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VALUATION OF COMPANIES

A LEGAL ANALYSIS

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SOLICITORS AND ADVOCATES

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Introduction

The issue or transfer of equity shares or other securities invariably involves the valuation of the underlying company. The principles and rules for valuing companies lie at the intersection of law and accounting. Various statutes and regulators are involved in this crucial activity. Company law seeks to ensure that companies do not shortchange their existing shareholders by issuing securities below their fair market value. The Reserve Bank of India has issued a number of rules and regulations under the Foreign Exchange Management Act, 1999 to staunch the outflow of foreign exchange on account of non-residents underpaying for Indian securities or selling Indian securities to Indian residents at prices exceeding their fair market value. The Securities and Exchange Board of India endeavours to prevent investors, especially retail investors, from being offered securities at a value higher than the applicable fair market value. Income tax authorities too have an interest in ensuring fair valuation of securities that are issued or bought and sold, to prevent tax evasion. This paper delves into the myriad laws, rules and regulations that are at play, in relation to the valuation of companies.

Valuation of companies under the Companies Act, 2013

When is a valuation report required under the Companies Act?

The Companies Act, 2013 ("**Companies Act**") requires a valuation report from a registered valuer in several situations, some of which are:

- For the private placement of securities under Section 42 of the Companies Act. If the consideration for the securities being issued is not cash, then as per Rule 12(5) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, a valuation report for such consideration is also required.
- For the preferential issue of shares under Section 62(1)(c) of the Companies Act read with Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 ("**Share Capital and Debentures Rules**"). If the consideration for the securities being issued is not cash, then as per Rule 2(d)(xii) of the Share Capital and Debentures Rules, a valuation report for such consideration is also required.
- If the preferential issuance is by a listed company, the price of the shares need not be determined by the valuation report of a registered valuer as per the second proviso to Rule 13(1) of the Share Capital and Debentures Rules.
- For the issue of sweat equity shares to directors/ employees at a discount or for consideration other than cash as per Section 52 of the Companies Act read with Rule 8 of the Share Capital and Debentures Rules**,** a valuation report is required for the intellectual property rights or of know how or value additions for which for which sweat equity shares are to be issued.
- For the acceptance of deposits which are secured by a charge on the assets of the Company as per Rule 6 of the Companies (Acceptance of Deposits) Rules, 2014. The amount of such deposits and the interest payable thereon shall not exceed the market value of such assets as assessed by a registered valuer.
- For entering into an arrangement with a director or any director of a holding, subsidiary or associate company, in terms of which such person acquires or is to acquire assets for consideration other than cash, from the company or when a company acquires or is to acquire assets for consideration other than cash, from such person, under Section 192 of the Companies Act.
- For any corporate debt restructuring under Section 230 of the Companies Act.
- For any merger or the amalgamation of any two or more companies under Section 232 of the Companies Act
- For the acquisition of any stake held by minority shareholders under Section 236(2) of the Companies Act. For a Company Liquidator appointed by the National Company Law Tribunal ("**NCLT**") pursuant to or in connection with the winding up of a company to submit a report to the NCLT regarding the assets of the company, under Section 281 of the Companies Act.

Who can be a valuer?

- Chapter XVII (Section 247- Valuation by registered valuers) of the Companies Act and the Companies (Registered Valuers and Valuation) Rules, 2017 ("**Valuation Rules**") deal with the appointment of valuers. Section 247 of the Companies Act provides that:

  "*(1) Where a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets (herein referred to as the assets) or net worth of a company or its liabilities under the provision of this Act, it shall be valued by a person having such qualifications and experience, registered as* *a valuer and being a member of an organisation recognised, in such manner, on such terms and conditions as may be prescribed and appointed by the audit committee or in its absence by the Board of Directors of that company."*

What should the valuation report contain?

Rule 18 of the Valuation Rules provides that a valuation report should contain:

(a) background information of the asset being valued;
(b) purpose of valuation and appointing authority;
(c) identity of the valuer and any other experts involved in the valuation;
(d) disclosure of valuer interest/conflict, if any;
(e) date of appointment, valuation date and date of report;
(f) sources of information;
(g) procedures adopted in carrying out the valuation;
(h) valuation methodology;
(i) major factors that influenced the valuation;
(j) conclusion; and
(k) caveats, limitations and disclaimers.

Can securities be issued at a price higher than the price determined by the valuer?

