PART-VI

WEALTH TAX, GIFT TAX AND ESTATE DUTY

RELATING TO COMPANIES

CHAPTER-9

POSITION OF COMPANIES UNDER THE THREE TAXES

a. WEALTH TAX AND COMPANIES

i. INTRODUCTION

The Wealth Tax Act, 1957, owes its origin principally to the recommendations made by a British economist, Professor Nicholas Kaldor, in his report on "Indian Tax Reform", 1956.

The levy of Wealth Tax on companies, in general, was made applicable for the first time in the assessment year 1957-58, and it was withdrawn by the Finance Act, 1960, after remaining in force for three years. It is important to note that no definite reasons were given for the withdrawal of this levy just after a period of three years.

ii. REINTRODUCTION OF THE LEVY

The Finance Act, 1983 has again revised the levy of wealth tax on closely-held companies. While proposing for the enactment of this levy, the Finance Minister stated in the Parliament:

1. According to the mechanism of the Wealth Tax Act, at least one important reason can be located for its withdrawal. The expression "debts owed" in section 2(m) creates many difficulties. In Kesornam Industries & Cotton Mills Ltd. v. CIT (1966) 59 ITR 767(SC), the Supreme Court held: "If the meaning of the word 'debt' could be ascertained, the expression 'owed' would not cause any difficulty. The verb 'owe' means "to be under an obligation to pay" and it does not really add to the meaning of the word "debt".

2. Clause 40 of the Finance Act, 1983, provides for levy of Wealth Tax on all companies, except those in which the public are substantially interested, as defined in section 2(1B) of the Income Tax Act, 1961.

3. On the basis of section 2(1B) of the Income Tax Act, the levy of wealth tax would be on the following kinds of companies:
   a) a private limited company,
   b) unlisted public limited companies in which the majority of the shareholding is not held by either:
      1) the government, or
      2) a statutory corporation, or
"It has come to my notice that some persons have been trying to avoid personal wealth tax liability by forming closely-held companies, to which they transfer many items of their wealth, particularly jewellery, bullion and real estate. As companies are not chargeable to wealth tax, and the value of the shares of such companies does not also reflect the real worth of the assets of the company, those who hold such unproductive assets in closely-held companies are able to successfully reduce their wealth tax liability to a substantial extent. With a view to circumventing tax avoidance by such persons, I propose to revive the levy of wealth tax in a limited way in the case of closely-held companies..."

It is with this end in view that the levy of wealth tax has been revived. For the purpose of determining the net wealth of a company, only the 'specified assets' shall be taken into consideration. It is heartening to note that shares or bank deposits have not been included in the 'specified assets'.

3 contd. iii) a listed public company, or its wholly-owned subsidiary.


5. Since the rate of wealth tax is 2% on companies, whereas it ranges 3% to 5% in the case of individuals.

6. The specified assets are as follows:
   i) gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals;
   ii) precious or semi-precious stones;
   iii) ornaments made of gold, silver, platinum or any other alloy of such metals;
   iv) utensils made of gold, silver, platinum etc;
   v) land other than agricultural land;
   vi) building or land appurtenant thereto other than building or part thereof used by the assessee as a factory, godown, warehouse, hotel or office for the purpose of its business or as a hospital, creche, school, canteen, library, recreational centre, shelter, rest room or lunch room mainly for the welfare of its employees, provided that the income of the employees chargeable under the head salaries does not exceed Rs 18,000 p.a.

While calculating such chargeable income, the value of all non-monetary benefits or amenities will be excluded.

vi) motor cars,

vii) any other asset which is represented by a debt secured on any one or more of the assets referred to above.
The last clause in the enumerated list of 'specified assets', which is likely to open prolific litigation, is as under:

"h) any other asset which is represented by a debt secured on any one or more of the assets referred to above".

In other words, even an asset which is not included in the given list of specified assets, shall be considered as a specified asset, if such an asset is represented by securing debt, over any of the given 'specified assets'. In this context, questions may arise, that if debts have been secured partially on 'specified assets', and partially on 'non-specified assets', then how much of the debts would be considered for the purposes of computing the net wealth. It is common knowledge that companies borrow funds by getting their assets hypothecated, sometimes entailing a charge over all the assets of the company—whether 'specified' or 'non-specified' assets.

