VALUATION OF SHARES

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Chapter: VIII

VALUATION OF UNQUOTED SHARES FOR TAX ON INCOME
(INCLUDING CAPITAL GAINS)
01 INTRODUCTION

01.01 Income tax is an annual charge on income. Tax is charged on income of every person and is levied on the 'total income' to be computed in accordance with the provisions of Income Tax Act, 1961. Total income is computed under the heads:

(1) Salaries, (2) Income from house property, (3) Profits and Gains from business and profession, (4) Capital gains and (5) Income from other sources.

01.02 "Though there are different conceptions of "Income" for the purpose of taxation, income is broadly defined as the true increase in the amount of wealth which comes to a person during a stated period of time" (Commissioner of Corporation and Taxation v. Filoon 38 NE 2nd 693, 700).

01.03 Where a transaction involving transfer or otherwise of share in a company results into generation of actual or deemed increase in wealth of a

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1. Commissioner of Corporation and Taxation v Filoon 38 NE 2nd 693, 700.
person; income for tax purposes is generated. Computation of an income from transactions involving transfer of shares would involve looking into the cost and/or value of the said shares, which at times would have to be determined artificially on the date of transaction.

01.04 To give relief to the assessee from capital gain attributable to inflation or fall in value of rupee; scheme of Capital Gain provide for the notional substitution of value from time to time. This value as on day, is allowed as substitute for the original cost. The substitute notional replacement value for the purposes of capital gains would require appraisal of the value of shares as on that date.

01.05 For the purposes of income tax the appraising would involve either ascertainment of the cost of acquisition of shares in a company for capital gain or ascertaining the fair market value for income under other heads of income.

01.06 The issues of appraisal of shares in a company would involve -
a) Principles of Valuation.
b) Principles of ascertaining cost.

01.07 For the purpose the shares may be divided into classes -

a) Unquoted shares, and
b) Quoted shares.

01.08 In this Chapter we shall deal with the Unquoted shares i.e. shares that are not quoted on any Recognised Stock Exchange.

01.09 Though each transaction would have its own peculiarities, general principles of valuation could be summarised.

02 STATUTORY PROVISIONS

02.01 The various provisions of Income Tax Act, that needs consideration are given in Annexure I. There are large number of court judgements throwing light on the various aspects of the provisions of law and setting out the guiding principles for appraisal of shares in a company.

02.02 Provision or Rules under the Income Tax Act do not provide for the mechanism or rules for the
valuation of shares in a company. By Direct Tax Law (Amendment) Bill 1988, renamed Direct Tax Amendment Law 1989 as further amended by Direct Taxes Second Amendment Act 1989, both under Wealth Tax Act and Gift Tax Act, identical mechanism for the appraisal of shares is provided. As provided in Commissioner of Gift Tax Kerala II, Ernakulam v. Manmen Mathew (1986) 158 ITR page 466, 471 that "In absence of rules made under the Gift Tax Act, 1958, for determining the value of gifts the procedure prescribed in the rules under the Wealth Tax Act, 1957, for that purpose has to be adopted. The Gift Tax Officer had no discretion to fix the value of the shares arbitrarily without following any prescribed procedure or well known principles." On the same line in Shyamsukh Grag v. controller of Estate Duty M.P. (1984) 145 ITR Page 338, it was held that in the circumstances in the absence of any contrary provision, the principles laid down by statutory rules framed under another taxing statute, namely, the W.T. Act, can be taken into

consideration in valuing the unquoted equity shares for the purpose of estate duty. In the absence of rules, valuation for the purposes of Act has to be made in accordance with well recognised method of valuation followed in India. The method of valuation prescribed by rule 1D of the Wealth Tax Rules, 1957. "Being the only statutorily recognised method of valuation of unquoted equity shares in this country, it would not be wrong to adopt that method of valuation for purposes of the estate duty also."


02.03 Under the similar circumstances and when occasion for appraisal of value of share in a company arise under the Income Tax Act, in absence of rules for valuation of shares under that Act, it may be found appropriate to seek guidance from the statutorily recognised method of valuation under Wealth Tax Act if not for finality atleast for a guidance to frame basic framework. In Controller of Estate Duty V VJ Krishna (1974) 96 ITR page 95

Murthy Govind Bhatt J said "The rule (WT Rules) can be looked into only for the purposes of knowing

the manner of break up method of valuation which is one of the recognised methods of valuation."

02.04 The rules under Wealth Tax Rules 1957 are now made part and parcel of the valuation mechanism section 7 of the Wealth Tax Act 1957. The amendment of Section 7 by the Direct Taxes Amendment Act 1989 has removed the concept of open market value. This is discussed in detail in part dealing with the valuation of shares for Wealth Tax purpose. However, the definition of fair market value U/s 2 (22B) of the Income Tax Act, 1961 still contemplates the fair market value to be the price that the capital asset would ordinarily fetch on sale in open market on relevant date. Though Appendix III to Wealth Tax Act 1957 is practically for all purposes the reproduction of the existing rules the fact that there is a conceptual difference between the Income Tax Act and the Wealth Tax Act as to definition of value should be borne in mind before the reliance is placed on Wealth Tax valuation methods. This is also more important as now in case of Wealth Tax concept of market value is given a go by and replaced by statutory value.
03 GUIDING PRINCIPLES FOR VALUATION

03.01 In CWT V Mahadev Jalan (1976) 36 ITR 621 (SC) Supreme Court has laid down the guiding principles for valuation of shares. They are affirmed by the Assam and Nagaland High Court in Mahadev Jalan V CWT (1968) 69 ITR Page 170 Calcutta High Court in CWT V Executors of Estates of Sir E.C. Benthal (1980) 121 ITR 814 (Cal) have adopted the same principles. These principles are back bone of fiscal valuation of shares of a Company in India.

