PRICEWATERHOUSECOOPERS

# STEP IRELAND

## SHARE VALUATIONS IN A TAXATION CONTEXT FOR FAMILY COMPANIES

**SPEAKER:** Eddie O'Donovan
PricewaterhouseCoopers

**DATE:** 16 May 2003

**Let me start off with two quotations:**

"Fiscal valuations and the negotiations around them often have an abstract, almost academic quality. Values in such circumstances will be what they can be argued to be; rarely will they be testable in the real world. The valuer must therefore, bring to the task all his practical and theoretical knowledge, deploying his arguments skilfully and realistically".

CG Glover "Valuation of Unquoted Securities" (1986).

"In the field of valuation the experience of the valuer and his ability to form a sound commercial judgement is of overriding importance. The process of valuation cannot be reduced to the application of a set of abstract formulae".

Vinelott J in Re Cumana (1986).

## 1. Occasions for Valuation

Valuations for tax purposes arise in many situations, e.g.

***Capital Gains Tax***

- Disposals/transfers of shares between connected persons
- Valuations as at 6 April 1974
- Transfers of shares on death – at market value
- Buy back of shares

***Gift and Inheritance Tax***

- Inheritance arising from death
- Lifetime gifts
- Discretionary trust levy

***Stamp Duty***

***Income Tax***

- Share option schemes
- Approved profit sharing schemes
- Issue of shares to employees at "undervalue"

## 2. Legislative Framework

Ideally the value of shareholding at any particular date should be the same for all taxation purposes. There are however, provisions in the acts which will bring about a divergence of values in certain cases.

The main provisions in the legislation dealing with valuations of unquoted shares are as follows:

### 2.1 <u>Capital Gains Tax and CAT</u>

| <u>Section 548 TCA</u> | Similar Provisions in other legislation |
| --- | --- |
| 1) "Market Value" in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market." | S 15 (1) CAT Act (S 26 CAT CA 2003) |
| 2) In estimating the market value of any assets no reduction shall be made in the estimate on account of the estimate being made on the assumption that the whole of the assets is to be placed on the market at one and the same time. | S 15 (2) CAT Act (S 26 CAT CA 2003) |

| Section 548 TCA | Similar Provisions in other legislation |
|---|---|
| 4) "Where shares and securities are not quoted on a stock exchange …………………… …………………it shall be assumed …………………. that, in the open market which is postulated ………………………… there is available to any prospective purchaser of the asset in question 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" | S15 (5) CAT Act (S 26 CAT CA 2003) |

## 2.2 **Special CAT Provisions for Controlled Private Companies**

S 16 (1) CAT Act (S 27 CAT CA 2003)

"The market value of each share in a private trading company which (after the taking of the gift, or the inheritance) is ……. a company controlled by the donee or successor shall be ascertained by the Commissioners for purposes of tax, as if it formed part of a group of shares sufficient in number to give the owner of the group control of the company."

"Private trading company" means a private company which is not a private non-trading company.

For CAT purposes a company is, under Section 16 (3), controlled by a donee or successor "where it is under the control of any one or more of the following, that is to say, the donee or successor, the relatives of the donee or successor, nominees of the donee or successor nominees of relatives of the donee or successor, and the trustees of a settlement whose objects include the donee or successor or relatives of the donee or successor ……… and a company controlled by the donee or successor.

## 2.3 **<u>Stamp Duty – Section 19 SDCA 1999</u>**

Section 19 SDCA 1999 applies the rules in Section 15 CATA (S 26 CAT CA 2003) where shares have to be valued for stamp duty purposes. Where there are disposals of shares at arm's length the stamp duty will, in practice, be based on the actual consideration passing.

## 3. Decisions of the Courts on the meaning of "Market Value"

Not surprisingly, since the basic definition of "market value" was first introduced for estate duty purposes in 1894, there has been much litigation concerning its meaning.

a) The fundamental difference between a valuation for tax purposes and a commercial valuation is that the open market sale envisaged by the statute is a hypothetical one between a willing hypothetical vendor and a willing prudent hypothetical purchaser and which sale is deemed to be open to the whole world (see Lynall v IR Commissioners [1968] 3 ALL ER 322 and [1971] 2 ALL ER 914 House of Lords).

b) It does not matter that an actual sale would be impossible or that an actual sale would fetch a price restricted by the Articles of Association (see A-G v Jameson [1904]; IRC v Crossman [1936] 1 ALL ER 762, House of Lords; Lynall v IRC).

c) The value for tax purposes is the best price obtainable in the open market (see Earl of Ellesmere v IRC [1918] 2 KB 735).

d) "Those assets" being valued (in Section 548 (1) TCA 1997 means the shares in the company and not the underlying assets of the company itself. "It is impossible to treat a share as being an interest in the company's assets, or an aliquot share in the company's capital, and to regard the contract arising from and contained in the company's Articles of Association as a separate and independent thing. The contract and the rights and liabilities that flow from it are of the very essence of the share". (See IRC v Crossman [1935]).

