

(1991) 06 KAR CK 0017

In the Karnataka High Court

Case No : T.R.C. No's. 50 and 51 of 1986 and T.R.C. No's. 91 to 95 of 1987

Commissioner of Wealth Tax

APPELLANT

Vs

S. Jindal

RESPONDENT

Date of Decision : 03-06-1991

Acts Referred:

Wealth Tax Act, 1957 — Section 2, 3, 7
Wealth Tax Rules, 1957 — Rule 1D

Citation : (1991) 100 CTR 217 : (1992) 194 ITR 539 : (1992) 63 TAXMAN 371

Hon'ble Judges : R. Ramakrishna, J;K. Shivashankar Bhat, J

Bench : Division Bench

Advocate : G. Chanderkumar, for the Appellant; G. Sarangan, for the Respondent

Judgement

K. Shivashankar Bhat, J.—The Revenue sought and obtained reference of the following question, under the provisions of the Wealth-tax Act, 1957 ("the Act" for short) :

"(1) Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in holding that, in valuing shares under rule 1D of the Wealth-tax Rules, the entire provisions for taxation appearing on the liabilities side of the balance-sheets should be deducted from the value of the assets ?

(2) Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in approving the assessee's method of valuation in respect of unquoted shares in preference to the valuation adopted by the Wealth-tax Officer as per the provisions of rule 1D of the Wealth-tax Rules, 1957 ?

(3) Whether, on the facts and in the circumstances of the case, the Tribunal is justified in law in adopting the market value of the unquoted equity shares after 1967 ignoring the provisions of rule 1D ?

(4) Whether, on the facts, and in the circumstances of the case, the Tribunal is right in law adopting the market value of the unquoted shares of Jindal

Aluminium Ltd. at Rs. 100 per shares as against the value determined by the Wealth-tax Officer ?"

2. The first question is covered by the decision of this court in CWT v. N. Krishnan [1968] 162 ITR 309. Following the said decision, the question is answered in the negative and against the assessee.

3. The next three questions are essentially the same and the answer lies in the answer to the second question. The basic question involved is whether rule 1D is mandatory and is exhaustive of the method of valuation.

4. The assessment year in question is 1981-82. The assessee is a shareholder of the company called M/s. Jindal Aluminium Ltd., a private limited company. He declared the value of its share at Rs. 100 per share. The Wealth-tax Officer did not accept the contention of the assessee that the break-up; the assessee contended that, in the case of a going concern, the yield method is the proper mode of valuing the shares. The Wealth-tax Officer held that rule 1D was mandatory and the valuation has to be done by the break-up method as provided therein. Thus, the value per share was arrived at Rs. 121 as against the value of Rs. 100 shown by the assessee. The conclusion of the Wealth-tax Officer as to the value was not accepted by the Appellate Assistant Commissioner who opined that the value of each share will be Rs. 101.61 and it seems that he applied the break-up value method. The appeal filed by the Revenue was dismissed by the Appellate Tribunal. The Appellate Tribunal noticed the difference in the views expressed by various High Courts as to the binding nature of rule 1D and held that rule 1D was a directory provision and need not be applied always. The scheme of the Act is :

The tax is charged in respect of the net wealth of the assessee, as per section 3. As per section 2(m), net wealth is the aggregate value of all the assets, computed in accordance with the provisions of the Act, Section 7 provides for valuing the assets according to which the value of an asset should be estimated to be the price which the assets would fetch if sold in the open market.

5. Therefore, valuation of an asset, including that of a share is to be on the basis of its market price on the valuation date for which purpose a market if, necessary, is imagined to exist. Section 7, before the framing of rule 1D, came up before the Supreme Court for interpretation, with reference to the valuation of shares in Commissioner of Wealth Tax Vs. Mahadeo Jalan and Mahabir Prasad Jalan and Others etc., . After considering the difference between a public limited company and a private limited company and the non-availability of a free market for the shares of private companies, the Supreme Court proceeded to examine the approach of a buyer of shares and held (at p. 629) :

"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 investments in view which will give on its a higher yield or ensure for his capital better prospects. It may be that he may not excepts a higher dividend to be maintain or that these dividends are likely to be reduced or there is a likelihood of the security of capital being in jeopardy, 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 or break-up value of a shares as on liquidation hardly enters into consideration where the shares are of a going concern. The basic yield method in cases where the shares are quoted and transaction 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 to which a reference has been made earlier."