The factors which are likely to determine the value of share on any particular day or at any particular time are:

(i) the profit-earning capacity of the company on a reasonable commercial basis;
(ii) its capacity to maintain these profits of a reasonable return for the capital invested;
and in special cases, such as Investment Companies, the asset backing; and
(iii) 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

3. CWT V Executors of Estates of Sir E.C. Benthal (1980) 121 ITR 814 (Cal.)
of issue of further capital where the existing shareholders 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 their 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.

Though ultimately the facts and circumstances of the case, the nature of the business of the company, the prospects of profitability and such other considerations will be taken into account in ascertaining the correct value of shares, the following principles are normally applicable:

1. 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, if profits are not reflected in the dividends, then one can, on examination of the balance sheet.
ascertain the profit-earning capacity of the concern and, on the basis of potential yield, fix the valuation. 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. 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.
2) 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.

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

4) Valuation by reference to the assets would be justified where the fluctuations of profit and uncertainty of the conditions at the date of the valuation prevent any reasonable estimation of prospective profits and dividends.

However, the aforesaid rules are no hard and fast rule. But the market value, unless in
exceptional circumstances, cannot be determined on the hypothesis 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.

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. 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.

03.02 As is explained in the above two judgements, the two possible approaches to the accounting aspects of appraisal of share valuation would involve either (a) break-up method and/or (b) yield method of valuation of shares in a company. The details on both these methods are annexed hereto as Annexure IV.

03.03 However it is to borne in mind that value and cost are separate concepts.
04.01 Cost is a fact while value is an opinion. Any enquiry to ascertain cost to a person would be most difficult one. It is dependent upon large number of factors like -

1) Who I am;
2) How strong my negotiating position is;
3) How great my marketing and bargaining skills are; or how weak is that of my seller;
4) How is my credit worthiness;
5) How good is my timing for purchases;
6) How much time I have to find the seller;
7) How much access I have to the appropriate market;
8) How badly I need the product; Is my seller aware of my urgency;
9) How badly my seller wants to sell the product;
10) How ignorant or foolish my seller is or I am; and
11) What are the limits placed by Government and social custom and on my ability and willingness to lie and cheat.
04.02 When cost is to be ascertained the best person to answer is the person who has incurred it. Any other person doing it without recourse to him (person incurring it) would arrive at his cost or his opinion on what is the value and not the cost.

04.03 But in absence of the information from the person who has incurred it the value as indicated arrived to be modified keeping in mind issues raised in para 04.01. Cost to two persons could not be same. Even when same price is paid apparently cost may vary, say for example, if payment is made from no cost own fund and interest bearing borrowed fund.

05 CONCEALED INCOME

05.01 In order to appreciate the appraisal occasion under Income Tax Act provisions of sec. 69, 69A, 69B and 69C, they are reproduced hereunder:

Unexplained Investments.

69. Wherein the financial year immediately preceding the assessment year the assessee has made investments which are not recorded in the books of account, if any, maintained by him for
any source of income and the assessee offers no explanation about the nature and source of the investments or the explanation offered by him is not, in the opinion of the Income-tax Officer, satisfactory, the value of the investments may be deemed to be the income of the assessee of such financial year.

Unexplained Money, etc.

69A. Where in any financial year the assessee is found to be the owner of any money, bullion, jewellery or other valuable article and such money, bullion, jewellery or valuable article is not recorded in the books of account, if any, maintained by him for any source of income, and the assessee offers no explanation about the nature and source of acquisition of the money, bullion, jewellery or other valuable article, or the explanation offered by him is not, in the opinion of the Income-tax Officer, satisfactory, the money and the value
of the bullion jewellery or other valuable article may be deemed to be income of the assessee for such financial year.

Amount of Investments, etc., not fully disclosed in books of account.

69B. Where in any financial year the assessee has made investments or is found to be the owner of any bullion, jewellery or other valuable article, and the Income-tax Officer finds that the amount expended on making such investments or in acquiring such bullion, jewellery or other valuable article exceeds the amount recorded in this behalf in the books of account maintained by the assessee for any source of income, and the assessee offers no explanation about such excess amount or the explanation offered by him is not, in the opinion of the Income-tax Officer, satisfactory, the excess amount may be deemed to be the income of the assessee for such financial year.
Unexplained expenditure, etc.