Thus particular attention has to be paid to the rights attaching to the shares whether by virtue of the Articles of Association or general law.

e) The use of hindsight must be rejected:-

> "It is necessary firmly to reject the wisdom which might be provided by the knowledge of subsequent events", per Danckwerts J in Holt V IRC [1953] 1 WLR 1488.

f) The emphasis is on the hypothetical nature of both the vendor and purchaser. It is not the actual shareholder who is considered but an anonymous shareholder whose only characteristic is that he owns the shares in question, "Of course, the hypothetical vendor may be a director, but he equally well may not be a director. One must, therefore, only endow him with the characteristics which must necessarily belong to all hypothetical vendors, namely, that of owning the block of shares in question". Lynall v IRC per Cross LJ.

g) The sale hypothesised by the statute is not a forced sale.

## 4. Information Standards

In the hypothetical open market which has to be considered the vendor is endowed only with the characteristic of owning the shares in question. As we have already seen he may or may not be a director of the company. In determining the price which a prudent purchaser might pay the amount of information that would be made available in the particular circumstances will have to be considered.

The statute says that in this hypothetical open market there would be available information which would have been made available in a private treaty sale.

## 5. The Valuation of Controlling Interests

The two methods of valuation which, in my experience, are most commonly used by Revenue for valuing controlling interests are:

a) Earnings Valuation
b) Assets Valuation

### 5.1 <u>**Earnings Valuation**</u>

In arriving at the earnings valuation it is necessary to:

- Determine future maintainable after the tax profits of the company, and
- Apply a suitable multiple (Price/Earnings ratio) to these to capitalise the company.

#### 5.1.1 ***Determination of Future Maintainable Profits***

In considering future maintainable profits one would normally have regard to the profits of the company for, say the three years prior to the valuation date.

In my experience the Revenue are much more focused on historical profits than on budgeted future profits.

Where past profits are being used as a guide to future maintainable earnings it may be necessary to adjust the profits shown by the accounts for such items as:

- any unusual/exceptional profits/losses arising which are unlikely to re-occur
- reasonable level of directors remuneration
- arm's length rent for the premises if owned by the shareholders
- interest free loans provided to, or by, the company

- pension provisions for directors and employees

Having adjusted the profits per the accounts for these items a maintainable profit before tax is arrived at by, say,

- a weighted average of the three years
- a straight average of the three years, or
- depending on the trend, perhaps the results of the latest year

When the maintainable profits before tax have been arrived at it is then necessary to determine the taxation liability which would arise on those profits. This will give the maintainable after tax profits.

5.1.2 ***Applying Appropriate Price Earnings ("P/E") Ratio***

In determining the P/E ratio to be applied to the maintainable after tax profits one would have regard to:

(a) The P/E ratio of similar quoted companies. Very often there will be none, or if there are such quoted companies they will be so much bigger, and more diversified, that a direct comparison may not prove meaningful.

(b) The P/E ratios applied in other relevant recent sales of private companies, in the Irish market. Again no suitable precedents may be available.

(c) Experience/judgement in dealing with valuations of shares in private companies.

The P/E ratio applied in valuing private companies will tend to be significantly lower than that applied in valuing quoted companies in similar industries. The main reasons for this are:

- lack of marketability of the shares
- restrictions on transfer

- private companies tend to be smaller and carry a higher risk
- perhaps no proper management structure in the private company.

Obviously the P/E ratio used in valuing a particular private company will depend on a broad range of factors but, as a very general rule, it will, in the current climate, tend to lie in the range of say 5 to 8.

### 5.2 **Assets Valuation**

Apart from the fact that an assets valuation is relevant when valuing majority holdings the assets basis will be used in the following circumstances:

(i) If the company has gone into liquidation.
(ii) If there is a likelihood of liquidation due to poor profitability.
(iii) Where there is reasonable certainty of early realisation of assets.
(iv) Where the profits afford no measure of the value of the shares having regard to real value of the capital.

