Estate Duty Office

Guidelines for Valuation of Unincorporated Business

These notes are issued for general information and guidance only. They have no binding force and do not affect a person's right of appeal to the Courts. The information and advice in these notes is based on current tax laws at the time of printing. The examples in these guidelines are for illustration only. Each case should be considered on its own merits.

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Index

Paragraphs		**Pages**
1	Introduction	1
2	Value for estate duty purposes – general principles	1 – 3
3	The sole trader: legal nature	3
4	The partnership: legal nature	3 – 4
5	Information and documents required for preparing a valuation	4 – 5
6	Methods of valuation	5
7	Valuation based on sales	5
8	Valuation based on earnings	5
9	Valuation based on net assets value	6
10	Sole trader	6
11	Partnership	6 – 7
12	Valuation of goodwill	7 – 9
13	Conclusion	9

1. Introduction

1.1 Estate Duty is imposed on the capital value of all property, real and personal, settled or unsettled, which passes or is deemed to pass on the death of the deceased. The duty is assessed by reference to the aggregate principal value of all the property liable to duty. Consequently, a valuation is required for each property as at the date of death.

1.2 There are three common vehicles for doing business: sole trader, partnership and limited company. Each has its own advantages and disadvantages. A sole trader, as the name suggests, owns and runs the business according to his own wishes, but he has to bear all the risks. The benefits of a partnership include the sharing of the risks and enlargement of the capital base, but in case of default, each partner will still be jointly and severally liable for all the debts of the partnership. Incorporation, though subject to a greater degree of legal regulation, is the most popular among the three, mainly because of its two principal advantages – separate legal personality and limited liability (unless personal guarantees have been given). These two advantages have distinguished the valuation of a limited company from that of an unincorporated business.

1.3 Because of the absence of an open market, valuation of unincorporated businesses has often caused difficulties and problems for personal representatives and practitioners. These guidelines explain how unincorporated businesses are valued for estate duty purposes. It begins with an outline of the general principles for determining the principal value of a property liable to duty, followed by a brief insight into the legal nature of a sole trader and a partnership business, then a checklist of the information and documents required for preparing a valuation, before moving on to discuss the common methods for valuing unincorporated businesses. The valuation of goodwill is set out in the final paragraphs.

2. Value for estate duty purposes – general principles

2.1 Section 13(5) of the Estate Duty Ordinance, Cap.111 (“the EDO”) prescribes the measure of the principal value of property liable to duty. Under the provision, the principal value is the price which, in the opinion of the Commissioner, the property would fetch if sold in the open market at the time of the death of the deceased. No reduction in the estimated price is to be made on the ground that the whole of the property is to be placed on the market at one and the same time, but depreciation of the value by reason of the death of the deceased may be allowed for.

2.2 It is immaterial that the property is not saleable in the open market, or a sale in the open market is forbidden, for example, by restrictions contained in the partnership agreement. A hypothetical open market and a hypothetical sale are assumed. The price to be decided upon is the sum that would be paid by a hypothetical willing purchaser to a hypothetical willing vendor for the property in the open market at the time of death of the deceased.

2.3 In the hypothesis, the hypothetical purchaser is presumed to be someone who is willing but prudent, and the hypothetical vendor, willing but not anxious. Neither would rush into transaction. Both are prepared to purchase/sell at a fair price. Other assumptions are: (a) the sale is to take place at the time of the death; (b) there has been adequate publicity before the sale; (c) all preliminary arrangements to facilitate the sale have been made; (d) the seller has honestly given as much information to all likely purchasers as he was entitled to give; (e) the purchaser has obtained as much information as he can properly do; (f) all classes of purchasers are included; and (g) the method of sale is not restricted. The open market price is to be that, having regard to the actual circumstances prevailing at the time of the death, a purchaser would pay for the right to stand in the vendor's shoes.

2.4 Section 13(5) does not require the highest possible price. What is required is an estimate of the price which would be realized under the reasonable competitive conditions of an open market at the time of the death. The sale realized on a forced sale is not an acceptable criterion, nor is the fixed price as provided for in the partnership agreement, even if a deceased member's representatives are compelled to sell the deceased's interest to the surviving partner(s). [but see paragraph 11.1]

2.5 The basis of valuation is the gross sale price without any allowance for the cost of sale including commission.

2.6 While subsequent evidence is not necessarily to be excluded, the valuation is to be based upon such knowledge and information that would have been available at the time of the death.