The Madras High Court was confronted with this very nature of problem in CIT v. M.N. Rajam. The relevant facts were that the loan was taken against the security of a house property, which was exempt up to the value of Rupees 1 lakh. The department contended that since the loan has been taken against the security of an exempted asset, such a debt cannot be allowed, while computing the net wealth of the assessee. The Madras High Court, after an analytical surgery of the Act, held as under:

"Net wealth is an amount by which the aggregate value of the assets exceeds the aggregate value of the debts. The words 'such assets shall not be included in the net wealth' can only mean the value in terms of the money of any such assets. This is because only the value of an asset is capable of being either included or not included in the net wealth. The second part of the opening words of section 5(1) accordingly shows that the subject matter of the exemption cannot be assets as such, but only their value in terms of money. To turn from the general to the particular, section 5(1)(iv) itself contains a clue to show that what is exempt is the value of the house property and not the property as such...It is easy to see why the department wants the court to hold that under section 5(1)(iv) the house as such is an asset on which wealth tax is not payable. A finding to this effect would have its repercussions on the applicability of section 2(m) (ii) of the Act...Section 2(m)(ii) thus sees

7. (1982) 133 ITR 75
debts in a dichotomous classification:

1) debts secured on assets (which may be described colloquially as taxable assets) and,

2) debts secured on assets (which may be described again colloquially as exempted assets).

It is not the case of a debt about which we can say that it is secured on an exempted asset. At the same time we cannot say that it is secured on a taxed asset. The truth is that the debt in question is secured on house property whose value is chargeable to tax as to one half and exempted from tax as to the other half. Accordingly, the one and only inquiry under section 2(m)(ii) is to see whether it can be said of any item of asset that it is "property in respect of which wealth tax is not chargeable". An item of house property can be brought within the charge, either because it is not used as the assessee's residence or to the extent that its value exceeds Rs one lakh. In either case, it would be property of a kind about which nobody can confidently assert, without fear of contradiction that it is property in respect of which wealth tax is not chargeable*.

As the court has rightly pointed out, the proviso to section 5(1)(iv) restricts the exemption to Rs 1 lakh in respect of house property by bifurcating the value of the property and apportioning the same between the exempt and non-exempt portion of the value of the property; but section 2(m)(ii) does not contemplate any division or apportionment of the debts incurred against such property the value of which is only partly exempt from wealth tax. But the court did not wish to make any express ruling in regard to the divisibility of the debt and consequent admissibility thereof on the basis of non-divisibility or apportionment between the exempt and taxable portion of the value of the property.

Thus, in view of this judgment of the Madras High Court in CIT v. M.N. Raja, it can be very clearly said that the debt secured on those assets, which are partly exempted shall be allowed,

8. Ibid, 83

9. The Madras High Court distinguished its reasoning in this decision from that of its earlier ruling in T.V. Srinivasan v. CWT (1980) 123 ITR 464, primarily on the ground that the property in Srinivasan's case was of a value which was below the amount of exemption, and no part of the value of the property attracted liability to wealth tax.

10. Ibid
while computing the net wealth. It is only in those cases where the asset's value itself remains less than or equal to the exempted limit, that the debt secured on such an asset shall not be allowed for computing the net wealth. Moreover, the Madras High Court subsequently held in CWT v. C.H. Satish that in respect of the debt secured on house property exceeding Rs 1 lakh in value and for additional security secured on the LIC policy itself, the debt taken from LIC would be allowed for computing the net wealth, notwithstanding this fact that the value of the policy is exempt from the charge of wealth tax altogether.

It is submitted that the Madras High Court has really taken the most realistic view of the situation. Perhaps, it would be correct to say that the principle enunciated in these two cases, CWT v. M.N. Rajam and CWT v. Satish should be given statutory recognition. Even the philosophy of Income Tax legislation admits that the representation of an income-yielding thing procured from borrowings is not necessary to claim the interest on borrowings as admissible business expense.

Lord Thankerton delivered in the House of Lord's judgment in Hughes v. Bank of New Zealand as under:

"Expenditure in the course of the trade which is unremunerative is none the less a proper deduction, if wholly and exclusively made for the purposes of the trade. It does not require the presence of a receipt on the credit side to justify the deduction of an expense".

11. The aforesaid decision in Rajan's case has been subsequently affirmed by the same High Court in CWT v. CH Satish (1982) 133 ITR 834, wherein it has been again clarified that the assessee could claim deduction in respect of loans taken from LIC against the security of his house property exceeding a value of Rs 1 lakh

12. (1982) 133 ITR 834

13. Ibid


15. Enlarging the ambit of 'debts owed', even the Supreme Court's decision in CIT v. Rajendra Prasad Moody(1978) 115 ITR, 519 supports this view. In Moody's case, the court followed its earlier decision in Eastern Investments Ltd. v. CIT (1951) 20 ITR 1, where the Supreme Court relied on a decision of the House of Lords in Hughes v. Bank of New Zealand (1938) 6 ITR, 636

16. 21 TC 472, 524
is specifically or specially authorised to do so by its Articles of Association.

11. POLITICAL CONTRIBUTIONS BY A COMPANY

As early as 1957, Chagla, C.J., of the Bombay High Court opinion-ed that any attempt on the part of any business house to finance a political party is likely to contaminate the very spring of democracy.

Though the Calcutta High Court, very reluctantly, allowed the alteration in the Articles of Association of the Company in *Indian Iron and Steel Co. Ltd.* in view of the prevailing position in law, but the following passage extracted from that judgment remains an eye-opener to the law-makers.

