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1950 *Present:* **Jayetileke C.J. and Gratiaen J.**

MACKIE *et al.*, Appellants, *and* THE ATTORNEY-GENERAL, Respondent

S. C. 88—D. C. Colombo, 71

Estate duty—Valuation of "Management shares" in a company—"Tangible assets" basis and profits basis—"Balance sheet method"—Circumstances where "tangible assets" method of valuation is appropriate—"Goodwill" non-existent in a speculative business—Estate Duty Ordinance (Cap. 187), section 20 (1)—Amending Ordinance No. 8 of 1941, section 6 (a).

In regard to valuation, for purposes of estate duty, of shares (not being preference shares) held by a deceased person in a Company at the time of his death in September, 1940—

Held, (i) that the price which the willing vendor could reasonably expect to obtain and a willing purchaser could reasonably expect to have to pay for the shares in question is the measure of the value contemplated in section 20 (1) of the Estate Duty Ordinance. In order to estimate the price which a prudent purchaser might reasonably be expected to pay for the shares it is necessary to examine the nature and history of the business, the risks involved and the extent to which the Articles of Association might be expected to depreciate the value of the shares.

(ii) that where the Article of Association impose restrictions on the alienation of shares, such restrictions generally depress the value of the shares. Where the Articles restrict the right to transfer shares, the shares must be valued, for the purpose of estate duty, on the basis that in spite of the Articles of Association the notional purchaser of the shares would be entitled to be put on the Company's register in respect of them, and if, by reason of the restrictions, the shares have depreciated in value such fact should be taken into consideration.

(iii) that the "tangible assets" or "balance sheet" method such as is contemplated in section 6 (a) of the amending Ordinance No. 8 of 1941, was the appropriate method for valuing the shares, where the business carried on by the Company was a highly speculative one and, therefore, it was not possible to predict that the profits earned in the years preceding the death of the deceased would be maintained in the future.

(iv) that "goodwill" is non-existent in a speculative business.

(v) that in valuing shares provision must be made, out of the profits, for reserves and income tax.

APPEAL from an order of the District Court, Colombo.

One C. W. Mackie died at Aberdeen, Scotland, on September 7, 1940, leaving property in Ceylon which included two assets namely, 9,201 Cumulative Preference Shares, and 5,000 Management Shares in C. W. Mackie & Co., Ltd.

C. W. Mackie & Co., Ltd., was a private company incorporated in Ceylon in the year 1922. The business of the company was to buy and sell rubber on a very large scale. It was a highly speculative business and, further, the right to transfer shares in the company was restricted by the Articles of Association. The question for consideration in this appeal was in regard to the valuation, for purposes of estate duty, of the 5,000 Management Shares held by the deceased.

H. V. Perera, K.C., with *S. J. Kadirgamer*, for the executors-appellants.

R. R. Crossette-Thambiah, K.C., Solicitor-General, with *Douglas Jansze*, Crown Counsel, for the Crown respondent.

Cur. adv. vult.

May 22, 1950. JAYETILEKE C.J.—

This is an appeal by the appellants who are the executors of the last will and testament of C. W. Mackie, deceased, against an order made by the Additional District Judge of Colombo on an appeal preferred by them to the District Court under section 34 of the Estate Duty Ordinance, Chapter 187, confirming the valuation made by the Commissioner for purposes of estate duty of 5,000 Management Shares held by the deceased in C. W. Mackie & Co., Ltd.

C. W. Mackie died at Aberdeen, Scotland, on September 7, 1940, leaving property in Ceeylon which included two assets, namely, 9,201 Cumulative Preference Shares, and 5,000 Management Shares in C. W. Mackie & Co., Ltd.

On December 22, 1942, the appellants delivered to the Commissioner of Estate Duty a declaration of property under section 29 (1) of the Ordinance in which they valued the 9,201 Cumulative Preference Shares at Rs. 758,438.43, and the 5,000 Management Shares at Rs. 4,925 on the figures appearing in the balance sheet as at December 31, 1939 (P8) adopting the method of valuation known as the " tangible assets " method. They valued the Cumulative Preference Shares at Rs. 82.43 per share and the Management Shares at 98½ cts. per share.

On February 15, 1943, the Assessor made a provisional assessment in accordance with the figures furnished by the executors and on April 21, 1944, he made an additional assessment under section 33 (1) of the Ordinance in which he assessed the 9,201 Cumulative Preference Shares at Rs. 828,090 and the 5,000 Management Shares at Rs. 1,500,000 which works out to Rs. 90 and Rs. 300 per share, respectively.

The appellants delivered to the Commissioner of Estate Duty a written notice of objections dated May 19, 1944, by which they objected to the increased assessment on the following grounds:—

(1) That the Cumulative Preference Shares could only be valued at par plus the proportion of such profits available for dividend as the holders of the shares were entitled to receive in respect of preference dividends in arrears. On this basis they were prepared to accept a valuation of Rs. 87.601 per share of Rs. 806,017 as certified by the auditors of the Company.

(2) That the Management Shares could only be valued on the nett value of the Company's assets at the date of death of the deceased after providing for the value of all the Preference Shares. On this basis they were prepared to accept a valuation of Rs. 203,094 at Rs. 40.6188 per share as certified by the auditors less Rs. 10.6188 for depreciation under the proviso to section 20 (1) of the Ordinance by reason of the death of the deceased.

The appellants raised the figures given by them in their declaration of property to Rs. 806,017 and Rs. 203,094 as a certain sum had accrued as profits between January 1, 1940, and September 6, 1940.

On May 20, 1946, the Commissioner of Estate Duty notified to the appellants his determination to maintain the assessment dated April 21, 1944, subject to a reduction of the valuation of the Management Shares to Rs. 250 per share. The reason for the reduction is not known.

The appellants appealed to the District Court of Colombo against the Commissioner's assessment. Section 40 of the Ordinance says that upon the filing of the petition of appeal and the service of a copy thereof on the Attorney-General, the appeal shall be deemed to be and may be proceeded with as an action between the appellant as plaintiff and the Crown as defendant.

At the trial the following issues were framed:—

(1) Is the market value of the Preference and Management Shares in the assessment excessive ?
(2) Should the Preference Shares be valued as stated in paragraph 10 (*c*) of the petition and if not at what sum ?
(3) Should the Management Shares be valued as stated in paragraph 10 (*c*) of the petition and if not at what sum ?
(4) Did any goodwill attach to the Management Shares at the date of the death of the deceased and if so what figure ?
(5) Was the Management Shares as computed in terms of section 20 (1) of the Estate Duty Ordinance Rs. 1,250,000 and if not what sum ?

After the issues were framed the learned Attorney-General accepted the value placed on the Cumulative Preference Shares by the executors as the difference was very small and the trial proceeded on issues 1, 3, 4, and 5. After trial the learned Additional District Judge answered the issues as follows:—

(1) No.
(3) No.
(4) Yes, Rs. 250.
(5) Yes. The value of the Management Shares is Rs. 1,250,000,

and dismissed the action with costs.

The present appeal is against that judgment.

At the argument before us the claim for depreciation by reason of the death of C. W. Mackie was not pressed.

The appellant's valuation of the shares is based on the " tangible assets " value whilst that of the Commissioner is based on the profits value.

Two questions arise for decision on this appeal, (1) whether on the facts of this case the " tangible assets " basis is the appropriate basis of valuation of the shares, (2) if it is not, whether the valuation according to the profits basis is excessive.

The answer to these questions does not depend upon the credibility of the witnesses, which I may say was not questioned at the argument before us. Counsel for the appellants pointed out that the judgment of the learned Additional District Judge is not helpful as he has failed to

appreciate the evidence. For instance he failed to appreciate why Mr. Lander raised his valuation of the Management Shares from 98½ cents each to Rs. 40.6188 each.

Mr. Lander, a Chartered Accountant of considerable experience, valued the shares for the appellants. His valuation is as follows :—

	Rs. c.	Rs. c.
Total assets	2,286,005 2	
Due to creditors		400,186 27
Preference Shares		209,988 0
Dividend arrears 1930–32		
Preference Share dividends 1933–1940		522,720 0
Preference Share Capital ..		900,000 0
	2,286,005 2	2,121,994 27
Balance	164,010 75	
Add profits from January 1, 1940, up to January 6, 1940	46,982 96	
	210,993 71	
Book value of investments in excess of broker's valuation	7,899 30	
	203,094 41	
Divide by 5,000	40·6188	

Mr. Gunasekera, the Assistant Commissioner of Estate Duty, and Mr. Satchithananda, a Chartered Accountant, valued the shares for the Commissioner. Mr. Gunasekera's valuation is as follows :—

	Rs. c.	Rs. c.
1936 Profit	97,391 0	
1937 Loss		42,003 0
1938 Profit	149,485 0	
1939 Profit	787,640 0	
1940 (1.1.40—6.8.40) Profit ..	454,532 0	
	1,489,048 0	42,003 0
Total profit	442,003 0	
	1,447,045 0	
Average profit per year ..	310,080 0	
Deduct Preference Share dividends ..	79,200 0	
	230,880 0	
Capitalize at 15 per cent. ..	1,539,200 0	
Divide by 5,000	307.84 per share	

Mr. Satchithananda's valuation is based on the " weightage method ". He took the nett profits for five years up to the end of 1940 and weighted the profits and losses by multiplying the figures from 1 to 5.

