Estate Duty Office

Guidelines for Valuation of Unquoted Shares

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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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 as at the date of death.

1.2 While section 13(5) of the Estate Duty Ordinance, Cap.111 ("the Ordinance") prescribes the open market price as a measure of value, there is no open market for some property including unquoted shares. There are several methods to value unquoted shares the choice of which depends on the type of company to be valued and the size of the deceased's holding. This has often caused difficulties and problems for personal representatives and practitioners.

1.3 These guidelines explain how unquoted shares are valued for estate duty purposes. We shall outline the general principles for determining the principal value of a property liable to duty, list the factors affecting the value of a shareholding, and present a checklist of the information and documents required for preparing a share valuation. The different methods for valuing a controlling shareholding, a minority shareholding, preference shares and goodwill will be covered.

2. Value of property for estate duty – general principles

2.1 Section 13(5) of the Ordinance prescribes the measure of the principal value of all property for duty purposes, except holdings in a private company passing on the death of a person who controlled or is deemed to have controlled the company [see paragraphs 5.1 to 5.4].

2.2 Under section 13(5), the principal value of any property is the estimated 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

2.3 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 Articles of Association of a private company. 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.

2.4 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) all classes of purchasers are included; and (e) 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.

2.5 Section 13(5) of the Ordinance 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 Articles of Association of a private company, even if a deceased member's representatives are compelled to sell the shares at this price to other members.

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

2.7 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. Factors affecting the value of an unquoted shareholding

3.1 A company is a separate legal person capable of perpetual succession, and distinct from its shareholders who have no proprietary interest in its underlying assets. The shareholder's interest in the company is the ownership of a bundle of rights, including the rights to receive dividends, to vote and to receive surplus assets on winding-up. The exact rights vary according to the class of shares held. They are defined in the Articles of Association of the company. The bigger the bundles of rights, the more valuable the shares. The most common types of shares are: ordinary, preference and deferred shares.

3.2 Unlike quoted shares, unquoted shares are often subject to restrictions on transfer. In some cases, the board of directors or the directors are empowered to refuse to register transfer as they deem fit. The Articles of Association of the company may provide an option for the other shareholders of the company to buy the shares at a fixed price before they can be sold to a non-member. Such a fixed price is not the open market price for estate duty purposes. As explained in paragraphs 2.3 and 2.4, the vendor is a hypothetical person. He may or may not be a director of the company or a member of the family that controls the company. He is endowed only with the characteristics common to all hypothetical vendors, namely, owning the block of shares in question. Given the restrictions on transfer, the value estimated in accordance with section 13(5) of the Ordinance should be greater than the fixed price but less than the price obtainable if the restrictions were removed.

3.3 There is no open market price for unquoted shares. The value of an unquoted shareholding is affected by many factors including – the nature and size of the shareholding passing, the manner in which the remaining shareholdings are held, the profitability and future prospects of the business, the dividend policy and cover, the strength of asset backing of the company, the prospect of capital gains, the quality of management and so on.

3.4 The common methods of share valuation are dividend yield [see paragraphs 9.1 to 9.5], price earnings ratio [see paragraph 8.1 to 8.5] and net asset basis [see paragraphs 10.1 to 10.4]. The choice of the appropriate method will depend on the type and size of the shareholding and the nature of business.

4. Information and documents required for preparing a share valuation

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

(a) Details of the issued share capital of the company at the date of death and the change(s) in capital structure, if any, during the last three years before death.

(b) The rights of the respective classes of shares in relation to voting, dividend and on winding-up.

(c) Details of the shares to be valued and the manner in which the remaining shareholdings are held.

(d) Details of the directors of the company and their relationship.
(e) Details of the business activities of the company.
(f) Annual reports and accounts for the last three years before the date of death.
(g) Details of the investment and landed property held by the company as at the date of death.

5. Controlling shareholding – method of valuation

5.1 In the case of a controlling shareholding, section 44(1) of the Ordinance requires that the valuation be based on assets value instead of the estimated open market price specified in section 13(5).

5.2 This special method of valuation is also applicable to cases where the deceased held a 50% shareholding and had, in addition, at any time during the three years ending with his death, a casting vote as chairman of the company by virtue of the Articles of Association. He is deemed under section 44(3) to have control of the company.

5.3 In broad outline, the basis of valuation is as follows. The value of the company's assets, including goodwill, at the date of the deceased's death, is ascertained as prescribed by section 13(5) of the Ordinance, i.e. at the price they would fetch if sold in the open market in the most advantageous manner. From the aggregate value of these assets are deducted the company's liabilities other than its share capital. The net value of the assets so ascertained is deemed to be the value of all the shares issued. The value of the shareholding passing is the proportionate net value of the assets. In arriving at the valuation, no discount is given for any restrictions on transfer. Neither is there any allowance for the cost of realization.

