Tax Hotline

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ITAT REJECTS DCF VALUATION IN THE APPLICATION OF 'ANGEL TAX'

The Bangalore bench of the Income Tax Appellate Tribunal[1] has upheld the levy of the "angel tax" on a part of the infusion of capital in preference shares issued by the taxpayer. This was despite the fact that the taxpayer had adopted one of the prescribed valuation methods for determining the market value of shares. The introduction of the "angel tax" was met with a degree of scepticism. This decision of the tribunal to reject the taxpayer's choice of valuation methodology compounds that scepticism to consternation.

THE LAW

This case pertains to the assessment year 2016-17. This section summarises the relevant law as it stood at that time.

Section 56(2)(viib) of the Income Tax Act 1961 generally applied to an unlisted company receiving capital for issuing shares to resident[2] investors. Under this provision any investment received by such a company which exceeds the fair market value of the shares being issued is characterized as taxable income. The key issue, therefore, is how must one determine the "fair market value". Rule 11UA of the Income Tax Rules 1962 prescribes the manner in which this valuation should be done. At the time of the extant case, this rule prescribed that the fair market value of "unquoted shares and securities other than equity shares" to be the price at which they could be sold in the open market for which the taxpayer may obtain a valuation report from a merchant banker or an accountant.[3] Clause a(ii) of the explanation to Section 56(2)(viib) nonetheless allows the taxpayer to adopt another valuation methodology if it can substantiate its veracity based on the value of the company's assets including its intangible assets.[4] Such other valuation should be adopted only if it is higher than the valuation established according to the prescribed method. As the bare reading of the law suggests, the income tax authorities are empowered to question the method of valuation only if the taxpayer chose to adopt a method which was not explicitly prescribed under the Income Tax Rules.

DECISION

The taxpayer – MobiCom Technologies Pvt. Ltd. – was a company which was a resident of India. It raised capital by issuing preference shares to an investor. The fair market value of these shares was determined by the taxpayer in accordance with the DCF method, which was certified by an accountant.

The income-tax authorities challenged this choice of the DCF method on the following grounds. *First*, they rejected the choice of method for being suitable for equity shares alone, and not for preference shares. *Secondly*, the authorities suggested that the taxpayer should have adopted a different valuation methodology to arrive at the correct valuation on the basis of the value of its assets including intangible assets. *Thirdly*, the authorities justified the rejection of the DCF method on the ground that there was substantial variation in the projected sales/revenue on the one hand, and the actual results on the other.

Citing these arguments the tax authorities concluded that only the face value of the shares should be treated as a capital investment, and the entirety of the share premium on these shares should be taxed as income under the "angel tax" provisions. The tribunal upheld this decision and relied on the precedent set by it in *M/s. Agro Portfolio Pvt. Ltd. vs. ITO*.[5] In that case, it had decided that the income tax authorities could reject the DCF valuation, and apply the NAV method if the correctness of the result of DCF method cannot be verified. Accordingly, the tribunal rejected the DCF valuation report submitted by the taxpayer and upheld the alternative valuation of share value adopted by the tax officer.

ANALYSIS

The judgement appears to suffer from a number of infirmities. First, it is true that the taxpayer had issued preference shares. Assuming these were compulsorily convertible preference shares (as appears to be the case from the judgement), Rule 11UA(1)(c) left it entirely to the taxpayer to determine the fair market value in a manner which may be certified by a merchant or an accountant.[6] It is apparent from the record that a chartered accountant had indeed certified such valuation. Therefore, the valuation report provided by the accountant in the extant case ought to be accepted.

Secondly, it is also true that Clause (a)(ii) of the explanation to Section 56(2)(viib) of the Act provides for a method which is different from the ones prescribed by Rule 11UA. However, such method may be adopted only if the valuation under it is higher than the valuation arrived at by way of a prescribed method. Surely, that provision could not have been relied on by the tribunal to justify a valuation which is lower than the DCF value.