69C. Where in any financial year an assessee has incurred any expenditure and offers no explanation about the source of such expenditure or part thereof, or the explanation, if any, offered by him is not, in the opinion of the Income-tax Officer, satisfactory, the amount covered by such expenditure or part thereof, as the case may be, may be deemed to be the income of the assessee for such financial year.

05.02 Section 69, 69A, 69B and 69C pertaining to dealing of different sets of circumstances under which concealed income is ascertained:

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<th>Sec.</th>
<th>Conditions</th>
<th>What is to be added</th>
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<tbody>
<tr>
<td>69</td>
<td>Investments not recorded in the books of accounts and no explanation is offered or explanation not found satisfactory.</td>
<td>&quot;The Value&quot; of the investment, is to be taken.</td>
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<tr>
<td>Sec.</td>
<td>Conditions</td>
<td>What is to be added</td>
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<td>69A</td>
<td>Money, Bullion, Jewellery or other valuable articles not recorded in books of accounts and no explanation not found satisfactory.</td>
<td>&quot;The Value&quot; of the money, Bullion, jewellery or other valuable article is to be taken.</td>
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<td>69B</td>
<td>Investments, Money, Bullion, Jewellery or other valuable articles amount of expense recorded in books but it exceeds the amount recorded in books and no explanation is offered or explanation not found satisfactory.</td>
<td>&quot;The Excess Amount&quot; which is not recorded in books. In other words excess of expenses recorded in books and actual is to be taken.</td>
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<tr>
<td>69C</td>
<td>Expenditure incurred no explanation as to the source of the expenditure</td>
<td>&quot;The Amount Covered by Such Expenditure&quot;. In other words actual expenses for which no explanation is given is to be taken.</td>
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05.03 The critical study of the requirement of Section 69 and 69A in contrast to Section 69B and 69C would indicate the emphasis under two different sets of circumstances. In the case where Section 69 and 69A are applicable, the situation is that - "Investments, Money, Bullion, Jewellery and other valuable articles are either not recorded in books of accounts and assessee is not in position to explain the nature and source of such investment or source of acquisition. In such a case value of such investment, Money, Bullion, Jewellery is to be added."

05.04 In the case that are covered by Section 69B and 69C the situation relating to "Investments or Bullion, Jewellery or other valuable articles or Expenses are not fully recorded in books of accounts and the assessee is not in position to explain the nature and source of such a difference between what is recorded in books and what is actually incurred such actual difference between the actual cost of acquisition or expenditure and what is recorded is to be added.

05.05 Thus the legislative intention in the first case is (69 and 69A) to get the value added and
the Second case "The Actual Difference" is to be added.

05.06 Now where as the value is an opinion the cost is a fact. Thus in case covered by 69 and 69B the value would be the value of the item under consideration. No enquiry is needed as to what has been its cost to the assessee and what has been incurred by him on the item, where as in contrast when "The Cost" is to be added what has been incurred by the assessee is to be ascertained and if there is excess the same is to be added.

05.07 The appraising of value the same could be done following the principles enunciated by Mahadev Jalan's case and Kusumbern D Mahadevia's case and method given in Annexure IV.

05.08 But when the question arises as to what was actually incurred, cost is to be ascertained. To ascertain what cost a person has incurred depends entirely upon how well he has maintained his records and how honest he is to bring out the same to the appraiser. Any thing else arrived at by the appraiser would be cost which in his opinion would have been paid and would be nothing but a value. The
occasions for ascertaining the cost would arise primarily when 69B and 69C come into operation. These sections are sections where concealment of particulars of income are suspected. In absence of proper information cost could be ascertained by applying methods explained in Annexure IV. But it is doubtful whether the same would be accurate.

06 BONUS SHARES: METHOD OF ASCERTAINING COST

06.01 There are four possible methods for determining the cost of bonus shares.

a) The first method is to take the cost as equivalent to the face value of the bonus shares.

b) The second method is to take the cost as NIL because nothing is paid by shareholder in each.

c) The third method is to take the cost of the original shares and to spread it over the original shares and bonus shares taken collectively, and

d) The fourth method is to find out the
fall in price of the original shares
and to attribute it to bonus shares.

06.02 While discussing the four methods Justice (then he was) Hidayatullah in Commissioner of Income Tax V. Dalmia Investment Company (56) (1964) 52 ITR page 567 to 582\(^1\) said as under:

"It is convenient to begin with the contention that the cost of the bonus shares must be taken to be their face value. The argument requires close attention, because support for it is sought in certain pronouncements of Lord Sumner to which reference will be made presently. Mr. Kapur contends that a company cannot ordinarily issue shares at a discount, and argues that a fortiori it cannot issue shares for nothing. He submits therefore, that the issue of bonus shares involves a two-fold operation - the creation of new shares and the declaration of a dividend or bonus which dividend or bonus must be deemed to be paid to the shareholder and to be returned by him to acquire the new shares. Since the amount

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credited in the books of the company as contribution of capital by the shareholder is the face value of the bonus shares, he contends that the cost to the shareholder is equal to the face value of the bonus shares. He relies upon the decision of the Privy Council in Swan Brewery Co. Ltd. V. Rex. In that case, Lord Sumner observed:

"True, that in a sense it was all one transaction, but that is an ambiguous expression. In business, as in contemplation of law, there were two transactions, the creation and issue of new shares on the company's part, and on the allottees' part the satisfaction of the liability to pay for them by acquiescing in such a transfer from reserve to share capital as put an end to any participation in the sum of £1,01,450/- in right of the old shares, and created instead a right of general participation in the company's profits and assets in right of the new shares, without any further liability to make a cash contribution in respect of them."