6. The court noted the possibility of dividends not reflecting the real profits of the company in certain cases. In the case of non-profit making company which is really in financial difficulty, break-up method was found to be a correct mode of valuing the shares, and, in the case of a going concern, valuation was to be done on the basis of the yield. The Supreme Court said AIR 1973 SC 1027 (at p. 630 of 86 ITR) :

"But where a person holds shares in a company which is making losses and where it does not justify a declaration of dividends even from reserves as temporary boost or where there is a possibility of its capital structures 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 qualification 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."

7. At page 1029, six points were given as a summary points 3, 4, and 5 are relevant here, and they read (at p. 633 of 86 ITR) :

"(3) In the case of a private 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 and declare dividends, if the setback is temporary then it is perhaps possible to take the estimate of the value of the shares before setback 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 purpose."

8. The further observations of the Supreme Court highlight the need to provide for unforeseen circumstances and the difficulty in evolving any fixed formula to arrive at the value of shares. The Supreme Court observed (at p. 634 of 86 ITR) :

"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 referred, can not be determined on the hypothesis that because in a private limited company by the break-up method. The yield 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 none the less is one of the methods."

9. This law was declared by the Supreme Court with reference to the assessment years 1957-58 and 1958-59. On October 6, 1967, rule 1D was inserted in the relevant Scheme to the Act providing for valuation of unquoted equity shares of companies referred to therein.

10. Section 7 provides for estimating the value and the scope of this has to be understood in the light of the observations of the Supreme Court while valuing the shares; the tests indicated by the Supreme Court are to be understood as inherent in section 7 itself. Therefore, rule 1D which is against is part of the Act has to be read in harmony with section 7. Though it is stated that the value shall be determined in the manner laid down in the Schedule, the said "manner" should be a relevant mode of valuation; the manner cannot be irrelevant to the subject-matter of valuations; the rule should reflect an appropriate mode of valuation as, otherwise, the rule is liable to be an asset to a single mode, which, in a fact situation, will be inappropriate to value it.

11. The Supreme Court has pointed out that the yield method is the most appropriate method of valuing the shares of a going concern (in the case of unquoted equity shares) and the break-up method is applicable to a case of a company ripe for winding up. The Supreme Court has further pointed out that situations may arise where any particular method may not yield a proper result and, therefore, no hard and fast rule can be laid down. This emphasises the need to have flexibility in the provisions to value the shares, as, otherwise, application of any rigid formula may lead to arbitrariness and unreasonableness, resulting in artificial valuation of shares of a particular assessee.

12. To read rule 1D as mandatory is to confine the principles of valuation to the

said provisions and exclude the application of the real and relevant principles to a particular situation. This should not be so. Therefore, interpretative process, if any, should aim at reading rule 1D as directory, leaving sufficient room for the application of the relevant principles of valuations depending upon the fact-situation.

13. Several decisions were cited enunciating the principles of interpretations of the word "shall" as either mandatory or directory. It is unnecessary to repeat them. One of the principles is to find out the consequences of reading the provisions as mandatory and if the consequences is to render the statutory provisions harsh, onerous or arbitrary, such a reading should be avoided. Another principle is to "read down" a statutory provisions so as to make it a valid provision and prevent its nullification as unconstitutional; the third principles applicable is to read the provisions so as to be in consonance with the object and scheme of the statute and thus limit operation of the particular provision to effectuate the said statutory object.

14. The object of rule 1D is to aid the valuation of shares. The principles applicable while valuing shares vary, depending upon the financial and commercial standing of the company (as pointed out by the Supreme Court) and, therefore, rule 1D should not be read so as to exclude the application of those relevant principles; the object of the Wealth-tax Act is to charge the net wealth of an individual to tax and the net-wealth being the aggregate of the value of assets, that value should, as far as possible, be estimated to arrive at a correct valuation.

15. By reading rule 1D as mandatory, all the salutary principles of interpretations will be violated; it will be most appropriate to read it as a directory provision. We read it accordingly.