"Joint Stock companies are not intended to be adjuncts to political parties and possible sources of revenue for these parties. They are statutory bodies working under statutory conditions for different purposes. Secondly, it will induce the most unwholesome competition between business companies by introducing the race, who could pay more to the political funds of the political parties. In that competition business interest is bound to suffer in the long run. In the bid for political favouritism by the bait of money the company who will be the highest bidder may secure the most unfair advantage over the rival trader companies. Thirdly, it will mark the advent and entry of the voice of the big business in politics and in the political life of the country."

17 contd. University, department of Chemical Technology.

The counsel on behalf of the revenue contended before the Bombay High Court that the language of section 158 of the Income Tax Act, 1922 was clear, and that it only permitted deduction of the sum(s, i.e. cash) paid by the assessee as donations. The Bombay High Court held *(Ibid, 486)*

"Such a submission was technical in the extreme and that if one were to look to the substance of the transaction, there would be no doubt that what the assessee-company gave to the University of Bombay was ultimately a sum of Rs. 6,600".

Even under the 1961 Act, the position remains the same. Following Associated Cement Company's case, the Bombay High Court held in *CIT v. Traub (India) P. Ltd.* (1977) 118 ITR 525 (Bom):

"It is true that there is a slight change in the language, however, the basic phrase which was required to be construed in Associated Cement Company's case (1968) 68 ITR 478(Bom) was "sums paid", and under the appropriate clauses of section 80G also this phrase occurs at various places, and to that extent there is no change in the language as far as the basic expression "sums paid"."


In C.G.T. v. P. Cheevergese, Travancore Timbers & Products, the Supreme Court held:

"The expression in the course of carrying on of business etc., means that the gift should have some relationship with the carrying on of the business. If the donor makes a gift only while he is running the business, that may not be sufficient to bring the gift within the first part of clause (xiv) of section 5(1) of the Gift Tax Act, 1958. It must further be established, to bring the gift within that provision, that there was some integral connection or relation between the making of the gift and the carrying on of the business".

The expressions used in section 5(1)(xiv) of the Gift Tax Act, 1958 are "for the purpose of" and "bonafide for the purpose of business" which entitle for the exemption from Gift Tax. Purpose means the object, plan or design. To put it differently, the object of making the gift or the design or intention behind it, should be related to business.

In theory, the donations so made by the company for political purposes would not be entitled for exemption under the Gift Tax Act. As a consequence of the widespread practice of political contributions, section 13A dealing with incomes of political parties was inserted by Taxation Laws (Amendment) Act, 1978 with effect from 1-4-1979.

C. ESTATE DUTY AND COMPANIES

i. CONCEPT OF CONTROLLED COMPANY

Section 17, Estate Duty Act, 1953 circumvents the tax avoidance by those who Transfer their property in favour of a controlled company. In order to attract the provisions of sub-

20. 83 ITR 403 (SC)

21. The total ban on contributions by companies to political parties or for political purposes introduced in 1969 by virtue of section 293A of the Companies Act, 1956 could not Salvage the emerging practice effectively. It is important to note that the two amendments to section 293A tabled before the Parliament in 1976 and 1979 aiming at clarifying the meaning of 'political party' failed to secure Parliament's approval, as a result of which the legal ban on company donations introduced in 1969 continues to hold the field even now.

22. Sub-section (4) of section 17 defines a 'controlled company' as a company which is, was or would have been deemed to be under the control of not more than five persons. Persons who are relatives of one another, or persons who are nominees of any other person, persons in partnership or
section(1) of section 17, whereby the charge of duty is created, following ingredients shall have to be present there:

1. The property transferred should not be an interest limited to cease on a death; a fortiori, that the deceased's interest in the property would not be worthless after his death.

2. The property should not have been transferred in a fiduciary capacity.

3. Benefits must accrue to the deceased at any time during the three years ending with the death.

It is important to note that a transfer made by the deceased in a fiduciary capacity is outside the purview of the section, even if the fiduciary capacity was imposed on him by a disposition made by himself.

In other words, the property of which the deceased himself was the owner, which he transferred to himself as a trustee for someone else, and later on transfers to a company, would not be governed by section 17(1). Interestingly enough, despite of such a well-knit machinery of section 17, if the property earlier transferred to the company has been mortgaged, then the provisions of section 17 cannot apply to a mortgagee, for the simple reason that the section deals with that property in which the deceased had a beneficial interest. Unlike this aspect, there is a separate provision in U.K. to check such an abuse too.

22 contd. interested in any shares or obligations of the company through the medium of a trust, are to be treated as a "single" person.

Further a controlled company would be, as a consequence of the aforementioned, a company in which the public are not substantially interested.

