Tax Hotline

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TAX ON SHARE ISSUANCES: DCF VALUATIONS NOT BE REJECTED ORDINARILY

- The tax authorities are entitled to scrutinize the valuation report and determine a fresh valuation either by himself or by calling for a final determination from an independent valuer.
- However, tax authorities cannot change the method of valuation which has been opted by the tax payer.
- Higher Discounted Cash Flow valuation based on projected profits in the future, despite being a loss-making entity today, upheld by Delhi ITAT.

Recently, India has witnessed various tax rulings on the valuation of shares issued by a company, specifically DCF valuation. Recently, while the Delhi Bench of the Income Tax Appellate Tribunal upheld a Discounted Cash Flow ("**DCF**") valuation of a loss making company in the case of *India Today Online Pvt. Ltd. v. ITO Ward 12(2) New Delhi*[1], in *TUV Rheinland NIFE Academy Pvt. Ltd. vs. ITO*,[2] the Bangalore Bench of the Income Tax Appellate Tribunal ("**Tribunal**") rejected the valuation of shares conducted by the taxpayer as per the DCF method for the purposes of section 56(2)(viib) of the Income Tax Act, 1961 ("**ITA**"), on the rationale that the very basis for the valuation had not been substantiated or verified by the taxpayer.

While the several of the legal arguments raised by the tax authorities are similar across these cases, the following analysis focuses more on the *Rheinland NIFE Academy* case since it is important to understand circumstances where the Courts are willing to set aside valuation reports in the case of share issuance.

BACKGROUND

TUV Rheinland NIFE Academy Pvt. Ltd ("the **taxpayer**") is an Indian company engaged in the business of providing vocational training through various centres across India. In the financial year 2014-15, the taxpayer issued 5,00,000 shares having face value of INR 100 each, at a premium price of INR 479 per share, to its parent, TUV Rheinland (I) Pvt. Ltd. ("**TUVR India**"). The share premium, which amounted to a total of INR 23.95 crore, was computed by the taxpayer as per the DCF method based on a valuation report obtained by the taxpayer from a chartered accountant. The DCF method of valuation calculates the present share value of a company based on projections of the company's future cash flows.

At the first stage of assessment, the Assessing Officer ("**AO**") rejected the share valuation in the report, by reasoning that it relied solely on values certified by the management of the taxpayer. The AO proceeded to ascertain the fair market value ("**FMV**") of the shares based on the current net asset value ("**NAV**") of the company and concluded that the FMV of the shares should be INR 84.20 per share as opposed to INR 479 per share as charged by the taxpayer. The AO thus passed an order making an addition of INR 19.74 crore to the taxpayer's income, being the difference between the two share premium amounts as determined by the AO and the taxpayer. The addition was made by the AO under section 56(2)(viib) of the ITA, which brings to tax premium charged by a company on issue of shares above their face value, on the difference between the actual consideration received for such shares and the FMV of the shares. For the purposes of calculating the FMV of shares under Section 56(2)(viib), Rule 11UA(2) of the Income Tax Rules ("**ITR**") gives the taxpayer an option to either apply the DCF method or the NAV method.

Aggrieved by the order of the AO, the taxpayer appealed to the Commissioner of Income-tax (Appeals) ("**Commissioner**"), who passed an order dismissing the appeal. On an appeal by the taxpayer from the order of the Commissioner, the Tribunal upheld the addition and ruled in favor of the tax department ("**Revenue**").

RULING OF THE TRIBUNAL

At the outset, the Tribunal rejected the argument of the taxpayer that share premium, being a capital receipt, should not be taxable under section 56 of the ITA which only intends to tax 'income'. The Tribunal reasoned that the definition of 'income' under Section 2(24)(xvi) of the ITA was amended with effect from April 01, 2013 to also include consideration received for issue of shares exceeding the FMV as referred to in section 56(2)(viib). Thus, such share premium was indeed 'income' which could be taxed under Section 56 of the ITA.

The Tribunal also rejected the arguments of the taxpayer that any price between a willing buyer and seller should be the FMV and should not require justification, and that the price should not be relevant in cases where the shares were issued to the parent company.

