Tax Insights

from India Tax & Regulatory Services

Tax officer is required to accept the prescribed method adopted by the taxpayer for determining FMV of shares

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In brief

In a recent ruling[1], the Mumbai bench of the Income-tax Appellate Tribunal (Tribunal) held that the taxpayer had the option to choose any of the prescribed methods under the law to determine the fair market value (FMV) of unquoted shares and it was beyond the jurisdiction of the tax authority to insist on a particular method.

In detail

Facts

- The taxpayer was in the business of developing and cultivating land for agricultural purposes. It issued shares at a premium during the year under consideration.
- In accordance with the provisions of Rule 11UA(2) of the Income-tax Rules, 1962 (the Rules) read with section 56(2)(viib) of the Income-tax Act, 1961 (the Act) either discounted cash flow (DCF) method or the net asset value (NAV) method could be adopted for valuation of unquoted equity shares.
- The taxpayer had adopted DCF method based on a valuation report of a Chartered Accountant (valuer).
- In earlier years, the tax officer (TO) had accepted this approach and had not raised any objections.
- However, in the year under consideration, the TO rejected the valuation based on the following contentions:
  - No business activity was carried out during the year;
  - Share premium was disproportionate to business activities;
  - Astronomical projections considered that the DCF method was limited to five years;
  - Valuation report was not based on an independent evaluation by the valuer.
- Thereafter, the TO computed the FMV of shares by adopting the NAV method.
- On appeal, the Commissioner of Income-tax (Appeals) decided the issue in favour of the taxpayer by holding that the TO was not justified in rejecting the method of valuation adopted by the taxpayer.

Issue before the Tribunal

Whether the TO was justified in rejecting the method of valuation adopted by the taxpayer and adopting a different method?

Taxpayer's contentions

- Section 56(2)(viib) of the Act read with Rule 11UA(2) of the Rules provides the

[1] ITA No. 4854/ Mumbai/ 2016

taxpayer with an option to adopt any of the two prescribed methods to determine the FMV of shares.

- The taxpayer had adopted one of the prescribed methods to determine the FMV of unquoted shares. Therefore, the TO could not deviate from the method adopted by the taxpayer and insist on selection of a different method to determine the same.
- In earlier years also, the DCF method of valuation was accepted by the TO without any objection.

Tribunal's ruling

- The Tribunal observed that Rule 11UA(2) of the Rules read with section 56(2)(viib) of the Act provides an option to the taxpayer to opt for a method for determining FMV of shares.
- The Tribunal held that the TO could not adopt a method of his choice, especially when the Act allows to choose one of the two methods.
- The Tribunal observed that it was beyond the jurisdiction of the TO to insist upon a particular method.
- The Tribunal also observed that the contention of the taxpayer that the TO should not have deviated from the earlier years' decisions without assigning any concrete and justifiable reasons was acceptable.
- The Tribunal opined that tax determination could not be left to whims and fancies of the TO. Assessment is a serious task and has to be accomplished in a disciplined manner. When a taxpayer had been allowed a certain concession in earlier year/(s), the same could not be withdrawn in subsequent years, without giving any plausible reason.

The takeaways

This is a welcome ruling by the Tribunal as it confirms that Rule 11UA(2) of the Rules read with section 56(2)(viib) of the Act provides an option to taxpayers for choosing one of the prescribed methods of valuation of shares. This ruling also confirms that it is also not open to the tax authorities to decide on these methods of valuation, without providing any cogent reasons for rejecting the method adopted by the taxpayers.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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