TO cannot disregard the valuation method exercised by the taxpayer for determining FMV of shares under section 56(2)(viib) read with Rule 11UA(2)

September 21, 2018

In brief

In a recent ruling,[1] the Jaipur bench of the Income-tax Appellate Tribunal (Tribunal) held that a taxpayer has the option to choose any of the methods prescribed under Rule 11UA(2) of the Income-tax Rules, 1962 (Rules) to determine the fair market value (FMV) of its unquoted shares for computation of income under section 56(2)(viib) of the Income-tax Act, 1961 (the Act). Further, it held that the tax officer (TO) cannot adopt a method of his choice, as the option to choose a method by a taxpayer under the law would be nugatory and purposeless.

In detail

Facts

- The taxpayer was a private limited company. The taxpayer did not carry on any business activity for three years post its incorporation.
- During financial year 2012-13, the taxpayer issued equity shares of face value INR 10 each at a premium of INR 60 per share to resident parties by way of conversion of existing loans into share application money.
- The taxpayer opted for the discounted cash flow (DCF) method prescribed under the provisions of Rule 11UA(2) of the Rules read with section 56(2)(viib) of the Act and obtained valuation report of a Chartered Accountant (valuer) showing FMV of shares at INR 95.90 per share.
- The TO rejected the basis of valuation of shares and computed the FMV of shares at INR 32.76 per share applying the net asset value (NAV) method. The difference between the premium charged at INR 60 and the premium of INR 22.76 per share was held to be income under section 56(2)(viib) of the Act in the hands of the taxpayer.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the TO's action.

Issues before the Tribunal

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

Taxpayer's contentions

- Rule 11UA(2) of the Rules provides an option to the taxpayer to adopt any of the two prescribed methods (NAV or DCF) to determine the FMV of shares.
- The TO could not deviate from the method adopted by the taxpayer and compel the taxpayer to adopt a different method.
- The receipt of share premium by the taxpayer

[1] ITA No. 884/JP/ 2016

was not unjust even when no business activity had commenced and the issue of shares at a premium was a commercial decision, which did not require any justification under law. It was prerogative of the Board of Directors of the company to decide the premium amount and it was the wisdom of the shareholder whether they would want to subscribe to the share at a premium amount or not.

- The valuation report as per the DCF approach was based on future projections and estimations/ assumptions and any variation between these valuations and the actual figures were obvious. To this extent, the comparison made by the CIT(A) was unjust.
- Projections for later years reconciled with actuals.
- Section 56(2)(viib) of the Act read with Rule 11UA(1)(b) of the Rules requires the taxpayer to obtain valuation report from a registered valuer. The taxpayer had complied with such requirement.
- Valuation was in accordance with the Technical Guidance Note issued by the Institute of Chartered Accountants of India on the DCF method of valuation.
- The taxpayer further contended that the DCF method of valuation is more suitable than the NAV method for a new/ start-up company, as such organisations have very little or no capital base.

Revenue's contentions

The prerequisite for issue of share at premium is the substantial increase in the net worth of the income which is mainly due to the profitability, credibility, goodwill etc., of the concern. In absence of such factors these shares did not have intrinsic value to give rise to premium in the business.

Tribunal's ruling

- Rule 11UA(2) of the Rules read with section 56(2)(viib) of the Act provides an option to the taxpayer to choose a method to determine the FMV of shares.
- The TO could not adopt a method of his choice, especially when Rule 11UA gives an option to the taxpayer to choose the method of valuation. Permitting the Revenue to do so would render clause (b) of Rule 11UA(2) nugatory and purposeless.
- The comparison of the valuation *vis-à-vis* the actual figures was unjustified, as the forecast on which the valuations were based was beyond the control of the taxpayer, and the actual numbers may differ from the projections.

The takeaways

This is a welcome ruling by the Tribunal, as it confirms that tax authorities cannot change the method of valuation adopted by the taxpayer for a different method, as per Rule 11UA(2) of the Rules read with section 56(2)(viib) of the Act.

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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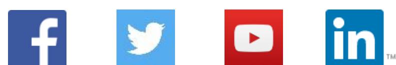

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