Example 1

Issued share capital	2,000 Ordinary $1 shares
Number of shares passing on death	1200 shares
Net assets value	$1,000,000
Value of each share	$1,000,000/2000 = $500 per share
Value of shareholding passing	$500 x 1,200 = $600,000

5.4 Where there are different classes of shares, the net assets must first be apportioned among the classes of shares according to their respective rights, and the separate apportionments then rateably apportioned among the shares to which they relate.

Example 2

Issued share capital	2,000 Ordinary $1 shares and 8,000 "A" Ordinary Non-voting $1 shares (Other than voting rights, all shares are pari passu)
Net assets value	$1,000,000
Ordinary shares voting premium	$150,000 (Voting shares are allocated a premium value equivalent to 15% of the net worth of the company to reflect the voting right)
Net assets value apportioned to "A" Ordinary Non-voting shares	($1,000,000 - $150,000) x 8,000 / (2,000 + 8,000) = $680,000
Net assets value apportioned to Ordinary shares	$1,000,000 - $680,000 = $320,000
Value of "A" Ordinary Non-voting shares	$680,000 / 8,000 = $85 per share
Value of Ordinary shares	$320,000 / 2,000 = $160 per share

6. Minority shareholding – methods of valuation

6.1 Holding of less than 50% is regarded as a minority shareholding. A minority shareholder has no say in the company. But the size of a minority holding may affect its value. Holding of between 25% and 50% allows the holder to block a special or extraordinary resolution and prevent liquidation. As the holder could exert more influence in the company's affairs, such an influential minority holding would have a higher value per share than holdings below 25%.

6.2 Besides, size of the holding is relative. An identical holding might fetch a different price in two comparable companies depending on the manner in which the remaining shares are held. A holding of even only 10% may have additional value to a holder of say 41% holding to whom it would give control of the company. Where all of the remaining shares are owned by another shareholder, an influential minority holding may only be worth a small additional premium. If the deceased's holding were the single largest shareholding in the company, a greater premium would be warranted. Each valuation must therefore be considered on its own merits.

6.3 There is a proposition that holders of minority shareholdings were mainly concerned with dividends. Hence, undistributed earnings should not have any bearing on the valuation of an uninfluential minority shareholding. Another suggestion is that to value a minority holding by reference to the underlying assets of the company is not in accordance with either the legal view or common sense. The reasons are that a minority holding has no say in the running of the company, and in policies on dividends, retention of earnings and disposal of assets, and that the prospects of receiving any distribution or realizing any capital appreciation are entirely dependent on the will of others. We do not share their views.

6.4 An investor in unquoted companies is different from an investor in quoted shares. He should be more concerned with the future prospects of the company and the long-term capital gain, rather than the immediate return of profits in the form of dividends. In Re Harry Charrington, deceased (1975) 1 HKTC 723, Leonard, J. said at page 733:

> "In the highly volatile atmosphere of Hong Kong, the ordinary investor is attracted more readily by the possibility of capital gain than by the probability of secure annual returns."

6.5 In addition to the prospective dividends, the main factors affecting the estimated value of a minority holding include the earning capacity of the company and prospects of a capital appreciation. Their order of importance varies depending on the type of company in which the shares are to be valued.

7. Types of company

7.1 Understanding the operations of the company provides an insight into its future prospects and the inherent risks. This would have a bearing on the estimated maintainable profits, dividends and yield. [see paragraphs 8.1 to 9.5].

7.2 The nature of the company would determine the method of valuation.

(a) Trading and/or manufacturing companies
The investment decision of an ordinary investor in this type of company is influenced by the profitability of the company or the amount of dividends and bonus. In these cases, the usual method of valuation is by reference to the earnings or dividends. But if the trading results of the company are so meagre that are incompatible with its huge assets value, valuation by asset basis may be employed.

(b) Property or investment holding companies
There is a tendency for an investor in this type of company to place particular importance on the value of its underlying assets and the prospect of a capital gain rather than the dividend return. Valuation is normally on an asset basis.

(c) Property dealing companies
As the property is bought with the intention of quick resale, it is appropriate to treat the company as a trading concern and value the shares by reference to earnings or dividends. But if there is no regular earning stream or dividend payments, or if the company holds a large reserve of property, net assets basis will be more appropriate.

(d) Property development companies
Given their holding of a large reserve of land or property, net assets basis is more appropriate.

(e) Service companies
The common features of such companies are high earnings but virtually no assets. The valuation approach will be the same as trading company.

