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ITAT held that no deemed income arose on issue of shares at a premium as per DCF valuation

Taxpayer has an option to do valuation of shares either on DCF method or NAV and AO cannot determine the own value.

The Tribunal held that no income arose under section 56(2)(viib) of the Act, on rights issue of unquoted equity shares at a premium by the taxpayer to its holding company, as the shares were issued at fair market value arrived as per the prescribed discounted cash flow valuation methodology.

Facts of the case:

Vodafone M-Pesa Ltd.[1] (taxpayer) is in the business of mobile wallet business. During assessment year 2015-16, the taxpayer had issued shares of face value Rs.10 each at a premium of Rs.14.70 per share, and accordingly had received share premium of Rs.148,78,54,000. As per Section 56(2)(viib) of the Income tax Act, 1961 (the Act) read with Rule 11UA of the Income tax Rules, 1962 (the Rules), valuation of unquoted shares can be arrived at either by taking the net asset value (NAV) or discounted cash flow (DCF) method, at the option of the taxpayer. The taxpayer had relied on valuation report provided by independent valuer calculating the value of shares as per DCF method.

During the assessment proceedings, AO asked the taxpayer for the working of premium and valuation report as per Rule 11UA of the Income tax Rules, 1962 (the Rules). AO observed that valuation report was prepared by adopting DCF method based on the information and projections provided by the management of the taxpayer without the valuer independently enquiring into the projections or the claim made by the taxpayer. Further, the AO noted that the projection of sales and operating expenses have been made by the taxpayer without any rationale. Based on the actual sales, the AO observed that the projections were nowhere near the actual state of affairs and accordingly rejected the report submitted by the taxpayer. The AO himself calculated the fair market value of the equity shares based on NAV at Rs.4.15 per share and accordingly the excess amount received of Rs.20.55 per share was taxed under section 56(2)(viib) of the Act.

An appeal was preferred by the taxpayer before the first appellate authority the Commissioner of Income-tax (Appeals) [the CIT(A)].

Decision of the CIT(A):

The CIT(A) accepted the contentions of the taxpayer that the fair market value could be calculated either through NAV or DCF method and the taxpayer can adopt higher of valuation and it need not be NAV valuation only. However, the CIT(A) rejected the valuation report submitted by the taxpayer as being erroneous and accepted the DCF valuation only to the extent of actual performance in the subsequent years and accordingly partly allowed the appeal.

The CIT(A) further stated that there will always be some element of subjectivity in forecast data provided and the actual results will always differ from the forecasts. It is the general experience

[1] TS-831-ITAT-2019(Mum). I.T.A. No. 1073/Mum/2019 and I.T.A. No. 2032/Mum/2019

that in the same line of business some companies do extraordinarily well and others fail because their marketing strategy was not good or their competitors were better. If we accept the reasons given by the AO, no new company or company with a new idea would ever be able to choose DCF method for determination of fair market value of its shares because there would be insufficient or no background data and projections would always be questionable. Clearly, this is not the intention of the legislature or else they would have prescribed that only companies with certain years of business behind them would be allowed to use DCF method for determination of fair market value of their shares. The CIT(A) adopted the fair market value of equity shares at 40 percent of the projected DCF value, as the actual sales were approximately 40 percent of the projected sales. Accordingly excess amount was taxed under section 56(2)(viib) of the Act.

Aggrieved by the order, taxpayer and the income-tax department preferred an appeal before the Tribunal.

Decision of the Tribunal:

The Tribunal upheld the order of CIT(A) and rejected the appeal filed by the income-tax department and held that the taxpayer has an option to choose the valuation methodology.

Further the Tribunal acknowledged that valuation of shares is itself a projection of future events or activities and has to be done with some accuracy. However no person in the world can project with 100 percent accuracy. The Tribunal acknowledged that tax laws in more than one place, depend on the skills of the professionals like merchant banker only to value the valuation of shares or other volatile securities and it is left to the wisdom of valuer to accept or reject or to carry out independent investigation of the projections provided by the taxpayer. The Tribunal rejected the method adopted by the CIT(A), as trying to evaluate the accuracy of the valuation at the time of assessment or on factual data in subsequent years is not proper since the actuals are based on so many factors subsequent to the date of valuation.

Further Tribunal has relied on the co-ordinate bench decision in Cinestaan Entertainment (P.) Ltd.[2] wherein it was held that "*Rule 11UA provides two valuation methodologies for valuation of shares at the option of taxpayer; one is asset based NAV method and other is DCF method based on future projections which depend on various factors and projections made by the Management and the Valuer, like growth of the company, economic/market conditions, business conditions, expected demand and supply, cost of capital and host of other factors. If the statute provides that the valuation has to be done as per the prescribed method and if one of the prescribed methods has been adopted by the assessee, then Assessing Officer has to accept the same and in case he is not satisfied, then we do not find any express provision under the Act or rules, where Assessing Officer can adopt his own valuation in DCF method or get it valued by some different Valuer. There has to be some enabling provision under the Rule or the Act where Assessing Officer has been given a power to tinker with the valuation report obtained by an independent valuer as per the qualification given in the Rule 11U".*

Observation:

The Tribunal observes that the legislative intent of introducing section 56(2)(viib) of the Act is anti-tax abuse measure to deter the generation and use of unaccounted money, by increasing the onus of proof on closely-held companies for funds received from shareholders and is not applicable to genuine business transactions.

[2] [2019] 106 taxmann.com 300 (Delhi - Trib.)

Further, it highlights that if an expert does the valuation, then the tax officer has to accept the same as there is no provision in law or rule where the tax officer can adopt his own valuation in a DCF method or get valued by some different valuer.