

Section 56(2)(viib) – Tribunal upholds rejection of valuation report by TO, where no evidence provided to substantiate numbers

June 5, 2018

In brief

In a recent ruling,¹ the Delhi bench of Income-tax Appellate Tribunal (Tribunal) held that to determine the fair market value (FMV) the tax officer (TO) could reject the method of valuation adopted by the taxpayer, if the taxpayer failed to produce evidences to substantiate the basis of data supplied, to arrive at the FMV.

In detail

Facts

- The taxpayer, a private limited company, had allotted 315,000 equity shares of face value of INR 10 each at a premium of INR 40 per share.
- A merchant banker had derived the FMV per share, applying the discounted cash flow (DCF) method, at INR 50 per share.
- According to the taxpayer, the allotment was made at fair value and in accordance with the provisions of section 56(2)(viib) of the Income-tax Act, 1961 (the Act) read with Rule 11UA of the Income-tax Rules, 1962 (the Rules).
- The TO rejected the valuation report of the merchant banker and determined the FMV at INR

9.60 per share, following the net asset value (NAV) method and made an addition under section 56(2)(viib) of the Act.

- The Commissioner of Income-tax (Appeal) [CIT(A)] upheld the TO's order.

Issues before the Tribunal

Whether the TO was justified in ignoring/ rejecting the selection and valuation methods opted by the taxpayer?

Taxpayer's contentions

- The TO was not supposed to ignore the option exercised by the taxpayer.
- The TO could not impose a method other than the one adopted by the taxpayer.
- In case the TO disagreed with the valuation, the TO could have referred the

same to the income tax department valuation officer (DVO) to determine the FMV of such capital asset.

Revenue's contention

- The figures relating to cash flow to equity, risk free return, expected returns and beta were not justified. Further, even the discounting rate adopted was very high.
- The figures in the valuation report was cooked up without providing any reliable basis of assumptions.
- It was possible that the company had decided the price of shares and travelled back to tailor the figures with the reverse engineering.
- Unless the taxpayer justified facts and figures

¹ ITA No. 2189/ Del/ 2018

and provides evidence justifying such figures, the authorities were constrained to reject the method which could not be verified.

- The authorities had no go but to adopt NAV method.
- The taxpayer did not respond to the notice requesting for justification of facts and figures.
- The disclaimer clause appended to the valuation report revealed that valuation of shares was not realistic.
- It stated that they had solely relied upon the information received from the taxpayer without any independent verification, truthfulness, accuracy and completeness of the information and financial data provided by the taxpayer. The merchant banker declined any responsibility if it affected the results presented due to the lack of completeness or truthfulness of such information.

Tribunal's ruling

- The taxpayer had not responded to the TO's notices for providing justification to valuation data.

- The taxpayer did not produce any evidence to substantiate the basis of projections in the cash flow even before the CIT(A).
- The merchant banker had disclaimed to have undertaken an independent enquiry to verify the truth or otherwise of the figures furnished by the taxpayer, at least on test basis. The merchant banker had not done anything applying their expertise, except for applying formula to the data provided by the taxpayer. This led to support the possibility of tailoring the data by applying reverse engineering to the pre-determined conclusions.
- The contention of the taxpayer that the TO had no jurisdiction to adopt a different method than the one adopted by the taxpayer, and that the TO was bound to make reference to the DVO was not acceptable.
- Unless and until the taxpayer produces evidence to substantiate the basis of projections and provides reasonable connectivity between those projections with material evidences, it was not possible even for the DVO to

conduct any exercise of verification of acceptability of the value determined by the merchant banker.

- It was ruled that in the given circumstances, there had not been any possibility for verifying the correctness or otherwise of the data and in absence whereof, it was not possible to verify the correctness of the result using the DCF method. Without such evidence reference to DVO also would not serve any purpose.
- The appeal was dismissed.

The takeaways

- There are conflicting decisions of coordinate benches.²³
- This decision seems to be in line with the Kolkata bench decision. This decision also rules that the claim of the tax payer for referring the matter to DVO without providing the required details asked by the TO will not be acceptable.

Let's talk

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

² DCIT v. Ozoneland Agro Private Limited [ITA/ 4854/ Mum/ 2016]

³ Microfirm Capital Private Limited v. CIT [ITA No. 513/ Kol/ 2017]

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