

Commissioner of Gift Tax, Bombay

Vs

Smt. Kusumben D. Mahadevia

Civil Appeals Nos. 129, 512

(P.N. Bhagwati, R.S. Pathak JJ)

05.12.1979

JUDGMENT

BHAGWATI, J. -

1. These appeals by special leave raise a short question as to whether a reference should have been called for by the High Court in each of these cases. Some of these cases are under the Gift Tax Act while others under the Wealth Tax Act. They all relate to the valuation of the ordinary shares of a private limited company called Mafatlal Gagalbhai Pvt. Ltd. which is admittedly an investment company. The assesseees in these cases claimed in the course of assessments to gift tax or wealth tax, as the case may be, that the value of the shares should be taken to be the figure arrived at by M/s. C. C. Choksy & Co., Chartered Accountants, by applying the profit-earning method of valuation of shares without making any adjustment in the profits of the company. It is not necessary for the purpose of these appeals to set out the different figures of valuation given in the report of M/s. C. C. Choksy & Co. and claimed by the assesseees as representing the correct value of the shares on the material dates, because the question with which we are concerned is one of principle and the actual figures of valuation are not relevant. The Gift Tax and the Wealth Tax Officers did not accept the figures of valuation given by the assesseees on the basis of the profit-earning method and valued the shares at much higher figures by applying the break-up method. This naturally involved the assesseees in higher tax liability and hence they preferred appeals to the Appellate Assistant Commissioner. The Appellate Assistant Commissioner applied what has been described in the record as 'rule of three' and reduced the valuation of the shares but the figures determined by the Appellate Assistant Commissioner were still higher than those claimed by the assesseees. Since the valuation of the shares made by the Gift Tax and the Wealth Tax Officers was reduced by the Appellate Assistant Commissioner, the Revenue was dissatisfied and it, therefore, preferred appeals against the orders of the Appellate Assistant Commissioner to the Tribunal. The assesseees were also unhappy with the valuation made by the Appellate Assistant Commissioner since he did not accept the valuation put forward on their behalf and hence they too preferred cross-objections in the appeals filed by the Revenue. The appeals and the cross-objections in the cases forming the subject-matter of Civil Appeal No. 129 of 1976 were heard together by the Tribunal. The only controversy before the Tribunal was as to which method should be followed for valuing the shares of the company. The Revenue contended that in the case of an investment company like Mafatlal Gagalbhai Pvt. Ltd., the proper method of valuation would be to take the mean of two values, one arrived at by applying the profit-earning method and the other by applying the break-up method, while the assesseees pleaded for adopting only the profit-earning method, since in their submission that was the only method which could be applied for valuation of shares of a going concern. The Tribunal by a common judgment accepted the contention of the assesseees and adopted the valuation of the shares made by M/s. C. C. Choksy and Co. by applying the profit-earning method and in the

result rejected the appeals of the Revenue and allowed the cross-objections of the assesseees. We shall discuss in some detail the reasons which weighed with the Tribunal in coming to this decision when we deal with the arguments of the parties, but suffice it to state for the present that in taking this view, the Tribunal followed the recent decision of this Court in *C. W. T. v. Mahadeo Jalan* ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103). Similar orders were passed by the Tribunal in the appeals and cross-objection relating to the other assesseees. The Revenue was obviously aggrieved by the orders of the Tribunal and, therefore, it made applications to the Tribunal for referring to the High Court the following question of law, namely,

Whether the Tribunal is right in holding that the shares of an investment company have to be valued only on the basis of the yield without taking into account the assets owned and reflected in the balance sheet.

said to arise out of the orders of the Tribunal. The applications for reference were rejected by the Tribunal on the ground that no referable question of law arose out of the orders of the Tribunal. The Revenue thereupon made applications to the High Court for calling for a reference but those applications also met with the same fate. Hence the Revenue preferred petitions for special leave to appeal in the case of all the assesseees and special leave having been granted in some of the petitions, the present appeals have come up for hearing before us.

