares, which was introduced in Finance Act 1998, now found in TA 1988 sections 140A-140H. Other relevant developments include the introduction of the self-assessment tax regime, the imposition of PAYE and NIC on shares that are readily convertible assets (RCAs)[3] and the publication of the Inland Revenue's internal manuals.

I am increasingly frustrated as I refer back to that old article by the fact that it is no longer current. So I thought I would update it with the assistance of my colleague, Liz Morgan, and share the result with the readers of PTPR. I have taken the opportunity to update the original article in a number of other respects, particularly as regards "*the doctrine of convertibility*".

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. It comes as no surprise that, at a meeting of the Shares Valuation Fiscal Forum in July 2001, a senior Inland Revenue official commented that share schemes are "*...the big growth area for [the Shares Valuation Division]...*".

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2 *Personal Tax Planning Review,* Volume 3, 1993/94, Issue 3, page 233.

3 TA1988 section 203F. In the context of shares, and depending on the specific facts, RCA status is not restricted to listed shares.

There are a number of occasions when a valuation of shares is required in order to quantify a tax charge under Schedule E or to establish whether or not such a charge arises. The latter point is important, for example, in the context of approved employee share option schemes, where one of the requirements for approval is that the option price represents, or is within a defined range of, fiscal market value.

The main provisions under which Schedule E 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 their market value or certain categories of employees or directors being granted rights to acquire shares;
- 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 140A - a director or employee acquiring an interest in shares on terms that make his interest only conditional;
- TA 1988 section 140D - a director or employee acquiring shares which confer on the holder an immediate or conditional entitlement to convert them into shares of a different class;
- TA 1988 section 162 - a director or higher paid employee acquiring shares at an undervalue in pursuance of a right or opportunity available by reason of his employment;
- TA 1988 section 138 - the forerunner of FA 1988 section 79, now applicable only to shares acquired before 26 October 1987;
- FA 1988 sections 78 and 79 - on the growth in value of shares acquired by a director or employee where the right or opportunity to acquire the shares arose by reason of his employment, and either the shares are in a dependent subsidiary, or the shares are initially subject to restrictions which are subsequently removed etc;
- TA 1988 section 185 and Schedule 9 - to ensure that the exercise price of options and the aggregate value of the shares in respect of which options are granted meet the conditions for Inland Revenue approval of company share option plans 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 (approved profit sharing schemes are being phased out from 1st January 2003);

- FA 2000 section 47 and Schedule 8 – in the case of all-employee share incentive plans (or "SIPs") market value is relevant in (a) setting the maximum number of "free shares" which may be awarded in any tax year; (b) setting the number of "partnership shares" which may be acquired; (c) determining the price at which "matching shares" must be acquired; (d) setting the number of "dividend shares" acquired through the reinvestment of dividends; (e) calculating the income tax charge on the value of shares ceasing to be subject to the SIP; (f) calculating the amount of the corporate deduction (g) calculating the cost of the shares for capital gains tax (CGT) purposes; and

- FA 2000 section 62 and Schedule 14 – in the case of enterprise management incentives (EMI), market value is relevant in (a) determining the maximum number of shares in respect of options which may be granted to any one employee and in total; (b) calculating the income tax charge on the option exercise where the option was granted at a discount; (c) in some cases determining whether there is a disqualifying event.

It will be seen that there is an increasingly wide range of circumstances where fiscal share values are needed for Schedule E purposes. As the number of occasions of charge has been growing, so too has the diversity of the valuation principles. The practitioner needs to keep his wits about him. Where RCAs are involved, the employer also needs to understand the principles and to act promptly in making his best estimate of the amount chargeable to Schedule E in order to comply with PAYE obligations. As regards the employer, at the standing committee debate on RCAs during the passage of the Finance Bill in June 1998, one member expressed anxiety about the valuation of shares in private companies. Interestingly, it appears from the then Financial Secretary to the Treasury's comments that she did not foresee any difficulties for employers and she urged members not to "*......make a mountain out of a molehill....*". Finally, of course, the ultimate responsibility under self-assessment for reporting and paying tax on the correct amount of Schedule E income rests with the employee. This is so regardless of whether or not PAYE is applicable.

Any consideration of Schedule E valuations starts with the implications of the *doctrine of convertibility*. In some cases the CGT valuation rules contained in TCGA 1992 sections 272 - 273 are imported. Finally, there is what might be described as the hybrid categories of valuations that have emerged, principally in the course of legislation that has been bolted on to the Schedule E rules in order to bring an increasing range of events within the scope of income from employment.