3. The sole trader: legal nature

3.1 The sole trader is the simplest trading vehicle. With rare exceptions, it is often a small trading business or one-man practitioner of a particular profession such as doctors, dentists, barristers, and public accountants. It has no legal identity separate from its owner. The owner takes full responsibility for the business, and is entitled to all its profits. He is personally and solely responsible for any debts and losses of the business. There is no limit to his liabilities. His personal assets will be at risk if his business fails. Any debts owing by the business to him are not deductible for valuation purpose. The advantages of running a sole trader business are its simplicity and flexibility. It can be established, changed, sold and terminated very quickly. However, the business ends with the death of the owner and, if business activity is to continue, a new business must be established by the interested parties.

3.2 The technical skill and the personality of the owner are often linked with the value of goodwill, especially if the business is art production, commission agencies, or the specific performance of a professional nature. For this reason, goodwill is often heavily discounted or accepted as valueless on the death of the owner of the business because goodwill is deemed to have died with him.

4. The partnership: legal nature

4.1 Section 3 of the Partnership Ordinance, Cap. 38 (“the PO”) defines partnership as the relation which subsists between persons carrying on a business in common with a view of profit. It may be a continuing business venture such as a firm of public accountants, or a single venture, for example, the production of a film. A partnership is not a separate legal entity. Similar to a sole trader, there is no limit to the liabilities of the partners, whether active or sleeping. It may be possible to set up a limited partnership under the Limited Partnerships Ordinance, Cap.37 which limits the liability of certain partners, but such partnerships are outside the scope of these guidelines.

4.2 There is no legal requirement for a written partnership agreement. In the absence of agreement to the contrary, the PO sets out the terms which regulate the rights and obligations of partners, for example: profits and losses are shared equally; a partnership ends upon the death or retirement of any partner; and no interest is paid on capital contributed by a partner except the 8% interest on advances in excess thereof.

4.3 While partners are free to adopt whatever terms they like, a partnership agreement cannot alter the financial responsibilities of a partner that are defined by statutes such as the PO and the Inland Revenue Ordinance, Cap.112 ("the IRO"). Being an agent of the firm and of the other partners, any partner can enter into contracts and incur obligations that are binding on all partners (section 7 of the PO). Every partner in a firm is liable jointly with the other partners for all the partnership debts incurred while he is a partner (section 11 of the PO). A partnership is an income tax paying entity and tax upon the partnership is recoverable out of the assets of the partnership, or from any partner (sections 22(1) and (4) of the IRO). A retired partner continues to be liable for partnership debts incurred before his retirement, unless creditors and his former partners agree to release him (section 19(2) and (3) of the PO). Partners are bound to render true accounts and full information of all things affecting the partnership to any partner or his legal representatives (section 30 of the PO). Property originally brought into the partnership stock or acquired, whether by purchase or otherwise, on account of the firm, or for the purposes and in the course of the partnership business, is partnership property (section 22(1) of the PO). Property bought with money belonging to the firm is deemed partnership property (section 23 of the PO).

5. Information and documents required for preparing a valuation

5.1 Before preparing the valuation, the following information and documents should be available:

(a) The financial statements (profit and loss account and balance sheet) for three consecutive years with the last year ending nearest to the date of the deceased's death.

(b) A copy of the partnership agreement, if any, or particulars of the arrangement among partners.

(c) Details of the owner(s) of the business and their relationship.

(d) Partners' profit/loss sharing ratio.

(e) Details of the business activities.

(f) Details of the landed property owned by the partnership as at the date of death.

(g) Details of the business bank accounts not reflected in the balance sheets, if any.

6. Methods of valuation

6.1 There are many variables in the valuation of an unincorporated business. Most of them are subjective. Depending on the emphasis placed on particular factors in the valuation process, different valuers appraising the same business could end up with different open market prices. There is no cut-and-dried answer. The common methods to value business include valuation based on sales, on earnings and on net assets.

7 Valuation based on sales

7.1 Valuation based on sales is the least popular among the three. **The business worth is determined by applying a multiplier to the annual sales**. It is often used in valuing consultancy businesses, PR agencies, retailers, etc., particularly those newly started businesses with low fixed costs, few assets and little earnings, or businesses without balance sheet. The limitations of this method are the choice of the multiplier and the disagreement over the use of sales as the basis of valuation which has ignored the costs of sale and expenses.

8. Valuation based on earnings

8.1 **The business worth is determined by capitalization of the future maintainable earnings.** It is commonly used in valuing businesses with high earnings and few assets, or without balance sheet. The difficulty of choosing the multiplier aside, the main problem with this valuation method is the complexity of projecting future sales and recasting the past financial statements to reflect the effects on profits of perks that the owner(s) take(s) from the business.

9. Valuation based on net assets value

9.1 Given the limitations of the other methods, it has been our practice to value as a going concern a deceased's proprietary right in a business, whether of a sole trader or partnership, taking into account the value of goodwill as well as the other assets.