2. The sole question that arises for determination in these appeals is whether any question of law arises out of the orders of the Tribunal which needs to be referred to the High Court. It is true that there must be a question of law arising out of the order of the Tribunal before a reference can be made, but it is not every question of law that is required to be referred by the Tribunal to the High Court. Where the answer to the question of law is self-evident or is concluded by a decision of this Court, it would be futile to make a reference and in such a case the Tribunal would be justified in refusing to refer the question to the High Court vide *C. I. T. v. Chander Bhan* ((1966) 60 ITR 188 : (1966) 3 SCR 176 : AIR 1966 SC 1490); *Mathura Prasad v. C. I. T.* ((1966) 60 ITR 428 (SC)) and *C. I. T. v. Indian Mica Supply Co. Ltd.* ((1970) 77 ITR 20 (SC)). Now there can be no doubt that in the present case the question as to which method should be adopted for valuation of the shares of *Mafatlal Gagalbhai Private Ltd.*, a private limited company which was an investment company and at all material times a going concern - whether it should be the profit-earning method or a combination of the break-up method and the profit-earning method - is clearly a question of law. But the argument of the assesseees was that the determination of this question was completely covered by a recent decision of this Court in *C. W. T. v. Mahadeo Jalan* ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) in favour of the assesseees and no useful purpose would be served by calling for a reference. The Revenue conceded that the decision in *Mahadeo Jalan* case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) did lay down certain principles for valuation of shares in a limited company, but its contention was that these principles were no more than broad guide-lines and they did not eliminate the necessity of finding out the appropriate method of valuation in each case which came before the taxing authority and hence it was necessary to make a reference so that the proper method for valuation of the shares of *Mafatlal Gagalbhai Pvt. Co. Ltd.* could be determined by the High Court. The controversy between the parties thus centred round the question as to what was decided by this Court in *Mahadeo Jalan* case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) and whether it laid down what method should be applied for valuation of shares of a private limited company which is an investment company carrying on business as a going concern. If the method to be applied in such a case could be found to have been judicially laid down by this Court in *Mahadeo Jalan* case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103), all that would be necessary to be done for arriving at the valuation of the

shares in Mafatlal Gagalbhai Company Private Limited would be to apply that method and it would be wholly unnecessary to call for a reference. Let us, therefore, examine the decision in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) and see whether any principle of valuation of shares is laid down in it which would be applicable in case of a company like Mafatlal Gagalbhai Private Limited.

3. The decision in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) was rendered under the Wealth Tax Act and the question was as to what was the appropriate method for valuation of shares of a private limited company for the purpose of wealth tax. The Tribunal adopted the break-up method and arrived at the valuation of the shares on that basis, but on a reference, the High Court took the view that in case of a company which is a going concern the only proper method of valuation of shares is the yield value method and not the break-up method. The Revenue carried the matter in appeal to this Court and in a judgment delivered by Jagannathan Reddy, J. this Court examined the question of valuation of shares in depth and after referring to various decisions of the English, Irish and Australian Courts, laid down the following principles for valuation of shares in a limited company : (SCC p. 166, para 11)

- (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 of 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 ((1952) 2 All ER 775 (PC)) a valuation by 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.

Since the company involved in this case was a private limited company which was a going concern, the Court following the above principles, negated the applicability of the break-up method for valuation of the shares and upheld the view taken by the High Court that the yield method was the proper method for arriving at the valuation of the shares.