Section 62(1)(c) of the Companies Act states that the price of the shares should be determined by the valuation report of a registered valuer. Rule 13(2)(g) of the Share Capital and Debentures Rules too states that the price of the shares or other securities to be issued on a preferential basis, either for cash or for consideration other than cash, shall be determined on the basis of valuation report of a registered valuer. These provisions give the impression that companies are required to issue shares and other securities at the exact same price as that determined by the registered valuer.

However, since the objective behind requiring companies to adhere to a valuation by a registered valuer is to ensure that companies do not issue shares at a price less than their value, there is no restriction on a company issuing securities at a price higher than the one determined by the registered valuer. Rule 13(3) of the Share Capital and Debentures Rules states that the price of shares or other securities to be issued on preferential basis shall not be less than the price determined on the basis of valuation report of a registered valuer.

Valuation of companies under SEBI Regulations

Valuation reports are required for various types of compliances under various regulations framed by the Securities and Exchange Board of India ("**SEBI**").

Who can be a valuer?

Various regulations framed by SEBI have, by and large, recognized valuers appointed under Section 247 of the Companies Act.

As per the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("**ICDR Regulations**"), a "valuer" is a person who is registered under Section 247 of the Companies Act and the relevant rules framed thereunder or as specified by SEBI. The SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008 ("**Security Receipts Regulations**") follows almost the same approach by defining a valuer as a person who is a "registered valuer" under section 247 of the Companies Act, but unlike the ICDR Regulations, omits[1] the reference to SEBI. The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**LODR Regulations**") follow the definition of valuer given in the ICDR Regulations. The SEBI (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 ("**Administrator Regulations**") state that the term "registered valuer" shall have the meaning provided under the Companies (Registered Valuers and Valuation) Rules, 2017.

Valuation methodology under ICDR Regulations

(i) As per clause 158(6)(b) of the ICDR Regulations, the conversion price of debt, derived at as part of a debt restructuring scheme, shall be certified by two independent valuers;

(ii) As per clause 163(3) of the ICDR Regulations, specified securities may be issued on a preferential basis for consideration other than cash, the valuation of the assets in consideration for which the equity shares of a company may be issued, shall be done by an independent valuer which shall be submitted to the stock exchanges where the equity shares of the issuer are listed;

(iii) As per clause 165 of the ICDR Regulations, where the shares of an issuer are not frequently traded, the price determined by the issuer shall take into account the valuation parameters that are customary for valuation of shares in such companies. The issuer is required to provide a certificate from an independent valuer certifying compliance with this Clause, to the relevant stock exchange.

Valuation methodology under Administrator Regulations

(i) As per clause 7(2)(b), the Administrator shall engage the services of a registered valuer to evaluate the properties of defaulter that are attached by the Recovery Officer and for submission of a certified valuation report in accordance with SEBI guidelines;

(ii) As per clause 8(1), the Administrator shall undertake the process of sale of properties after conducting independent valuation of such properties by a registered valuer.

Valuation methodology under LODR Regulations

(i) The provisions of Clause 87C(1) require that valuation of listed security receipts are valued on a quarterly basis by an independent valuer.

Valuation methodology under Security Receipts Regulations

(i) The provisions of clause 38G(1) require that valuation of listed security receipts are valued on a quarterly basis by an independent valuer.

Pricing Guidelines under the Foreign Exchange Management Act, 1999

One of the main objectives of the Foreign Exchange Management Act, 1999 ("**FEMA**") is to conserve India's foreign exchange. So, in general, if a non-resident buys securities of an Indian company from an Indian resident, FEMA requires the price to be not less than the fair market value of the company, since this transaction involves the inflow of foreign exchange. If a non-resident

[1] The implication of such omission is that under the ICDR Regulations, SEBI may frame rules to specify who may be a valuer, whilst SEBI may not do so under the Security Receipts Regulations. This is an academic point since SEBI have the power and ability to amend the Security Receipts Regulations to give itself the right to frame rules to specify who may be a valuer under the Security Receipts Regulations.

sells securities of an Indian company to an Indian resident, FEMA requires the price to be not more than the fair market value of the company, since this transaction involves the outflow of foreign exchange.

Rule 21 of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("**FEMA Non-Debt Instruments Rules**"), which has been issued under FEMA, encapsulates the afore-mentioned principles and provides as follows:

1) The price of equity instruments of an Indian company,-

a) issued by such company to a person resident outside India shall not be less than:

(i) the price worked out in accordance with the Securities and Exchange Board of India guidelines[2] in case of a listed Indian company or in case of a company going through a delisting process as per the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;

(ii) the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with the Securities and Exchange Board of India or a practising Cost Accountant, in case of an unlisted Indian Company.

