

Commissioner of Wealth Tax

Vs

Mahadeo Jalan and Mahabir Prasad Jalan and Others Etc.

Civil Appeals Nos. 1135, 1136, 1765 and 1767 of 1969

(P. Jagmohan Reddy, H. R. Khanna JJ)

13.09.1972

JUDGMENT

JAGANMOHAN REDDY, J. –

1. These appeals are by special leave against the judgment of the High Court of Assam and Nagaland. Appeal No. 1136 of 1969 is of Mahadeo Mrigendra Jalan, by Mahadeo Prasad as the karta of Hindu undivided family while appeal No. 1135 of 1969 is by him in his individual capacity. In both these appeals, the Hindu undivided family as well as the individual were holding shares in five companies in respect of which shares, dividend was being declared. The Wealth-tax Officer computed the valuation of those shares on the basis of the break-up value and included them in their total wealth. In Appeals Nos. 1765, 1766 and 1767 of 1969 the respondents are Mahabir Prasad Jalan, Mahadev Jalan and Madan Mohan Jalan respectively. All these appeals pertain to assessment years 1957-58 and 1958-59. In respect of these years the value of the shares in private limited companies were included in the total wealth of the respective assesseees on the basis of their yield though some of the companies were not paying dividends while others were declaring dividends throughout. The first two appeals which related to a later year seem to have been heard by the High Court and disposed of on December 12, 1967, while the last three appeals were disposed of later on February 4, 1969, mainly on the basis of the judgment of the High Court in the first two appeals. For the years 1957-58 and 1958-59 relating to the three persons referred to above, the Wealth-tax Officer had, as in the case of assessment for the year 1959-60 adopted the break-up value of the shares as disclosed on the balance sheets of the company in computing their value as if each of the companies was brought to liquidation. This assessment was confirmed by the Appellate Assistant Commissioner. The Tribunal however held that certainly this basis is one of the recognised modes of valuation of the shares of the private companies which are not saleable in the open market but in so far as those cases were concerned the valuation on the basis of the yield derived from the shares will be a more reasonable method to be adopted in the particular circumstances of their respective cases. Accordingly be adopted the valuation on that basis in respect of each of the companies as specified in its order. In the first two appeals also the Wealth-tax Officer and the Appellate Assistant Commissioner adopted the break-up value as the basis as in the other cases, and agreed with that basis inasmuch as the assessee had failed to place before the Wealth-tax Officer and the Appellate Assistant Commissioner facts and figures relating to dividends declared by the respective companies. It was also stated by the Tribunal that at the time of hearing by the Tribunal in the case of last three appeals, it was apparently not brought to the notice of the Tribunal that the companies being private limited companies the dividends declared would be controlled by persons controlling the companies so as to suit their own purpose, as such, the maintainable profits rather than the dividends declared would afford a reasonable basis. While so stating, it was observed that this aspect of the case need not be taken note of since the objection before it is only on the principle

whether to adopt the 'break-up value' method. In respect of the first two appeals therefore the Tribunal held that the adoption of the 'break-up' value was in order.

2. On an application under Section 66(1) the Tribunal referred the following question for the opinion of the High Court, viz.

"Whether on the facts and in the circumstances of the case the principle of 'break-up' value adopted by the Income-tax Tribunal as the basis for valuation of the shares in question is sustainable in law?"

When the reference came up for hearing before the Bench of the High Court, it was felt that as the question required an abstract answer as to whether the principle of 'break-up value' is sustainable in law and as in their opinion the Tribunal wanted to refer for the opinion of the court "the doubt they experienced in dealing with the case which related to the question as to whether the 'break-up value' method is correct method to be adopted in the facts and circumstances of the case or it is the 'yield value' method to be adopted, that question was re-framed and a further statement of the case called for from the Tribunal. The question as re-framed is as follows :

"Whether on the facts and in the circumstances of the case the Tribunal was justified in law to follow the method involving the principle of 'break-up' value instead of the method involving the principle of 'yield value' in determining the value of the shares in question under Section 7 of the Wealth-tax Act ?"