9.2 Net assets value is the total value of the fixed and current assets owned by the business minus its long-term and current liabilities. The values shown on the balance sheet for the assets may not represent their true values at the time of death, particularly for the following items – landed properties, stock and work-in-progress, plant and machinery, vehicles and debtors (part of the debts might not be fully recoverable). Provision for liabilities might not have been fully made, such as long service payments. In most cases, the assets will need to be revalued. The assessed values will substitute the book values on the balance sheet, and deductible liabilities not fully provided for will be allowed.

10. Sole trader

10.1 In valuing a sole trader, any debts owing to the owner is not deductible. By the same token, any debts owing by the owner to the business is to be deducted from the value of the business.

11. Partnership

11.1 In valuing a partnership, special attention will need to be paid to the provisions under the partnership agreement if any, as to the treatment of goodwill and/or the method of valuing a partner's share of interest in the partnership on his death. If these provisions are acted upon and the agreement is purely a commercial arrangement containing no element of bounty, they will usually be accepted as the measure of value for duty purpose (even where it is stipulated that nothing shall be reckoned for goodwill). The Commissioner is not, however, bound to accept the exclusion of goodwill or the values fixed by a partnership agreement which is not a purely commercial transaction.

11.2 It has been established that the partners are collectively entitled to each and every asset of the partnership, in which each of them therefore has an undivided share. The valuation of an interest in a partnership should be by reference to the appropriate share of net assets value including the goodwill – profit/loss sharing ratio times net assets value – without any discount for the costs of sale. Adjustment is then made to this value by (a) adding the amount owing by the partnership to the particular partner on loan and current account, or (b) deducting the amount owing by the particular partner to the partnership.

12. Valuation of goodwill

12.1 Section 3 of the EDO defines assets to include goodwill. Whenever a business is valued on net assets basis, a separate valuation for goodwill will need to be prepared. But if the business is unprofitable and has to be valued on a break-up basis, the goodwill has no value.

12.2 Goodwill has been described as the benefit and advantage of the good name, reputation and connection of a business. It is nothing more than the possibility that the old customers will resort to the old place. By its nature, goodwill can be inherent (generated by the location of the business) or personal (generated by the personality and special skills of a particular individual or group of individuals) or free (advantages attached to the business other than the first two categories).

12.3 In commercial practice, goodwill is normally valued at a number of years' purchase of the company's estimated future super profits, according to the custom of the trade or the circumstances of the particular business. Three factors will need to be determined, namely, the expected profits, the required return from tangible assets, and the multiplier. **For simplicity, we normally value the goodwill at one year's super profits. The super profits are calculated by deducting from the assessable profits (either a simple average of the last three years' assessable profits, or in the case of increasing /declining profits, the weighted average) a sum which is equivalent to a 10% return on the net capital employed.** As our "multiplier" is only one, no question of excessiveness should arise. Any objection on this ground would be refused unless there is evidence to show that profits have been substantially reduced by reason of the death of the deceased.

12.4 Example

The deceased’s share in a partnership		25%
Balance Sheet		
Fixed assets		
Furniture and fixture		$628,000
Current assets		
Debtors	$1,458,239	
Bank balances	$4,768,268	
Sundry deposits	$5,000	
	$6,231,507	
Less: Current liabilities		
Creditors	($678,200)	
Net current assets		$5,553,307
Net assets value		$6,181,307
Initial capital		$500,000
Accumulated profits		$2,581,307
Partners’ current accounts		
The deceased partner	$1,500,000	
Others	$1,600,000	
		$3,100,000
		$6,181,307
Computation of the deceased’s interest in the partnership		
Net assets value		$6,181,307
Less: Partners’ current accounts		($3,100,000)
		$3,081,307
Add: Goodwill (see below)		$1,512,917
Business net worth		$4,594,224
The deceased’s 25% share		$1,148,556
Add: the deceased partner’s current account		$1,500,000
The deceased’s interest in the partnership		**$2,648,556**

Calculation of goodwill:

Assessable profits for the year ended 31.3.2001		$1,788,217
Assessable profits for the year ended 31.3.2002		$1,826,989
Assessable profits for the year ended 31.3.2003		$1,623,457
Subtotal		$5,238,663
Average annual profits		$1,746,221
Less: Normal return on net assets		
Balance as at 1.4.2000	$1,857,255	
Balance as at 1.4.2001	$2,283,562	
Balance as at 1.4.2002	$2,858,324	
	$6,999,141	
Average	$2,333,047	
Say 10%		$233,304
Goodwill		$1,512,917

13. Conclusion

13.1 These notes are issued for general information and guidance only, and do not purport to be comprehensive. There is no obligation on the estate representative to obtain a professional valuation in support of the business value as sworn in the affidavit or account. But in some cases, complex issues may be involved, and appointment of a professional adviser, such as an accountant, a surveyor or a solicitor, may be needed.