4. It is clear from this decision that 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 would represent the value of the shares. But where the shares in a public limited company are not quoted on the stock exchange or the shares are in a private limited company the proper method of valuation to be adopted would be the profit-earning method. This method may be applied by taking the dividends as reflecting the profit-earning capacity of the company on reasonable commercial basis but if it is found that the dividends do not correctly reflect the profit-earning capacity because only a small proportion of the profits is distributed by way of dividends and a large amount of profits is systematically accumulated in the form of reserves, the dividend method of valuation may be rejected and the valuation may be made by reference to the profits. The profit-earning method takes into account the profits which the company has been making and should be capable of making and the valuation, according to this method is based on the average maintainable profits. Of course, for the purpose of such valuation, the taxing authority is not bound by the figure of profits shown in the profit and loss account because it is possible that the amount of profits may have suffered diminution on account of unreasonable expenditure or the directors having chosen to take away a part of the profits in the form of remuneration rather than dividends. The figure of profits, in such a case would have to be adjusted in order to arrive at the real profit-earning capacity of the company. It would, thus, be seen that in the case of a company which is a going concern and whose shares are not quoted on the stock exchange, the profits which the company has been making and should be capable of making or in other words, the profit-earning capacity of the company would ordinarily determine the value of the shares. That is why in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) the Court quoted with approval the following observations of Williams, J. in McCathie v. Federal Commissioner of Taxation (69 CLR 1 quoted in ((1973) 1 SCC 157 at 165) : "... the real value of shares which a deceased person holds in a company on 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, than upon the amounts which the shares would be likely to realise upon a liquidation", and stated in no uncertain terms that : "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". The break-up method would not be appropriate for valuation of shares of a company which is a going concern, because as pointed out by the Court in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103), "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 or break-up value of a share as on liquidation hardly enters into consideration where the shares are of a going concern". It is only where a company is ripe for winding up or the situation is such that the fluctuations of profits and uncertainty of conditions at the date of valuation prevent any reasonable estimation of the profit-earning capacity of the company, that the valuation by the break-up method would be justified. The Revenue leaned heavily on the observation in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) that the factors likely to determine the valuation of a share include "in special cases such as investment companies, the asset-backing" and urged on the strength of this observation that in the case of an investment company, the asset-

backing was a relevant consideration and the break-up method could not, therefore, be considered as totally irrelevant. This contention, we are afraid, is based on a wrong reading of the observation of the Court. When the Court said that in case of an investment company, the asset-backing is a relevant factor in determination of the value of the shares, what the Court meant was that in order to determine the capacity of the company to maintain its profits the asset-backing would be a relevant consideration. The profit-earning capacity of the company which would determine the valuation of the shares would naturally have to take into account not only the profits which the company is actually making but also the profits which the company should be capable of making and in order to arrive at a proper estimation of the latter, the asset-backing would be a relevant factor in case of an investment company. It would not be right to read the observation of the Court as suggesting that valuation of the assets would be a relevant factor in determining the valuation of the shares. The Revenue, of course, did not plead for exclusive adoption of the break-up method and wanted the mean of the values arrived at by applying the break-up method and the profit-earning method to be taken as representing the valuation of the shares, but we do not see on what principle can a combination of the two, methods be justified. There is no authority either in any judicial decision or in any standard textbook on valuation of shares which recognises the validity of a combination of the two methods, though it may sound acceptable as a compromise formula. In fact, Adamson has criticised this combination of the two methods as unscientific in his book on "The Valuation of Company Shares and Businesses", (fourth edition) at page 55, where he has said :

The mere averaging of two results obtained by quite different bases of approach can hardly be said to represent any logical approach, whatever its merit as a compromise. Despite its evident popularity in many quarters, it has not been given judicial recognition in decisions involving the fixation of a value by the Court.

The combinations of the two methods advocated on behalf of the Revenue has, thus, no sanction of any judicial or other authority and cannot be accepted as a valid principle of valuation of shares.

5. The Revenue then pointed out that the principles of valuation set out by the Court in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) were, merely broad guide-lines and they did not obviate the necessity of considering each case on its own facts and circumstances and in support of this contention the Revenue relied on the observation made by the Court that in setting out these principles, the Court had 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". Now it is true, as observed by the Court, that there cannot be any hard and fast rule in the matter of valuation of shares in a limited company and ultimately the valuation must depend upon the facts and circumstances of each case, but that does not mean that there are no well settled principles of valuation applicable in specific fact-situations and whenever a question of valuation of shares arises, the taxing authority is in an uncharted sea and it has to innovate new methods of valuation according to the facts and circumstances of each case. The principles of valuation as formulated by the Court are clear and well-defined and it is only in deciding which particular principle must be applied in a given situation that the facts and circumstances of the case become material. It is significant to note that immediately after making the above observation the Court hastened to make it clear, as if in answer to a possible argument which might be advanced on behalf of the Revenue on the basis of that observation that 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.

