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Controversies Around Valuation of Shares Under the Income-Tax law

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Synopsis

With respect to issue of shares by closely held companies' section 56(2) (viib) of the Income-tax Act, 1961 mandates valuation of shares either by DCF method or NAV method. In this article we have discussed the power of tax authorities to change the method of valuation which has been adopted by companies. We have further discussed that whether under DCF method does the tax authorities have power to change the projected financials with the actual performance of the company. we have critically analysed these issues in view of plethora of judgements

1. Introduction

Income-tax laws are ever evolving. Many provisions in the Income-tax Act, 1961 ("the Act") were introduced just to curb the mal-practices of tax evasion. One such practice is issue or transfer of shares of closely held companies (like private limited companies) either at unreasonable premium or low prices to bring in unaccounted money. To curb such practices valuation provisions were introduced in the Act.

In this article, we will discuss the valuation provisions of the Act and controversies around those.

2. Share valuation requirement under the Act and consequences

With respect to issue of shares by closely held companies' section 56(2) (viib) of the Act mandates valuation of shares. While, section 50CA and section 56(2)(x)(c) mandates valuation when the shares of a company are transferred from one person to another.

Section 56(2)(viib) was introduced in the Act vide the Finance Act, 2012, seeking to tax closely held companies which issue shares to those shareholders who are tax residents of India at a premium which is in excess of the fair market value ("FMV") of the shares provided the FMV is above face value of shares. Such excess premium is deemed to be the income of the company. Section 50CA of the Act, which is applicable at the time of transfer of shares of an unlisted company, provides that where the consideration received by the transferor of shares is less than FMV, then FMV is considered as sale consideration and capital gain tax will apply accordingly.

On the other hand, section 56(2)(x)(c), which is relevant for the purchaser of shares of any company, provides that if the consideration paid is lower than the FMV, then excess of FMV over the consideration paid will be regarded as income from other sources and subjected to tax.

From the above provisions it is abundantly clear that determining FMV of the shares is very critical while dealing in shares, especially for private limited companies. Unlike, FEMA and Companies Act, Income-tax Act provides specific rules and methods for determining the FMV of shares. The purpose behind introducing valuation rules in the Act would have been to provide clarity and stability to law.

3. Determination of FMV of the shares

As per explanation to section 56(2)(viib) the FMV of the shares should be:

a) the value as may be determined in accordance with the rule 11UA(2) of the Income-tax Rules, 1962 ("the Rules"); or
b) as may be substantiated by the company to the satisfaction of the tax officer based on the value on the date of issue of shares of its assets, including intangible assets being goodwill, know how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

As per explanation to section 56(2)(x)(c) and section 50CA, the FMV of the shares is determined as per rule 11UA(1)(c) of the Rules. There are no issues with respect to valuation method prescribed in the rule 11UA(1)(c) of the

Rules which is primarily valuation based on Net Asset Value ("NAV") for assets and liabilities of the company as per given formula. However, there are lots of controversies with respect to rule 11UA (2) of the Rules which is applicable for closely held companies issuing shares. As per the rule 11UA (2) the FMV of unquoted equity shares as determined in the following manner, **at the option of the taxpayer**, namely:

a) the FMV of unquoted equity shares based on NAV method computed as per given formula; or
b) the FMV of the unquoted equity shares determined by a Merchant Banker as per Discounted Cash Flow ("DCF") method**.**

4. Tax Controversy

This Article addresses the followings issues with respect valuation under rule 11UA(2)[1]:

a) Do the tax authorities have the right to change the method of valuation, which has been adopted by the taxpayer for section 56(2)(viib) of the Act read with rule 11UA(2) of the Rules?

b) For applying DCF method, are the tax authorities justified in making a comparison of the projected financials with the actual performance of the company?

In the recent past, Indian courts in a plethora of judgements have dealt with the provisions of section 56(2) (viib) and shedding some light on this issue.

Issue #1

Rule 11UA (2) gives a choice to the company either to apply NAV method or DCF method for valuing the shares. Many times, it happens that tax authorities taking pro-revenue stand and changes the method adopted by the company if it suits their revenue generation goal. This resulted into many court cases.

a) In the case of **Mantram Commodity (P) Ltd. vs. ITO 127 taxmann.com 462 (Delhi-Trib.) [2021]** the Delhi Tribunal addressed the issue on the valuation of unquoted equity shares and the powers of tax authorities to reject the valuation report merely on their assumptions. In the said case, during the assessment proceedings the tax officer observed that the taxpayer company had no real business and was of the view that the credit worthiness and genuineness of the transaction are highly suspicious. Relying on these facts, the tax officer arbitrarily rejected the valuation furnished by the company which was based on NAV method. The officer adopted the FMV as the Face Value without appreciating the formula provided in the rule 11UA (2) of the Rules.