Lord Summer adhered to his view later in the House of Lords in Commissioner of Inland Revenue V. John Blott but Lord Dunedin and he were in minority and this view was not accepted by the majority. In view of this conflict, it is necessary to state what really happens when a company issues bonus shares.

A limited liability company must state in its memorandum of association the amount of capital with which the company desires to do business and the number of shares into which that capital is to be divided. The company need not issue all its capital at the same time. It may issue only a part of its capital initially and issue more of the unissued capital on a later date. After the company does business and profits result, it may distribute the profits or keep them in reserve. When it does the latter, it does not keep the money in its coffers; the money is used

1. Commissioner of Inland Revenue V. John Blott (1921) 2 A.C. 171, 8 Tax Cas. 101.
in the business and really represents an increase in the capital employed. When the reserves increase to a considerable extent, the issued capital of the company ceases to bear a true relation to the capital employed. The company may then decide to increase its issued capital and declare a bonus and issue to the shareholders in lieu of bonus, certificates entitling them to an additional share in the increased capital. As a matter of accounting the original shares in a winding up before the increase of issued capital would have yielded to the shareholder the same return as the old shares and the new shares taken together. What was previously owned by the shareholder by virtue of the original certificates is after the issue of bonus shares, held by them on the basis of more certificates. In point of fact, however, what the shareholder gets is not cash but property from which income in the shape of money may be derived in future. In this sense,
there is no payment to him but an increase of issued capital and the right of the shareholder to its evidence not by the original number of certificates held by him but by more certificates. There is thus no payment of dividend. A dividend in the strict sense means a share in the profits and a share in the profits can only be said to be paid to the shareholder when a part of the profits is released to him in cash and the company pays that amount and the shareholder takes it away. The conversion of the reserves into capital does not involve the release of the profits to the shareholder; the money remains where it was, that is to say, employed in the business. Thereafter the company employs that money not as reserves of profits, but as its proper capital issued to and contributed by the shareholder. If the shareholder were to sell his bonus shares, as shareholders often do, the shareholder parts with the right to participation in the capital of the
company, and the cash he receives is not dividend but the price of that right. The bonus share when sold may fetch more or may fetch less than the face value and this shows that the certificate is not a voucher to receive the amount mentioned on its face. To regard the certificate as cash or as representing cash paid by the shareholder is to overlook the internal process by which that certificate comes into being.

We may now see what was decided in the Swan Brewery's case. In that case the company had not distributed all its profits in the past. As a result, it had a vast reserve fund. The company increased its capital and from the reserve fund, issued shares pro rata. These shares, it was held by Lord Summer, were dividend. It was claimed in that case that there was no dividend and no distribution of dividend, because nothing had been distributed and

nothing given. Where formerly there was
one share, after the declaration of bonus
there were two but the right of participa-
tion was the same. This argument was not
accepted and the face value of the shares
was taken to be dividend. Section 2 of
the Act of Western Australia, however,
defined dividend to include "every profit,
advantage or gain intended to be paid or
credited to or distributed among the
members of any company." It is obvious
that it was impossible to hold that the
bonus shares were outside the extended
definition.

Swan Brewery's case\(^1\) has been accepted as
rightly decided on the special terms of
the section as indeed it was. In Blott's
case\(^2\), Rowlatt J. observed that the bonus
shares were included in the expression
"advantage" occurring in the highly arti-
ficial definition of the word "dividend".

In the Court of Appeal, Lord Sterndale M.R.

2. Commissioner of Inland Revenue V. John Blott
   (1921) 2 A.C. 171, 8 Tax Cas. 101.
and Warrington and Scrutton L.JJ distinguished the case on the same ground. It was, however, pointed out by the Master of Rolls that in Bouch v. Sproule Lord Herschell had observed that in such a case, the company does not pay or intend to pay any sum as dividend but intends to and does appropriate the undivided profits and deals with them as an increase of the capital stock in the concern.

Blott's case then reached the House of Lords. It may be pointed that at this stage that it involved a question whether super-tax was payable on the amount represented by the face value of the bonus share. For purposes of assessment of super-tax which was (as it is in our country) a tax charged in respect of income of an individual the total of all income from all sources has to be taken into account and the tax was exigible if the total increased.