Thirdly, the reference to the actual revenues of the taxpayer should have no bearing on what their projections were

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for the purposes of the DCF valuation, as long as these were certified by a merchant banker, or under the law as it was for the relevant tax year, an accountant. The law does not provide any room for a difference of opinion between the certified valuation by an expert valuer, and by the income tax authorities.[7] This is assuming that the certification process had been undertaken appropriately. The tax authorities cannot adopt a simplistic argument that actual performance was at variance from projected financials considered under the DCF method of valuation.[8] The tax officer may reject the valuation only by proving that the methodology resorted to by the taxpayer did not adhere to the standards prescribed by law.[9]

Clearly, the tribunal accepted the tax authorities' grounds for rejecting the taxpayer's chosen method of valuation. However, there is a conspicuous lack of causality between those grounds on the one hand, and the outcome on the other. The decision is silent on the reasons why the face value of the shares was accepted as their fair market value.

The decision also flies in the teeth of several precedents. For instance, it has been held in a number of cases that the income-tax authorities cannot question the valuation adopted so long as it has been conducted in a correct manner.[10]

It is important to discuss the tribunal's decision in *Agro Portfolio*. In that case, the merchant banker was found not to have engaged in an independent valuation exercise, nor had they applied their expertise whilst affirming the accuracy of the DCF value adopted. Therefore, the tribunal's blind invocation of *Agro Portfolio* also appears to be erroneous.

It is pertinent to note that the CBDT has, through a recent notification,[11] amended the valuation methodology under rule 11UA. The notification has broadened the scope of the valuation methods, by providing various other possible methods that the taxpayer may adopt. This includes providing methods of valuation particular to compulsorily convertible preference shares. Whilst it does retain discretion of adopting the valuation method at the taxpayer's option, the risk of the provision being applied incorrectly remains, which can, in turn, have a damning impact on a company's cash flows and capital requirements.

– Anirudh Srinivasan & Dr. Dhruv Janssen-Sanghavi

You can direct your queries or comments to the authors.

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[1]ITA No. 494/Bang/2023.

[2]This provision has now been extended to investments received also from non-residents investors from 1 April 2024.

[3]As of 1 April 2018, only a merchant banker may certify the valuation. Rule 11UA(1)(c), Income Tax Rules, 1962 (as applicable to the extant case).

The applicable valuation methodology for unquoted equity shares, whilst forming part of the same rule, were (and continue to be) separate. That rule prescribed two main methods of valuation: the net asset valuation method ("**NAV**"); or the discounted cash flow ("**DCF**") valuation method certified by a merchant banker or an accountant. The choice of the valuation method is left entirely to the taxpayer. See: Clause (a)(i) of the Explanation to Section 56(2)(viib) of the Income Tax Act, 1961 read with Rule 11UA(2), Income Tax Rules, 1962.

[4]Clause (a)(ii) of the Explanation to Section 56(2)(viib) of the Income Tax Act, 1961.

[5]ITA No. 2189/Del/2018

[6]Rule 11UA(1)(c) of the Income Tax Rules, 1962.

[7]Microfirm Capital (P.) Ltd. v. Deputy Commissioner of Income-tax, Circle- 8 (1), Kolkata, [2018] 62 ITR(T) 109 (Kolkata - Trib.)..

[8]Commissioner of Income Tax, Corporate Circle-3, Chennai v. VVA Hotels (P.) Ltd, [2020] 429 ITR 69 (Madras); Brio Bliss Life Science (P.) Ltd. v. Income-tax Officer, [2023] 200 ITD 167 (Chennai - Tribunal); SB Industrial Engineering (P.) Ltd. v. Assistant Commissioner of Income-tax, [2023] 198 ITD 282 (Chennai - Tribunal); Deputy Commissioner of Income-tax-6(2)(1), Mumbai v. Credtalpha Alternative Investment Advisors (P.) Ltd, [2022] 94 ITR(T) 596 (Mumbai - Tribunal).

[9]Income-tax Officer v. Appealing Infrastructure (P.) Ltd., [2023] 201 ITD 719 (Delhi - Tribunal).

[10]Signure Technologies (P.) Ltd. v. Assistant Commissioner of Income Tax, Circle - 6(1)(1), Bengaluru, [2020] 83 ITR(T) 521 (Kolkata - Trib.); Vodafone M-Pesa Ltd. v. Principal Commissioner of Income Tax, [2018] 92 taxmann.com 73 (Bombay)..

[11]CBDT notification G.S.R. 685(E) dated 25th September 2023.

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