TA 1988 Section 131 and the Doctrine of Convertibility

The basis of share valuation for section 131 derives from the fundamental principle of identifying what it is that section 131 can charge to tax. The 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*". Lord Macnaghten observed that the employee was taxed "*.....not on what saves his pocket, but on what goes into his pocket.....*".

The identity of the perquisite was debated at length in *Abbott v Philbin* (1961) 39 TC 82, where the courts held that the perquisite crystallised at the point where the taxpayer acquired an unconditional legal right. In *Abbott*, of course, the courts decided that the unconditional right was an option to acquire shares, not the shares themselves. The option itself was not transferable, but Lord Reid explained how the option could be turned to account, so that *the doctrine of convertibility* still applied:

> "if you get an option to buy shares below the market price it seems to me that the option is capable of being turned to pecuniary account by exercising it, acquiring the shares and immediately selling them. It is true that that involves an extra step, but why should that matter?"

The principle that a non-assignable contractual right to acquire shares can be a perquisite and have a value was followed in the savings-related share option scheme case of *Williamson v Dalton* [1981] 55 TC 575.

Section 131 is wide enough to include both gifts of shares and the acquisition 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* [1935] 19 TC 174). In the High Court, Finlay J observed "*.....in substance, the thing can be turned into money....*". Although the privilege was not money, it was money's worth.

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* (1960) 39 TC 344, where the recipient of the 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 upward or downward. 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; and

- 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.

The CGT Rules on Valuation

TCGA 1992 section 272(1) 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 hypothetical willing buyer and a hypothetical 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*". This provision was introduced in 1973 following the leading Estate Duty case of *Re Lynall* (1971) 47 TC 375. Briefly, in Lynall, it was held that the information available to the hypothetical purchaser excluded information that the directors of the company would make available only to certain potential purchasers. Following FA 1973, for unquoted shares the CGT valuation principle assumes that no potential purchaser, for example the purchaser via a private treaty, is to be excluded.

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.

The legislation affecting share valuations has been considered by the courts on numerous occasions. From the many decided cases a number of key points emerge.

- 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 would then be subject to the same restrictions on transfer (see *A-G (Ireland) v Jameson* (1905) 2 IR 218).

- 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 135

This section deals with Schedule E charges in the context of share option arrangements. Section 140(3) applies CGT valuation principles, but only to the grant of an unapproved option, where section 135(5) sets a minimum chargeable value as being the excess of the market value of the underlying shares at the time the right is acquired over the option exercise price. At one time, it was thought that, typically, the Inland Revenue would treat the section 135(5) formula as being a maximum as well as a minimum. However, the advent of the self-assessment regime has called this assumption into question somewhat. The relevant self-assessment Notes helpfully tell the taxpayer to use the section 135(5) approach "*....unless [the taxpayer thinks] that the option had a higher value........*". In principle, the onus is on the taxpayer to consider more complex option valuation methodologies (for example the Blacks Scholes model). Thankfully, in practice there are few occasions on which the grant of an unapproved option will give rise to a Schedule E charge, as the vast majority of options cannot be exercised more than ten years after the option grant.

The remainder of section 135 makes no reference to "market value" per se. Instead, under subsection 3, which deals inter alia with the much more common taxable event that occurs on the option exercise, the employee 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 ....*".

With one exception, the use of "*a person*" rather than "*the person*" suggests the type of hypothetical sale envisaged by the CGT definition of market value. (The exception, which can of course have a significant impact, is the absence of the information standard assumed for unlisted shares by TCGA 1992 section 273, which refers to a sale "by private treaty" see above). The Revenue, apparently, take a different position. 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.

As section 135 refers to an amount that may be obtained from a sale in the open market, actual or notional selling costs can be taken into account for Schedule E, PAYE and NIC purposes.

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 CGT valuation rules are brought into play by section 137 (1)(b).

TA 1988 Section 140A

For the conditional share rules, determining the correct valuation rule is important for two reasons. First, to establish whether or not the shares are conditional and second, if they are, the taxable value on the section 140A trigger events.

Taking these in reverse order, in section 140A(5) the amount chargeable under the conditional share rules is defined as "*the amount (if any) by which the sum of the deductible amounts is exceeded by the market value of the employee's interest immediately after that interest ceases to be only conditional or, as the case may be, at the time of the sale or other disposal*". "Market value" in turn is defined in section 140A(6) as "*the amount that might reasonably be expected to be obtained from a sale of that interest in the open market at that time*".

Together, these provisions mean that 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, but the personal circumstances of the employee or director *are* relevant. Additionally, a sale by private treaty is not postulated.