In compliance with this direction the Tribunal drew up a supplementary of the case and submitted it to the High Court. In the statement the statement Tribunal stated :

"Before the Appellate Assistant Commissioner no alternative basis of valuation appear to have been claimed. For the first time before the Tribunal, the assessee filed a statement of the dividends declared by the aforesaid private companies during the years 1953 to 1957 and claimed that the market value of the shares should be worked out with reference to the average percentage of the dividends declared by each company and on the footing that the shares quoted in the market at Rs. 100/- each would yield a dividend of Rs. 6/-."

It was further stated by the Tribunal that the assessee had relied on the decision of the Tribunal for the assessment years 1957-58 and 1958-59 where it determined the market value of the shares on the yield basis but in so far as the assessment year 1959-60 it did not accept that the information furnished before it would be adequate for working out the market value on the basis of "maintainable profits" because it was of the view that "in cases of private companies declaration of dividend would be dictated by the directors having regard to the advantage in their personal assessments and not with reference to the capacity or other business considerations. It went on to say that :

"The 'maintainable profits' would be a certain percentage (say 80%) of the net profits of the company after deduction of taxes payable by it and this would be a measure of potential yield per share."

In this view the "break-up" value adopted by the Income-tax Officer in respect of the assessment of 1959-60 in the first two appeals was confirmed.

3. The High Court however did not agree with the basis adopted by the Tribunal though it recognised that the break-up value is also one of the methods for the purposes of calculation. It was contended before the High Court on behalf of the assessee that the 'break-up' value method will only be applied to a company which reached the stage of liquidation and winding up. After considering the respective contentions and the decisions referred to before it, the High Court observed as follows :

"We are satisfied that so far as the application of Section 7 of the Wealth-tax Act in determining the value of the shares of a deceased person on the date of his death is concerned, where those shares pertain to a going concern, the only proper method to adopt was the 'yield value' method and we think that the Tribunal was not justified in making the assumption that in the case of private company the dividend would be controlled by the persons controlling the company to suit their own purposes, and that, consequently, the 'maintainable profits' should be accepted as the basis and not the dividends. Unless there was some substantial material before the Tribunal to draw a different inference, the Tribunal, in our opinion, is not justified in doing so.

We are constrained to note that although the Tribunal had adopted the 'yield value' method in its decisions in regard to the previous years, the Tribunal had taken a new path and adopted the 'break-up' value method as the basis of the assessment. We feel that there is no material placed on the record to justify this change in the method to be adopted in calculation."

When the application for reference under Section 66(2) in respect of the last three appeals came before the High Court after an application under Section 66(1) had been rejected by the Tribunal, it observed :

"This is undoubtedly a question of law but the answer will be covered by the decision of this Court, dated June 9, 1967....

and so it thought it unnecessary to ask the Tribunal to refer the same point again and accordingly rejected the petitions. The special leave in respect of the first two appeals is against the judgment of the High Court holding that the 'yield method' was the proper method and in respect of the latter three appeals against the order refusing to direct the Tribunal to state a case. As a common question of law has to be determined these appeals are consolidated and heard together.

4. The question which has to be determined in this case is, what is the basis of valuation of shares in private limited companies for the purpose of Section 7 of the Wealth Tax Act 1957 (27 of 1957). Sub-section (1) of Section 7 provides that "the value of any asset, other than cash, for the purposes of this Act, shall be estimated to be the price which in the opinion of the Wealth-tax Officer it would fetch if sold in the open market on the valuation date". The valuation date, as has already been noticed, is December 31, of the calendar year. On that date the Wealth-tax Officer will have to ascertain what the shares will fetch if sold in the open market which would be the price which a willing seller will accept and a willing buyer will pay.

5. In valuing shares of a limited company certain factors have to be taken into consideration. Firstly, a share is not a sum of money but is an interest measured by a sum money and made up of various rights contained in the articles of association. They are of different categories such as the equity