16. In *Commissioner of Gift Tax, Bombay Vs. Smt. Kusumben D. Mahadevia*, , the Supreme Court applied the same principles of valuation and once again pointed out that, in the case of a company which is a going concern and whose shares are not quoted on the stock exchange, the yield method is the most appropriate mode of valuing shares. Though the decision in the context of the Gift-tax Act, the relevance of the principles is universal. In *CGT v. Executors and Trustees of the Estate of the Late Shri Ambalal Sarabhai*, (1988) 170 ITR 144 (SC) , this principles of valuation was again reiterated.

17. *Smt. Kusumben D. Mahadevia V. N. C. Upadhy and Others* *Kusumben D. Mahadevia Vs. Commissioner of Wealth-tax, Bombay City-I*, , is a decision on the Bombay High Court under the provisions of the Wealth-tax Act; the question was whether the word "shall" in rule 1D has to be read mandatory in effect. The High Court held it be directory. After referring to the scheme of the Act, the decision of the Supreme Court in *Commissioner of Wealth Tax Vs. Mahadeo Jalan and Mahabir Prasad Jalan and Others etc.*, and the recognised methods of valuations while valuing the unquoted shares of a private limited company, the Bench

observed (at page 816) :

"It is also a well-established rule of interpretations that when a literal construction of a statutory rule would render it ultra vires of the rule making authority, then the rule must be so construed as to be intra vires and held valid rather than construed as ultra vires and initially void."

18. At page 818, the matter was considered thus, while meeting the contention of the Revenue that rule 1D was mandatory :

"There are two reasons why, in this case, it will not be possible to determine the true nature of rule 1D merely relying on the use of the word "shall". It is well-known that the use of the word "shall" is never conclusive of the nature of the provision, that is, whether it is mandatory or directory. The question whether a particular provisions using the word "shall" is mandatory or directory cannot be resolved by laying down any general rule and depends on the facts of each case. One has to look to the object of the provisions; one has also to look to the object of the statute making the provision. The purposes for which the provisions has been made, its nature, and the intention of either the Legislature if the provision is the section of a statute or the intention of the rule-making authority in the case of sub-ordinate legislation will also have to be ascertained.

A provision which uses the word "shall" can always be considered as directory if the content of the provisions or the intention of the rule-making authority so demands."

19. Finally, the rule was held to be directory.

20. On the other hand, the decision of the Kerala High Court in COMMISSIONER OF WEALTH-TAX Vs. MAMMAN VARGHESE and OTHERS., , supports the revenue's contention. It was held therein that section 7 opens with the words "subject to any rules made in this behalf" thereby bringing out the paramountacy of the rules. The section then proceeds to use imperative language by providing that the value of any asset shall be determined. Rule 1D also uses imperative language and directs that the value of an unquoted equity share shall be determined in accordance with its provisions. In the context and from the purport of the section and the rule, there is no warrant or justification for construing the expression "shall" in the section and rule as "may"; rule 1D is, therefore, mandatory and its provisions have to be followed in determining the value of unquoted equity shares of a company for wealth-tax purposes. The Kerala High Court did not consider the effect of such an interpretation, on the validity of rule 1D and the hardship that may flow out of such an instance by abiding by rule 1D in all cases; with utmost respect to the learned judges, we prefer to follow the reasoning of the Bombay High Court which accords with our views. Mrs. Grace Collis and Others Vs. Commissioner of Wealth-tax, is again the decision of the Kerala High Court which follows the earlier decision of the said court. D. Renuka Vs. Commissioner of Wealth-tax, is the decision of the Andhra Pradesh High Court in which the Bombay High Court's view was followed, in

preference to the views of the High Court's of Kerala and Allahabad.

21. It is unnecessary to refer to other decision.

22. Consequently, we hold that rule 1D of the Wealth-tax Rules is directory and that the Wealth-tax Officer is not bound to apply it in all cases of valuation unquoted equity shares in a private company. Question Nos. 2 and 3 referred are, therefore, answered in the affirmative and against the Revenue; question No. 4 does not call for any specific answer.

23. References Answered accordingly.