With respect to the application of the DCF method, the Tribunal observed that the AO had not disregarded the choice of method but had instead rejected the valuation since the taxpayer had neither substantiated nor verified nor provided proof for the basis of the estimates adopted in the valuation. It was clarified that the AO rejected the valuation on this basis and not because the valuations were solely certified by the management. In support of its conclusion, the Tribunal also noted that the actual figures were a long way away from the projections which had been made. Thus the Tribunal did not accept the taxpayer's contentions that the AO had interfered with the

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taxpayer's statutory right under Rule 11UA(2) of the ITR to choose the method of valuation, but upheld the ruling in as much as the AO found the parameters adopted for the valuation defective / not verifiable. The Tribunal further relied on the ruling in *Agro Portfolio Pvt. Ltd v. ITO*[3] ("**Agro Portfolio**") to conclude that after rejecting the taxpayer's valuation, the AO had the authority to carry out its own independent valuation and adopt the NAV method for this purpose.

ANALYSIS

The ruling will certainly add to the apprehension of companies issuing shares at a premium based on DCF valuation. This is especially true for those companies and projects which have little or no asset base or earnings in the present, thus rendering the NAV method inappropriate. The conclusion of the Tribunal that the taxpayer should be able to substantiate the basis of the valuation raises a preliminary question regarding what constitutes sufficient proof for this purpose. This becomes important especially considering that DCF valuation is based on unknown future cash flows and is not a scientific method that can be predicted accurately. Another question which arises is whether the tax authorities have the power to reject the method adopted by the taxpayer and proceed with another method when the taxpayer is given a statutory right to make this choice. Further, although this was not the basis of the decision, the facts of this case indicate the possibility of tax authorities passing adverse assessment orders solely because the valuation conducted was based on projections certified by the management of the taxpayer. This raises the possibility that the AO may initiate assessment proceedings in every case where the taxpayer has used the DCF method based on projections made by itself, to verify the credibility of the data provided by the taxpayer.

Primarily, to answer what constitutes credible data, it may be important to understand how a DCF analysis is carried out. The DCF valuation uses forecasted cash flows of a company and discounts them back to arrive at the present value using a discount rate. Two major inputs are thus required – future cash flow projections and the discount rate. While a number of methods are used to calculate the discount rate, the most common is the application of the weighted average cost of capital. However, it is the cash flow projections that take into consideration a wide number of both micro and macro-economic factors that affect business operations.[4] For instance, these include factors such as the growth rate of the industry in which the company is operating, the GDP growth rate, historical revenue growth and past performance of the company, envisaged savings, competition in the industry, income tax rates, expansion plans, major internal policy changes and changes in the organizational set up of the company, caliber of managerial personnel, expected capital expenditure and so on. While some of these factors can be reasonably predicted, there are a large number of factors which may not possibly be predicted with scientific certainty.

In this regard, very recently the Bangalore bench of the Tribunal in *2M Power Health Management Services Pvt. Ltd. vs. ITO*[5] and thereafter in *Innoviti Payment Solutions Pvt. Ltd. vs. ITO*[6] ("**Innoviti**") has ruled that the projections made in the DCF method should be estimated with reasonable certainty by the taxpayer and if the taxpayer is unable to do so, the valuation should be considered unworkable. Interestingly, in *Innoviti's* case, the Tribunal also observed that such a requirement should not apply to start ups which do not have any past company data to compute future cash flows with reasonable certainty, and the projections therein can only be made on the basis of expectations. The Tribunal added that in such cases various macro and micro economic factors (such as those listed above) should be sufficient to determine whether the expectations are reasonable.

With respect to whether the AO can reject the valuation method chosen by the taxpayer, the Bombay High Court in *Vodafone M Pesa Ltd. v PCIT*[7] ("**Vodafone M Pesa**") has held that while the tax authorities have the power to scrutinize the valuation report and are entitled to determine a fresh valuation, they do not have the power to change the valuation method which has been chosen. This view finds support in the rulings of the Jaipur bench of the Tribunal in *Rameshwaram Strong Glass Pvt. Ltd. vs. ITO*[8] and *ACIT vs. Safe Decore Pvt. Ltd.*[9] However, a conflicting view has been taken by the Delhi bench of the Tribunal in *Agro Portfolio* wherein the Tribunal ruled that if the taxpayer does not provide any evidence to substantiate the data on which the DCF valuation is based, the AO has the power to reject the DCF method and value the shares using the NAV method. The present case followed this ruling in *Agro Portfolio* and concluded that the AO could proceed with the NAV method after rejecting the DCF valuation conducted by the taxpayer. However, the Tribunal did not consider the decision of the Bombay High Court in *Vodafone M Pesa,* and should arguably have followed it in place of the conflicting tribunal orders. Incidentally, this question also arose in *Innoviti* wherein the Bangalore bench of the Tribunal followed the decision of the Bombay High Court in *Vodafone M Pesa*.