His valuation is as follows :—

				Rs.	c.	Rs.	c.
1.9.35—31.8.36	..		..	29,039	0		
1.9.36—31.8.37	..		..			5,337	0
1.9.37—31.8.38	..		..			73,894	0
1.9.38—31.8.39	..		..			489,775	0
1.9.39—31.8.40	..		..			507,420	0
When weighted	29,039	0×1	..	29,039	0		
	5,337	0×2	..			10,674	0
	73,894	0×3	..			221,682	0
	489,775	0×4	..			1,959,100	0
	507,420	0×5	..			2,537,100	0
				29,039	0	4,728,556	0
						29,039	0
						4,699,517	0
Weighted average	4,699,517 0 / 15		..			313,300	0
Less Preference dividends			..	67,300	0		
Reserve..	..		..	30,000	0	97,300	0
						215,980	0
Average yield at 16 per cent. 215,980×100 / 16	..		..			1,349,875	0
Value of share	..		..			270	0

Mr. Gunasekera's and Mr. Satchithananda's valuations are based on the assumption that the profits would be maintained for at least five years.

Mr. Lander, Mr. Gunasekera and Mr. Satchithananda valued the shares on the footing that the business was a going concern.

In *Abraham v. Federal Commissioner of Taxation* [1], the report of which is not available to us but a note of which appears in Adamson[2], it was held that the final assessment of the value of the shares must be made principally on the basis of the income yield but where owing to exceptional circumstances the valuation on this basis presents enormous difficulties it is legitimate to rely more than usual on the assets value.

In *Findlay's Trustees v. Commissioners of Inland Revenue* [3] Lord Fleming said:

"I do not doubt that when one is seeking to ascertain the profits which will probably be earned by a business in the future it is quite usual to do so by taking an average of the profits actually earned for the three preceding years. This probably operates quite equitably when one is dealing with a well-established business which has normal ups and downs but has no violent fluctuations in either direction."

[1] *70 Commonwealth L. R. 23.*
[2] *The Valuation of Company Shares and Businesses.*
[3] *22 A. T. C. 437.*

Mr. Lander gave as his reason for adopting the " tangible assets " method that the business carried on by the Company was a highly speculative business and therefore it was not possible to predict that the profits earned in the years preceding the death of the deceased would be maintained in the future. Mr. Gunasekera and Mr. Satchithananda agreed with Mr. Lander that the business was a very speculative one but they thought that as the war was on the profits would be maintained in the future. Mr. Gunasekera said " I cannot think of a more speculative business than Mackie's. Mr. Satchithananda said " A rubber business can be said to be a speculative business because the risk is greater. It is a very risky business."

Section 20 (1) of the Ordinance which is identical with section 7 (5) of the Finance Act, 1894, provides that the value of any property shall be estimated to be the price which, in the opinion of the Assessor, such property would fetch if sold in the open market at the time of the death of the deceased. Section 20 (1) was amended by Ordinance No. 8 of 1941 as follows:—

> " (6) (*a*) Where the property to be valued consists of shares (not being preference shares) in any company which by its articles restricts the right to transfer its shares or which is a company controlled by not more than five persons, and the Commissioner is satisfied that the shares have not, within the period of twelve months immediately preceding the death of the deceased, been quoted in the official list of a recognized stock exchange in the United Kingdom or in a list of a like nature issued in Ceylon by any association of brokers approved by the Financial Secretary for the purposes of this sub-section, the Commissioner may direct that the principal value of such shares for the purposes of this Ordinance shall not be ascertained in the manner provided by sub-section (1), but shall be ascertained by reference to the value of the total assets of the company."

The amending Ordinance does not apply to this case because it came into operation after the death of the deceased but it shows that the " tangible assets " method is an appropriate method to be adopted in the valuation of shares which are subject to restrictions. In *Ellesmere v. Inland Revenue Commissioners* [1] Sankey J. said:

> " What is meant by the words ' the price which it would fetch if sold in the open market ' in Section 7 (5) of the Finance Act 1894 is the best possible price that is obtainable, and what that is is largely, if not entirely, a question of fact."

The price which the willing vendor could reasonably expect to obtain and a willing purchaser could reasonably expect to have to pay for the shares in question is the measure of the value under the section. In order to estimate the price that a prudent purchaser might reasonably be expected to pay for the shares it is necessary to examine the nature and history of the business, the risks involved and the extent to which the restrictions in the Articles might be expected to depreciate the value of the shares.

[1] *(1918) 2 K. B. at 740.*

C. W. Mackie & Co., Ltd., was a private Company incorporated in Ceylon in the year 1922 *inter alia* to take over and carry on the business carried on by the deceased as a dealer in rubber. It had a paid up capital of Rs. 1,000,000 divided into 19,800 8 per cent. Cumulative Preference Shares of Rs. 50 each and 5,000 Management Shares of Rs. 2 each. Clause 5 of the Memorandum of Association provides that the Management Shareholders are entitled to all profits and other monies of the Company available for dividend which the directors determine to distribute after making provision for reserve and depreciation and after paying the cumulative preferential dividends and the directors' fees. By Articles 91 and 94 of the Articles of Association the deceased was appointed a life director and was given full control of the business of the company and the power to arrange the policy of the company. It appears from P2 that up to the year 1926 the deceased held 3,625 out of the 5,000 Management Shares and that in that year he purchased the remaining 1,375 shares. The right to transfer shares in the Company was restricted by the Articles of Association.

Article 38 provides that any person proposing to transfer any share shall give notice in writing to the Company that he desires to transfer the same. Such notice shall specify the sum he fixes as the fair value and shall constitute the Company his agent for the sale of the share so fixed, or, at the option of the purchaser, at the face value to be fixed by the Auditors in accordance with the Articles.

Article 39 provides that the shares specified in the transfer notice shall be offered by the Company in the first place to the Life Director, and, if they are not taken up by him within 90 days, shall be offered by the Company to any person selected by the Life Director whom he may deem it desirable in the interests of the Company to admit to membership. Subject as aforesaid the share shall be offered by the Company to the other members.

Article 41 provides that in case any difference arises between the proposing transferor and the purchasing member as to the fair value of a share the Auditors shall, on the application of either party, certify in writing the sum which, in their opinion, is the fair value and such sum shall be deemed to be the fair value and in so certifying the Auditors shall be considered as acting as Experts and not as Arbitrators.

Article 43 provides that the proposing transferor shall be at liberty to sell or transfer the shares to any person and at any price if the Company fails to find a member willing to purchase the shares. But *Article 45* provides that the Directors may refuse to register any transfer of shares where they are not of the opinion that it is desirable to admit the proposed transferee to membership.

There are certain Articles which relate to the compulsory acquisition of shares, and which prevent a shareholder from owning or being interested in any other business in rubber to which reference should be made. I refer in particular to Articles 46, 47, 48, 49, 50, 53 and 54.

Article 45 provides that the holders for the time being of 9/10ths of the issued capital may at any time serve the Company with a requisition to

enforce the transfer of any particular shares not held by the requisitionists whereupon the Company shall forthwith give notice to the holder of such shares notice of such requisition; and unless within 14 days afterwards the holder shall give to the Company a transfer notice in respect of his shares in accordance with Article 38 he shall be deemed at the expiration of that period to have certainly given such notice and to have specified therein the amount of capital paid up on the shares as the sum he fixes as the fair value.

Article 49 provides that in the event of the death of an ordinary director the Life Director and the surviving ordinary directors for the time being may at any time within four years thereafter serve the Company with a requisition to enforce the transfer to them in proportion to the existing shares held by them respectively of any shares standing in the name of any ordinary director and the provisions of Article 46 as to giving notice and other relevant provisions of that Article shall apply to every such requisition.

Article 48 provides that no member of the Company other than the Life Director shall, without the consent of all the members for the time of the Company, or the Life Director, be interested as a shareholder, Director, Partner, Manager or otherwise in any concern carrying on any business in competition with the Company or any interests opposed to those of the Company and if it be proved to the satisfaction of the shareholders that any member has committed a breach of this Article they may serve him with a notice in writing requiring him to retire from or otherwise determine his interest in such concern and stating that in the event of non-compliance with such requisition within 28 days his shares shall be liable to forfeiture and unless within 28 days after the service of such notice it shall be proved to the satisfaction if the Directors that the requisition has not been complied with the whole of or any of the shares of such member may be forfeited by resolution of the Directors to that extent.

Article 49 provides that a member of the Company other than the Life Director shall not, without the Company's consent or the consent of the Life Director. either solely or jointly with, or as Director, Manager or Agent of or for, any other Company or person or persons directly or indirectly carry on or be engaged or concerned or interested as a shareholder or otherwise in any business which the Company is authorised to carry on and the Directors may by resolution forfeit without prejudice to the provisions of Article 30 the shares of any member who acts in contravention of this provision. Article 30 provides that a member whose shares have been forfeited shall be liable to pay to the Company all calls made as payable and not paid on such shares at time of forfeiture and interest thereon up to the date of payment without any deduction or allowance for the value of the shares at the time of forfeiture.

