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What's New

Tax Insights

29 September 2023

Addition under section 56(viib) of the Act rejecting DCF method adopted by taxpayer for valuation of preference shares, stating it to be hypothetical method of estimation lacking cogent basis – Bangalore bench of the Tribunal

In brief

The Bangalore bench of the Income-tax Appellate Tribunal[1] (Tribunal) rejects the discounted cash flow (DCF) method adopted by the taxpayer company to determine the fair market value (FMV) of the preference shares, stating that it is a hypothetical method of estimation and lacks cogent basis where the taxpayer could not substantiate the basis of projections in cash flow. The Tribunal confirms addition of the share premium amount under section 56(2)(viib) of the Income-tax Act, 1961 (the Act).

In detail

Facts

- The taxpayer is engaged in providing software development services.
- During the financial year relevant to the assessment year 2016–17, the taxpayer allotted 1,045 preference shares, each convertible into 12 equity shares after financial year 2019–20, for INR11,000 per share (including a premium of INR10,000 per share) amounting to INR11.495m.
- The FMV of these preference shares was arrived at by a chartered accountant using the DCF method.
- The Tax Officer (TO) made an addition of INR10.45m (1,045 shares of INR10,000 each) under section 56(2)(viib) of the Act by rejecting the DCF method and was of the view that forecasting the future growth is a hypothetical estimation and not in accordance with rule 11UA of the Income-tax Rules, 1962 (Rules).

Revenue's contention

- While performing the valuation, the fundamentals and assumptions, as adopted by the valuer, were highly inflated in comparison to the actual revenue in the last three years; hence, the FMV did not reflect the true state of affairs of the taxpayer.
- It was also observed that there was a substantial variance between the projections (used by the valuer) and the actual results achieved by the taxpayer.

[1] ITA No. 494/Bang/2023

- Moreover, the method adopted by the taxpayer to determine the FMV of the equity share will not be applicable to determine the FMV of preference shares; hence, the same was unacceptable.
- To satisfy alternative valuation mechanism provided in section 56(2)(viib) of the Act, value of assets including intangible assets was not provided by the taxpayer. Hence, the explanation rendered for determination of FMV of preference shares was not acceptable. Therefore, the face value of the preference shares ought to have been taken as the value of the share at which the appellant company should have received the preference share capital including the premium.
- In the absence of correctness of the result of DCF method, the TO has no option but to reject the DCF method and to go by net asset value method to determine the FMV of the shares.
- Therefore, only the face value of the preference shares at INR1,000 per share should have been received by the company and the share premium of INR10.45m was found to be in excess of FMV of the share and, thus, added to the total income of the taxpayer.

Taxpayer's contention

- The shares under consideration are preference shares and not equity shares and that determination of FMV of the preference share can be done by applying rule 11UA(1)(c)(c) of the Rules.
- For the purpose of valuation, projections and reliable future estimates should not be insisted upon, while macro and micro economic factors affecting the business should be considered.
- Addition under section 56(2)(viib) of the Act is not applicable, particularly when the shares are issued at a price lower than the value determined as per the DCF method.
- Rejection of the report issued by the chartered accountant, determining the FMV as per the provisions of law, is bad in law. Since the TO was doubtful to accept the valuation report, it was bound to make a reference to the income-tax department valuation officer (DVO) to determine the FMV.
- No addition can be made under section 56(2)(viib) of the Act without first determining the FMV of the shares in terms of rule 11UA of the Rules. In view of the provisions under section 56(2)(viib) of the Act read with rule 11UA(2) of the Rules, the TO cannot adopt a different method other than the one adopted by the taxpayer.

Tribunal's observations and ruling

- It was observed that the DCF method followed by the taxpayer is a hypothetical method of estimation without any cogent basis.
- The Tribunal did not find any merit in the prayer of the taxpayer with respect to calling for a fresh valuation from the DVO.
- The FMV of preferential share was rightly taken by the TO as the value of the share at which the company should have received the preference share capital including the premium.
- In view of the provisions of section 56(2)(viib) of the Act read with rule 11UA of the Rules, there is no reason to interfere with the order passed by the lower authorities in not accepting the valuation report so prepared by the chartered accountant.
- The finding of the authorities to this effect – that the share premium received by the company is in excess of the FMV of the share – the addition thus made under section 56(2)(viib) of the Act is found to be just and proper.
- Accordingly, the Tribunal concluded that the order passed by the lower authorities was without any ambiguity and upheld the same.

The takeaways

This ruling has once again affirmed that, although valuation may be a scientific and technical exercise, the same needs to be conducted based on realistic assumptions and logical estimates.

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