

ANDHRA PRADESH HIGH COURT

D. Renuka

Vs

Commissioner of Wealth-Tax

(B J Reddy, CJ. Y.B Rao, J.)

29.07.1988

JUDGMENT

B.P. Jeevan Reddy, J.

1. Two questions are stated by the Income-tax Appellate Tribunal under Section 27(1) of the Wealth-tax Act, 1957. They are :

"(1) On the facts and in the circumstances of the case, whether the Appellate Tribunal is justified in holding that the liability due to the Life Insurance Corporation is not allowable as deduction as the debt is incurred on the exempted asset ?

(2) On the facts and in the circumstances of the case, whether the Tribunal is justified in holding that the unquoted shares of Biological Evans Ltd. should be valued as per Rule 1D of the Wealth-tax Rules, 1957 ?"

2. So far as the first question is concerned, it is agreed by counsel for both the parties that it has to be answered in the affirmative, i.e., in favour of the Revenue and against the assessee, following the decision of this court in Mohd. Ashroff Khan v. CWT . The question is accordingly answered. Thus, only the second question survives for consideration.

3. The assessment years concerned in this case are 1981-82, 1982-83 and 1983-84. On the relevant valuation dates, the assessee was holding certain shares of Biological Evans Ltd. The said company is a closely held public limited company whose shares are not quoted on the Stock Exchange. The assessee valued the said shares on the basis of 'yield method', which was rejected by the Wealth-tax Officer, who valued the same on the 'break-up method'. On appeal, the Appellate Assistant Commissioner set aside the assessment so far as this aspect is concerned and directed the Wealth-tax Officer to redo the assessment after considering the assessee's objections. The Revenue appealed to the Income-tax Appellate Tribunal which upheld it holding that Rule 1D of the Wealth-tax Rules is mandatory and that, therefore, the valuation of the shares should be done according to the break-up method contained in the said rule. The Tribunal refused to follow

the decision of the Bombay High Court in *Kusumben D. Mahadevia v. N.C. Upadhyia* holding that Rule 1D is directory. It preferred to follow the decision of the Allahabad High Court in *CWT v. Padampat Singhania*, where the said rule was held to be mandatory. Thereupon, the assessee applied for and obtained this reference.

4. Section 7 of the Wealth-tax Act prescribes the mode of valuation of assets. Sub-section (1) says :

"Subject to any rules made in this behalf, 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."

Section 46 confers the rule-making power upon the Board. Sub-section (1) generally says that the Board may make rules for carrying out the purposes of the said Act, while Sub-section (2) specifies the heads with respect to which rules can be made. Clause (a) of Sub-section (2) says that the rules made under Section 46 may provide for "the manner in which the market value of any asset may be determined".

5. In pursuance of the aforesaid rule-making power, the Central Board of Revenue made the Wealth-tax Rules, 1957. Rule 1D is one of the rules which was introduced by the Wealth-tax (Amendment) Rules, 1967, with effect from October 6, 1967. Rule 1D specifies the manner in which the market value of unquoted equity shares of companies other than investment companies and managing agency companies, is to be determined. In so far as it is relevant, the rule reads as follows :

"1D. The market value of an unquoted equity share of any company, other than an investment company or a managing agency company, shall be determined as follows : --
The value of all the liabilities as shown in the balance-sheet of such company shall be deducted from the value of all its assets shown in that balance-sheet. The net amount so arrived at shall be divided by the total amount of its paid-up equity share capital as shown in the balance-sheet: The resultant amount multiplied by the paid-up value of each equity share shall be the break-up value of each unquoted equity share. The market value of each such share shall be 85 per cent. of the break-up value so determined: Provided that where, in respect of any equity share, no dividend has been paid by such company continuously for not less than three accounting years ending on the valuation date, or in a case where the accounting year of that company does not end on the valuation date, for not less than three continuous accounting years ending on a date immediately before the valuation date the market value of such share shall be as indicated in the Table below"