A further wrinkle is found in section 140C, which sets out the cases where an interest is to be treated as only conditional. Here one of the conditions for an interest in shares being conditional is that the terms on which shares are acquired are not such that, "*.....on the transfer, reversion or forfeiture, that person will be entitled in respect of his interest to receive an amount equal to or more than the amount that might reasonably be expected (if there were no provision for transfer, reversion or forfeiture) to be obtained from a sale of that interest in the open market at that time.......*". Once again the reference is to *the* person, the sale is a hypothetical one, but a private treaty sale is not postulated. And here any actual transfer provisions must be ignored in calculating the amount that is to be treated as the "market value". The precise nature of the valuation principle in section 140C is key in determining what type of arrangement falls within the conditional share regime.

TA 1988 Section 140D

Section 140D, peculiarly, appears to take a different approach. Here, through a combination of section 140D(5) and 140F(3), the only distinction between s.140D and the CGT statutory valuation principle appears to be the absence of the private treaty provisions in TCGA 1992 section 273. The identity, circumstances and knowledge of the shareholder appear not to come into account.

This is a strange conclusion, given that a different position seems to apply in sections 140A and 140C. One wonders if the Parliamentary draftsmen really appreciated the (admittedly very fine) distinctions which can be drawn.

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 CGT 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(11) 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. Indeed, the Inland Revenue are understood to have opined that any restrictions, including personal restrictions, are taken into account for section 162 purposes.

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, as for sections 140A and 140C, 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, without the private treaty postulation.

TA 1988 Section 138 (applicable only to share acquisitions before 26 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.

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 CGT rules.

It is worthy of note that there can be 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.

FA 2000 – SIPs

Schedule 8, paragraph 125 imports the CGT definition of market value. This is subject to one modification. In determining the initial market value of any free shares that are subject to restrictions, or risk of forfeiture (for the latter, within the meaning of TA section 140C), the effect of such restrictions or risk is ignored. As with other approved share schemes (see above), there is some flexibility on the date from which market value is taken, including the use of averages of values.

FA 2000 – EMI Share Options

The CGT definition of market value is imported for EMI options via FA 2000 Schedule 12, paragraph 66 and there is the element of flexibility as to dates and averaging. Paragraph 10 contains a modification for shares subject to restrictions or risk of forfeiture similar to the SIP rules in Schedule 8.

The Inland Revenue Manuals

The Shares Valuation Division manual has very little to say about share valuations for Schedule E purposes, although hopefully a bespoke chapter on Schedule E will be available electronically in the not too distant future. Meanwhile, there is some comment in Chapter 7 of the Share Schemes Manual and selected aspects of this are referred to below.

At paragraph 7.2 of Chapter 7, the Manual refers to three different bases of share valuation for Schedule E purposes:

- "... money's worth – the extent to which the asset can be converted into money by the person receiving it, used in ICTA 1988, s.19
- sale by a person in the open market used in ICTA 1988 s.135, ICTA 1988 s.140A and FA 1988, s.77-85
- the amount that the shares might fetch on the sale in the open market, i.e. the CGT valuation, used in ICTA 1988, s.162.....".

Paragraph 7.21 is headed *Post acquisition charges: Valuation*. In the context of the Finance Act 1988 rules (and presumably section 140A and section 135, given the comment at paragraph 7.21 of the Manual, but see below) there is the following comment on the definition of value. *"...This definition is similar to, but not exactly the same as, the definition of market value to be found in TCGA 1992, s.272(1). The difference lies in the emphasis put on the value of the shares to the person holding them. The meaning is intended to equate to the concept of pecuniary worth which is relevant when valuing benefits for general Schedule E purposes. The amount on which the tax is charged is the real value of the shares to the employee who holds them...... "*.

Conclusion

The analysis 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 (option exercise)	Yes (but Revenue may disagree)	Yes*
TA 1988 s.140A	No, personal characteristics are relevant	Yes*
TA 1988 s.140C	No, personal characteristics are relevant. However, forfeitability is ignored.	Yes*
TA 1988 s.140D	Yes (?)	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
FA 2000 s.47 and Schedule 8	Yes. Restrictions / forfeiture may be ignored	Yes but with (limited) flexibility on valuation date
FA 2000 s.62 and Schedule 14	Yes. Restrictions / forfeiture may be ignored	Yes, but with (limited) flexibility on valuation date

* However, the private treaty information standard is not postulated.

There is also a very real practical problem in that, with limited exceptions such as Inland Revenue approved options and SIP's, the Shares Valuation Division will not agree a valuation before the event, which leads to considerable uncertainty for the parties involved. One possible solution where the intention is that the share transaction should take place at market value in order to avoid any tax liability 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". Further, whenever a valuation after the event is in point, 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!