23. In other words, section 17 is the antithesis of section 7 which deals with the principle of cessor of interest.

23A. The term 'disposition' has been defined in rule 2(6) as follows:

"A disposition includes any trust, covenant, agreement or arrangement, whether by a single operation or by associated operations, and also, in relation to shares in or debentures of a company, the extinguishment or any alteration of rights, attaching thereto, whether effected by a single operation or by associated operations,


25. Section 58(5), U.K. Finance Act, 1840
Rule 5(1)(b), Estate Duty (Controlled Companies) Rules, 1953 refers to the legal title to receive. In other words, it would be deemed "benefit" to the deceased, even though it might not have been actually received by the deceased. For example, surrender of 'right' shares, which the company issued and the deceased refrained from taking them, would be regarded as 'benefit' for the purposes of section 17.

The extent of charge under section 17 is determined in accordance with the following formula, after making statutory adjustments.

\[
\text{Total benefits accruing to the deceased within 3 years prior to death} \times \frac{\text{assets of the company}}{\text{total net income of the company}}
\]

According to rule 10, the value of the assets of the company is to be ascertained without making any allowance under section 44 of the Act for debts or encumbrances. The Controller has to make allowances of all liabilities of the company from the principle value of its assets. No deduction, however, is to be made for liabilities of the company which are:

1) Liabilities in respect of shares in or debentures of the company; and

2) Liabilities incurred otherwise than for the purpose of the business of the company wholly and exclusively. "Shares" include stock.

26. It is by virtue of Explanation 2 to section 2(15) that the scope of the term 'benefit' under section 17 gets invigorated. Explanation 2 is as under:

"The extinguishment at the expense of the deceased of a debt or other right shall be deemed to have been a disposition made by the deceased in favour of the person for whose benefit the debt or right was extinguished, and in relation to such a disposition the expression 'property' shall include the benefit conferred by the extinguishment of the debt or right".

27. Balasubramanian, Law and Practice of Estate Duty, 4th Edn, 223

28. For example, excessive remuneration paid by the company to its directors would not be in the normal course of business. Thus it shall be disregarded.
29. Rule 11(1) will not apply where the 'slice' worked out under section 17 will be less than the property transferred by the deceased. It will be clear from the following illustration (Cf. Chopra, Law and Practice of Estate Duty in India IVth Edn. 415). The deceased subscribed Rs one lakh in cash for 10,000 shares in a company whose capital is Rs 10 lakhs. The company’s net assets at the date of death amount to Rs 11 lakhs. The net income for the three years amounted to Rs 1,50,000, 1,30,000 and 1,20,000. The company paid 8% dividend during each of the 3 years. The 'slice' according to the provisions of section 17(2) will be:

Total benefits = Total income x Assets

Total benefits = \( \frac{8}{100} \times 1,00,000 \times 3 = 24,000 \)

Total income = 1,50,000 + 1,30,000 + 1,20,000 = 4,00,000

'Slice' = \( \frac{24,000}{4,00,000} \times 1,00,000 = 6,000 \)

As the value of the property transferred by the deceased i.e. Rs 1 lakh is greater than the value of the slice, rule 11(1) does not come into play. Thus no duty is payable on Rs 66,000. Of course, the valuation of shares will be dutiable.

30. Let us take the following illustration (Cf. Chopra, Law and Practice of Estate Duty in India 4th Edn. 116). The deceased transferred property worth Rs 10 lakh to a company, and in return got 10,000 'A' shares of Rs 10 each, and 90,000 'B' shares of the same value were allotted to others. Thus the total share capital of the company was Rs 10 lakhs. The 'A' shares were entitled during the deceased’s lifetime to dividends up to 20% per annum in priority to 'B' shares, and they were to become 6% per annum non-participating preference shares after death. The company's net assets at death amount to Rs 15 lakhs. The net income in the last three years was 3 lakhs in each year. The deceased died eight years after the transfer. The dividends during the last 3 years paid on 'A' shares were of Rs 7½ lakhs and in the whole 8 years of Rs 14 lakhs. No dividends were paid on 'B' shares.

'Slice' under section 17(2) will be:

\( \frac{7.50,000}{9.00,000} \times 15,00,000 = 12,50,000 \)

As the 'slice' i.e. Rs 12,50,000 is more than the property transferred by the deceased, Rule 11(1) comes into play, hence either this value or the value worked out by applying the provision of Rule 11(1), whichever is lower, shall be chargeable under section 17(2).
d. VALUATION OF SHARES

i. GENERAL PRINCIPLES OF SHARE VALUATION

'Valuation of shares' is one of the most technical branches of fiscal legislation. The concept and method of valuation of shares under Direct Tax Laws are important because they have significant bearing on the wider question of 'investment climate'. It depends upon the nature of business of the company concerned, the economic climate, the government policy, past performance of the company, growth prospects, profit earning capacity of the company on a reasonable commercial basis, capacity to maintain those profits, accumulated reserves and chances of 'bonus' shares, the prospects of issue of 'right' shares, and a host of other tangible and intangible factors.