6. It would be evident from a reading of the rule that it incorporates what is broadly known as the "break-up method". It says that, for determining the value of equity shares of a company, whose shares are not quoted on the Stock Exchange, the method to be adopted is : the value of total liabilities as shown in the balance-sheet of the company shall be deducted from the total value of

its assets as shown in the balance-sheet. The net amount so arrived at shall then be divided by the total amount of its paid-up equity share capital as shown in the balance-sheet. The amount so obtained shall be multiplied by the paid-up value of each equity share and the figure so obtained shall be the break-up value of each unquoted equity share. 85% of the break-up value so determined of each share shall represent the market value. The proviso deals with situations where dividend has not been declared by such company continuously for not less than three accounting years ending on the valuation date, or in the case of a company whose accounting year does not end on the valuation date, for not less than three continuous accounting years ending on a date immediately before the valuation date. Explanation I specifies that the balance-sheet means the one drawn up on or immediately preceding the valuation date ; in the absence of both, it means the one immediately succeeding it. Explanation II says that certain items shall not be treated as assets or liabilities, as the case may be, for the purpose of the rule.

7. Unencumbered by any authority, one would think that once there is a rule prescribing the manner in which unquoted equity shares of a company are to be valued, it is that rule that has to be applied and followed. The question whether the rule is directory or mandatory, would be out of place in such a situation. If there had been no rule, indubitably the valuation has to be done adopting such method as would, in the opinion of the Wealth-tax Officer, lead to the ascertainment of the value which the asset would fetch if sold in the open market on the valuation date. But, it must be remembered that Section 7(1) itself opens with the words "Subject to any rules made in this behalf", and Section 46 (2) (a) expressly empowers the Board to make rules prescribing the manner in which the market value of any asset is to be determined. Once a rule is made prescribing the manner in which a particular asset is to be valued, that rule has to be followed, unless the rule is invalid for one reason or the other. Now, in this reference, neither is the validity of the rule questioned, nor can such a question be gone into herein. One should, therefore, think that there could have been no controversy about the applicability of the rule, nor would the question whether the rule is directory or mandatory have arisen. The purpose behind saying that the rule is not mandatory but only directory is to say that the said rule need not be followed except in certain limited number of cases, and that the unquoted equity shares of a company should be valued in a manner, and on a basis different from the one stated in the rule. In other words, the idea is to value these shares on the "yield basis". The attempt undoubtedly is to practically nullify the rule and follow a different basis and method for valuing such shares. In a number of decisions, the Allahabad High Court has held that Rule 1D has to be followed in the matter of valuation of unquoted equity shares of a company, and that no other method is permissible (vide *CWT v. Laxmipat Singhania* ; *CWT v. Sripat Singhania* ; *Bharat Hari Singhania v. CWT* and *CWT v. Padampat Singhania*). The same view has been taken by the Kerala High Court in *CWT v. Mamman Varghese* [1983] 139 ITR 351. As against this, the Bombay, Delhi and Madras High Courts have taken the view that since Rule 1D does not achieve the purpose indicated in Section 7(1), i.e., ascertainment of the value which the asset would fetch if sold in the open market on the valuation date, it should be treated as directory. It is observed by the Delhi and Bombay High Courts that the break-up method incorporated in Rule 1D does not

lead to, nor is relevant for ascertaining the true market value as contemplated by Section 7(1), and that the break-up method indicated in the said rule is relevant only in the case of valuing the shares of a company which is about to be wound up. For this reason, it is held that the method contained in the said rule need not be followed in the case of "going concerns". While the Allahabad and Kerala High Courts' view is commended for our acceptance by the Revenue, the assessee asks us to prefer the view taken by the Bombay, Delhi and Madras High Courts.