The valuation of the net assets is normally a simple matter if one has an up-to-date Balance Sheet and current valuations of the company's land and buildings, and quoted (or unquoted) investments, if any.

If the valuation relates to a date well into the company's financial year, one would normally take into account the estimated after tax profits arising in the period from the last balance sheet date to the date of the valuation.

The treatment of certain of the liabilities (on the balance sheet or off) often creates problems where asset backing becomes a feature of negotiations. Three main areas in which differences of opinion tend to arise are:

***Deferred Tax***

From a purchasers point of view the deferred tax at the time of acquisition absorbs the benefit of future capital expenditure. It is therefore a real liability.

***Government Grants***

With regard to Government Grants these should normally be treated as part of the equity interest in a valuation of a company which is likely to continue as a going concern.

***Pension Provisions***

The omission from the balance sheet of all or part of the provision for pensions has been a major factor in shareholders' funds being overstated in Irish private companies. On numerous occasions acquiring companies have found that to bring pension provisions in line with their own very substantial liabilities had to be booked. The Revenue may, however, resist a deduction for pension provisions in arriving at the net asset value.

## 6. The Valuation of Minority Holdings

A minority shareholder in valuing his interest in the company would normally expect the shares to carry a lower value per share then those forming part of a controlled holding because of the inability to dictate the election of directors, the direction of the corporation, and the performance of his investment.

The inability to dictate dividend payments, and most importantly the likely restriction on the sale of the shareholding would be other reasons for the shares carrying a lower value.

Broadly speaking there are three classes of minority holdings:

i) 0-10% Holding

Such a shareholder has no rights. If the remaining shares are held by a single shareholder then the minority shareholder is in a very disadvantaged position. It would normally be appropriate to significantly discount such minority shares from rateable valuation.

On the other hand if the remaining shares are held by a large number of small shareholders holdings of 0-10% may, in certain circumstances, command a higher value.

ii) Holding of between 10% and 25%

Where a minority shareholder owns between 10% and 25% of the outstanding shares he is disadvantaged in the same way as the 0-10% holder except that, in some circumstances, he may be able to apply to the Courts on the grounds of the oppression of the minority shareholders.

Here, a somewhat lesser discount from rateable values would likely be appropriate.

iii) Where a minority shareholder owns between 25.1% and 49.9% of the shares the other shareholder (assuming there is only one) although he still controls the company cannot alter the Articles or place the company in liquidation without the consent of the minority. Therefore, the discount from rateable valuation should be somewhat less than that for a holding of 10% to 25%.

## 6.1 **Dividend Yield Valuation**

The method of valuation most appropriate to the valuation of small minority holdings is the dividend yield basis. The textbooks would suggest that this is because the minority shareholder has no control over the company and can only look to the dividend paid. As the size of the holding increases greater cognisance will be taken of the other bases of valuation.

Where there is a history of regular dividend payments and where the holding to be valued is small the valuation should be by reference to a dividend yield basis, perhaps with some mark-up to reflect strong earnings, strong asset backing or the possibility of a takeover.

One of the key factors in a dividend yield valuation is the required yield. This may be obtained by reference to the yields obtainable on quoted shares together with a mark up to reflect the restrictions in transfer etc. Certain valuation textbooks suggest a mark up of between 25% and 33⅓% on the yields available on quoted shares.

The following is an example of a dividend yield basis of valuation:

| | | |
|---|---|---|
| Issued share capital | 100,000 shares of €1 each | |
| Annual dividend | | €20,000 |
| Dividend per share | | 20% |
| Expected yield | Say | 5% |
| Dividend yield value | | |

$$\frac{\text{Maintainable dividend \%}}{\text{Expected yield \%}} = \frac{20}{5} = \text{€4 per share}$$

Although the dividend yield basis of valuation will be used where there is a history of dividend payments more often than not either nominal dividends, or no dividends are paid by closely held companies. In these circumstances a dividend yield valuation may be carried out based on a notional dividend with a reasonable cover. However, I prefer to look at the earnings and assets valuation to arrive at the overall valuation and to apply a suitable discount to reflect the lack of marketability and lack of control of the minority shareholder.

## 6.2 Range of Discounts on Assets/Earnings Valuations

The discount to be used in valuing minority holdings varies with the size of the shareholding. For a shareholding of over 50%, or even a strategic minority holding giving de facto control, the lack of marketability is less significant than for a small minority holding.