Explanation: In case of convertible equity instruments, the price or conversion formula of the instrument should be determined upfront at the time of issue of the instrument. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with these rules.

b) transferred from a person resident in India to a person resident outside India shall not be less than,-

(i) the price worked out in accordance with the Securities and Exchange Board of India guidelines in case of a listed Indian company;
(ii) the price at which a preferential allotment of shares can be made under the Securities and Exchange Board of India Guidelines, as applicable, in case of a listed Indian company or in case of a company going through a delisting process as per the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;
(iii) the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with the Securities and Exchange Board of India or a practicing Cost Accountant, in case of an unlisted Indian company.

c) transferred by a person resident outside India to a person resident in India shall not exceed:

(i) the price worked out in accordance with the relevant Securities and Exchange Board of India guidelines in case of a listed Indian company;

a. the price at which a preferential allotment of shares can be made under the Securities and Exchange Board of India Guidelines, as applicable, in case of a listed Indian company or in case of a company going through a delisting process as per the Securities

[2] Which can be found in Part IV of Chapter V of the ICDR Regulations.

and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009 ("**Delisting Regulations**"): Provided that the price is determined for such duration as specified in the Securities and Exchange Board of India Guidelines, preceding the relevant date, which shall be the date of purchase or sale of shares;

b. the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with the Securities and Exchange Board of India or a practising cost accountant, in case of an unlisted Indian company.

Explanation: The guiding principle shall be that the person resident outside India is not guaranteed any assured exit price at the time of making such investment or agreement and shall exit at the price prevailing at the time of exit.

(ii) in case of swap of equity instruments, subject to the condition that irrespective of the amount, valuation involved in the swap arrangement shall have to be made by a Merchant Banker registered with the Securities and Exchange Board of India or an investment banker outside India registered with the appropriate regulatory authority in the host country.

(iii) where shares in an Indian company are issued to a person resident outside India in compliance with the provisions of the Companies Act, by way of subscription to Memorandum of Association, such investments shall be made at face value subject to entry route and sectoral caps.

(iv) in case of share warrants, their pricing and the price or conversion formula shall be determined upfront:

Provided that these pricing guidelines shall not be applicable for investment in equity instruments by a person resident outside India on a non-repatriation basis.

2) The pricing guidelines specified in the FEMA Non-Debt Instruments Rules shall not be applicable for any transfer by way of sale done in accordance with regulations framed by SEBI where the pricing is specified by SEBI.

Determination of fair market value under the Income Tax Act, 1961

Sections 56(2)(viib) the Income-tax Act, 1961 ("**the IT Act**") contains an anti-abuse provision. This section provides that if a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be treated as income from other sources. For the purpose of Section 56(2)(viib) of the IT Act, Rule 11UA of the Income Tax Rules, 1962 ("**IT Rules**") prescribes the following rules for determining the fair market value of shares and securities.

<u>In case of listed securities:</u>

(i) if the securities are received by way of a transaction carried out through any recognized stock exchange, the fair market value of such securities shall be the transaction value as recorded in such stock exchange;

(ii) if the securities are received by way of a transaction carried out other than through any recognized stock exchange, the fair market value of such shares and securities shall be,

(a) the lowest price of such shares and securities quoted on any recognized stock exchange on the valuation date, and

(b) the lowest price of such shares and securities on any recognized stock exchange on a date immediately preceding the valuation date when such shares and securities were traded on such stock exchange, in cases where on the valuation date there is no trading in such shares and securities on any recognized stock exchange;

<u>In case of unlisted equity shares</u>

In case of unlisted equity shares, the fair market shall be determined in the following manner under clause (a) or clause (b), at the option of the assessee, namely:-

(a) the fair market value of unquoted equity shares = **(A - L) x (PV)/ (PE)**

where,

A = book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;

L = book value of liabilities shown in the balance-sheet, but not including the following amounts, namely:-

(i) the paid-up capital in respect of equity shares;

(ii) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;

(iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;

(iv) any amount representing provision for taxation, other than amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund as refund under the Income-tax Act, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;

(v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;

(vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;

PE = total amount of paid-up equity share capital as shown in the balance-sheet;

PV = the paid-up value of such equity shares; or

(b) the fair market value of the unquoted equity shares determined by a merchant banker as per the Discounted Free Cash Flow method.