shares, preference shares, fully paid-up shares or partly paid-up shares. Apart from these there are also debentures. The shares can be in a public limited company or a private limited company and in the latter case they are subject to certain restrictions. A private company has been defined in Section 3(iii) of the Companies Act as a company which by its articles : (a) restricts the right to transfer its shares, if any; (b) limits the number of its members to 50 not including certain categories specified in (i) and (ii) of that clause and (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company subject to the proviso that shares held jointly are to be treated as if they are held by a single member. A public company under Section 3(iv) is a company which is not a private company. It may be observed that the three conditions which distinguish a private company from a public company are cumulative and if any one of the conditions is not fulfilled the company will be a public company. It may also be noted that where under the articles of the company the right to transfer shares is restricted without being first offered to other members at a price which is either fixed in advance or in a prescribed manner or where the directors have a power to veto a transfer, the fixation of the value of the share will have to be determined ignoring the restriction as to transfer because they are an inherent element in the property which has to be valued. This restriction may not necessarily be deprecatory because the chance of acquiring the shares of other members in the company on advantageous terms is itself a benefit. In cases where shares have to be valued by reference to the assets of the company restrictions on alienation are irrelevant.

6. The shares the transfer of which is not restricted may be sold on the stock exchanges for which there is official market quotation. There may also be shares in public limited companies for which there are no quotations on the stock exchange. Generally the price at which a reasonably willing purchaser would buy the shares postulates a hypothetical purchaser but even in such a case it is to be assumed that the vendor would only be willing to sell the share for its real value and the purchaser would be willing to pay the price. This has to be always determined notionally. Where shares in a company are bought and sold on the stock exchange and there are no abnormalities affecting the market price, the price at which the shares are changing hands in the ordinary course of business is usually their true value. These quotations generally reflect the value of the asset having regard to the several factors which are taken into consideration by persons who transact business on the stock exchange and by the buyers who want to invest their money in any particular share on shares. Even where they are quoted on the stock exchange, the quotations do not depend entirely on the yield or the dividend declared. There are several factors which are taken into consideration which affects and determines the quotation, namely the factors which are taken into consideration by a person who wants to sell his shares and the factors which a buyer who wants to purchase them considers as determining the price which price the buyer is willing to pay and the seller to receive. Leaving aside any distress sales, the factors which in our view are likely to determine the fixation of a share on any particular day or at any particular time is, firstly, the profit-earning capacity of the company on a reasonable commercial basis; secondly its capacity to maintain those profits or a a reasonable return for the capital invested, and in special cases such as investment companies, the asset-backing; the prospects of capitalisation of its earning in the shape of declaration of bonus shares or where the company is financially and commercially sound, the prospects of issue of further capital where the existing share-holders have a right to apply for and obtain them at a certain price which is generally less than the market value, offering an increased yield on his investment, on the assumption that the company will be able to maintain the same rate or at least increase the aggregate payment of dividends on the increased capital. It may be mentioned that a new share issue, whether an existing share-holder subscribes for them or not, invariably reduces the average unit cost of his total holding with the consequent increase in the rate of his average return on the cost.

8. Take the case of a person who wishes to buy shares in particular company. If this purpose is only to invest, he might enquire as to what are the various companies which have good prospects and are a sound investment, often referred to as "as good as guilt edged securities". This would involve the ascertainment of whether the concern in which he intends to invest is financially and commercially sound, what is the yield that it will give on the capital which he invests, whether that yield will be maintained, whether the shares will appreciate in value and are easily marketable whenever he desires to dispose of them. In certain cases a person may want to take risks by investing in shares which having regard to various trends in the commercial world and in any particular industry has prospects of improvement and the value of the shares going up with the corresponding prospect of the return or yield obtainable on the capital invested being much higher than what he would get in other sounder concerns. There may yet be investors who notwithstanding that the company is not in a solvent condition or is unable to pay dividends for a number of years are willing to purchase the controlling interest for the purpose of manipulation or bringing it to liquidation for obtaining some benefit. Ignoring such cases, where a purchaser or seller is considering the various factors for purchase or sale of shares in a company, the dominant factor determining the price he will pay or receive as the case may be is the yield.

9. Now, what are the factors which a seller will take into consideration when he wants to sell his shares ? Where he is not obliged to sell because he is not in need of money, he would first consider whether the return he is getting is reasonable having regard to the current market price. Here again the factor of yield would enter into his consideration not so much on the capital he initially invested but on that which he expects to realise on the sale. He may have a better investment in view, which will give on it a higher yield or ensure for his capital better prospects. It may be he may not expect a higher dividend to be maintained or that these dividends are likely to be reduced or there is a likelihood of the security of capital being in jeopardy, and therefore he wishes to make a prudent sale. From what we have stated, among the factors which govern the consideration of the buyer and the seller where the one desires to purchase and the other wishes to sell, the factor of break-up value of a share as on liquidation hardly enters into consideration where the shares are of a going concern. The basic yield method in cases where shares are quoted and transactions take place on the share market may not be different but where shares are not quoted it is in these latter cases the yield must be determined after taking into account various factors as to which a reference has been made earlier.