Article 50 provides that a person who ceases to be a member of the Company shall not without the Company's consent or the consent of the Life Director at any time within five years from the date he ceases to be a member, either solely or jointly with, or as Director, Manager or Agent of or for any other Company or person or persons directly or indirectly, carry on or be engaged or concerned or interested in the business of a

Merchant, Produce Broker or Commission Agent in the Island of Ceylon or permit or suffer his name to be used or employed in, carry on or in connection with any such business.

Article 54 provides that the Directors may call on the executors or administrators of a deceased member (other than the Life Director) to transfer the shares of the deceased to some person to be selected by such Executors or Administrators and approved by the Life Director or (if the Life Director be dead) by the Ordinary Directors and if the Executors or Administrators do not comply forthwith with such call they shall be deemed to have served the Company with a transfer notice under Article 38 and to have specified therein a sum equal to the amount paid upon the shares as the fair value and the provisions of that and the subsequent Articles shall take effect.

In the case of *Commissioners of Inland Revenue and others v. Crossman* [1] where there were restrictions similar to those contained in Articles 38 and 41, the House of Lords held that the value of the shares for the purpose of duty must be estimated at the price which they would fetch if sold in the open market on the terms that the purchaser should be entitled to be put on the Company's register as the holder of the shares and should hold them subject to the provisions of the Articles of Association including those relating to the alienation and transfer of shares in the Company. In the course of his judgment Viscount Hailsham, L.C., said:

" I think full justice is done to the meaning of the sub-section if the property to be valued is determined by the earlier Sections and Section 7 is treated as being merely a statutory direction as to the method by which the value is to be ascertained. In order to comply with that statutory direction it is necessary to make the assumptions which the Statute directs. This is not to ignore the limitations attached to the shares. In the present case a share in such a company as this, with an unrestricted right of transfer would probably be worth twice as much as the £355, which is fixed by Findlay J. "

The shares must therefore be valued on the basis that in spite of the Articles of Association the notional purchaser would be entitled to be put on the Company's register in respect of them, and if, by reason of the restrictions, the shares have depreciated in value such fact should be taken into consideration.

The business of the Company was to buy and sell rubber on its own account on a very large scale. It was carried on by the deceased himself from 1922 up to 1931 when he retired and settled down in England leaving Mr. Williams in charge. The deceased, however, kept in touch with the business and controlled its policy right up to his death. The Company had a very large store which cost nearly Rs. 300,000 to build in 1926. Between 25 per cent. to 30 per cent. of the Island's exports of rubber passed through the hands of the Company. The manner in which the business was carried on was described by Mr. Williams. He said:

" Mackie kept a large stock of rubber in hand. He bought whether there was an immediate prospect of selling or not. His plan was to

[1] *(1936) 1 A. E. R. 762.*

buy as much rubber as possible and stock. He used to buy 50 or 60 tons of rubber a day. He would buy in a ralling market and try to sell in a irsing market. It was very difficult to find out what a falling market was and what a rising market was. We could not wait for a falling market to buy. We had such large stocks that the rubber had to be turned over. In a falling market we had to sell 50 or 60 tons and try to cover up buying it at a lower price. It we had 5,000 tons of rubber in stock at any one time and if the price went up by one cent a pound we would make Rs. 110,000 and if the price went down by one cent we would lose that amount. We used to send rubber to Germany, Australia, Holland, Czechoslovakia and London. We had dealer agents and broker agents in London and other places. We ship the rubber and they sell it. They send bids. If we pay more here we send a counter-offer. Sometimes they take, sometimes they don't. "

As I said before Mr. Lander said that the business was a speculative one and the experts called by the Crown admitted it. It may be useful for me to state in detail what the witnesses called by the appellants said on the point.

Mr. Lander said :

" The results show quite clearly that it was a business with a very sensitive produce—rubber, and they indicate that a highly speculative policy had been indicated. There were large profits made in certain periods and very large losses in certain other periods. In 1926 there were large reserves about 3/4 million rupees. The losses gradually eliminated that reserve. In 1932 the Company was insolvent. The movements of rubber over history have been unpredictable. Large fortunes have been made in rubber and large fortunes have been lost in rubber. Rumours of extended production in other countries, changes in policy of consumers and also availability of shipping affect the price. At any time it would have been a gamble to buy any interest in the Company."

Mr. Williams said:

" I have a large experience in the commercial aspect of rubber. It is very difficult to predict with any accuracy the future rubber market. It is not known what is going to happen except on a very few occasions. Mr. Mackie carried on a very speculative business. Buying of any interest in Mackie's at any time would have been a gamble."

Mr. Hayward, the Managing Director of the Rubber and Produce Traders' Ltd., which carried on a business similar to that of Mackie & Co., Ltd., up to 1938, when it was closed down owing to heavy losses, said:

" Dealing in rubber is a highly speculative business. There is an exchange for dealing in rubber in London, New York and Singapore and in these three places people gamble in the turnover. Change of Government, over-production, rumours of war, synthetic rubber, large production of motor cars all affect the price of rubber. The Company made half a million rupees in 9 months in 1940. All that could have been lost in three months if it took a wrong view of the market."

Mr. Cumming, a partner in E. John & Co., a firm of produce brokers, said:

> "In a company like Mackie & Co., Ltd., very much risk in the business is involved because one must be certain of taking the right view. It is a speculative business like the races. At normal times the prices fluctuated."

The fluctuations in the price of rubber between 1922 and 1940 are to be seen in P10 and the profits and losses of the Company and the dividends paid in P7. P7 shows that between 1922 and 1926, there were profits amounting to Rs. 3,441,359, between 1927 and 1932, there were losses amounting to Rs. 1,804,304, and between 1933 and 1940, there were profits amounting to Rs. 1,911,233. It also shows that dividends were paid on the Preference and Management Shares in 1926, and a sum of approximately Rs. 750,000 was carried to the general reserve, that the preference share dividends for 1927 and 1928 were waived, no dividends were paid on the Preference Shares from 1930 to 1940, and for the first time between 1927 and 1940 the assets exceeded the liabilities in 1940. It is clear from the figures in P7 that any five years is not comparable with the next five years and cannot be taken as a reasonable anticipation of the next five years. The fluctuations in the profits and losses have been so violent that there is no normality in the history of the company disclosed in the balance sheet P7. One cannot of course expect normality in a business which is not carried on on business principles but is in the nature of a gamble. Yet Mr. Gunasekera said:

> "If Mackie died in 1926, I would probably have valued the shares still higher than I have done now unless there was some known factor. After a person had bought them he would have received nothing up to 1940. From 1926 up to 1932 he would have lost all his capital and the Company would have been wound up."

It was argued that the losses during that period were due to the world depression. The depression commenced in the latter part of 1929, but there were losses in 1927 and 1928. There are no materials before us which lend the slightest support to that contention. P10 shows that from 1929 to 1932, the price of rubber dropped steadily and the probability is that the losses were due to the Company speculating heavily in a falling market. The passage quoted above from Mr. Gunasekera's evidence demonstrates how fallacious his method of valuation is when it is applied to a speculative business. With regard to the future prospects of rubber he said that as the market in 1940 was good there was no prospect in the fall in the price of rubber in the next six years. This seems to be pure speculation on his part. It is true that rubber was a munition of war but what guarantee was there that there would be no fluctuations in the price of rubber and that the war would go on for six years. Mr. Hayward, who according to Mr. Gunasekera had an intimate knowledge of the rubber market and knew much more about the rubber market than he did, said that, though the Company had made half a million rupees in the first nine months of 1940, it could have lost all that in the next three months if it took a wrong view of the market. It must be remembered that the deceased died at a time when the war had reached

a very critical stage for England. France was out of the war and England and the Empire were alone against Germany and Italy. The Battle of Britain had begun and everyone was in doubt whether the Royal Air Force would be able to withstand the tremendous attack by the German Air Force which was superior in strength. It is with the price which a hypothetical purchaser must reasonably expect to have to pay for the shares at this critical period with which we are now concerned. A prospective purchaser may be an investor or a speculator. In normal times an investor would probably not have been interested in these shares because no dividends had been paid for 14 years. A speculator may have been interested in them but could the seller have reasonably expected him to pay anything more than the " tangible assets " value for them? I think not. Could the seller have reasonably expected him to pay even that at a critical period like 1940, when there was the possibility of all human affairs being dislocated? I think not. Mr. Williams and Mr. Cumming gave useful evidence on this point. Mr. Williams said that on the death of the deceased if he got the shares very cheap he would have bought them as a gamble. Mr. Cumming said that in 1940, his firm would not have been willing to make any underwriting proposition for these shares because the risk was too great owing to the nature of the shares and the war conditions. It was difficult to foresee things and people were anxious to keep their money in their Banks.