<u>In case of unlisted securities other than equity shares</u>

In case of unlisted securities other than equity shares, their fair market value shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of such valuation.

Commonly used valuation methodologies

The valuation of an enterprise or a business or the shares of a company is not an exact science and may be carried out using various methodologies. Factors such as the specific nature of the business, whether the entity is listed on a stock exchange, the industry or sector to which the company belongs, its past track record and the ease with which the growth rate in cash flows to perpetuity can be estimated and the extent to which industry and comparable company information is available play a significant role in valuation. Valuation results fluctuate with time, changes in prevailing market conditions and prospects, industry performance and general business and economic conditions. The application of any particular method of valuation depends on the purpose for which the valuation is done.

Some of the generally accepted valuation methodologies are as follows:

a. **<u>Net Asset Value Method ("NAV")</u>**

   The value arrived at under this approach is based on the latest available audited/ provisional financial statements of the business and may be defined as shareholders' funds or net assets owned by the business. The Net Asset Value is generally used as the minimum break-up value for any business since this methodology ignores the future return the assets can produce and is calculated using historical accounting data that does not reflect how much the business is worth to someone who may buy or invest in the business as a going concern. This method is usually used in case where the asset base dominates earnings capability.

b. **<u>Discounted Cash Flow Method</u>**

   Discounted cash flow (DCF) is a valuation method used to estimate the value of an investment based on its expected future cash flows. DCF uses projections of how much money a business will generate in the future, to ascertain its current value. The present value of expected future cash flows (both incoming and outgoing) is arrived at by using a discount rate to calculate the DCF. If the DCF is above the current cost of the investment, the possibility of making a profit on the investment is higher.

   The weighted average cost of capital (WACC) is used usually used to calculate the discount rate. WACC takes into consideration the rate of return expected by shareholders.

   The DCF method has limitations, since the estimate of future cash flows could prove inaccurate.

   Where realization of an investment or a flotation of the underlying business is imminent and the pricing of the relevant transaction has been substantially agreed, the Discounted Cash Flows (from the investment, rather than from the business) methodology (or, as a surrogate, the use of a simple discount to the expected realization proceeds or flotation value) is likely to be the most appropriate methodology.

c. **<u>Book Value</u>**

   A company's book value can be calculated using information from its balance sheet. To calculate book value, the company's liabilities need to be subtracted from its assets. All intangible assets should also be excluded. The figure that one arrives at represents the value of any tangible assets the company owns.

The main drawback of this method is that balance sheet figures cannot be equated with fair value and relying on basic accounting metrics would not provide a business's true value.

Enterprise Value

The enterprise value of a company can be calculated by adding its debt and equity and then subtracting the amount of unused cash, that it the cash that is not used to fund business operations.

Therefore, **Enterprise Value** = Debt + Equity – Cash

EBITDA

EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. Those who rely on EBITDA do so in order to obtain a picture of an enterprise which is not distorted by tax policies since taxes hide the real success or failure or a business. Also, expenses incurred in buying equipment or a building is offset through depreciation or amortization over a period of time. For certain types of companies, depreciation and amortization can make their earnings look worse than they are and so, valuation on the basis of EBITDA would make sense.

Comparable Companies Market Multiple Method ("CMM Method")

Under this methodology, market multiples of comparable listed companies are computed and applied to the business being valued in order to arrive at a multiple based valuation. This is based on the premise that the market multiples of comparable listed companies are a good benchmark to derive the value of the subject company. This method applies the most appropriate and reasonable multiple to the relevant operating performance metrics of the subject company to estimate its value. The difficulty here is in the selection of a comparable company since it is rare to find two or more companies with the same product/service mix, size, business strategy, geography, stage of lifecycle etc.

Recent Case Law Involving Valuations

1. ***Cognizant Technology-Solutions India Private Limited* v. *The Dy. Commissioner of Income Tax, Large Taxpayer Unit-1*[3]**

During the financial year relevant to the AY 2014-15, Cognizant Technology Solutions India Private Limited ("**Cognizant India**") carried out a buyback of its equity shares having a face value of Rs. 10/- each ("**Cognizant Shares**") from some of its shareholders, as a result of which it purchased, *inter-alia*, (i) 9,16,133 Cognizant Shares from Messrs. Cognizant (Mauritius) Limited (ii) 2,59,253 Cognizant Shares from Messrs. Cognizant Technology Solutions Corporation, USA, (iii) 16,709 Cognizant Shares from Messrs. Market RX Inc. USA and (iv) 11,873 Cognizant Shares from Messrs. CSS Investments LLC, USA. It paid a price of Rs. 23,915/- per Cognizant Share to each seller.