6. Here in the present case Mafatlal Gagalbhai & Co. Pvt. Ltd. was a private limited company which was a going concern and it was neither ripe for liquidation nor were there any exceptional circumstances which should attract the applicability of the break-up method. The profit-earning method was, therefore, the only method which could properly be applied for arriving at the valuation of the shares in the company and the Tribunal was right in accepting the figures of valuation in the report of M/s. C. C. Choksy & Co., based on the application of the profit-earning method. The answer to the question of law relating to the method to be adopted for valuation of shares in the company was clearly concluded by the decision in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) and the High Court was, therefore, justified in refusing to call for a reference on this question.

7. It is true that in the present appeals, the question of valuation arises not only under the Wealth Tax Act but also under the Gift Tax Act, but since the provision for determining the value of an asset is the same in Section 6 sub-section (1) of the Gift Tax Act as it is in Section 7 sub-section (1) of the Wealth Tax Act, the principles of valuation laid down in Mahadeo Jalan case ((1972) 86 ITR 621 : (1973) 3 SCC 157 : 1973 SCC (Tax) 103) must apply equally in relation to valuation of shares to be made for the purpose of the Gift Tax Act. It was, however, contended on behalf of the Revenue that there is a vital difference between Section 6 sub-section (1) of the Gift Tax Act and Section 7 sub-section (1) of the Wealth Tax Act inasmuch as Section 6 Sub-section (1) of the Gift Tax Act is subject inter alia to the provision of sub-section (3) of that section and this latter sub-section provides that where the value of any property cannot be estimated under sub-section (1) because it is not saleable in the open market, the value shall be determined in the prescribed manner and Rule 10 sub-rule (2) of the Gift Tax Rules prescribed the manner of valuation of shares in a private limited company where the Articles of Association contain restrictive provision as to the alienation of shares, by providing that in such a case, the value of the shares "if not ascertainable by reference to the value of the total assets of the company, shall be estimated to be what they would fetch if on the date of gift they could be sold in the open market on the terms of the purchaser being entitled to be registered as holder subject to the articles, but the fact that a special buyer would for his own special reasons give a higher price than the price in the open market shall be disregarded". The argument of the Revenue was that Mafatlal Gagalbhai Pvt. Ltd. was a private limited company and its Articles of Association admittedly contained restrictive provision as to the alienation of shares and, therefore, Rule 10 sub-rule (2) was applicable and according to that sub-rule, the value, of the shares was required to be ascertained by reference to the value of the total assets of the company and it was only if the value was not so ascertainable that it could be determined in any other manner. The break-up method was thus, according to this sub-rule, the primary method to be applied for arriving at the valuation of the shares and in the circumstances the Tribunal was wrong in determining the value of the shares by applying the profit-earning method, at least so far as the valuation under the Gift Tax Act was concerned.

8. Now it is difficult to see how the question whether the valuation of the shares should have been made on the basis of the break-up method by reason of Rule 10 sub-rule (2) of the Gift Tax Rules can be required to be referred by the Tribunal to the High Court. It is well settled that no question can be referred to the High Court unless it arises out of the order of the Tribunal and, as pointed out by this Court in *C. I. T. v. Scindia Steam Navigation Co. Ltd.* ((1961) 42 ITR 589 : (1962) 1 SCR 788 : AIR 1961 SC 1633), a question of law can be said to arise out of the order of the Tribunal only if it is dealt with by the Tribunal or is raised before though not decided by the Tribunal and a question of law not raised before the Tribunal and not dealt with by it in its order cannot be said to arise out of its order, even if on the facts of the case stated in the order the question fairly arises. It is obvious that this question sought to be raised on behalf of the Revenue was neither raised

before the Tribunal nor decided by it and the only argument advanced before the Tribunal was that the mean of the values arrived at on an application of the profit-earning method and the break-up method should be taken to be the value of the shares. There was no argument addressed in the Tribunal that the break-up method should be adopted because that was the primary method prescribed by Rule 10 sub-rule (2) and the Tribunal had, therefore, no occasion to deal with such argument. This question obviously, therefore, does not arise out of the orders of the Tribunal and it cannot be required to be referred to the High Court.

9. There were the only contentions urged on behalf of the Revenue and since there is no substance in them, the appeals fail and are dismissed with costs.

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