Broadly stated, there are five methods of valuation of shares, namely:

a. Break-up value method;
b. Capitalisation of profit method;

c. Under the break-up value method, the value per share is arrived at by valuing the assets of a company and deducting therefrom all the liabilities and dividing the net assets by the number of shares. It was held in CWT v. Khanna (1971) 82 ITR that the value of goodwill has also to be taken into consideration for purpose of computing the break-up value of the shares. However, according to the present Wealth Tax Rules, no value would be placed on goodwill for determination of net wealth of the company unless goodwill is appearing as an asset in the Balance Sheet itself.

d. This method is based on the philosophy that the value of shares depend not upon the physical assets held by the company but on the capacity of such assets and the management of the company to generate income from such assets. Under this method the 'maintainable profit' is arrived at by taking the average of the company's profits for the last 3 to 5 years after making certain suitable adjustments and such 'maintainable profit' is capitalised on the basis of the yield obtainable on similarly quoted shares.

This method calls for the consideration of two important factors, namely:

1. The future maintainable profit, and
2. The rate of capitalization

In estimating the future maintainable profit, the average net earning of the company on the basis of past earnings is to be ascertained first. To arrive at true average profit, the number of years selected for averaging should be reasonable. Usually, a period of three years is taken.
The particular method to be adopted depends upon the purpose of valuation and the facts and circumstances of a particular company. The Supreme Court has laid down the general principles of share valuation in a limited company in CWT v. Mahadeo Jalal as under:

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. If the results of the two methods differ, an intermediate figure may have to be computed by adjustment of unreasonable expenses and adopting a reasonable proportion of profits.

3. In the case of a private limited company also where the expenses are incurred out of all proportion to the commercial venture, they will be added back to the profits of the company in computing the yield. In such companies the restriction on share transfers will also be taken into consideration 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 whereas 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.

As contd. concept of 'going concern'. As a matter of fact, the 'net worth' of the shares cannot be ignored.

32. (1972) 86 ITR 621 (SC)
At least one thing is clear, 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. The Supreme Court has quoted extensively from Green on Death Duties in Mahadeo Jalan's case, which brings with clarity the valuation of shares in one-man companies or so called controlling companies.

Not infrequently, the dividends represent only a small proportion of the company's profits and large sums are systematically accumulated in the form of reserves. It is important to remember in this connection that the interests of shareholders in unquoted companies often differ from those of investors in quoted shares, especially as respects dividend policy. Where the shares are held by a few individuals (particularly members of a single family), it will not necessarily be to their advantage to have the greatest possible amount paid out to them as dividends. Retention of the profits by the company may suit them better than the receipt of taxable dividends. A purchase of shares in a company which distributes only a small fraction of its profits is unlikely to prove attractive to an investor in search of current income, but the open market is by no means confined to such investors. It includes, for instance, the existing members of the company, to whom the shares may be more valuable than to others and who may wish to exclude outsiders, and surtax payers whose goal is capital appreciation rather than current income.

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

33. Sixth Edition, 407
Often this important question has arisen as to whether the value of shares should be arrived at on the basis of balance sheet figures of the company or at the 'realisable value' of the assets after ascertaining the true liabilities. In an inflationary economy the book values do not reflect the true market value of land, building, plant, machinery, shares, stock-in-trade etc. Under the present Wealth Tax Rules, the unquoted equity shares except shares of investment companies and holding companies are to be valued according to the book value of the assets subject to prescribed adjustments.

The Wealth Tax Officer has powers under section 7(2) to determine the net value of the assets of the running business as a whole. It was held by the Supreme Court in Kesoram Industries and Cotton Mills Ltd that the values as appearing in the balance sheet of a company are not conclusive and the W.T.O. can go beyond the balance sheet for arriving at the true market value. However, this Supreme Court's judgment in Kesoram Industries relate prior to the substitution of the words 'as may be prescribed' in section 7(2) of the Wealth Tax Act. According to the prescribed Wealth Tax Rules, 28(2), the book value of the individual assets may be increased if there is a differential of 20% between the market value and the book value of a particular asset.

For arriving at the break-up value of shares, no deduction is allowed for expenses such as brokerage, stamp duty etc. The tax

34. The written-down value of fixed assets also depend upon the depreciation policy followed by the company. The inventories are also valued by some companies at cost, by some companies at market value and by some companies at the lower of cost or market value.

35. A discount of 15% of the break-up value is given for comparative unmarketability of unquoted shares and a further discount varying from 2% to 10% is given when no dividend has been paid for 3 or more consecutive years, depending upon the period for which dividends have not been paid.

36. (1966) 59 ITR 767. The Supreme Court held in this case that dividend proposed does not become a debt until it is declared by the company in a general meeting.

37. Pandit Lakshmi Kant Jha v. CWT (1968) 69 ITR 545
liability, which is implicit when an asset is sold at a profit is also not taken into account under the said rules. The Allahabad High Court held in Bharat Hari Singhania v. CIT that the method of valuation prescribed by section 7(1) of the Wealth Tax Act does not postulate deduction of any necessary expenses which the assessee was bound to incur in relation to such sale. The Court held that the estimated amount of capital gains notionally liable to be paid is not to be deducted from the value of the unquoted shares which it would fetch at an open sale.