Cognizant India filed its Income-tax return for the Assessment Year 2014-15, on 29 November 2014 which was subsequently revised on 07 October 2015. Cognizant India's case was selected for regular assessment under section 143(3) of the IT Act by issue of

[3] ITA No. 2820/Chny/2019

notice under section 143(2) dated September 8, 2015. Several hearings were held by the Assessment Officer during the course of the regular assessment and Cognizant India furnished all the information called for from time-to-time. Amongst the various details called for, the Assessment Officer also requested for and examined the following details in relation to the aforementioned buy-back of shares:

- Valuation of the shares bought-back, including justification of the valuation methodology followed by Cognizant India.
- Explanation on non-applicability of section 2(22) of the IT Act and section 115-0 of the IT Act to the buy-back of shares
- Explanation regarding non-applicability of section 115QA of the IT Act to the buy-back of shares
- Explanation regarding Circular No. 3 of 2016 dated 26 February 2016[4] issued by the Central Board of Direct Taxes ("**CBDT**") that is applicable to Cognizant India's case.

After examining all the information submitted and explanation offered by Cognizant India, the Assessment Officer passed an order under section 143(3) of the IT Act on 31 December 2016 ("**the Assessment Order**") wherein certain adjustments were made to the total income of Cognizant India. With respect to the buy-back of the Cognizant shares, the stand adopted by Cognizant India was accepted by the Assessment Officer and hence, no adjustment was made to the tax liability of Cognizant India on account of the said transaction. The Assessment Officer specifically determined a sum of 'Nil' against 'Dividend Distribution Tax' in the Income-tax Computation Form forming part of the Assessment Order.

On the same transaction involving a buy-back of shares by Cognizant India, assessment orders were passed against two of Cognizant India's shareholders who filed a Writ Petition challenging such assessment orders ("**Shareholder Orders**"). The Madras High Court took note of the Shareholder Orders and so on March 21, 2018 the Commissioner of Income Tax ("**CIT**") issued a notice under section 263 of the IT Act seeking to set-aside the Assessment Order and to direct the Assessment Officer to examine the examine the valuation of shares bought-back, the applicability of sections 2(22), 115-O, 115QA and 195 of the IT Act to the said buy-back of shares. The said Writ Petition was dismissed by the Madras High Court *vide* its order dated June 25, 2019 and Cognizant India was directed to file a suitable response to the notice under section 263 of the Act before CIT, who in turn was directed to pass an order without being influenced by any findings of the Court with respect to the Shareholder Orders.

Cognizant India, thereafter, challenged the Shareholder Orders through a writ petition before a Division Bench of the High Court. The Division Bench, *vide* its order dated July 5, 2019, upheld the order passed by the Single Judge and also directed the CIT to pass an order under section 263 of the IT Act within two weeks of Cognizant India filing its reply to the show-cause notice. Cognizant India was directed to file its response within two weeks of receiving the High Court's order in the Writ Appeal.

In compliance with the said directions of the Court, Cognizant India filed its written submission on July 19, 2019 and also appeared before the CIT on 25th July 2019 in the proceedings under section 263 of the IT Act. Cognizant India submitted before the CIT that the Assessment Order is neither 'erroneous' nor 'prejudicial to the interest of the revenue' and hence, the CIT does not have jurisdiction to set-aside the Assessment Order under section 263 of the IT Act.

[4] This circular clarified that any amount paid by a company to its shareholders during the period from April 1, 2000 till May 31, 2013 under a share buyback scheme shall be treated as capital gains under Section 46A of the Income Tax Act, 1961 and not as dividend.

The CIT, after considering relevant submissions of Cognizant India, was of the opinion that the assessment order passed by the Assessment Officer was erroneous and on August 1, 2019 passed an order under section 263 of the IT Act, setting aside the Assessment Order and directing the Assessment Officer to examine the valuation of the Cognizant Shares bought-back. The learned CIT further directed the Assessment Officer to determine the fair market value of the Cognizant Shares bought back, and treat any excess consideration paid to the shareholders towards buy-back of shares as 'dividend' and consequently, charge dividend distribution tax under section 115-O of the IT Act.