8. In *CWT v. Mahadeo Jalan*, the Supreme Court enunciated the several principles applicable in the matter of valuation of shares. The Supreme Court was dealing with a situation obtaining prior to the framing of Rule 1D. Certain principles were, therefore, enunciated without reference to Rule 1D. So far as the determination of the value of the shares of a public company--which are not quoted on a Stock Exchange--is concerned, the court held that their value is determined by reference to the dividends, if any, reflecting the profit-earning capacity on a reasonable commercial basis. If, however, the profits are not reflected in the dividends declared and a low earning yield is shown by the company, which is unrealistic on a consideration of the financial affairs disclosed for the relevant year, it was held, that 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, determine the valuation. It was observed that the profits which the company has been making and should be making, will ordinarily determine the value (vide principle No. 2). The fifth principle enunciated in the said decision is that, where the company is ripe for winding up, then the break-up value determines what would be realised by that process. For our purposes, it is unnecessary to notice the other four rules. The court, however, cautioned that the rules evolved by it are not hard and fast rules, and that the "yield method" is a generally applicable method, while the "break-up method" is the one to be resorted to in exceptional circumstances, or where the company is ripe for liquidation. At the same time, it was recognised that the "break-up method" is also one of the methods for determining the value of such shares. The above principles constitute the basis of the decisions of the Bombay and Delhi High Courts. Their reasoning is this : Section 7(1) of the Act requires the Wealth-tax Officers to ascertain the value which the shares would fetch if sold in the open market on the date of valuation. The rules to be made in that behalf should be such as to lead to that result. But Rule 1D, incorporating as it does the break-up method, is not the proper method to be adopted in the case of a going concern, as pointed out by the Supreme Court in *Mahadeo Jalan's* case, The breakup method incorporated in the rule is appropriate only in the case of companies which are ripe for winding up. Rule 1D, therefore, does not carry out the purpose of Section 7(1). Indeed, there is a certain inconsistency between the rule and Section 7(1). Instead of declaring the rule to be invalid, the proper course would be to read it down, notwithstanding the use of the word "shall" in the rule. The word "shall" occurring in the rule should be read as "may", thereby making the rule directory. Moreover, Section 46(2)(a), which empowers the rule-making authority to provide the manner in which the market value of any asset may be determined, uses the expression "may". It says, the rules made under Section 46 may provide for "the manner in which the market value of any asset may be determined". Therefore, a rule under Section 46(2)(a) can only be made in such manner

as to give discretion to the Wealth-tax Officer to apply the rule, if necessary, and compute the value according to the manner prescribed in that rule. For this reason also, the application of Rule 1D must be deemed to be discretionary with the Wealth-tax Officer and ought not to be applied in the case of a going concern. It was also observed that it is not possible to attribute any intention to the Central Board (rule-making authority) in promulgating Rule 1D, to rule out all other and more appropriate methods of valuation and apply the "break-up method" which is applicable only in a limited number of cases, as pointed out hereinbefore. What is significant to be noticed is that the decision of the Bombay High Court was rendered not only on a reference made under Section 27 of the Wealth-tax Act, but also on a writ petition questioning the validity of the rule. Similarly, the decision of the Delhi High Court was also rendered in a writ petition, wherein the validity of the rule could be gone into. Of course, both the courts did not choose to strike down the rule, but preferred to read it down. But, as pointed out by us hereinbefore, the course adopted by the said courts practically amounts to nullification of the rule. According to the ratio of the said decisions, the rule is to be applied only for determining the value of shares of a company which is ripe for winding up ; in all other cases, the rule is not to be followed and the "yield method", pointed out by the Supreme Court in Mahadeo Jalan's case , has to be applied.

9. This is a case where it is possible for the court to take either view. While the view commended by the Department is based upon a literal interpretation of the rule, the view contended for by the assessee cannot be said to be unreasonable. Indeed, it is this situation which -has led to a sharp division of opinion between the High Courts in India--the Allahabad and Kerala High Courts adopting the literal interpretation and the Bombay and Delhi High Courts taking the other view. Both the views have certain merits and are open to certain criticism, which aspect is quite evident from the preceding discussion. However, on a consideration of the rival points of view, we are inclined to adopt the view commended by the assessee--and which view is supported by the Bombay and Delhi High Courts, besides the Madras High Court. The main reason why we have chosen not to adopt the view taken by the Allahabad and Kerala High Courts is that it brings about a situation unrelatable to realities and it would be unjust to assessees in general to adopt that view, more particularly in the case of wealth-tax.

10. Accordingly, we answer the second question referred to us in the negative, i.e., in favour of the assessee and against the Revenue. We hold that Rule 1D is only directory and it lies within the discretion of the Wealth-tax Officer to apply the said rule in a given case or not. If the shares to be valued are those of a going concern, Rule 1D shall not ordinarily be applied and the shares shall be valued on the basis of the "yield method" indicated as principle No. 2 in Mahadeo Jalan's case . Rule 1D may be applied in cases where it is found that the "yield method" does not lead to determination of the market value, as contemplated by Section 7(1). In the valuation of shares of companies which are ripe for winding up, Rule 1D shall, of course, be applied.

11. Answered accordingly