It is important to note that the Supreme Court's decision in CWT v. Mahadeo Jalan pronounced the law as it stood prior to the statutorily fixing the valuation of unquoted equity shares by rules under the Wealth Tax Act. Thereafter, it is no longer applicable, so far as valuation of unquoted equity shares under the Wealth Tax Act at present are concerned. Of course, one principle well defined is enumerated in section 7, that if the value arrived at under the said rules does not approximate to or equate with the market value, subject to any rules made in this behalf, then only the open market value shall be considered. The concept of 'open market value' being the very essence of the substantive law, cannot be whittled down by the rules.

It has been held by the Bombay High Court in Kusumaben D. Mahadevia v. CIT that the statutory rules prescribed under the Wealth Tax Act for valuing unquoted equity shares of a company are directory and not mandatory, as section 7(1)(a) is a machinery section, and it is not obligatory to value the unquoted equity shares on the break-up value method as per Rule 1(D) of the Wealth Tax Rules.

The rules published by the CBDT dealing with the valuation of shares under Wealth Tax Act contain the following major changes:

38. 119 ITR 258
39. Ibid
40. (1981) 124 ITR 799
41. However, the Allahabad High Court in CWT v. Padampat Singhania (1979) 117 ITR 443, held that the unquoted shares have to be valued in accordance with Rule 1(D) of the Wealth Tax Rules. However, in the opinion of the writer, the decision of the Bombay High Court is more convincing.
1. An 'unquoted share' has been defined in clause 1(1)(a) in place of the existing clause 1(1) as an equity or preference share which is not regularly quoted on any recognised stock exchange in India, and also includes a share quoted on the stock exchange but deemed to be unquoted share under the Explanation to Rule 1E.

2. The Explanation for the purpose of Rule 1D and 1E creates a fiction whereby any quotation in respect of any equity shares on a recognised stock exchange in India is found to be less than 2/3 of the value arrived at in accordance with the provisions of Rule 1D and Rule 1E, the share shall be deemed to be an unquoted share.

3. A new rule 1E prescribes the method of valuation for unquoted equity shares of an investment company.

4. The main difference between Rule 1D and Rule 1E is that for determining the value of unquoted shares of non-investment companies, the book value of the assets and liabilities as shown in the balance sheet shall be taken, subject to prescribed adjustments, whereas under Rule 1E for determining the value of unquoted shares of investment companies, the market value of the assets on the valuation date would be taken into account. However, both under Rule 1D and 1E, the break-up value method has been prescribed.

42. The definition of 'investment company' is given a wider scope so as to include a company whose gross total income does not mainly consist of income under the head of 'Interest on securities', 'Income from House Property', 'Capital Gains', and 'Income from other sources' would also be brought within its purview.

43. Rule 1D provides for arriving at the market value of unquoted shares of companies other than investment companies and managing agency companies, as under:

"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 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% of the break-up value so determined".
5. The break-up value shall be reduced depending upon the level of average distributable income up to 10% of the paid-up capital and reserves, and the break-up value shall be increased when the average distributable income exceeds 10% as per the formula given in the rules.

6. The definition of assets remains the same but the liabilities definition has been changed, so as not to include any amount representing provision for taxation to the extent it exceeds the amount representing the difference between the tax payable with reference to the book profits of the company and the amount of advance tax paid during the financial year, immediately preceding the assessment year relevant to the accounting year.

In CWT v. Ashok K Parikh, the following question was referred to the Gujarat High Court by the Tribunal:

"Whether on the facts and in the circumstances of the case, the Tribunal was right in law in holding that for the purpose of computation of the market value of the shares of M/s Mehta Parikh & Co. (Pvt) Ltd., the advance tax paid under section 210 of the Income Tax Act, 1961 and shown on the assets side of the balance sheet of the said company cannot be deducted from the tax payable, in determining whether the provision for taxation is in excess over the tax payable with reference to the book profits in accordance with the law applicable thereto within the meaning of clause (ii)(e) of Explanation II to Rule 1D of the Wealth Tax Rules, 1957?"

The Gujarat High Court observed:

"...It must be borne in mind that sub-clause (e) of clause (ii) of Explanation II deals with a provision, that is, it does not deal with the actual payment made by the company concerned, but it deals only with the provision for liability for taxation and it is therefore, clear that the words "other than the amount referred to in clause (i)(a)" refer

44. The 'average distributable income' has been defined as the average of the distributable income of the company ending with the valuation date and the distributable income of 2 immediately preceding accounting years.

The distributable income has been defined to mean the income as per the profit and loss of the company, as increased by the amount of any reserve or provisions not allowable as a deduction under the Income Tax Act and as reduced by any Income Tax, Surtax or any amount set apart for payment of dividends in respect of preference share capital.