The learned Additional District Judge says in his judgment that Mr. Hayward was optimistic about the future of rubber when he was coming back from England in August, 1940. If the learned Judge intended to say that Mr. Hayward was optimistic about the future of rubber for a long period it is a clear misdirection because Mr. Hayward explained in his cross-examination that what he meant was that as the war was in progress he could not take a long view. On a short view he was optimistic, that is, for the next three or four months.

For the reasons given by me I am of opinion that Mr. Lander's method is the more appropriate method to be adopted for the valuation of the shares. That is the method contemplated in the amending Ordinance 8 of 1941 for the valuation of shares of this nature and that was the method which was adopted in 1926 when the deceased acquired the outstanding shares which belonged to Mr. Robertson and others. The figure paid by the deceased represented only the value of the " tangible assets " remaining for each share. Nothing was added on account of goodwill, presumably because in a speculative business there can be no goodwill.

Leake says:

" There seems to be no doubt about the truth of the proposition that before it is possible to justify value being put upon the goodwill of any undertaking it must be shown that the expected future annual profits exceed the normal annual wage or hire of the capital invested having regard to the nature of the risk."

In a speculative business one cannot expect profits but can only hope for profits.

[1] *On Goodwill.*

There remains the question whether Mr. Gunasekera's valuation is excessive. It was mainly on Mr. Gunasekera's valuation that the Crown relied.

Mr. Perera argued that the rate of conversion adopted by Mr. Gunasekera was too low and that Mr. Gunasekera should have made provision for reserves and Income Tax and an allowance for depreciation in view of the restrictions.

There is a conflict of evidence between Mr. Gunasekera and Mr. Satchithananda as to what the risk rate should be in a speculative product like rubber. Mr. Gunasekera said that he took 10 per cent. as the risk rate in adopting 15 per cent. as the appropriate rate of conversion, but Mr. Satchithananda said that he would allow 20 to 25 per cent. for risk. Mr. Satchithananda's evidence is supported by the evidence of Mr. Cumming, who said that, in a business of this kind, a person would expect 25 to 30 per cent. as profits. There is the further fact that, when the shares held by one Mr. G. L. Lyon in Heath & Co. were valued in 1943, for purpose of Estate Duty, the rate of conversion adopted was 14 per cent. though there was no risk in the business at all. Heath & Co. carried on business as exporters of tea and, occasionally, rubber on a commission basis. Mr. Gunasekera said that, if the rate of conversion adopted in the valuation of those shares was 14 per cent., he would agree that the rate adopted by him in this case should be higher.

If the risk rate is taken as 20 per cent. and the rate of conversion as 25 per cent. in the present case which, in my opinion, is by no means excessive Mr. Gunasekera's valuation of the shares will be reduced to Rs. 190 per share.

An examination of Mr. Gunasekera's valuation, which I have set forth fully above, shows that he has made no provision for reserves and Income Tax and no allowance for depreciation. Mr. Gunasekera said that he generally allows a reasonable amount for reserves, but he made no allowance in the present case for the reason given in the following passage in his evidence:—

> " I did not apply the principle of weightage because I did not deduct from these figures any tax payable. I also did not allow a sum that should be withheld from distribution to maintain reserves as I thought that the two items would be counterbalanced."

Mr. Gunasekera did not demonstrate how the two items were counterbalanced. I find it extremely difficult to understand what he intended to convey in the passage quoted above, and I have no alternative but to ignore his evidence on the point. Mr. Satchithananda said that in valuing shares provision must be made out of the profits for reserves and Income Tax. P7 shows that a sum of Rs. 750,000 which works out to Rs. 150,000 a year was carried to the general reserve in 1926. If that had not been done the Company would, in all probability, have been wound up before 1932, and the necessity to decide the problems we are confronted with would not have arisen. Again, P9 shows that, in the year 1940, when the Company became solvent after a period of about ten years, a further sum of Rs. 150,000 was carried into the general reserve. It seems to me that Rs. 150,000 is not too large a sum to be put into the reserve annually

having regard to the highly speculative nature of the business carried on by the Company. If that sum is deducted out of the average profits Mr. Gunasekera's valuation would be reduced to approximately Rs. 80 a share. If Income Tax at 15 per cent., the rate current at the date of death of the deceased, is also deducted the nett balance available for the Management Shares would be Rs. 45,248 which when capitalised at 25 per cent. would result in reducing Mr. Gunasekera's valuation to Rs. 36 a share.

Adamson [1] says that restrictions on the alienation of shares, either by vesting in the Directors a general power to refuse to register a transferee whom they consider would be an undesirable member, or by specific requirements as to the consideration payable to an intending seller, or as to the method of offering the shares for sale, or by giving them or the auditors the power to fix a fair value to be paid to the sellers, and similar restrictions detract from the value of the shares for certain purposes, unless a controlling interest is being dealt with, namely, a holding of more than 75 per cent. of the total issued shares, which would place the purchaser in a position to use his voting power to remove the restrictions. He says further that such restrictions limit the market, and make the shares unattractive to many investors and to banks for security purposes. Even if all the preference shares belonging to the deceased were sold along with the management shares the purchaser would have had only 14,000 out of 24,000 shares, which would not have given him a controlling interest in the Company. The extent to which restrictions, similar to those contained in some of the articles referred to above, depress the value of the shares can be gathered from the passage in the judgment of the Lord Chancellor quoted above and from the following observations of Lord Fleming in the *Trustees of J. T. Salvesen v. Commissioners of Inland Revenue* [2]:—

> " I may say at once that I regard these restrictions as depreciating their value very considerably . . . . All the witnesses were agreed that the restrictions would depreciate the value of the shares but the only witness who put a money value on the restriction was Mr. Robertson-Durham who said that, in his opinion, it might make a difference as much as 8*s*. 4*d*. on his value of £1—6—8 and, in my opinion, this figure is by no means excessive."

Mr. Lander did not get an opportunity of putting a money value on the restrictions because the Crown did not disclose Mr. Gunasekera's method of valuation either in the pleadings or in his cross-examination. This is indeed a matter to be regretted. On the materials before me I can only say that the value of the shares is depressed by the restrictions I have referred to.

Mr. Satchithananda's method of valuation is, as I have said before, also based on the maintainability of future profits, and for the reasons given by me is inapplicable to a speculative business. But it seems to me that there are other reasons for rejecting it. For instance, according to P16, which Mr. Satchithananda referred to as the Students' Note

[1] *The Valuation of Company Shares and Businesses.*
[2] *9 A. T. C. 42.*

issued to him by H. Foulk, Lynch & Co., Ltd., when he was a student, there must be a trend of profits to apply the "weightage method". An examination of P7 shows that there was no trend of profits from August 1, 1935, up to July 31, 1940. There is also the fact that Mr. Satchithananda admitted in his evidence that in valuing shares all abnormal and all war profits must be excluded and that he failed to exclude the abnormal and war profits made in the years 1938, 1939 and 1940. He admitted further that if the profits made in the war years 1939, 1940 and 1941 were excluded the weighted average would be nil.

I would accordingly uphold Mr. Lander's valuation of the 5,000 Management Shares held by the deceased. On the basis of this valuation it is agreed that the appellants are entitled to a refund of Rs. 166.929.57. I would set aside the order made by the learned Additional District Judge and enter judgment in favour of the appellants for the sum of Rs. 166,929.57 with interest as prayed for in para. (*d*) of the prayer of their petition of appeal dated June 14, 1946. The appellants will be entitled to costs here and in the Court below.

GRATIAEN J.—

This appeal relates to the valuation for purposes of estate duty of 5,000 "Management Shares" held by the deceased C. W. Mackie in the firm of C. W. Mackie & Company, Ltd., at the time of his death. A separate dispute regarding the value of 9,201 Cumulative Preference Shares belonging to the deceased in the same Company was settled in the course of the proceedings in the Court below.

C. W. Mackie died in Scotland on September 7, 1940, and was at that date possessed of a considerable estate in Ceylon and abroad. The Company in which he held the "Management Shares" with which this appeal is concerned was a private Company incorporated in Ceylon in 1922. He was the Life Director and as such he had a controlling interest in the Company's affairs under the Articles of Association. The paid up capital was Rs. 1,000,000 divided into 19,800 Cumulative 8 per cent. Preference Shares of the par value of Rs. 50 each (of which the deceased held 9,201) and 5,000 "Management" or ordinary shares of the par value of Rs. 2 each (of which he had held the entirety since December 31, 1926). The Preference Shareholders had a prior right to be paid their dividends at the rate prescribed for them, but had no further right to participate in the profits of the Company. Any profits left over were available for payment as dividends to the Management shareholders—but only to an extent which the Directors might recommend ; in the event of liquidation, all undistributed profits were to be paid to them after repayment of the capital and arrears of dividends due to the Preference Shareholders. I shall refer later to the restrictions imposed by the Articles of Association on the transfer of a shareholder's interests in the Company.

