Validity of Discounted Cash Flow Method under Section 56(2)(viib) discussed by Delhi High Court

Section 56(2)(viib) of the Income Tax Act,1961 was introduced in the Finance Act 2012 which requires a Company, not being a company in which the public are substantially interested, to issue shares at Fair Market Value (FMV). Any consideration received by such issuing Company in excess of the FMV, to the extent it exceeds the face value of such shall be liable to tax. The legislative intent behind insertion of provisions of section 56(2)(viib) and alike provisions was to tackle the menace of Black Money.

For the purpose of section 56(2)(viib), FMV shall be the value, Higher of the following:

(a) as may be determined in accordance with such methods as may be prescribed. Methods prescribed under Rule 11UA are Book value Method (NAV) and Discounted Cash flow method; or
(b) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

The whole thrust for such insertion is to bring measures to tax hefty or excessive share premium received unjustifiably by private companies on issue of shares without carrying underlying value to support such uncalled for premium and thereby enriching itself without paying taxes legitimately due to them. It also seems that subscription to the shares issued by a company at a substantial premium (not necessarily backed by a valuation justifying the premium) was supposedly resorted to convert unaccounted money.

In the case of PCIT Vs Cinestaan Entertainment Pvt Ltd, 2021, the Hon'ble Delhi High Court held that both the authorities have questioned the assessee's commercial wisdom for making the investment of funds raised in 0% compulsorily convertible debentures of group companies. The authorities were trying to suggest that the assessee should have made investment in some instrument which could have yielded return/profit in the revenue projection made at the time of issuance of shares, without understanding that strategic investments and risks are undertaken for appreciation of capital and larger returns and not simply dividend and interest. Any businessman or entrepreneur, visualize the business based on certain future projection and undertakes all kinds of risks. It is the risk factor alone which gives a higher return to a businessman and the Income-tax department or Revenue official cannot guide a businessman in which manner risk has to be undertaken. Such an approach of the Revenue has been judicially frowned by the hon'ble apex court on several occasions, for instance in the case of S. A. Builders Ltd. V. CIT (Appeals) [2007] 288 ITR 1 (SC) and CIT v. Panipat Woollen and General Mills Co. Ltd. [1976] 103 ITR 66 (SC). The courts have held that the Income-tax Department cannot sit in the armchair of businessman to decide what is profitable and how the business should be carried out. Commercial expediency has to be seen from the point of view of businessman. Here in this case if the investment has made keeping assessee's own business objective of projection of films and media entertainment, then such commercial wisdom cannot be questioned. Even the prescribed rule 11UA(2) does not give any power to the Assessing Officer to examine or substitute his own value in place of the value determined or requires any satisfaction on the part of the Assessing Officer to tinker with such valuation. Here, in this case, the Assessing Officer has not substituted any of his own method or valuation albeit has simply rejected the valuation of the assessee.

Section 56(2)(viib) is a deeming provision and one cannot expand the meaning of scope of any word while interpreting such deeming provision. If the statute provides that the valuation has to be time. Precisely, these factors have been judicially appreciated in various judgments some of which have been relied upon by the learned counsel, for instance:

Kakinad Fertilizere Ltd, In re, (SEBI) [2016] 195 C-C 325, 328 (Bom) [2015] ABR 291 (Bom)

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Kakinada Fertilizere Ltd, In re, (SEBI) [2016] 195 C-C 325, 328 (Bom) [2015] ABR 291 (Bom)

It is a well-settled position of law with regard to thevaluation that valuations is not an exact science and can never bedone with arithmetic precision. The attempt on the part of SEBI tochallenge the valuation which is by its very nature based on projections by applying what is essentially a hindsight view that the performance did not match the projection is done as per the prescribed method and if one of the prescribed methods has been adopted by the assessee, then the Assessing Officer has to accept the same and in case he is not satisfied, then wedo not find any express provision under the Act or rules, where Assessing Officer can adopt his own valuation in discounted cash flow method or get it valued by some different valuer. There has to be some enabling provision under the Rule or the Act where the Assessing Officer has been given a power to tinker with the valuation report obtained by an independent valuer as per the qualification given in the rule 11U. In this case, Assessing Officer has tinkered with discounted cash flow methodology and rejected by comparing the projections with actual figures. The Rules provide for two valuation methodologies, one is assets- based NAV method which is based on actual numbers as per latest audited financials of the assessee company.

Whereas in a discounted cash flow method, the value is based on estimated future projection. These projections are based on various factors and projections made by the management and the valuer, like growth of the company, economic/market conditions, business conditions, expected demand and supply, cost of capital and host of other factors. These factors are

considered based on some reasonable approach and they cannot be evaluated purely based on arithmeticalprecision as value is always worked out based on approximation and catena of underlying facts and assumptions. Nevertheless, at the time when valuation is made, it is based on reflections of the potential value of business at that particular time and also keeping in mindunderline factors that may change over the period of time and thus, the value which is relevant today may not be relevant after certainperiod of unknown to the law on valuations. Valuation being an exercise required to be conducted at a particular point of time has of necessity to be carried out on the basis of whatever information is available on the date of the valuation anda projection of future revenue that the valuer may fairly make on the basis of such information.