2. Commissioner of Inland Revenue v. John Blott (1921) 2 A.C. 71, 8 Tax Cas. 101.
a certain sum. Such additional duty is really nothing but additional income-tax and is conveniently described as super-tax. Viscounts Haldane, Finlay and Cave held that an amount equal to the face value of the shares could not be regarded as received by the taxpayer and that there was no more than the capitalisation of the profits of the company in respect of which certificates were issued to the shareholders entitling them to participate in the amount of the reserve but only as part of the capital. Lords Dunedin and Summer, however, held that the word "capitalisation" was somewhat "hazy" and the issue of the shares involved a dual operation by which an amount was released to the shareholder but was retained by the company and applied in payment of those shares. In our opinion, and we say it respectfully, the better view is that of the majority and our conclusions set out earlier accord substantially with it.
It follows that though profits are profits in the hands of the company, when they are disposed of by converting them into capital instead of paying them over to the shareholders, no income can be said to accrue to the shareholder because the new shares confer a title to a larger proportion of the surplus assets at a general distribution. The floating capital used in the company which formerly consisted of subscribed capital and the reserves now becomes the subscribed capital. The amount said to be payable to the shareholders as income goes merely to increase the capital of the company and in the hands of the shareholders the certificates are property from which income will be derived. Lord Dunedin did not rely upon Swan Brewery's case. He held that as the company could not pay for another, the shareholder must be taken to have paid for the bonus shares himself and the payment was the amount which came from the accumulated profits.

as profits. Lord Summer, however, stated that in Swan Brewery's case\(^1\) he did not rely upon the extended definition of dividend in the Australian statute, but upon the principle involved. He observed that as a matter of machinery, what was done was to keep back the money released to the shareholders for application towards payment for the increased capital.

Lord Summer had already adhered to his view in an earlier case of the Privy Council, but Swan Brewery's case\(^1\) and Blott's case\(^2\) were considered by the Privy Council in Commissioner of Income-tax V. Mercantile Bank of India Ltd.\(^3\)

Lord Thankerton distinguished Swan Brewery's case\(^1\), and followed Blott's case\(^2\), though in Nicholas v. Commissioner of Taxes of the State of Victoria\(^4\), Blott's case\(^2\) was distinguished on the ground that

2. Commissioner of Inland Revenue V. John Blott (1921) 2 AC, 171, 8 Tax Cas. 101.
the definition in the Unemployment Relief Tax (Assessment) Act, 1933, also included within a person's assessable income "any dividend, interest, profit or bonus credited, paid or distributed to him by the company from any profit derived in or from Victoria or elsewhere by it", and that bonus shares must be regarded as dividend under that definition.

The Indian Income-tax Act defines "dividend" and also extends it in some directions but not so as to make the issue of bonus shares a release of reserves as profits so that they could be included in the term. The face value of the shares cannot, therefore, be taken to be dividend by reason of anything in the definition. The share certificate which is issued as bonus entitles the holder to a share in the assets of the company and to participate in future profits. As pointed out above, if sold, it may fetch either more or less. The market price is affected by many inponderables, one such being the yield or the expected
yield. The detriment to the shareholder, if any, must therefore be calculated on some principle, but the method of computing the cost of bonus shares at their face value does not accord either with fact or business accountancy.

Can we then say that the bonus shares are a gift and are acquired for nothing? At first sight, it looks as if they are so, but the impact of the issue of bonus shares has to be seen to realise that there is an immediate detriment to the shareholder in respect of his original holding. The Income-tax Officer, in this case, has shown that in 1945 when the price of shares after issue of Bonus share became stable, it was Rs. 9 per share, while the value of the shares before the issue of bonus shares was Rs. 18/- per share. In other words, by the issue of bonus shares pro rata, which ranked pari passu with the existing shares, the market price was exactly halved, and divided between the old and the bonus shares. This will ordinarily be the case
but not when the shares do not rank pari passu and we shall deal with that case separately. When the shares rank pari passu the result may be stated by saying that what the shareholder held as a whole rupee coin is held by him, after the issue of bonus shares, in two 50 n.p. coins. The total value remains the same, but the evidence of that value is not in one certificate but in two. This was expressed forcefully by the Supreme Court of the United States of America, quoting from an earlier case, in Eisner v. Macomber, thus:

"A stock dividend really takes nothing from the property of the Corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original

1. Eisner v. Macomber (1920) 26 U.S. 189, 64 L.Ed. 521
shares together representing the same proportional interest that the original shares represented before the issue of the new ones .... In short, the corporation is no poorer and the stock-holder is no richer than they were before .... If the plaintiff gained any small advantage by the change, it certainly was not an advantage of £ 417,450 the sum upon which he was taxed ... What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new.

.... If a shareholder sells dividend stock, he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished."

Swan Brewery's case 1, it may be pointed out,

was distinguished here also on the basis of the extended definition. It follows that the bonus shares cannot be said to have cost nothing to the shareholder because on the issue of the bonus shares, there is an instant loss to him in the value of his original holding. The earning capacity of the capital employed remains the same, even after the reserve is converted into bonus shares. By the issue of the bonus shares there is a corresponding fall in the dividends actual or expected and the market price moves accordingly. The method of calculation which places the value of bonus shares at nil cannot be correct.

This leaves for consideration the other two methods. Here we may point out that the new shares may rank pari passu with old shares or may be different. The method of cost accounting may have to be different in each case but in essence and principle there is no difference. One possible method is to ascertain the exact
fall in the market price of the shares already held and attribute that fall to the price of the bonus shares. The market price must be the middle price and not as represented by any unusual fluctuation.

