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Notional income cannot be taxed, Revenue needs to follow valuation method adopted by taxpayer

The Bangalore Bench of the Indian Income-tax Appellate Tribunal (ITAT) rendered its decision that notional income cannot be taxed in the hands of the taxpayer. Further, the Assessing Officer can scrutinise the valuation report but cannot change the valuation methodology adopted by the taxpayer

Facts of the case:

- VBHC Value Homes Pvt. Ltd. (taxpayer)¹ is a company engaged in the business of building affordable and budget homes across India.

Issue 1: Notional lease rent

- During the Financial Year (FY) 2014-15, corresponding to Assessment Year (AY) 2015-16, the taxpayer leased out plant and machinery, office equipment to its subsidiaries in exchange of lease rent. The lease rent was determined by the taxpayer by adding the depreciation charged on the assets and the interest payable on bank loan.
- During the course of audit proceedings, the Assessing Officer (AO) noted that the depreciation amount claimed by the taxpayer [as per the provisions of the Income-tax Act, 1961 (ITA)] was higher than the depreciation amount considered for determining the lease rent. Further, the AO held that the lease rent to an unrelated third party would have fetched the taxpayer a minimum 8% of written down value (WDV) of the assets as lease rent, over and above the cost.

Based on the above findings, the AO re-computed a higher lease rent [being 8% of the WDV plus interest expense and depreciation as per the ITA] as income of the taxpayer.

Issue 2: Valuation of shares

- During the FY 2014-15, corresponding to AY 2015-16, the taxpayer issued fresh shares and obtained a valuation report from a Chartered Accountant (CA) in this regard, determining the value of shares as per the discounted cash flow (DCF) method.
- During the course of audit of the income tax return, the Assessing officer (AO) determined the value of shares issued by the taxpayer as per the net asset value (NAV), instead of the DCF method adopted by the taxpayer on the following basis:
 - The CA had not authenticated the projections of the taxpayers; and

¹ VBHC Value Homes Pvt Ltd v. ITO ITA No.2541/Bang/2019 & ITA No. 37/Bang/2020

- The DCF method adopted by the taxpayer for valuation of shares was irrational and did not have relevance to the factual financial results of the taxpayer.

The value of shares as per the NAV method was lower than the value determined as per the DCF method adopted by the taxpayer. Accordingly, the AO taxed the differential between the consideration received for issue of shares and the value of shares determined as per the NAV method, as income from other sources under section 56(2)(viib) of the ITA in the hands of the taxpayer.

On appeal, the Commissioner of Income tax Appeals [CIT (A)] upheld the AO's order on both the issues. Aggrieved by the CIT(A)'s order, the taxpayer filed an appeal before the Bangalore Bench of the Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

Issue 1: Notional lease rent

- The ITAT noted the principle laid down in the case of Highway Construction Co. Pvt. Ltd. v. CIT² that where income is not actually received by the taxpayer and it has not accrued to the taxpayer, then the income-tax authorities are not authorised to include such income which was neither due nor collected.

Further, in the current case as well, it was not the case of the AO that the taxpayer had received or a higher lease rental had accrued to the taxpayer.

- In view of the above and considering that no contrary judicial precedent of the jurisdictional Kerala High Court or the Supreme Court was brought on record, the ITAT held that notional lease rent could not be taxed in the hands of the taxpayer.

Issue 2: Valuation of shares

- The ITAT noted that the decision of the Bangalore ITAT in the case of Innoviti Solution Payment Solution Pvt Ltd³ amongst others, had held as follows:
 - The AO can do own valuation or obtain a fresh valuation report from an independent valuer, but he cannot change the method of valuation opted by the taxpayer.
 - For scrutinising the valuation report, the facts and data available on the date of valuation only has to be considered. The actual result of future cannot be a basis to decide about reliability of projections.
 - The primary onus to prove the correctness of the valuation report is on the taxpayer.

The Bangalore ITAT had relied on the decision of the Bombay High Court in the case of Vodafone M-pesa Ltd⁴, while arriving at the said conclusion.

² Highway Construction Co. (P.) Ltd. v. CIT [1993] 199 ITR 702 (Gau. HC)

³ Innoviti Payment Solutions (P.) Ltd v ITO 3(1) (1) [2019] 102 taxmann.com 59 (Bangalore - Trib.)

⁴ Vodafone M-pesa Ltd vs Pr.CIT [2018] 92 taxmann.com 73 (Bom. HC)

- Given the above and considering the issue involved in the present case was similar, the ITAT restored the matter back to the AO for fresh examination with following condition:
 - The AO could scrutinise the valuation report submitted by the taxpayer either by himself or through an external valuer but the AO could not change the method of valuation opted by the taxpayer (i.e. DCF).

Comments:

- This ruling affirms the principle that notional income cannot be taxed in the hands of the taxpayer. It would be pertinent to note that there are certain provisions under the ITA which empower the Revenue to tax a higher value, for example substitution of stamp duty value as sales consideration in cases where the actual sale consideration on sale of immovable property, is lower than the stamp duty value, which should be taken note of by taxpayers while relying on this ruling.
- This ruling affirms the principle that tax authorities can scrutinise the valuation report but cannot change the valuation methodology adopted by the taxpayer while determining the value of shares for the purpose of section 56(2)(viib).



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