45. (1981) Tax 61(3)-88 (Guj)

46. Ibid, 91
to the provision for taxation other than the provision for advance tax. The words "the amount referred to in clause (i)(a)" do not mean the amount paid as advance tax under section 18A of Income Tax Act, 1922 or section 210 of the Income Tax Act, 1961. Really speaking, the words "referred to in clause (i)(a)" means the amount mentioned in clause (i)(a) and the entire sub-clause (e) of clause (ii) of Explanation II refers to the provision and not to payment and therefore, while considering this question of provision for taxation, and to what extent the provision is in excess of the amount of tax payable as per the book-profits in accordance with the law applicable thereto, what one has to see is not the payment made but the provision made by the company in its balance-sheet on the liabilities side.

Further, the Gujarat High Court traced out the genesis of Explanation II in the following words:

"In our opinion, sub-clause (a) of clause (i) of Explanation II is intended to give benefit to the shares of those companies which have been prompt in making payment of their advance tax under the provisions of the law relating to income tax...But because of the words "other than the amount referred to in clause (i)(a)" occurring in the parenthesis in sub-clause (e) of clause (ii), if any advance tax is already paid, that has not to be brought back, as the W.T.O. and the A.A.C. seek to do in the instant case. Sub-clause (e) of clause (ii) and sub-clause (a) of clause (i) of the rule operate in two different fields altogether. Clause (i)(a) operates in the field of actual payment of advance tax. Clause (ii)(e) operates in the field of excess provision for taxation other than the provision for taxation regarding advance tax, and it is in this light that rule 1D has to be approached".

Elucidating the difference between the two concepts "actual payment" and "provision for certain liabilities", the Gujarat High Court succinctly summed up the entire position as under:

"...It is only a process of interpretation bearing in mind the basic distinction between 'actual payment' which is one concept and 'provision for certain liabilities' which is another concept altogether, that the two clauses (i)(a) and (ii)(e) of Explanation II to rule 1D, can be properly interpreted and understood, and in our opinion, this is the only way of interpreting these two clauses of Explanation II to rule 1D. Under these circumstances, it is obvious that the Wealth Tax authorities were not justified in seeking to add back the amount of advance tax paid under the provisions of income-tax law".

47. Ibid, 92
48. Ibid
considered against the provision made in the year for which the balance sheet has been prepared. For this a necessary amendment may be done in sub clause (e) of clause (ii) of Explanation II to Rule 1D.

As regards the valuation of preference shares under Wealth Tax Rules, according to Rule 1C(1) where the rate of dividend of preference shares is 8% or more, the paid-up value of the preference shares is adopted as the fair market value. In case the rate of dividend is less than 8%, a reduction from the paid-up value is made to arrive at the adjusted paid-up value. This adjusted paid-up value is adopted as the fair market value of the preference shares. The adjusted paid-up value is arrived at in the same proportion as the stipulated rate of dividend or the rate as increased under section 3 of the preference shares (Regulation of dividends) Act, 1960 bears to 8%.

The rate of dividend of 8% which has been taken as the yardstick of the normal yield for determining the market value is low and most unrealistic, as it is common knowledge that preference shares carrying 11% yield are quoted at 50% discount on the stock exchanges. It is, therefore, submitted that the rules are changed and the rate of capitalization is increased from 8% to 15%, in consonance with the prevalent yield from deposits in ‘blue chip’ companies.

51. For example, if the stipulated rate of dividend is 4% and the paid-up value of the share is Rs 100, the adjusted paid-up value would be Rs 50 which will be the fair market value of the share. Rule 1C(2) provides for the reduction from the paid-up value or adjusted paid-up value at graduated scale according to the number of accounting years for which the dividends on preference shares have fallen in arrears. If the dividends are in arrears for 3 years on cumulative preference shares, the scale of discount is 5% and in the case of non-cumulative preference shares, it is 10%. The discount increases up to 20% on cumulative preference shares and 40% in the case of non-cumulative preference shares, where the dividends are in arrears for 6 years or more.

52. The Chokshi Committee also recommended that Rule 1C(1) of the Wealth Tax Rules should be amended to provide for the normal yield which should be 1% higher than the rate notified by the Controller of Capital Issues under the Capital Issues (Exemption) Order. The 1% concession in yield is to give allowance for comparative non-negotiability of unquoted preference shares.
With the reintroduction of wealth tax levy on controlled companies, interesting area of prolific litigation has been opened, as to whether break-up value method or the income-yield method or the averaging of the two would be considered, particularly in the case of investment companies. Shivavux Mistry, a leading chartered accountant of this country, states:

"Where the assets backing is very strong, it is reflected in a lower rate of capitalization of earnings and a higher rate of discount of the net worth. In deciding upon a capitalization rate in a particular case, the important factors to be taken into consideration are: the nature of the business, the risk involved and the stability or irregularity of earnings".