10. If profits are not reflected in the dividends which are declared and a low-earning yield for the shares is shown by the company which is unrealistic on a consideration of the financial affairs disclosed for that year, the Wealth-tax Officer can on an examination of the balance sheet ascertain the profit earning capacity of the concern and on the basis of the potential yield which the shares would earn, fix the valuation. In the Estate Duties Act both here, in England and in analogous Acts in some of the other Commonwealth countries, similar provisions as under the Wealth-tax Act provide for estimating the value of the assets to be the price which in the opinion of the concerned officer would fetch if sold in the open market on the date of the death. In dealing with the valuation of assets under such Acts Green on Death Duties (sixth edition) considers factors other than those of valuation by reference to dividends. At page 407 it is stated :

"Not infrequently, the dividends represent only a small proportion of the company's profits and large sums are systematically accumulated in the form of reserves. It is important to remember in this connection that the interests of share-holders in unquoted companies often differ from those of investors in quoted shares, especially as respects dividend policy. Where the shares are held by a few individuals

(particularly members of a single family), it will not necessarily be to their advantages to have the greatest possible amount paid out to them as dividends. Retention of the profits by the company may suit them better than the receipt of taxable dividends. A purchase of shares in a company which distributes only a small fraction of its profits is unlikely to prove attractive to an investor in search of current income, but the open market is by no means confined to such investors. It includes, for instance, the existing members of the company, to whom the shares may be more valuable than to others and who may wish to exclude outsiders, and surtax payers whose goal is capital appreciation rather than current income."

Again at page 409 it is observed :

"A valuation by reference to earnings is apposite as respects unquoted shares whenever the dividend alone does not truly represent the profitability of the company..... The 'dividend' and 'earnings' methods of valuation are not mutually exclusive and both may be used in conjunction. Where the value brought out by one differs widely from that shown by the other, an intermediate figure may be appropriate.....

Where a company is engaged in a profitable business, but the shareholders are also directors and prefer to take what they need from the company in the form of remuneration rather than dividends, the profits distributed by way of remuneration must be taken into account in the valuation. In practice, a dividend yield valuation may be adopted in those cases by assuming the distribution of a reasonable proportion of the profits (e.g. the average distribution of the comparable companies) as dividend : alternatively the value may be estimated by reference to earnings. In either case, the profits will be adjusted to include remuneration paid in excess of a normal management charge."

But where a person who holds shares in a company which is making losses and where it does not justify a declaration of dividends even from reserves as a temporary boost or where there is a possibility of its capital structure being affected or if that state of depression continues in other words the company is ripe for liquidation, the valuation may well be the break-up value of the shares. In this case, however, we need not go into all the niceties and important qualifications and limitations which may have to be applied in cases where the company's assets and liabilities have to be taken into consideration in fixing the value of the shares. The general principle of valuation in a going concern is the yield on the basis of average maintainable profits, subject to adjustment, etc., which the circumstances of any particular case may call for. In *Attorney General of Ceylon v. Mackie* ([1952] 2 All ER 775 PC) however the fluctuations in profits and the wartime uncertainties precluded any reliable estimate of maintainable profit. In these exceptional circumstances it was held that in the absence of definite evidence to the contrary the value of the business as a going concern exceeded evidence that of the tangible assets. Lord Reid referring to the argument that in accepting the balance sheet method the Supreme Court of Ceylon erred in law because that can only give a break-up value which it was necessary to find the value of the business as a going concern observed at p. 779 :

"It is true that a purchaser of the shares held by the deceased could have obtained a controlling interest in the company as a going concern, and in their Lordships' judgment it is right to value these shares by reference to the value of the company's

business as a going concern. No doubt, the value of an established business as a going concern generally exceeds and often greatly exceeds the total value of its tangible assets. But that cannot be assumed to be universally true. If it is proved in a particular case that at the relevant date the business could not have been sold for more than the value of its tangible assets, then that must be taken to be its value as a going concern. In their Lordships' judgment it has been proved in this case that the deceased's holding could not have been sold in September, 1940, at a price based on any higher figure than the value of the tangible assets of the company."