The discount to be applied is a matter of individual judgement. It will be influenced by the spread of shareholdings within the company. For example a 25% shareholding alongside three other 25% shareholders is obviously more valuable than a 25% holding where the remaining 75% of the shares are held by a single shareholder.

The following range of discounts might be appropriate for valuing minority holdings, assuming Section 16 does not apply:

| Size of Holding | Suggested Range of Discount |
|---|---|
| 50% | 20% to 30% |
| 25% to 49% | 30% to 40% |
| 0% to 24% | 50% to 80% |

Discounts in investment holding companies and property rental companies would tend to be somewhat less than discounts on similar size and spread of holdings in a trading company. This would seem to be due to the greater prospect of a liquidation in an investment holding or rental company.

The above are rough and ready guidelines and it should be borne in mind that no two companies are exactly alike and that the spread of shareholdings within a company is very material.

## 7. The Revenue Perspective

The Revenue, in approaching a valuation will, in my experience, tend to look at it to see whether it is reasonable and whether there is any potential for raising additional tax from it.

If the Revenue choose to examine a valuation they will normally request the completion of one of their standard share valuation forms i.e. SD4 or Q7.

Previous arm's length transactions in the shares between unconnected persons are very persuasive in arriving at a valuation for the shares. This information, is requested on the Revenue forms. When the Revenue examine a valuation in detail they will, in my experience, be very conscious of the additional taxation yield which might be derived from it.

In my experience, in the absence of any violent fluctuations in profits, the Revenue have tended to look either at the profits or the latest year or at an average of three years profits and to treat these as the future maintainable profits. The Revenue do not tend to look at profits of the year in which the shares have to be valued unless the valuation date is close to the accounting year end.

## 8. Surcharge for Under Valuation of Assets

In considering how much any particular valuation can be "trimmed" for submission to the Revenue one would have to have regard to the provisions which give rise to a surcharge when assets are undervalued.

***Capital Acquisition Tax***

Section 79 FA 1989 (S 53 CAT CA 2003) imposes a surcharge for CAT purposes where valuations are found to be understated.

The amount of surcharge is in accordance with the following table: -

| Estimate of Market Value of Asset in Return as a % of ascertained Value | Surcharge |
|---|---|
| | |
| Between 0% and 39.9%<br>Between 40% and 49.9%<br>Between 50% and 66.9% | 30%<br>20%<br>10% |

If the value submitted is in excess of 67% of the ascertained value no surcharge arises.

The surcharge will be liable to interest as if it were part of the Gift of Inheritance Tax.

There is provision for appealing to the Appeal Commissioners against the surcharge.

***Stamp Duty***

A surcharge also applies for the undervaluation of shares for stamp duty purposes. This is dealt with in Section 15 SDCA 1999.

## 9. Issues – Areas of Frequent Conflict

a) Voting and Non-Voting Shares

How should the overall valuation of the company be divided between the voting and non-voting shares?

A commonly suggested solution to this type of problem, and one which is normally acceptable by Revenue, is to attribute 15% of the overall value of the company to voting shares and to apportion the remaining value of the company among the different classes of shares having regard to the rights (other than voting) which attach to the shares.

b) Level of Director's Remuneration in a Family owned Company

The level of Director's Remuneration in a family owned company is another common area of conflict. In some family companies the level of director's remuneration is too low while in other cases the surplus profits of the company are taken out by way of director's bonus at the end of the year. The question as to what is an adequate level of directors remuneration leads to interesting debates with the Revenue.

Salary surveys are useful in determining an appropriate level of remuneration for directors.

c) Loss Making Companies

Companies which tend to make losses, and perhaps reach a break-even position occasionally, would normally tend to be valued on a discounted assets basis.

In arriving at an overall valuation for the company the level of discount on the net asset value is a frequent area of conflict. In arriving at a net asset value the Revenue will reject claims for specific deductions for losses on stocks, debtors and redundancy payments, which would arise on a close down. They will however agree a discount on the net asset value to reflect the lack of earnings in the company. The level of the discount will depend on the circumstances of the case.

d) <u>April 1974 Values of Minority Holdings in a Family Company</u>

On a liquidation or a take over minority shareholders will receive the same amount per share as controlling shareholders. When dealing with the April 1974 value of each holding for capital gains tax the value of each share held by a minority shareholder will be substantially less than the value per share of a controlling shareholder. Therefore a capital gains tax liability could arise on the minority holder without any liability arising on the majority shareholder.