The other method is to take the amount spent by the shareholder in acquiring his original shares and to spread it over the old and new shares treating the new as accretions to the old and to treat the cost old price of the original shares as the cost price of the old shares and bonus shares taken together. This method is suggested by the department in this case. Since the bonus shares in this case rank pari passu with the old shares there is no difficulty in spreading the original cost over the old and the new shares and the contention of the department in this case is right. But this is not the end of the present discussion.

This simple method may present difficulties when the shares do not rank pari passu or are of a different kind. In such cases, it may be necessary to
compare the resultant price of the two kinds of shares in the market to arrive at a proper cost valuation. In other words, if the shares do not rank pari passu, assistance may have to be taken of other evidence to fix the cost price of the bonus shares. It may then be necessary to examine the result as reflected in the market to determine the equivale cost. In England paragraph 10 of Schedule IX to the Finance Act 1962 provides for such matters and for valuing rights issue but we are not concerned with these matters and need not express an opinion.

It remains to refer to three cases to which we have already referred in passing and on which some reliance was placed. In Commissioner of Income-tax V. Manecklal Chunilal and Sons Ltd., the assessee held certain ordinary shares of the face value of Rs.100/- in Ambica Mills Ltd. and Arvind

1. The Finance Act 1962 paragraph 10 of Schedule IX (U.K.)
Mills Ltd. These two companies then declared a bonus and issued preference shares in the proportion of two to one of the face value of Rs.100/- each. These preference shares were sold by the assessee and if the face value was taken as the cost, there was small profit. The department contended that the entire sale proceeds were liable to be taxed, because the assessee had paid nothing for the bonus shares and everything received by it was profit. The assessee's view was that the cost was equal to the face value of the shares. The High Court rejected both these contentions and held that the shares previously held must be divided between those shares and the bonus shares in the same proportion as their face value and the profit or loss should then be found out by comparing the cost price calculated on this basis with the sale price. In our opinion, there is difficulty in the High Court's decision. The preference shares and the ordinary shares could hardly be valued in the proportion of their face value. The ordinary shares
and the preference shares do not rank pari passu.

The next case is Emerald Co. Ltd. V. Commissioner of Income-tax. In that case, the assessee had, at the beginning of the year, 350 shares of which 50 shares were bonus shares and all were of the face value of Rs.250 each. The assessee sold 300 shares and claimed a loss of Rs.35,801 by valuing the bonus shares at face value. The department arrived at a loss of Rs.27,766 by the method of averaging the cost, following the earlier case of the Bombay High Court just referred to. The Tribunal suggested a third method. It ignored the 50 shares and the loss was calculated by considering the cost of 300 shares and their sale price. The loss worked out at Rs. 27,748 but the Tribunal did not disturb the order of the Appellate Assistant Commissioner in view of the small difference. The High Court held that the method adopted by the department was proper but this court, on appeal,

held that in that case the method adopted by the Tribunal was correct. This court did not decide which of the four methods was the proper one to apply, leaving that question open. The reason was that the assessee originally held 50 shares in 1950; in 1951, it received 50 shares. It sold its original holding three days later and then purchased another 100 shares after two months. In the financial year 1950-51 (assessment year 1951-52), the income tax officer averaged the price of 150 shares and found a profit of Rs. 1,060 on the sale of 50 shares instead of a loss of Rs. 1,365 which was claimed. The assessee did not appeal. In the financial year 1951-52 (assessment year 1952-53), the assessee started with 150 shares (100 purchased and 50 bonus). It then purchased 200 shares in two lots and sold 300 shares, leaving 50 shares. The assessee company claimed a loss of Rs. 35,801. The Income-tax Officer computed the loss at Rs. 27,766 and the Tribunal computed the
loss at Rs. 27,748. The Tribunal, however, did not disturb the loss computed by the Income-tax Officer in view of the slender difference of Rs. 18. The High Court's decision was reversed by this court because the High Court ignored all intermediate transactions and averaged the 300 shares with the 50 bonus shares. The shares in respect of which the bonus shares were issued were already averaged with the bonus shares. This was not a case of bonus shares issued in the year of account. It involved purchase and sale of some of the shares. The average cost price of the original and bonus shares was already fixed in an earlier year by the department and this fact should have been taken into account. No doubt, Chagla C.J. observed that it was not known which of the several shares were sold in the year of account, but in the statement of the case it was clearly stated that bonus shares were untouched.
The decision of this court in Emerald Co's case\(^1\) however leads support to the view which we have expressed here. The bonus shares can be valued by spreading the cost of the old shares over the old shares and the new issue taken together, if the shares rank pari passu. When they do not, the price may have to be adjusted either in the proportion of the face value they bear (if there is no other circumstance differentiating them) or on equitable considerations based on the market price before and after the issue."