8. Valuation based on earnings

8.1 In the stock market, analysts tend to compare the performance of quoted companies based on their price earnings ratios. There has been a tendency in the commercial practice to follow this approach in the valuation of unquoted shares. Under this approach, the value of unquoted shares is related to the earnings attributable to each share rather than the dividend payable on such share. Trading, manufacturing and service companies are mostly valued on this basis.

8.2 The price earnings ratio (P/E) formula can be expressed as follows:

Earnings per share (net) x P/E ratio = Price

8.3 Earnings for ordinary shares are defined as net maintainable profits after tax and preference dividends. To establish the level of maintainable profits, the following information is needed: the company's past profits record, current year's result and forecasts for future profits. Any extraordinary items which are not recurring in nature must be excluded. The basis of calculating the maintainable profits varies according to the merits of individual cases. It could be:

(a) The average of the last three years' profits if there is little difference between the figures; or
(b) The weighted average of the last three years' profits with greater weight on the latest results, if the profits are likely to fall or fluctuate; or
(c) Last year's profits if the profits are likely to level out; or
(d) Last year's profits plus a mark-up if the profits are likely to rise.

8.4 The appropriate P/E ratio is normally selected by reference to the relevant quoted sector or comparable quoted companies. A discount of 20% will be allowed to reflect the "unmarketability" of the shares and restrictions on transfer. Such a discount is considered adequate having regard to the fact that the quoted P/E ratios are based on large public companies and transactions involving smaller holdings.

Example 3

Issued share capital	10,000 shares of $1 each
Shareholding passing	500 shares
Company's after-tax maintainable profits	$1,000,000

Price earnings ratio (say)	8
Value of company	$1,000,000 x 8 = $8,000,000
Value per share	$8,000,000/10,000 = $800

8.5 If a company has retained any profits or assets not immediately required for the purposes of its trade, a discounted value of all such assets may be added as a premium to the company's earning value. Similar formula can be used for the valuation of minority holding in hybrid companies involving both trading and investment activities.

9. Valuation based on dividends

9.1 The dividend approach involves the estimation of the 'yield' or annual percentage return which an investor would look for on his outlay, and the application of that yield to the prospective annual percentage rate of dividend on the shares. The formula can be expressed as follows:

dividend% ÷ dividend yield x nominal value = price

[See Example 4 below.]

9.2 The prospective dividend can be deduced from the history of the company with due regard to the company's earnings and future prospects. Depending on the individual circumstances of the case, the prospective dividend could be computed by reference to the following:

(a) The average of the last three years' payouts if there is little difference between the figures; or
(b) The weighted average of the last three years' payouts with greater weight on the latest payout, if there is indication that the amount of dividends could not be maintained; or
(c) The last payout if the dividend is likely to level out; or
(d) The last payout plus a mark-up if the dividends are likely to rise.

9.3 In practice, the expected yield is selected from the yield current at the date of death on comparable quoted shares or relevant quoted sector. One should compare like with like and make due allowance for features of disparity. There may be several quoted companies whose nature of business is on balance sufficiently similar. If their yields vary, it is customary to adopt their average as the basis of the estimate.

9.4 Yields based on quoted shares provide a starting point to which adjustments are made to reflect the quality of the company to be valued. Dividend cover is material to the valuation process. Assuming the dividend payments are identical, an ordinary investor will certainly be willing to pay more for shares with a high dividend cover (dividend cover means the number of times the dividend could have been paid out of current earnings), because there are greater prospects for income and capital growth. Similarly, other things being equal, shares in companies with stronger asset backing would fetch a higher price. Factors increasing the expected yield include the absence of an open market, restriction on transfer, low dividend cover irregular dividend payments, high gearing, poor liquidity, small size of the company, and control by the majority shareholder. Conversely, high dividend cover, low gearing, good liquidity and huge asset backing would reduce the yield.

9.5 Solely on account of the absence of an open market and restrictions on transfer, an upward adjustment of 20% to the "quoted yield" is considered appropriate. The adjustments in relation to other disparities vary from company to company and are to be decided on individual merits.

Example 4

Issued capital	100,000 shares of $10 each		
Dividends per share			
Year 1	$11		
Year 2	$8		
Year 3	$15		
Comparable quoted yield	4%		
Comparison with quoted comparable:			
Dividend cover	Equal	no adjustment	
Liquidity	Equal	no adjustment	
Gearing	Higher	say	+ 1.0%
Asset backing	Weaker	say	+ 1.0%
Size of the company	Smaller	say	+ 1.0%
Restrictions on transfer		say	+ 1.0%

Prospective dividend:	
(1 x $11 + 2 x $8 + 3x $15) / (1 + 2 + 3)	$12 per share or 120% of nominal value
Expected yield: 4% + 4%	8%
Value per share:	120% ÷ 8% x $10 = $150

10. Valuation on net assets

10.1 A valuation by reference to the company's assets is justifiable in the following cases:

(a) Property or investment holding companies.