The Delhi Tribunal opined that when the statute provides for a particular procedure, the authority must follow the same and cannot be permitted to act in contravention of the same. Tax officer has no power to do valuation other than the method prescribed in rule 11UA (2) of the Rules.

b) In the case of **Vodafone M-Pesa Ltd. vs. PCIT 92 taxmann.com 73 (Bombay) [2018]** the Bombay High Court addressed the issue on the application of DCF methodology and the powers of tax authorities to inquire into it.

In the said case, the High Court held that tax officer is undoubtedly entitled to scrutinise the valuation report and determine a fresh valuation either by himself or by calling for a final determination from an independent valuer to confront the petitioner. However, the basis has to be the DCF method only (as adopted by the company) and it is not open to him to change the method of valuation which has been opted for by the company.

c) Not only the above ruling similar view got affirmed in following cases:

- Flutura Business Solutions (P.) Ltd. vs. ITO 117 taxmann.com 567 (Bangalore Trib.) [2020]
- I-Exceed Technology Solutions (P.) Ltd. vs. ITO 119 taxmann.com 378 (Bangalore Trib.) [2020]

d) In the case of **Rameshwaram Strong Glass (P.) Ltd. vs. ITO 96 taxmann.com 542 (Jaipur-Trib.) [2018]** the Jaipur Tribunal addressed the issue on the application of DCF methodology and the powers of tax authorities to change or disregard the method.

The Tribunal held that where assessee company determined FMV of shares issued at premium on basis of DCF method in accordance with rule 11UA (2) read with section 56(2) (viib) and valuation report was

[1] Relevant for closely held companies issuing fresh shares to resident shareholders.

prepared as per guidelines given by the ICAI and no fault was found in same, tax officer was unjustified in changing method of valuation of shares to NAV method.

e) In case of **Cinestaan Entertainment (P.) Ltd. vs. ITO 106 taxmann.com 300 (Delhi- Trib.) [2019]** the Delhi Tribunal held that as per section 56(2)(viib) read with rule 11UA(2), the assessee company has an option to do valuation of shares and determine FMV either on DCF method or NAV method, and tax authorities cannot examine or substitute their own value in place of value so determined.

f) Similarly, in the case of **VVA Hotels (P.) Ltd vs. CIT 122 taxmann.com 106 (Madras) [2020]** the Madras High Court held that where assessee company determined FMV of shares issued at premium on the basis of DCF method and tax officer changed same to NAV method on ground that company's actual revenue varied from its projected revenue adopted for applying DCF method, since such variation between value of projected revenue and actual revenue was marginal and, further, there was no material to hold that company's projected revenue was fabricated, impugned change of method of valuation of shares was unjustified

However, in some cases contrary view has also been taken that the tax authorities can change the method of valuation.

g) In the case of **Agro Portfolio (P.) Ltd. vs. ITO 94 taxmann.com 112 (Delhi-Trib.) [2018]** the Delhi Tribunal addressed the issue on the application of DCF methodology and the powers of tax authorities to inquire into it. In the valuation report merchant banker had given disclaimer that no independent enquiry is caused by it to verify the truth or otherwise the figures furnished by the company. The merchant bankers solely relied upon, without independent verification, the truthfulness accuracy and completeness of the information and the financial data provided by the company.

The Tribunal observed that a perusal of this long disclaimer clearly shows that the merchant banker did not do anything reflecting their expertise, except mere applying the formula to the data provided by the assessee company. There has not been any possibility of verifying the correctness or otherwise of the data supplied by the company to the merchant banker, in absence of which the correctness of the result of DCF method cannot be verified. This left no option to the tax officer but to reject the DCF method and to go by NAV method to determine the FMV of the shares. Without such evidence, it serves no purpose even if the matter is referred to the Department's Valuation Officer. Therefore, there is no illegality or irregularity in the approach or conclusions by the authorities. Accordingly, the Tribunal added that in such cases, the tax authorities may be forced to reject the DCF method, since the same cannot be verified and instead, could adopt the NAV method to determine the liability of the taxpayer under section 56(2)(viib) of the Act.

h) In the case of **TUV Rheinland NIFE Academy Private Limited vs. ITO ITA No.3160/Bang/2018 (Bangalore-Trib.) [2019]** Tribunal allowed changing the method of valuation.