06.03 In Commissioner of Income Tax v. Gold Mohore Investment Co. Ltd. (1969) 74 ITR 62 (SC)\(^2\) the principles laid down above were followed. It is also followed in WH Brody & Co. Ltd. v. CIT (1979) 119 ITR\(^3\) CIT v. TVS & Sons Ltd. Mad. (1983) 143 ITR 644\(^4\), it was held that "The theory of averaging is a principle of costing resorted to, to determine the cost of bonus share alone with a view to reckoning the results of any transaction in respect of bonus.

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3. W.H. Brody & Co. Ltd. v CIT (1979) 119 ITR.
4. CIT v TVS & Sons Ltd. Mad (1983) 143 ITR, 644.
shares alone. But when the entire block of shares held by a shareholder is sold and in that side all the bonus shares held by the shareholder also figure, there can be no occasion or necessity for determining the cost of the bonus shares separately. The whole cost of the shares including bonus shares is already a known figure and it would be an unnecessary refinement to ascertain the individual cost of each share because of getting at the average cost of bonus shares, the average cost of the original shares must be inevitably reduced pro rata to.

06.04 From above, it is clear that the accepted method of valuation of Bonus shares is to take the amount spent by the shareholder in acquiring his original shares and to spread it over old and new shares treating the new accretion to the old and treat the cost of the old shares and bonus shares taken together. In case old and new shares rank pari-passu the spread should be even out in case they are not, it may be necessary to examine rights attached to each one and allocate the original amount spent.

06.05 While arriving at the cost of Bonus shares for the purposes of arriving capital gain or income the method followed in arrival of cost or original
shares and computation of profit therefrom is not relevant. CIT V Kishor Trading Co. Ltd. 133 ITR 1271, "When the cost of original share is to be substituted by a notional value on a notional date for capital gain it can either be the actual cost of acquisition or at the choice of assessee, the market value thereof on 1.1.1954. When the assessee elects to adopt the market value as on 1.1.1954 for the purpose of computation of Capital Gain or loss in transfer of its originally acquired shares he is in effect substituting the original cost of acquisition of such shares by another amount as allowed by the statute and the capital gain on the transfer has to be calculated on such cost." Subsequent issue of bonus shares does not effect or dilute the cost of acquisition of original shares Sultaj Cotton Mills Ltd. V. CIT West Bengal (CAC) (1979) 119 ITR page 666 Shekhawati General Traders Ltd. V. ITO (SC) (1971) 138 ITR page 788.

06.06 In a recent case before Bombay Tribunal No. 2732 & 4904/Bom/1985 Ay. 1981-82 and 1982-83

1. CIT V Kishor Trading Co. Ltd. 138 ITR 227.
2. Sultaj Cotton Mills Ltd. V. CIT West Bengal (CAC) (1979) 119, ITR 666.

Fourth Income Tax Officer1 similar question arose.

It was whether assessee is entitled to exercise option U/S 55 (2) of The Income Tax Act and take the fair market value prevailing on 1.1.1964? The tribunal opined in favour. In this case the shares held by the lady was gifted to her by her husband.

06.07 However deviating in principle that Bonus shares can not be considered to have Nil value so far as situation arising out of legal fiction created by sec. 64 (1) (iv) the recipient of Bonus share who did not acquire the original shares was treated as having incurred Nil cost. Following the argument it held -


kalpana's
(1961) 128 ITR 294 (SC) \(^1\) clearly reveals that where cost of acquisition of any capital assets to the assessee is 'nil' the charging provisions must be interpreted as being not referable to such capital assets and no tax can be levied in respect of capital gains on sale of such capital assets. Accordingly, no capital gain arose in regard to sale of 500 shares in question - CIT vs. Home Industries and Co. (1977) CTR (Bom) 238 ; (1977) 107 ITR 609 (Bom) and CIT vs. B.C. Srinivasa Setty (1981) 21 CTR (SC) 138 ; (1981) 128 ITR 294 (SC) relied on.

07.01 Following Supreme Court in the case of "Miss Dhun Dadabhoy v. CIT (1967) 6 ITR 651 (SC)\(^2\)" in

case where right to receive a right share is renounced for a monetary consideration and because of issuance of right shares there is a depreciation or the value of old shares the assessee is entitled to deduct the loss in the value of the old shares from the gains obtained by the renouncement of right to receive new shares. In such a case the question would arise as to what is the cost of old shares after allowances of such a set off. Should deduction in the fall of value of old shares allowed as deduction for computing the gain arising out of the renouncement of right share which would go to reduce the cost of the old shares?

07.02 Sec 43 (1) defines actual cost as "the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority."

Sub-Section (2) of 55 provides that for the purposes of S48 "Cost of acquisition" in relation to a capital asset shall be cost of acquisition to the assessee.

07.03 Accepting the principle that right to
subscribe to a right share is a right germane to the right to hold the old shares and as the proceeds of right renouncement of the right share is taxable as gains any reduction allowed in computation of such a gain arising out of fall in value of old share should go to reduce the cost of old share.

07.04 In Add CIT V Raj Kumari Bangur 154 ITR 849, it was held that in valuing the shares for capital gains the price of the right shares could not be averaged with the price of the original shares purchased for the purpose of determining the cost of acquisition of the shares in computing capital gains U/s 48. Thus bonus shares and right shares stand on the different footings so far as arriving at the cost.