In the Irish case of *Smith v. Revenue Commissioners* ([1931] Irish Report 643) on which on behalf the Revenue reliance was placed on the deceased and his son held all the shares in the private company the transfer of which was restricted. It was also found that the deceased had the controlling shares and that both father and sons drew yearly remuneration for the work done by them, the former getting 3,000, (pounds) per annum and the latter 1,000 (pounds) per annum. The average, of dividend for the six previous years was 5.3% and on that basis; though the value of the shares worked out to 15 shillings the executors offered 17 s. 6 d. The Revenue however fixed the value of the share at 22 s. 6 d. on the basis that the deceased who had a preponderating voting power could have brought it into voluntary liquidation and therefore the value should be worked out on the basis of excess of assets over liabilities as would be adopted in such a winding up. It was found by the Commissioners that the remuneration paid to the deceased at a figure of 3,000 (pounds) per annum for such business was out of all proportion to the value of their service. Hanna, J., observed at p. 654 :

"In this I agree : but, on the other hand, considerable weight must be given to the view put forward by the petitioners that it was a family company, where greater latitude would be given in the remuneration of the directors, who were the principal owners; and that it was a unique business, in which both the directors had special knowledge, and to which they gave constant daily attention, and had a special personal relationship with the majority of the customers. A purchaser in a hypothetical market of any of these shares would recognise the value of these factors, and make due allowance for much more than the ordinary remuneration. The evidence on either side went into great detail, and after the consideration of it I think that this company can be fairly regarded as one of capable of earning on a commercial basis 10% on its capital, and so I find. But, if this is to be taken as the principle test, it must be subject to the consideration, on the one hand, of the restrictions upon the transfer of the shares, and, on the other, of the added value by reason of the splendid security of the company's position."

11. It will be seen that this case does not support the contention that because the deceased was in a position to bring the company into voluntary liquidation the break-up value principle should be applied. If at all it is against that contention because on the evidence the valuation was determined on the profit earning capacity of the company. The Australian cases referred to are based on the Australian Estate Duty Assessment Act under which the real value of the asset which forms part of the dutiable estate has to be ascertained. Even then, it was held in *Mc. Cathie v. The Federal Commissioner of Taxation* (69 CLR 1) that the real value of shares held by a deceased on his death depends more upon the profits which the company has been making and should be capable of making having regard to the nature of his business than upon the amounts which the shares would be likely to realise upon liquidation, and that moneys paid as fees to directors in excess of a reasonable amount should be treated as profits when determining the reasonable earning capacity of

a proprietary company which bears the character of a partnership trading with limited liabilities, Williams, J., at page 11 observed :

"the real value of shares which a deceased person holds in a company at the date of his death will depend more on the profits which the company has been making and should be capable of making, having regard to the nature of its business, then upon the amounts which the shares would be likely to realise upon a liquidation."

In that case it was found that the business could not be said to be conducted with any lack of probity but since the remuneration received by ladies of the family who did not render any service was not admissible, it was added to the profits in arriving at a reasonable earning capacity.

12. It is also worth noticing that Section 16-A(1)(c) of the Australian Act has vested a discretion in the Commissioners to make an assessment on "an estimate of the sum which the holder of shares should be expected to receive in the event of the company being voluntarily wound up at the date of the death of the deceased". While considering the provision above referred to, it was observed by Williams, J., in *Federal Commissioner of Taxation v. Sagar* (71 CLR 422) that :

".....where a company is a going concern the instances would appear to be rare in which it would be proper to use para (c). One instance might be where the deceased held or controlled sufficient shares to enable him to pass a special resolution that the company be wound up voluntarily, but even then it would appear to be preferable, where practicable, to use para (a) or (b)."