On December 22, 1940, the executors of the deceased's estate furnished the Commissioner with a declaration in which, for purposes of estate duty, they valued each of the "Management Shares" at 98½ cents. this valuation was based (by reference to the figures in the last audited

balance sheet of the Company available before Mackie's death, i.e., for the year ending December 31, 1939) on a computation of the nett assets remaining for each "Management Share" after making provision for taxation and for the liability to preference shareholders in respect of capital and arrears of dividends. The valuation was accepted by the Assessor in his provisional assessment dated February 15, 1943. On April 21, 1944, however, he made an additional assessment whereby among other items, he increased the estimated value of each "Management Share" to Rs. 300 on a basis of computation which was not disclosed to the executors until December, 1948, when he gave evidence in the Court below. They appealed from this additional assessment to the Commissioner on May 19, 1944, but stated that they were now willing to accept a valuation of Rs. 40.6188 per "Management Share". The learned District Judge has wrongly assumed that this higher figure involved a serious inconsistency on their part. In actual fact, the same principle of valuation—i.e., " the balance sheet method "—was again adopted, but the higher figure of Rs. 40.6188 was arrived at by reason of an increase in the amount of the undistributed profits earned since January, 1940, as shown in the later balance sheet for the year ending December 31, 1940—proportionate adjustments having been made in those figures so as to ascertain the approximate position of the Company as at September 6, 1940.

On May 20, 1946, the Commissioner's determination on the appeal (at which there was no formal *inter partes* hearing) was communicated to the appellants, and, apart from items with which we are not now concerned, the Assessor's estimate of the value of each "Management Share" was reduced to Rs. 250. No reasons for the Commissioner's determination were then or at any later date notified to the appellants; nor were they made available during the proceedings before the learned District Judge or in this Court; the record of the evidence and of Counsel's observations indicates that even the Assessor and the (then) Solicitor-General who presented the case for the Crown in the lower Court seem to have been left to speculate as to the process by which the learned Commissioner had computed the value of the shares. Repeated attempts of the executors' lawyers, both before and at the commencement of the litigation which followed, to seek enlightenment as to the case which their clients were required to meet were either resisted or ignored. Full advantage was taken of the defective machinery of the Estate Duty Ordinance (Chapter 187) and of our Code of Civil Procedure for refusing to disclose information which, if available, would have helped to shorten the proceedings which followed. In the result, the executors, on whom lay the burden of disproving the correctness of the Commissioner's computation at the hearing of the appeal which they preferred in June, 1946, to the District Court of Colombo under section 34 of the Ordinance, entered upon a most unusual task. Indeed, the method of computation ultimately relied on by the Crown (whether it was the same as that adopted by the Commissioner is still a closely guarded secret) was not even specifically put in cross-examination to the appellants' expert witnesses for their criticism. I cannot commend this technique of litigation.

It is hoped that early steps will be taken to modernise the procedure regulating appeals between the Crown and its subjects in estate duty cases. Proceedings of this kind cannot be conducted satisfactorily unless the substantial points of contest are clarified at the earliest possible stage. In the present action, the precise nature of the controversy—namely the proper basis of valuing the deceased's shares—did not clearly emerge until after the case for the executors had been closed. In this country the Crown, as a litigant, still enjoys many immunities and privileges which have been swept away by the provisions of the Crown Proceedings Act, 1947, in England. So long as these and other immunities and privileges continue to exist, officers of the Crown should, for reasons of fairness and in the interests of justice, respect the long-established and honourable convention "not to throw any difficulty in the way of any proceeding for the purpose of bringing matters before a Court of Justice where any real point of difficulty that requires judicial decision has occurred . . . . unless there be some plain over-ruling principle of public interest concerned which cannot be disregarded". (*Vide* the English decisions approved by Lord Chancellor Simon in *Duncan v. Cammel Laird and Company*[1]). There should be no confusion in this connection between the claims of the *public interest* (to which the rights of every private litigant must of course give priority) and the desire for *financial advantage* to the public revenue.

After a protracted trial in the Court below the learned District Judge upheld the Commissioner's assessment, and valued the 5,000 "Management Shares" belonging to the deceased at the time of his death at Rs. 250 each. The present appeal is from his judgment. The grounds on which I differ from the learned Judge sufficiently appear in the reasons which follow. The relevant facts are not in dispute, and so questions as to the credibility of witnesses arises for consideration; the main question for decision relates to the principle of valuation which is most appropriate to the present case.

The value of the shares must be estimated to be the price which they would have fetched "if sold in the open market at the time of the death of the deceased." The language of Section 20 (1) of the Estate Duty Ordinance (Chapter 187) corresponds to that of Section 7 (5) of the Finance Act, 1894, of England. Admittedly the restrictions imposed by the Articles of Association upon the free transfer of shares in C. W. Mackie and Company, Ltd., would have prevented such a sale in the open market from taking place. It is nevertheless necessary to value the shares at the relevant date by reference to the price which they would have fetched at *a notional sale to a hypothetical purchaser* "on the terms that the purchaser should be entitled to be registered and to be regarded as the holder of the shares, and should hold them *subject to the provisions of the articles of association, including those relating to the alienation and transfer of shares in the Company*". *Commissioners of Inland Revenue v. Crossman*[2]. This principle of valuation which was laid down by the majority of the distinguished Judges who decided *Crossman's* case[2] is, I should imagine, seldom easy to apply in a particular case. As

[1] (1942) A. C. 624.

[2] (1937) A. C. 26.

Lord Fleming pointed out in *Salveson's Trustees v. Commissioners of Inland Revenue*[1] " the estimation of the value of shares by a highly artificial standard which is never applied in the ordinary share market must be a matter of opinion and does not admit of precise scientific or mathematical calculation ". It was no doubt for this reason that the Legislature decided, shortly after Mackie's death, to prescribe a statutory basis of computation in such cases. *The Estate Duty Amendment Ordinance, No. 8 of 1941*, sanctions a method of valuation—i.e., by assessing the value of the deceased shareholder's interest in the Company's assets (*including goodwill, if any*)—which is analogous to that laid down for similar cases in the Finance Act, 1930, and the later Finance Act, 1940, of England.

It is now common ground that the provisions of the amending Ordinance do not operate in the present case. Apart from the question whether the Ordinance may be regarded as having retroactive effect, the Legislature has, for some reason which is obscure, departed from the English model by leaving it entirely to the Commissioner to decide whether these provisions should operate or not in any particular case. There is no evidence that the Commissioner has so decided in regard to Mackie's shares, although the evasive averment in paragraph 4 of the answer filed on behalf of the Attorney-General seems to indicate that the revenue authorities were at one stage undecided as to which alternative position should be adopted in this connection with best advantage to the Crown.

As far as I can judge, the "balance sheet method" is, in some cases, a method which a Court of law may legitimately adopt when the application of other recognised methods for assessing the "market value" of shares presents great difficulty. In other words, whenever the provisions of the amending Ordinance do strictly apply, the method of valuation thereby prescribed is of course imperative; where the Ordinance does not apply, the method is nevertheless permissible if in all the circumstances of the case it is found to be the most appropriate method of estimating "market value" for purposes of estate duty. The value of a business is on this basis arrived at by adding the value of its goodwill, if any, to the value of its tangible assets. If no goodwill, in the commercial sense, exists the value of the business cannot exceed, although it may sometimes be less than, that of its tangible assets. Similarly, the value of a "share" in such a business is arrived at by reference to its proper proportion of the sum so computed, regard being had to the rights and benefits attaching to such "share" under the Articles of Association.

Various matters must be taken into account in order to assess the "market value" of the "Management Shares" held by Mackie at the time of his death. Of the many decisions which were cited to us, I have found the judgment of Lord Fleming in *Salveson's* case[1] specially instructive in the present context. "The problem can only be dealt with", he says, "by considering all the relevant factors as known at the date of the deceased's death, in order to determine what a prudent investor, who knew those facts, might be expected to be willing to pay for the shares". I propose to adopt this method of approach in the present case.

[1] *(1930) 9 Annotated Tax Cases, 43.*

Having first discussed what appear to me to be the factors for consideration by a prudent purchaser invited to make an offer for the shares, I shall then proceed to apply the method of valuation which seems most appropriate to the case.

In my opinion the chief factors for consideration, *as they existed and were known at the time of Mackie's death*, were (1) the nature of the business of the Company, (2) the history of the Company from its inception up to September 6, 1940, (3) the future prospects of the business generally, and of the Company in particular, (4) the state of the investment market at the relevant date, and (5) the extent, if any, to which the restrictions contained in the Articles of Association might be expected to depreciate the value of the shares. I shall deal with these questions in the order in which I have set them down.