(b) There is a strong probability that the company will be wound up or sold.

(c) Where the value of the real estate owned by the company is disproportionate to its relatively meagre trading results. See Harry Charrington, deceased (1975) 1 HKTC 723[1].

10.2 Net assets value is the total value of a company's fixed and current assets minus its long-term and current liabilities. The values shown on the Balance Sheet for the assets may not represent their true value at the time of death, particularly for the following items – landed properties, quoted and unquoted investment, stock and work-in-progress, plant and machinery, vehicles and debtors (part of the debts might not be fully recoverable). Besides, provision for liabilities might not have been fully made, such as long service payments.

10.3 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.

10.4 The revaluation of the assets and liabilities aside, there will be a discount to reflect the disadvantages of "unmarketability", restrictions on transfer and minority holding. The amount of allowance varies from 25% to 40%, depending on the size of the holding.

[1] The Court of Appeal upheld the use of asset backing, but uplifted the discount for minority holding and restrictions on transfer to 40%, in an estate duty valuation of a 10% holding in a non-dividend paying manufacturing company holding substantial landed property.

Example 5

The deceased's holding		1000 shares
Balance Sheet		
Fixed assets		
Landed properties at cost		$3,000,000
Current assets		
Quoted shares at cost	$362,383	
Debtors	$450,000	
Bank balances	$128,268	
Sundry deposits		
	$946,651	
Less: Current liabilities		
Creditors	($23,222)	
Net current assets		$922,429
		$3,922,429
Long-term liabilities		
Mortgage loan		($1,282,663)
Net assets value – book value		$2,639,766
Issued share capital (10,000 shares of $10 each)		$100,000
General reserves		$2,539,766
		$2,639,766

Revised net assets value		
Net assets value per Balance Sheet		$2,639,766
Add: increase in revaluation		
Landed properties	$6,800,000	
Less: book value	($3,000,000)	
	$3,800,000	
Quoted shares	$1,363,000	
Less: book value	($362,383)	
	$1,000,617	

	$4,800,617
Less: Bad debts written off	($40,000)
Revised net assets value	$7,400,383
Revised net assets value per share	
$7,400,383 / 10,000 shares	$740.03
Less: say 40% discount for a 10% holding	($296.03)
Value per share	**$444.00**

11. Valuation of preference shares

11.1 Preference shares have the rights to: (a) a fixed rate of dividend in preference to other shares; (b) the payment of arrears of dividends; and (c) return of capital on a winding up of the company. They usually have no voting rights. Dividend yield provides a satisfactory basis of valuation for cases where dividends are regularly paid.

11.2 The valuation process is comparatively simple because the dividend percentage is fixed. The only difficulty is the expected yield. Comparison may be made with the interest rate and fixed income products listed in the Hong Kong Stock Exchange. As the preference shares are low risk investment, the adjustment to the quoted yield should be smaller.

11.3 If the shares are entitled either to surplus income or assets, it will be necessary to assess such entitlement. Where the shares carry a voting right, a premium of 10% may be added.

11.4 Where the dividends are cumulative and in arrears, the valuation will be based on the cumulative amount of the arrears plus the amount paid up, subject to a discount for the delay in payment.

12. Valuation of goodwill

12.1 Section 3 of the Ordinance defines assets to include goodwill. Whenever a company 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.

Example 6

Calculation of goodwill:

Assessable profits for the year ended 31.3.2001		$2,368,583
Assessable profits for the year ended 31.3.2002		$2,853,624
Assessable profits for the year ended 31.3.2003		$2,632,528
Subtotal		$7,854,735
Average annual profits		$2,618,245
Less: Normal return on shareholder funds		
Balance as at 1.4.2000	$578,322	
Balance as at 1.4.2001	$692,568	
Balance as at 1.4.2002	$822,375	
	$2,093,265	
Average	$697,755	
Say 10%		$69,775
Goodwill		$2,548,470

13. Conclusion

13.1 Valuation of unquoted shares is not an exact science. It is impossible to lay down any all-embracing general rules. Almost every case is exceptional in some respects. The circumstances of different companies vary and in the end, the choice of valuation methodologies must be dictated by those circumstances. These notes are issued for general information and guidance only, and do not purport to be exhaustive. There is no obligation on the estate representative to obtain a professional valuation in support of the share 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.