Assertions that members of a family would act together would be rebutted. It should be remembered that the hypothetical vendor must be depersonalised, see Hinchliffe v Crabtree [1970] where Russell LJ said “we must forget that this block of shares happen to be owned by Mr Crabtree, who was a director and knew all about the negotiations”.

It follows that it cannot be argued that husband and wife would act together. The husband, if it is his shares that are being valued, is not to be taken as the seller of his shares. The holding is to be treated as an offer for sale by a depersonalised hypothetical seller.

e) <u>Deduction for Notional CGT</u>

In valuing say an investment holding company the question often arises as to whether the valuation should be reduced by the amount of the capital gains tax liability which would arise if all of the investments held by the company were disposed of.

If the investment company is not in liquidation the Revenue will refuse a deduction for this notional CGT liability.  There is however a strong argument that some deduction should be available for the notional CGT.

## Conclusion

### Some Key Points

- Previous arm's length transactions in the shares are very persuasive.

- The level of discount used in valuing minority holdings on a discounted assets (or earnings) basis depends on the spread of shareholdings in the company.

- The profits shown by the accounts may have to be adjusted in arriving at maintainable earnings.

- Where large divergences arise between earnings and asset valuations the value may lie somewhere between the two.

- In conclusion I might add that each company and each valuation are unique and circumstances at the date of the valuation may vary from case to case.

  Valuation is a matter of opinion – informed opinion – and opinions can differ but only within reasonable limits.

  I will finish with a quote from John McArcavy's booklet "Valuation for Estate Duty and Capital Gains Tax", where he quoted a UK estate duty official who, I feel, put the matter rather well in this way:

  > "Lastly though it is possible to enumerate all the ingredients that go to make up a value, such as dividend, earnings cover, and assets cover, I have yet to meet anyone who can state without fear of contradiction, how much of each ingredient to take. A valuation is like a recipe from which quantities are omitted. The finished article depends very much on the skill of the cook and to some extent on the taste of the consumer".

Appendix 1

**Example Co Ltd**

**1. <u>Background</u>**

In August 1989 David gave a gift of 10,000 shares of IR£1 each in Example Co Ltd to his son John. After the transfer the shareholdings in the company were:

| | |
|---|---|
| David | 14,499 |
| John | 10,500 |
| David's wife | 1 |
| | 25,000 |

Example Company was in the food business and availed of some manufacturing relief. It had 20 employees.

**2. <u>Net Assets</u>**

Net assets per Balance Sheet as adjusted for a revaluation of the land and buildings IR£641,000.

This did not take account of possible deductions for:

- Deferred Taxation – estimated at IR£39,000
- Back funding of pension liability for David.

## 3. Summarised Results

The summarised results of the company for the 3 years to 31 December 1988 were as follows:

| | 31/12/88 IR£'000 | 31/12/87 IR£'000 | 31/12/86 IR£'000 |
|---|---|---|---|
| Sales | 1,328 | 1,060 | 1,009 |
| Gross Profit | 526 | 443 | 490 |
| Profit before tax | 144 | 130 | 242 |
| Tax | 34 | 20 | 130 |
| Profit after tax | 110 | 110 | 112 |
| No dividends were paid during the above years | | | |
| Other relevant matters were: | | | |
| Charge for directors Remuneration | 151 | 113 | 81 |
| No of Executive Directors | 1 | 1 | 1 |
| Interest free loan to Company by Directors | 81 | 64 | |

There was no pension scheme in existence for Directors.

## 4. Most Important Factors Considered in Arriving at Valuation

***Maintainable Profits***

- Level of Directors Remuneration
- Effect of interest free loan from David
- No pension for directors
- Dependence of the business on David
- Variation in the taxation charge over the previous 3 years

***Price Earnings Ratio***

- 2 recent takeovers by public companies of private companies in the food business
- A previous abortive offer received for Example Co
- The lack of a proper management structure in the organisation
- Price Earnings ratios of Irish quoted companies – although these were particularly high at the time and consequently they were discarded by and large

***Assets Valuation***

- Deduction for the back funding of David's pension

However as the earnings valuation was significantly higher than the assets valuation the pension deduction was not crucial.

## 5. Main Areas of Dispute with the Revenue

- Level of Directors Remuneration
- P/E Ratio

## 6. Conclusion

| | |
|---|---|
| - Value agreed for CAT purposes (controlled holding valuation). | **IR£760,000** |
| - Discount from CAT valuation to reflect the valuation of a 40% holding for CGT purposes. | **40%** |