(1) *The Nature of the Business*: C. W. Mackie & Company, Ltd., had since its incorporation in 1922, been engaged in the business of rubber dealers, regularly purchasing in the open market and taking delivery of large stocks of rubber with a view to their sale and export in due course. Prices in the rubber market have throughout history been notoriously sensitive, and the Company, when dealing in this commodity, had invariably adopted an extremely speculative policy. Mackie and his Co-Directors did not undertake the safer functions of an agency business purchasing rubber for outside principals on a commission basis; their policy was to make purchases on their own account in the hope, but not the certainty, of selling the rubber at some later date at a higher figure ; when their predictions as to the future of the market proved correct, the Company earned very considerable profits ; but when their predictions proved wrong, the Company had no option but ultimately to sell its stocks at the lower market price and would in consequence sustain correspondingly heavy losses ; the risk of a falling market or the benefit of a rising market was on each occasion voluntarily undertaken by the Company. It was possible of course to tide over brief periods of adverse price fluctuations by holding its stocks, but this policy could not be carried out indefinitely. Mr. Williams, who had been a Director of the Company and its Manager for over twenty years, stated that it was not possible to predict the future market of rubber except on very rare occasions ; indeed, it is this unpredictability in the movements of the market which has tempted so many speculators to deal with this commodity in the world markets in the same manner as Mackie and Company, Ltd., had done since 1922. The element of chance is of the essence of such a business. The witnesses Williams, Hayward, Cumming and Lander spoke with authority regarding the nature of the business, and the witnesses called by the Crown did not seriously dispute their evidence on this point. Mr. Gunasekera, for instance, has had the benefit of long experience as an assessor in estate duty cases, and he admitted that he " could not think of a business which was more speculative than that of this particular Company ", while Mr. Satchithananda, who is a qualified Accountant, described the business as " very risky ". The actual trading results of the Company year by year since 1922 themselves provide the most compelling evidence on the point.

(2) *The History of the Company:* The audited annual balance sheets and profit-and-loss accounts from 1922 to 1939 would have been available

to an intending purchaser, who must be assumed to be " a person of reasonable prudence anxious to ascertain the relevant facts before making a bid for the shares ". *Findlay's Trustees v. Commissioners of Inland Revenue*[1]. He would have found in those documents that during the years 1922 to 1926 the Company had, in consequence of very favourable fluctuations in the price of rubber, made enormous trading profits amounting in the aggregate to Rs. 3,441,359. Out of this sum, the preference shareholders regularly received their annual 8 per cent. dividends ; and dividends amounting to as much as Rs. 1,950,000 had been declared and distributed on the " Management Shares ". If the story had ended there one might well have imagined that Mackie and those associated with him had succeeded in discovering some secret which had eluded and had continued to elude so many speculators in the rubber market. Mackie and the other Directors, however, made a more cautious assessment of their ability to predict the unpredictable. Out of the Company's undistributed past profits, they placed Rs. 747,901 to general and sundry reserves, and carried forward the balance sum of Rs. 356,913 to the trading account for 1927. It was indeed fortunate that at least this precaution had been taken. Within the next six years the Company, in consequence of consistently unfavourable fluctuations in the price of rubber sustained an aggregate loss of Rs. 1,804,304 so that the Company, by trading on its issued capital as well as its hidden capital of unpaid preference dividends, reserves and undistributed profit of an earlier period, was now virtually insolvent. The same speculative policy was however persisted in after 1932 with the help of overdraft facilities which Mackie, largely by his personal influence, was able to arrange. The years 1933 and 1934 showed favourable trading results. Then followed 1935 with a loss of Rs. 281,907. A slight profit was made in 1936 followed by a comparatively small loss in 1937. In 1938 the profits earned amounted Rs. 149,846. The year 1939, which was the last year for which the audited balance sheet woud have been available to an intending purchaser, showed a welcome gross profit of Rs. 787,641. Nevertheless, the position as at December 31, 1939, was still " far from healthy " as the Assessor admitted. A sum of Rs. 793,000 was due to the preference shareholders who had not been paid their dividends since 1927. The overdraft with the Bank stood at Rs. 1,485,471.25, and in spite of an extremely favourable year of business there was still a nett trading deficit of Rs. 150,828 after allowing for taxation and for the accumulated arrears of preference dividends (ignoring two years for which payment had been waived). One cannot think that any prudent business man would have been greatly attracted by a proposal that he should invest a very large sum of money, inadequately secured by tangible assets, in a business over which he would have no control, and whose fortunes had in the past been subject to such violent fluctuations. Even if the substantial profits earned up to the date of Mackie's death in 1940 (owing to the market prices having continued *for the time being* to show an upward trend under early war conditions) had been ascertained, I do not see how an optimistic view for all time could be considered justifiable. For how long and to what extent this upward trend would continue it was impossible to say. It

[1] *(1938) 22 Annotated Tax Cases, 436.*

has been proved that the trading profits during the second half of 1940 had appreciably declined in comparison with those of the earlier six months.

During the period January 1, 1927 to September 6, 1940, dividends had not been paid on either preference shares or on " Management Shares " ; and the nett trading loss sustained (after allowing for taxation) amounted to Rs. 107,614. Even if there was a reasonable prospect of history repeating itself and producing in the near future subtantial profits comparable to those of 1922 to 1926, it had to be borne in mind that income tax had come into force in Ceylon since 1931 and that, as Mr. Satchithananda admitted, business circles had become apprehensive (justifiably, as things turned out) of the early additional imposition of an Excess Profits Duty. Besides, the history of the Company had made it clear that in favourable years it was prudent to build up sufficient reserves to meet the reverses of unfavourable periods which, in a business of this nature, could not be eliminated in spite of the admitted advantages of skilful management. No doubt the war years 1939 and 1940 had, *up to date*, induced a rising market favourable to the speculator. But for how long those conditions would last, no man could sensibly predict. It is relevant in this connection to consider the view which Mackie's fellow directors in Ceylon had themselves taken of the Company's prospects two days before he died. In spite of a marked improvement in trading results since 1939, they recommended to him that, for the time being, only a small proportion of the arrears of preference dividends which had accumulated since 1927 should be paid out. This cautious attitude stands in sharp contrast to the reckless optimism with which, in the submission of the Crown, a hypothetical purchaser would have bid Rs. 1,250,000 for an investment backed at the relevant date by tangible assets worth only Rs. 203,094.41.

(3) *The Future Prospects of the Business* : I can find nothing in the evidence to justify the assumption that, taking a long view of the Company's future trading, the risks and hazards of speculation had now been eliminated, and that a prudent investor could confidently predict that the fortunes of C. W. Mackie & Company, Ltd., would no longer, as in the past, be subject to violent fluctuations. On the evidence, my view is that it still was, as it had always been, unsafe to form a conclusion in either direction. The Assessor claimed that there was good reason to anticipate that the market would continue to rise for about two years after September 6, 1940, after which smaller profits would again be earned. (He does not tell us why the possibility of losses in future trading should be excluded.) I do not know whether the view which he expressed was actually held by him at the relevant date ; it seems more probable that when he gave evidence at the trial he was fortified by " wisdom after the event " or by what the learned Solicitor-General, quoting an Australian decision, referred to as " hind-sight ". In prophesying the future of rubber prices, one man's guess is. I should imagine, no better than another's. At any rate, a Court of Law, when called upon to make assessments for estate duty purposes, cannot justifiably assume that a prudent investor would take a view as to the future which is not supported by reliable evidence of facts which were known

at the time. The events which happened after September 6, 1940, cannot be regarded as relevant *unless they were reasonably predictable on that date.* I have examined the Assessor's evidence with care, and I am not at all satisfied that any cautious person, reviewing the past and attempting to gauge the future at the time of Mackie's death, would have been willing to make a firm offer for the shares on the assumption that within the next six years he would receive back an aggregate sum equivalent to Rs. 1,250,000 in the form of annual dividends. The opinion of an expert is of special assistance only when he gives convincing reasons for his faith. In this respect the evidence of the Crown witnesses seems to me to have failed the test. It must not be forgotten that in the past even Mackie's predictions, in spite of all his accumulated experience of the rubber market, had proved completely wrong throughout the six-year period 1927 to 1932. That knowledge would, I think, have satisfied an investor that it is unsafe to attempt a forecast of the prospects of a rubber dealer's business wihout entering the realms of pure conjecture.

(4) *The Investment Market in September, 1940 :* The notional sale of Mackie's shares in the open market would have taken place during a critical period in world history. France had capitulated before Hitler's invading armies ; Europe was over-run ; the Battle of Britain had commenced, and its issue was still in doubt. The evidence in the case proves that these events had produced a marked reaction on the mood of investors in Ceylon. As far as this particular Company's activities were concerned, the general uncertainty of world conditions had been super imposed on the special hazards inherent in speculative trading. Mr. Lander stated tha it was difficult at that time to find anyone willing to risk large sums of money on speculative investments. Mr. Cumming, who is a senior broker in Colombo, suppotretd this statement. People preferred to keep their money in the banks, he said, and he doubted if Mackie's shares would in fact have been purchased at all if they could have been offered for sale in the open market. Mr. Cumming asserted that " no broker would have made an underwriting proposition for the sale of Mackie's shares ; at that time the risk was too great ". These witnesses were not expressing mere opinions on this aspect of the case ; they were stating uncontradicted facts. Mr. Williams was asked if he would have been willing to buy the " Management Shares " himself. " I would buy them *if I got them cheap for a gamble* " he replied. A prudent investor, I do not doubt, would have taken into consideration the views of persons conversant with conditions in the rubber market and the investment market before making a bid. The Assessor did not dispute this evidence. He suggested, however, that some buyer from abroad might have been interested in purchasing the shares, though he admitted that such an eventuality was " not very likely ". Mr. Satchithananda similarly thought that American or Canadian buyers might perhaps be attracted. I think that these vague suggestions carry the notion of a hypothetical purchaser much too far from reality. It is not clear how, at a notional sale, a bidder from abroad, could have been induced to offer very much more than local bidders were prepared to offer. The conclusion at which I have arrived is that under the existing conditions it would have been an extremely difficult matter to find a buyer for Mackie's

shares for a figure in excess of such security as was afforded by the proportionate interest at the time in the available tangible assets. There is evidence that at least one comparable business, discouraged by trading losses and diffident as to the future, had closed down in 1939, and that its proprietors had failed at that time even to find a buyer for their rubber stores. No suggestion has been made that its " goodwill ", if offered for sale, would have fetched any sum at all.