He goes on to state:

"Even in the case of an investment company, the tangible assets usually comprise shares mostly in related private companies, jewellery, gold, ornaments, precious stones and precious metals. For instance, where the assets of an investment company comprise wholly or mainly jewellery, etc, and the company carries on the business of hiring out such assets and if the income from such business is exceptionally low as compared to normal return expected of such assets, the break-up value method seems to be the appropriate method of valuation. Where an investment company has a share of profits in an industrial company and if the investment company is treated as a deemed industrial company under the Income Tax Act, the weighted income-yield-cum-break-up value method should be adopted in the circumstances. Similarly, where the assets backing net worth support is strong in an investment company, the weighted income-yield break-up value method should be adopted and not only the yield or profit-earning value method".

The learned author has given an empirical model based on the weighted average of yield method and break-up value method, as under:

53. Shivavux Mistry, 'A case for weighted yield assets-basis of share valuation' - Taxman Vol. 15, Sec. IV, Nov. 1983, 101, 104
<table>
<thead>
<tr>
<th>Return on capital*</th>
<th>Capitalization rate</th>
<th>Discount for non-market-ability</th>
<th>(in percentage)</th>
<th>weighting</th>
<th>Yield</th>
<th>Break-up</th>
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* Return on capital = \( \frac{\text{Adjusted net profit after tax}}{\text{shareholder's funds}} \) x 100

It is submitted that this weighted averaging of yield method and break-up value method justifiably rests on more logical grounds. With the reintroduction of levy of wealth tax, the most affected would be the investment companies, and in order to give full force to this reintroduction of levy this method would be the most suited method.

Shivaux Mistry very rightly justifies that the word 'weighting' implies according weights to the compensating or related factors corresponding to their importance in the light of the circumstances of the valuation. The Supreme Court in the case cautioned only against the averaging of the two different values, the yield value and the break-up value.
iii. VALUATION OF SHARES UNDER THE GIFT TAX ACT

The ratio of Supreme Court's decision in CIT v. Smt. Kusuben D. Mahadevia is that the value of equity shares depend more on the profits which the company has been making and is likely to continue to make having regard to the business, than upon the amount which the shares are likely to realise upon liquidation. The value of the shares cannot depend upon the physical assets. The Supreme Court followed its earlier decision in Mahadeo Jalan's case, where it held:

"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".

In a recent judgment of the Bombay High Court, Seth Hemant Bhaubhal Mafatlal (HUF) v. GTC, following the Supreme Court's judgment in Kusuben Mahadevia, the Court held:

"The Supreme Court had observed in Mahadeo Jalan's case 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 totally irrelevant. This meant that in order to determine the capacity of the company to maintain its profits the asset-backing would be a relevant consideration. The observations ought not to be read to suggest that the valuation of the assets would be a relevant factor in determining the valuation of the shares. The Supreme Court held that the combination of the two methods advocated on behalf of the revenue could not be accepted as a valid principle of valuation of shares".

54. (1980) 122 ITR 38
55. Ibid
56. (1983) 13 Taxmann 509(Bom). The petitioner held certain shares in two private limited companies. The companies were investment companies which were, at all material times, going concerns and were not ripe for liquidation. The articles of association of the companies contained certain restrictive provisions as to the alienation of shares. The petitioner claimed that the value of the gifted shares should be taken by applying the profit-earning method under section 6(1) of the Act.
57. Ibid
iv. VALUATION OF SHARES UNDER ESTATE DUTY ACT

Under the Estate Duty Act, 1953, for valuing the shares of controlled company, the market price of assets have to be found out. In other words, intangible assets such as patents, registered trade-marks and copy-rights are also valued and included in the value of assets, even if they do not appear in the balance sheet of the company.

As a matter of fact, no rules have been made under the Estate Duty Act prescribing the manner in which the value of unquoted shares, except shares of controlled companies, should be determined. The Mysore High Court held in *C.D. v. J. Krishna Murthy* that in the absence of rules, valuation for the purposes of Estate Duty has to be made in accordance with well-recognised methods of valuation followed in India, and that 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 estate duty also.

As regards the controlled companies, Rule 15 of the Estate Duty (Controlled Companies) Rules, 1953 provides for the valuation of shares. The thrust under Estate Duty is mainly on the basis of 'assets' - the property passing or deemed to pass on death. If the conditions laid down in sub rule (1) of rule 15 are satisfied, then the principal value of the shares shall be estimated in accordance with the net value of the asset of the company as given in Rule 11(2).


59. It is important to note that in such a case then the general principles of valuation enumerated in section 36 shall not be applicable. As regards the conditions laid down in rule 15(1), they are as under:

1. The deceased had the 'management control', for example, voting power or control over the Board of Directors of the company 'at any time' during three years before his death.

2. The deceased could have received or actually received more than one half of the dividends declared by the company 'at any time' during those three years, irrespective of this consideration that the dividends so declared does not relate to any period during such three years.

3. The deceased had 'at any time' during such a period of three years, beneficial interest in one-half of the nominal amount of shares.