07.05 The next question that arises is whether the entire reduction would go to reduce the cost or amount in proposition to the cost and market price. To explain let us say the original cost of share is Rs.25/- the market price cum right is Rs.50/- whereas ex right is Rs.40/-. The right is renounced for say Rs.10/-. From the gain of Rs.10/- reduction in value of old share due to

1. Add CIT V Raj Kumari Bajpai 154 ITR 849.
right is Rs.10/- is to be allowed so gain is NIL. Whether the original cost should be reduced to Rs.25/- less Rs.10/- i.e. Rs. 15/- or Rs. 25/- less Rs.5/- i.e. Rs. 20/-.

07.06 The correct view appears that the reduction of Rs.10/- should be made as to that extent right attached to the old share is considered to have been diminished thus attributed to the cost. However following the principles in respect of bonus shares in Shekhawati General Traders Ltd. V. ITO (SC) (1971) 138 ITR Page 786, and Sutlej Cotton Mills Ltd. V CIT West Bengal (CAL)2 1979, 119 ITR page 666, in respect of Bonus shares it may be argued that the valuation of original share is not affected by issuance of right share.

08 ASCERTAINMENT COST OF SHARES OF NRI.

08.01 Government of India, of late, has been encouraging Non Resident Indians to invest in the shares of Indian companies. The investments by NRIs is in form of hard currency. Now the fact of life

2. Sutlej Cotton Mills Ltd. V CIT West Bengal (Cal.) 1979, 119 ITR 666.
is that rupee value is continuously depreciating viz-a-viz all hard currencies like US Dollars, Pound Sterling etc. The question arises whether the cost of NRI purchase of shares is to be reckoned in the Indian currency or in the convertible value of the Indian currency. The one view is that once the hard currency is converted into Indian rupees and the shares having been held in Indian rupees the exchange fluctuations are not to be taken into account. Or in other words the cost in the hands of NRI is not dependent upon the change in exchange fluctuations. The principles laid down in CIT V Invest Import (1982) 137 ITR 310\(^1\) that so long there is no loss on Indian Currency loss on account of change in parity between foreign currency and Indian rupee is of no relevance.

08.02 The Direct Tax Laws (Second Amendment) Act 1989 amended the principles laid down by CIT V Invest Import (1982) 137 ITR\(^1\) by amending section 48 by insertion of provision and explanation to clause (a), has granted a specific concessions in this connection. Now it is permitted to keep both the cost of and acquisition and the sale price in terms of

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foreign currency and computing the capital gain in foreign currency first and then converting it into Indian currency. This method of computation shall be applicable in respect of capital gains accruing or arising from every reinvestment thereafter in the date of share in Indian company.

09 DISTRIBUTION OF SHARES IN SPICE AND EMPLOYEE STOCK OPTION PLANS.

09.01 Section 205 (3) of the Companies Act, 1956 provide that "No dividend shall be payable except in cash." However company may arrange the declaration of dividend in such a manner that there is in effect distribution of shares in another company as dividend. The company may under Employees Stock Option Plans (ESOP) allow the employee to subscribe to the shares of the company. In both these cases the shares so distributed or acquired need to be valued for the purposes of ascertaining in first case the dividend income and in the second case the value of perquisite.

09.02 In Ujjain General Trading Society Private Ltd. V Commissioner of Income Tax, Delhi (MP) (1968) 67 ITR 3151 it was held that when the shares of

another company are given in lieu of dividend the income from dividend is not the amount declared as dividend but the market value of shares so acquired. Thus the market value of shares should be treated as dividend income. Following the principles the case acquisition of shares under ESOP at a price lower than the market value would amount to perquisite in the hands of acquirer and should be ascertained.

09.03 Further definition of salary U/s 17(1) includes perquisites and perquisite is defined in the Act in an inclusive definition in section 17(2). The question arises whether distribution of shares of own company or of another company would amount to perquisite. The perquisite consists something taken voluntarily or under the terms of contract. Thus in the case where ESOP are not part of the contract the same are not perquisites. The question also arises that if it is treated as perquisite what shall be the cost of asset for computing capital gains.

09.04 In both the cases the shares are to be valued following the principles already explained herein-above.
10 VALUE OF SHARE IN CASE OF DISTRIBUTION
IN SPECIES BY COMPANY IN LIQUIDATION

10.01 Sec. 46 (2) is a deeming provision which would make the market value of assets on the date of distribution exigible to capital gains. The market value is nowhere defined. The market value is a term which could have many meanings. However the principles as explained in Mahadev Jalan and Kusum Dev Mahadevjas' case would be applicable, as to the valuation.

11. CONCLUSION

11.01 In valuing share of a company principles enunciated by Supreme Court in Mahadev Jalan's case still holds good. For ascertaining the cost, the things stand on a different footing. It is like searching for a person who is lost but does not want to be found out. Unless he decides to be found out the searcher would find it extremely difficult if not impossible to find it. In case of appraising of shares in a company for the purposes of property acquisitions the appraising problem relates to appraising of the specific real estate which is beyond the scope of this thesis.