Had any speculator confidently predicted a rising market for the period immediately following September, 1940, he would surely have preferred, through a reputable broker, to make purchases and sales of rubber in the open market during that period on his own account, and to personally control the destinies and the duration of his investments rather than tie up his capital in a business managed by persons whom he could not control. Any advantages which existed in the established business of C. W. Mackie & Company Ltd., would presumably have been rendered unnecessary by the allegedly " universal knowledge " that prices were certain to rise, and would in any event be counter-balanced by the restrictive covenants imposed by the Articles of Association. I shall now deal with that aspect of the matter.

(5) *The Articles of Association:* The special attraction of an investment in the shares of a public Company is that a shareholder (or, on his death, his legal representative) has under normal conditions little difficulty in selling his holding in the open market whenever he desires to do so. The hypothetical purchaser of Mackie's shares and his heirs would have been placed in a very difficult position in this respect. *Articles 38 to 43* lay down stringent restrictions on the sale and transfer of shares. If a member of the Company were willing to take over the shares of a member who desired to sell out, the price payable would be a sum which *the Company's auditors, and not the transferor* regarded as their " fair value " at the time. If no member of the Company were willing to take them over, the owner could not sell them except to a third party whom the Directors would agree to admit to membership (*Article 45*), and in any event, that third party would himself be discouraged by the same restrictions after securing his registration as a new shareholder.

On the death of a shareholder, his executor could be compelled to transfer the shares to a member of the Company at a price fixed as their " fair value " by the Auditors (*Articles 54 and 38*). It was argued for the Crown that a purchaser could circumvent this provision by floating a private Company, in which he would hold the major interest to purchase the shares. No doubt this would be possible, but the depreciatory effect of Article 54 on market value is self-evident.

A purchaser of the 5,000 " Management Shares " belonging to Mackie would further realise that, as the holder of less than 1/10 of the issued capital of the Company, his interests were liable to be compulsorily acquired by the majority holders *at the Auditors' valuation* (*Articles 46 and 38*). When this difficulty was pointed to the Crown witnesses in cross-examination, they were forced to admit that it was very unlikely that any person would buy the holding of the " Management Shares " unless he could protect himself by purchasing at the same time a sufficient number of Preference Shares from Mackie's estate so as to remove this

handicap. This, I imagine, would have greatly damped the enthusiasm and reduced the number of bidders interested in purchasing the " Management Shares ". In valuing a deceased person's property for purposes of estate duty, it is of course legitimate to consider the possible advantage of pooling all or some of his assets in the hope of fetching a higher figure than would be realised by a sale of each asset separately. *Ellesmere v. Inland Revenue Commissioners* [1]. There must be good reason to anticipate, however, that a sale of the properties in this fashion would in fact have proved more advantageous to the seller as well as to the buyer. In the present case, the Assessor and the Commissioner had in the first instance fixed the value of the " Management Shares " on the basis that they would be sold as a separate holding. Having regard to the state of the investment market in September, 1940, I doubt if it would have been desirable to confine the bidding for the " Management Shares " to persons who possessed sufficient capital to purchase Mackie's Preference Shares as well for their agreed value of Rs. 806,017. On the contrary, it might well have been more prudent to offer the " Management Shares " in even smaller blocks so as to attract more bidders willing to risk small sums in such a speculative investment. My own impression is that the belated suggestion of pooling these two groups of Mackie's assets for the purposes of a notional sale was not present in the Assessor's mind until he was confronted at the trial with the implications of Article 46. Mr. Satchithananda obviously did not originally contemplate a pooling of the shares. His valuation report does not refer to the Preference Shares at all in this connection and his evidence indicates that he had not taken the trouble to study the Company's Articles of Association closely before he entered the witness-box.

Further discouraging features in the Articles of Association were the restrictions which prevented a shareholder from holding interests in any other business which the Company was carrying on or was even authorised to carry on (*Articles 48 and 49*).

(6) *The Basis of Valuation.*—It is now necessary to consider which method of estimating the " market value " of shares in this particular private Company is, in the light of the unusual circumstances to which I have referred, the most appropriate. By the very nature of things no quotations in the public share market for investments in the same or in a comparable business are available to guide us. There is, however, a record of a private transaction which took place at the end of the trading year 1926, whereby Mackie had himself purchased 1,375 " Management Shares " from a retiring member of the Company, Mr. N. J. R. Robertson, and from certain others. These transactions took place *as between willing sellers and a willing buyer* at a time in the Company's history when the trading results for five consecutive years had been exceptionally favourable, and when the " goodwill ", *if any*, of the business could not, an any reasonable hypothesis, have been computed at a lower figure than in September, 1940. The Company's balance sheet then showed substantial reserves which were available to meet losses in future trading; and the introduction of income tax was not in contemplation at that time. In spite of these advantages, the basis of valuation agreed upon

[1] *(1918) 2 K.B. 435.*

by the parties to the transaction in 1926—namely " the balance sheet valuation "—was precisely the same as that on which the appellants have relied in the present case. Mackie voluntarily paid, and his sellers voluntarily accepted, a figure representing only the value at the relevant date of the tangible assets remaining for each " Management Share " in the balance sheet of the Company as a going concern, *no additional allowance whatsoever being made for goodwill.* This strongly indicates to my mind that the persons best acquainted with the risks attendant on the Company's activities realised that " *goodwill* " (measured in terms of the " *value of the capacity to earn* super-profits ") is non-existent in a speculative business whose profits or losses depend so largely on unpredictable market fluctuations. This same element of uncertainty which existed in 1926 had not been eliminated in September, 1940.

Mr. Lander's opinion is that for a business of this kind " the balance sheet method of valuation " is the most appropriate. He has since 1930 been a member of the firm of Messrs. Ford, Rhodes and Thornton, who are the Company's Auditors. His professional qualifications and the honesty of his views were not challenged at the trial, and I think that his opinion is entitled to considerable weight. Certainly, the implications of Article 38 would have led a prospective purchaser to hesitate before he made a higher offer than the figure at which the Company's Auditors valued the shares at the relevant date.

The Company's business was no doubt a well-established business conducted by a reputable management ; nevertheless it was essentially the business of a gambler or a speculator (call it what you will). If it were possible to place a market value on the Company's goodwill "—which, for purposes of valuation, represents " the benefit and advantage of the good name, reputation and connection of a business " (*Commissioner of Inland Revenue v. Muller* [1])—the value of Mackie's interests in the tangible assets should undoubtedly, as was done in *Findlay's* case,[2] be correspondingly increased. Where, however, there is no " goodwill " capable of assessment except by guess-work, it follows that (even if no deductions be allowed for the depreciatory effect of the restrictions contained in the Articles of Association) no prudent investor could reasonably be expected to offer more for a " Management Share " than the value of its present interest in the tangible assets. *This sum represents the full amount which he would be prepared to stake in the hazardous enterprise of speculating on the future price of rubber.* I cannot agree that this method of valuation is applicable only when there is an immediate prospect of liquidation. The figure arrived at does admittedly reflect the amount which would be available for distribution (less a proportionate share of liquidation expenses) in that eventuality. Nevertheless, the sum so calculated may, in an appropriate case, where no commercial " goodwill " exists as a separate asset, properly be regarded as the maximum value at the relevant date of the shareholder's interest in the business of the Company " *as a going concern* ".