An examination of the various aspects of valuation of shares in a limited company would lead us to the following conclusion :

- (1) Where the shares in a public limited company are quoted on the stock exchange and there are dealings in them, the price prevailing on the valuation date is the value of the shares.
- (2) Where the shares are of a public limited company which are not quoted on a stock exchange or of a private limited company the value is determined by reference to the dividends if any reflecting the profit earning capacity on a reasonable commercial basis. But where they do not then the amount of yield on that basis will determine the value of the shares. In other words, the profits which the company has been making and should be making will ordinarily determine the value the dividend and earning method or yield method are not mutually exclusive; both should help in ascertaining the profit earning capacity as indicated above. If the results of the two methods differ, an intermediate figure may have to be computed by adjustment of unreasonable expenses and adopting a reasonable proportion of profits.
- (3) In the case of a private limited company also where the expenses are incurred out of all proportion to the Commercial venture, they will be added back to the profits of the company in computing the yield. In such companies the restriction on share transfers will also be taken into consideration as earlier indicated in arriving at a valuation.
- (4) Where the dividend yield and earning method break down by reason of the company's inability to earn profits and declare dividends, if the set back is temporary

then it is perhaps possible to take the estimate of the value of the shares before set back and discount it by a percentage corresponding to the proportionate fall in the price of quoted shares of companies which have suffered similar reverses.

(5) Where the company is ripe for winding up then the break-up value method determines what would be realised by that process.

(6) As in *Attorney General of Ceylon v. Mackie* (supra), a valuation of reference to the assets would be justified where as in that case the fluctuations of profits and uncertainty of the conditions at the date of the valuation prevented any reasonable estimation of prospective profits and dividends.

12. In setting out the above principles, we have not tried to lay down any hard and fast rule because ultimately the facts and circumstances of each case, the nature of the business, the prospects of profitability and such other considerations will have to be taken into account as will be applicable to the facts of each case. But one thing is clear, the market value unless in exceptional circumstances to which we have referred, cannot be determined on the hypotheses that because in a private limited company one holder can bring it into liquidation, it should be valued as on liquidation by the break-up method. The yield method is the generally applicable method while the break-up method is the one resorted to in exceptional circumstances or where the company is ripe for liquidation but nonetheless is one of the methods.

13. It has been urged before us that the question as framed by the High Court does not correctly indicate the scope of the answer which was called for from that court and it was suggested that we should reframe the question. We certainly have the power to do so as long as new and different question is not raised but confine it only to resettling or reframing the question formulated by the Tribunal or as in this case by the High Court which called for a statement of the case on a question as reframed by it, before answering it so as to bring out the real issue between the parties : *Narain Swadeshi Weaving Mills v. Commissioner of E.P.T.* (26 ITR 765 at 774 : (1955) 1 SCR 952 : AIR 1955 SC 176) and *Kusum Ben De Mahadevia v. Commissioner of Income-tax.* (39 ITR 540 at 544 : (1960) 3 SCR 417 : AIR 1960 SC 907). The question as framed by the High Court is on the assumption that the yield method is the only method applicable and on that basis required the Tribunal to state a case on whether it was justified in law to follow the method involving the principle of break-up value. If the question is reframed bringing out the real issue between the parties which both Tribunal and the High Court attempted to do it would facilitate a proper answer. We accordingly reframe the question as follows :

"Whether on the facts and circumstances of this case the principle of break-up value adopted by the Tribunal as the basis of valuation of shares in question under Section 7 of the Wealth-tax Act is sustainable in law ? If not what would be the correct basis ?"

14. In the first two appeals Nos. 1135 and 1136 of 1969 the break-up value method was adopted by the Tribunal and its plea for not adopting the yield method was that a list of dividends were for the first time filed before it in respect of each of the companies. The Wealth-tax Officer and the Appellate Assistant Commissioner, as well as the Tribunal, had the balance sheets of each of the companies before them because the shares were valued on the break-up method in those cases on the basis of those balance sheets. If the balance sheets were filed they would also disclose the dividends as indeed the statement of the case shows that all the companies had declared dividends for the year

1959-60. Even otherwise, the Tribunal as a fact-finding authority, could have considered the list or sent then to the Wealth-tax Officer for any further enquiry it required. In the last three appeals, the Tribunal had adopted the yield method. In the result our answer to the first part of the question is in the negative and to the second part our answer is in terms of the principles already set out. Appeals Nos. 1765 to 1767 of 1969, the method adopted by the Tribunal being the proper method the refusal of the High Court to direct a case to be stated does not costs. One hearing fee.

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