The proposition that a particular method or course of action that has been prescribed by the legislature should be followed regardless of particular circumstances, finds support in the ruling of the Hyderabad bench of the Tribunal in *Medplus Health Services Pvt. Ltd vs ITO*[10]. In this case while the taxpayer had calculated the FMV of unquoted equity shares based on the formula provided under Rule 11UA of the ITR, the AO proceeded to determine the FMV based on the open market value. The AO reasoned that the valuation of any property is actually dependent on the value it would fetch if sold in the open market but because generally the details of this value is not available, there is a formula given to overcome the deficiency under Rule 11UA. However, the Tribunal did not agree with this view and concluded that the AO had to follow the particular method prescribed under the law and the same cannot be ignored.

Based on various judicial precedents therefore it may be concluded that while the taxpayers have the right to choose DCF valuation, they should be able to substantiate it with reasonable data since the tax authorities do have the power to question the correctness and reliability of such valuation. Therefore, the present ruling appears sound in so far as the Tribunal concluded that the valuation is to be rejected not because of the choice of method but because the parameters adopted by the taxpayer had not been verified. However, determination of what is acceptable evidence for this purpose, still remains an open question and further clarity may be required in this regard. Further, in so far as the ruling relates to the adoption of the NAV method by the tax authorities, it can be argued that the Tribunal should not have allowed the same and should have followed the decision of the higher judicial authority in *Vodafone M Pesa*.

Interestingly, while concluding that the valuation was not realistic, the Tribunal also took into consideration the AO's finding that the projections taken in the valuation were a long way away from the actual figures. Arguably, this appears to go against the very principles of the DCF method of valuation which is based on projections and therefore should not be compared with actual figures in the future. Interestingly, the rulings in *Innoviti* and *Rameshwaram Glass* dealt with this question and supported this view. This finding is also contrary to the approach adopted in

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the *India Today* case where the court held as follows while upholding a DCF valuation of a loss-making company:

"DCF method is a recognised method where future projections of various factors by applying hindsight view and it cannot be matched with actual performance, and what Ld. CIT (A) is trying to do is to evaluate from the actual to show that the Company was running into losses, therefore, DCF is not correct. Valuation under DCF is not exact science and can never be done with arithmetic precision, hence the valuation by a Valuer has to be accepted unless, specific discrepancy in the figures and factors taken are found. Then AO or CIT(A) may refer to the a Valuer to examine the same."

While such rulings as in the case of *India Today* or *Vodafone MPesa* provide sufficient comfort on the manner and basis on which such valuation reports may be questioned, there still remains a likelihood that the valuation report may be increasingly questioned and clients need to be cognizant of the risks due to divergent rulings on the issue.

Separately, another noteworthy aspect of the ruling is the conclusion that share premium referred to in section 56(2)(viib) is 'income' under the ITA owing to the expansion of the definition of income under section 2(24)(xvi) to specifically include such sum within its ambit. However it should be noted that since section 56(2)(viib) of the ITA only relates to share premium paid by resident investors, in cases where the investor is a non-resident, the share premium should not be considered to be 'income' under the ITA. This view has also been upheld by the Bombay High Court in *Vodafone India Services Pvt. Ltd. v. Union of India*.[11]

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You can direct your queries or comments to the authors

[1] ITA Nos. 6453 & 6454/Del/2018
[2] I.T.A.No.3160/Bang/2018
[3] [2018] 171 ITD 74 (Delhi - Trib.)]
[4] Guidelines issued by the Research Committee of The Institute of Chartered Accountants of India
[5] [2019] 102 taxmann.com 96 (Bangalore – Trib.)
[6] [2019] 102 taxmann.com 59 (Bangalore - Trib.)
[7] [2018] 92 taxmann.com 73 (Bombay)
[8] [2018] 96 taxmann.com 542 (Jaipur – Trib.)
[9] [2018] 169 ITD 328 (Jaipur - Trib.)
[10] [2016] 158 ITD 105 (Hyd)
[11] (2014) 368 ITR 1