Mr. Crown Counsel Jansze, who very ably argued a part of the case for the Crown, suggested that some additional allowance should be made for the fact that the purchaser of a " Management Share " would enjoy

[1] *(1901) A.C. 216.*

[2] *(1938) 22 Annotated Tax Cases, 436.*

the additional advantage of gambling with the capital contributed by the Preference Shareholders. His argument would have much force if it could be demonstrated that such an advantage would attract to a Management Shareholder a reasonably predictable assurance of higher dividend returns on his investment. In that event, the measure of this advantage could logically be assessed *in terms of " goodwill "* by reference to the super-profits which the " Management Shares " would be expected to earn by way of dividends. In the present case, however, the business of C. W. Mackie & Company, Ltd., is such as to leave its future prospects very largely, if not entirely, to chance, and for this reason I fail to see how the " advantage " to which Mr. Jansze refers can be assessed on any scientific basis. An issue was specifically raised at the trial as to whether any " goodwill " attached to the " Management Shares ", and, if so, what value should be placed on it. The Crown chose not to lead any evidence as to how " goodwill ", if it existed in this business should be valued as a separate asset. I understood the learned Solicitor-General to argue that in a Company constituted like C. W. Mackie & Company, Ltd.. " goodwill " attaching to a " Management Share " cannot be separately assessed. I am not satisfied that this is so except for the difficulty of recognising that it does exist at all. To my mind, if " goodwill ", measured in terms of " the capacity to earn super-profits ", had in fact been established it would have been a comparatively simple matter to assess its value separately in accordance with recognised accounting principles. In the firm of C. W. Mackie & Company, the " goodwill ", if it existed, of the business would have attached *exclusively* to the " Management Shareholders " to whom alone the maintainable " super-profits " must be ultimately paid. This presupposes that one could have reasonably predicted a higher investment return on the " tangible assets value " of a " Management Share " as at September 6, 1940 (i.e., Rs. 40.6188) than a prudent investor would normally expect to receive at the " risk-rate " appropriate to a rubber dealer's business (say, 25 per cent. per annum). In that event the value of the goodwill could be computed by capitalising these anticipated annual " super-profits " at the appropriate risk-rate. This sum, added to the value of the shareholder's interest in the tangible assets, would—subject to such allowance as was considered necessary for depreciation owing to the restrictions in the Articles of Association—represent the total value of each share for estate duty purposes.

I am satisfied that the " balance sheet method " of valuing shares in a highly speculative business, whose past history lacks evidence of any *steady* earning-power, is the most appropriate method to adopt because it is not possible to arrive at a logical assessment of the future maintainable profits from which dividends could be paid to the shareholder as a return for his investment. No evidence was led at the trial, and no authorities were referred to us in this Court, to induce me to take a different view.

The learned Solicitor-General asked for a ruling that the only acceptable method of estimating the market value of shares in any business is to capitalise (at the " risk-rate " appropriate to the business) the estimated

annual average of future maintainable profits which would be available to the shareholder concerned. I do not see how this principle of valuation can legitimately be extended beyond the limit of its logic. No doubt the method is preferable when it is possible, *by reference to past history and present knowledge*, to predict future maintainable profits under normal conditions. But the principle seems to me to break down when it is sought to be applied to a business where the element of incalculable risk which is inherent in its trading activities cannot be eliminated. As I read the judgment in *Salveson's case* [1] the method was not adopted by Lord Fleming in valuing shares in a Company engaged in a speculative whaling business, and he later pointed out in *Findlay's case* [2] that to take the average profits of the last few years for this purpose would only " operate quite equitably where one is dealing with a well-established business *which has normal ups and downs, but has no violent fluctuations in either direction* ". I therefore reject for the present case the method of valuation adopted by the Assessor who seems to have valued the shares " by the application of what is at last merely a rule of thumb ". I do not propose to deal specifically with Mr. Satchithananda's valuation. Wherever his valuation did not subtantially agree with that of the Assessor it was specially unconvincing. I have already expressed my opinion that in a business of this kind it is not possible to estimate future maintainable profits. *A fortiori*, the " weighted average " principle relied on by Mr. Satchithananda cannot be seriously considered. It is, I think, significant that at no stage of the Company's trading history would a valuation based on the formulae advocated by either of these witnesses have, in the light of subsequent events, been found to be justified. This only proves, in my opinion, that the profits or losses of any particular period of time cannot in this business be regarded as a reliable guide to the prospects of a later period.

I have now disposed of the main point of contest between the parties to the appeal. As the assessment made by the Assessor (and approved by the learned District Judge) was very fully discussed before us, however, I think it proper to state that, even if I had found myself able to accept his method of valuation, I should have held that the ultimate figure arrived at by him was greatly excessive. Taking into account the past history of the Company, I think that to take the average of only the past four and two-thirds years' profits, ignoring altogether the earlier period when heavy losses were incurred, attributes to a hypothetical purchaser a spirit of reckless optimism. Moreover, the Assessor has wrongly assumed in his calculations that, after the payment of preference dividends out of anticipated profits, the entire balance would be paid out to the purchaser of the " Management Shares ". I do not see how such an improvident policy on the part of the Directors could reasonably have been expected by a prudent investor. Admittedly, a deduction had to be made for income tax payable by the Company on its trading profits, and the unit rate for taxation applicable at the relevant date was 15 per cent. Besides, it would have been a rash and foolish purchaser indeed who would not have realised that a prudent management, with knowledge of what had happened in the past, was certain to build up

[1] *(1930) 9 Annotated Tax Cases, 43.*
[2] *(1938) 22 Annotated Tax Cases, 436.*

adequate reserves during profitable years to meet the losses of unsuccessful periods of trading. I have already pointed out that during the first five successful years of the Company's activities, the Directors took the sensible precaution of accumulating reserves at the rate of approximately Rs. 150,000 a year. In 1940, when funds were available for the first time since 1927 a similar sum was placed to reserve. If the balance sheets for 1941 and 1942 are relevant at all, they only serve to show that the Directors acted precisely as one would have expected them to act in successful years of trading. At the end of 1941, the amount standing to general reserve was increased to Rs. 300,000. In 1942, when the Company was fortunate in earning very large profits in consequence of having temporarily undertaken new and safer functions as buying agents for the Ceylon Government on a commission basis (a position not anticipated in September, 1940), the reserves were increased to Rs. 700,000 out of undistributed profits; and *for the first time since 1926* a dividend of only Rs. 50,000 was declared on the " Management Shares ". This figure represents only a 25 per cent. return on the " tangible assets " value of the shares in September, 1940, and is very considerably less than the *annual* dividends optimistically foreshadowed by the Assessor for his hypothetical purchaser. Moreover, it was reasonable to expect that the Directors, being Preference Shareholders, who now at last enjoyed a controlling interest in the business since the date of Mackie's death, would build up adequate reserves from the profits of a good year so as to ensure for themselves the regular payment of their own dividends in spite of any trading losses which might be sustained in future years. Even if the Assessor's anticipated future maintainable profits of the business could be accepted as reliable the market value of the shares must be substantially reduced if the proper allowances be made for taxation and reserves. I regret to say that I was not convinced by the explanation that he did not make these necessary deductions because, in his belief, they would have been counterbalanced by an increased figure for future maintainable profits on the " weighted average " principle (which principle he does not claim to have used in any of his previous assessments as an Estate Duty Officer). No Court can reasonably be invited by a valuer to accept a bald assertion that one material but undisclosed figure in a sum in simple arithmetic will probably counterbalance another figure which is also undisclosed. Finally, I cannot accept the view that a prudent purchaser investing his money in such a speculative business would have been content with a return of only 15 per cent. Mr. Satchithananda conceded in cross-examination that a rate of 20 per cent. to 25 per cent. would be more reasonable. I find that the Crown expert in *Salveson's case* [1] took the view that for an investment in the whaling industry (which certainly had not proved less speculative than the business of this Company) an expected return of 40 per cent. was not unreasonable. Moreover, in *Salveson's case*, the financial position of the Company at the date of valuation was such that sufficient reserves had already been accumulated to ensure the payment of dividends for the next five years even if no profits were earned during that period, still leaving an ample margin to meet trading losses as

[1] *(1930) 9 Annotated Tax Cases, 43.*

large as those which had ever been experienced in the past. In my opinion the market value of Mackie's shares on the basis of the Assessor's method, after making the necessary adjustments for taxation and sufficient reserves, and after applying a higher " risk-rate ", would not have been appreciably higher than Rs. 40.6188 per share. If, in addition, the depreciating effect of the restrictive clauses contained in the Articles of Association be taken into account, this figure is certainly not too low. In *Crossman's case* [1] Lord Halisham expressed the opinion that the value of the shares under consideration by him, if not subject to rigid restrictions, would probably have been twice as high as the figure which he finally approved. In *Salveson's case* [2] Lord Fleming considered a depreciation by approximately 33 1/3 per cent. to be fair and reasonable.

The appellants did not press their earlier contention that the figure of Rs. 40.6188 per share should, in terms of the proviso to section 20 (1) of the Ordinance, be further reduced by reason of Mackie's death. Nor did they claim depreciation on account of the restrictions contained in the Articles of Association. I would therefore hold that the " market value " of each of the deceased's 5,000 " Management Shares " should be fixed for estate duty purposes at Rs. 40.6188, which admittedly represents the proportionate interest of each share in the tangible assets of the Company as at September 6, 1940. My view is that no sum falls to be added to this sum on account of " goodwill " which, in my judgment and for the reasons which I have given, was non-existent and therefore incapable of assessment as an asset of the business.

Since preparing this judgment I have had the opportunity of reading the judgment of my Lord the Chief Justice. I respectfully agree with him that the appeal should be allowed and that judgment for the appellants should be entered, with costs, as indicated by him.

Appeal allowed.