Rameshwaram Strong Glass Pvt. Ltd. v. ITO [2018] I TAT Jaipur

Before examining the fairness or reasonableness of valuation report submitted by the assessee we have to bear in mind thatthe discounted cash flow method and is essentially based on the projections (estimations) only and hence this projection cannot be compared with the actuals to expect the same figures as were projected. The valuer has to make forecast on the basis of some material but to estimate the exact figures is beyond its control. At the time of making a valuation for the purpose of determination of the fair market value, the past history may or may not be available in a given case and therefore, the other relevant factors may be considered. The projections are affected by various factors hence in the case of company where, there is no commencement of production or of the business,does not mean that its share cannot command any premium. For such cases, the concept of startup is a good

example and as submitted the Income-tax Act has also recognized and is encouraging the start- ups.'

DQ (International) Ltd. v. Asst. CIT (ITA 151/Hyd/2015)

Valuation of an intangible assetonly the future projections along can be adopted and such valuation cannot be reviewed with actuals after 3 or 4 years down the line. Accordingly, the grounds raised by the assessee are allowed'.

The aforesaid ratios clearly endorsed our view as above. In any case, if law provides the assessee to get the valuation done from a prescribed expert as per the prescribed method, then the same cannotbe rejected because neither the Assessing Officer nor the assessee have been recognized as an expert under the law.

There is another very important angle to view such cases, is that, here the shares have not been subscribed by any sister concernor closely related person, but by an outside investors like, Anand Mahindra, Rakesh Jhunjhunwala, and Radhakishan Damania, whoare one of the top investors and businessmen of the country and if they have seen certain potential and accepted this valuation, then how the Assessing Officer or learned Commissioner of Income-tax (Appeals) can question their wisdom. It is only when they have seen future potentials that they have invested around Rs. 91 crores in the current year and also huge sums in the subsequent years as informed by the learned counsel. The investors like these persons will not make any investment merely to give dole or carry out any charity to a startup company like, albeit their decision is guided by business and commercial prudence to evaluate a startup company like the assessee, what they can achieve in future. It has been informed that these investors are now the major shareholder of the assessee company

and they cannot become such a huge equity stock holder if they donot foresee any future in the assessee-company. In a way the Revenue is trying to question even the commercial prudence of suchbig investors. According to the Assessing Officer either these investors should not have made investments because the fair market valueof the share is nil or the assessee should have further invested in securities earning interest or dividend. Thus, under these facts and circumstances of the case, we do not approve the approach and the finding of the learned Assessing Officer or the learned Commissioner of Income-tax (Appeals) so to take the fair market value of the shareat "nil" under the provision of section 56(2)(viib) and thereby makingthe addition of Rs. 90.95 crores. The other points and various other arguments raised by the learned counsel which kept open as the same has been rendered purely academic in view of the finding given above.

Other grounds are either consequential or have become aca- demic, hence same are treated as infructuous. In the result appeal of the appellant assessee is allowed."

From the aforesaid extract of the impugned order, it becomes clear thatthe learned Income-tax Appellate Tribunal has followed the dicta of the hon'ble Supreme Court in matters relating to the commercial prudence ofan assessee relating to valuation of an asset. The law requires determination of the fair market value as per prescribed methodology. The appellant-Revenue had the option to conduct its own valuation and determine the fair market value on the basis of either the discounted cash flow or net asset value method. The respondent, assessee being a startup companyadopted discounted cash flow method to value its shares. This was carriedout on the basis of information and material available on the date of valuation and projection of future revenue. There is no dispute that the

methodology adopted by the respondent-assessee has been done applying a recognized and accepted method. Since the performance did not match the projections, the Revenue sought to challenge the valuation, on that footing. This approach lacks material foundation and is irrational since the valuation is intrinsically based on the projections which can be affected by various factors. We cannot lose sight of the fact that the valuer makes forecastor approximation, based on the potential value of business. However, the underlying facts and assumptions can undergo change over a period of time. The courts have repeatedly held that valuation is not an exact science,and therefore cannot be done with arithmetic precision. It is a technical and complex problem which can be appropriately left to the consideration and wisdom of experts in the field of accountancy, having regard to the imponderables which enter the process of valuation of shares. The appellant, Revenue is unable to demonstrate that the methodology adopted by the respondent-assessee is not correct. The Assessing Officer has simply rejected the valuation of the respondent-assessee and failed to provide anyalternate fair value of shares. Furthermore, as noted in the impugned orderand as also pointed out by Mr. Vohra, the shares in the present scenario have not been subscribed to by any sister concern or closely related person,but by outside investors. Indeed, if they have seen certain potential and accepted this valuation, then the appellant-Revenue cannot question their wisdom. The valuation is a question of fact which would depend upon appreciation of material or evidence. The methodology adopted by the respondent-assessee, accepted by the learned Income-tax Appellate Tribunal is a conclusion of fact drawn on the basis of material and facts available. The test laid down by the courts for interfering with the findings of avaluer is not satisfied in the present case, as the respondent-assessee adopted a recognized method of valuation and the appellant-Revenue is unable to show that the assessee adopted a demonstrably wrong approach,or that the method of valuation was made on a

wholly erroneous basis, orthat it committed a mistake which goes to the root of the valuation process.

Thus, the court held that the question of law urged by the appellant, Revenue is purely based on the facts and does not call for our consideration as a question of law.