In this case Tribunal agreed to the argument of the assessee company that it has the statutory right to select either one of the two methods prescribed for the purpose of section 56(2)(viib). However, the Tribunal observed that neither the tax officer questioned the right of the assessee company to select the method of valuation nor has the officer dismissed the choice of DCF method as a method of valuation. The tax officer has examined the parameters adopted by the company for valuation by the DCF method and has rendered a finding that the valuation is not realistic as the actual figures were a long long way away from the projections made. Therefore, the contention of the assessee company that the tax officer had disregarded the valuation made under the DCF method is not correct. Thus, in absence of any valid and meaningful justification for the projections considered and adopted in determining FMV under the DCF method, Tribunal agreed with the decision of the tax officer to deploy NAV method.

Similar view was taken by the Bangalore Tribunal in another case of **Innoviti Payment Solutions (P.) Ltd. vs. ITO 102 taxmann.com 59 (Bangalore-Trib.) [2019]**.

Key takeaways

From the above discussion, overwhelming view appear to be that it is not open for the tax authorities to change the method of valuation once the choice is exercised by the company. However, if the tax authorities were able to demonstrate to the court that valuation report based on DCF method was not prepared on sound basis, like in the case of Agro Portfolio (supra) the valuer gave long disclaimers on the projections to the effect that it did not even verify the correctness of projections, the court agreed to disregard the valuation report. In such a case better view would be that tax officer carry out valuation on his own, but using the same methodology as adopted by the company, like approach followed by the Bombay High Court in the case of Vodafone M-Pesa (supra). The Companies (Registered Valuers and Valuation) Rules, 2017 also mandates those caveats, limitations and disclaimers used in the report should explain or elucidate the limitations faced by valuer, which should not be for the purpose of limiting his responsibility for the valuation report. In the preparation of a valuation report, the valuer should not disclaim liability for his/its expertise or deny his/its duty of care.

Issue #2

We all know that DCF method is about estimating future cash generation capacity of the company and discounting it back to the present value using an appropriate discounting rate. So, essentially, this is a futuristic method and based on projections. It is an established fact that no one predict future with accuracy and actual performance can go substantially tangent from projections. By the time tax authorities sits on doing assessment of the company considerable time gets lapsed and the tax authorities gets the opportunity to look at actual financial statement of the company and compare them with the projections adopted at the time of valuation exercise. If there are differences in the projected financials and the actual performance, it is commonly argued by the tax authorities that valuation report is unreliable and then they venture into doing valuation their own. As can be seen from the Delhi Tribunal ruling in the case of Agro Portfolio (supra) and Bangalore Tribunal in the case of TUV Rheinland NIFE Academy (supra) that when the actual performance was way different from projections or when there were long disclaimers on projected financials, even the court did not place reliance on the valuation report submitted by the company. Bangalore Tribunal even allowed the tax officer to change the valuation methodology from DCF to NAV method. However, Jaipur Tribunal in the case of Rameshwaram Strong Glass (supra) had a different view. In this case assessee company did not have any business. It just purchased land and issued shares on premium. According to the tax officer, the prerequisite for issue of share at premium was the substantial increase in the net worth, which was mainly due to the profitability, credibility, goodwill etc. of the concern, however, such requirements were not available in the present case. Therefore, he held that these shares did not have intrinsic value to give price to premium in the business, thus, premium did not appear to be justifiable and changed the valuation method to NAV.

The Tribunal observed that before examining the fairness or reasonableness of valuation report submitted by the assessee company, one has to bear in mind that the DCF method is essentially based on the projections (estimations) only and hence these projections cannot be compared with the actuals to expect the same figures as were projected. The valuer has to make forecast on the basis of some material but to estimate the exact figures is beyond its control. At the time of making a valuation for the purpose of determination of the fair market value, the past history may or may not be available in a given case and therefore, the other relevant factors may be considered.

The Tribunal finally held that projections were prepared on scientific basis and as per guidelines given by the ICAI and no fault was found in same. So, it was not open for the tax officer to challenge or change the method of valuation, once opted by the assessee company and to modify the figures as per his own whims and fancies. In any case, the tax officer cannot ask to prepare the valuation report based on actuals which is not contemplated in rule 11UA(2).

Key takeaways

DCF is one of the most used valuation methods despite its high reliance on projections. Courts does also agree with this fact and accept this method. Some time back under FEMA the only valuation method prescribed was DCF method. The above rulings make it clear that projections used in DCF method should have sound backing with the facts available on valuation date. Assumptions used in the projection should be scientifically made and adequately explained and described to defend the valuation report later on. A blindfolded reliance on the projections prepared by the management can lend into trouble when the report gets tested before authorities. Valuers should apply independent and unbiased mind on projections and question the management. Some due diligence on projections and description of basis of assumptions can go a long way in defending the valuation