The reasons cited by the CIT for its decision are as follows:

(i) Two Indian companies namely Messrs. Cognizant India Private Limited & Messrs. Market RX India Private Limited had amalgamated with Cognizant India, after which shares of Cognizant India held by US based entities were transferred to Mauritius based entities. The intrinsic value of shares of Cognizant India prior to the date of amalgamation was Rs. 22,582/- per equity share, whereas after amalgamation the intrinsic value of each share was reduced to Rs. 5,035.63. Thus, the CIT was of the opinion that when the fair market value of each Cognizant Share as on the date of buyback of Cognizant Shares was at Rs. 5,035/- per share, Cognizant India has purchased its own shares from its shareholders for Rs. 23,915/- per share in order to make payment to shareholders other than by way of dividend.

(ii) Cognizant India had determined the fair market value of the Cognizant Shares by following the DCF method and also future cash flows for the period from FY 2018-19 to FY 2022-23 in light of a scheme of arrangement and compromise approved by the Hon'ble Madras High Court in the FY 2016-17 and observed that there is a variation in free cash flows considered by Cognizant India which is ranging from 74% to 84% and thus, opined that Cognizant India has shown cash flows to overvalue the price of Each Cognizant Share at Rs. 23,915/- per share as against the actual value of the Cognizant Shares of Rs. 7,000/- to Rs. 8,000/- per share.

a. The CIT found that though the Assessment Officer called for the details of buyback of shares and Cognizant India furnished necessary information along with valuation report obtained from the independent valuer, the Assessment Officer has not analyzed the DCF method followed by Cognizant India and its cash flows to determine correct fair market value of the shares. The CIT also discussed the issue in light of provisions of Sec. 2(22)(a)[5] and 2(22)(d)[6] of the IT Act, and observed that as per the provisions of Sec. 2(22) (a) of the IT Act, any distribution by a company of its accumulated profits will be in the nature of dividends, if such distribution is in the nature of distribution of any part of assets of the company to its shareholders. However, the only exception[7] to the above is buyback of shares in terms of Sec. 77A of the Companies Act. Although, consideration paid for purchase of shares under buyback scheme results in capital gains in the hands of respective

[5] Section 2(22) of the IT Act provides an inclusive definition of 'dividend' and sub-clauses (a) to (e) cover different categories of dividends. Sub-clause (a) covers any '*distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company.*'
[6] Section 2(22) of the IT Act provides an inclusive definition of 'dividend' and sub-clauses (a) to (e) cover different categories of dividends. Sub-clause (d) covers '*any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not.*'
[7] This exception is contained in Section 2(22)(iv), which covers '*any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956*'.

shareholders and is liable to be assessed under section 46A[8] of the IT Act, the entire consideration paid by a company to its shareholders under the grab of buyback, will not amount to capital gains under section 46A of the IT Act. The capital gains under Section 46A of the IT Act, is limited to the extent of genuine consideration paid for buyback of shares. Any amount is paid over and above the genuine value of shares should be taxed as dividend in light of provisions of Sec. 2(22)(a) and 2(22)(d) of the IT Act. The CIT had ruled that though CBDT Circular No. 3 of 2016 excludes buyback of shares from the purview of provisions of dividend, the said Circular is applicable only for genuine transactions of buyback of shares. If an assessee pays its shareholders over and above the fair market value of such shares in relation to a buy-back, such excess consideration should be considered as deemed dividend in terms of Sec. 2(22)(a) of the IT Act.

Aggrieved by the aforesaid order passed by the CIT under section 263 of the IT Act, Cognizant India filed an appeal with Income Tax Appellate Tribunal, Chennai. Cognizant India submitted that buyback of Cognizant Shares was undertaken in accordance with provisions of Sec. 77A of the Companies Act, which does not mandate determination of fair market value or provide any specific methodology for valuation of shares. All particulars relating to the buyback of shares have been disclosed in the financial statements for the relevant financial year. The financial statements adopted by Cognizant India's shareholders and accepted by the Registrar of Companies clearly indicate that buyback of shares were undertaken in accordance with the applicable provisions of Companies Act. Cognizant India had remitted consideration to its shareholders after getting necessary approvals from the RBI and also deducted tax at source wherever applicable. Cognizant India further submitted that Sec. 46A is a specific provision for taxiing of capital gains in the hands of the shareholders in respect of buyback prior to June 1, 2013 and said capital gain is to be computed on full value of consideration and cannot be substituted for any other value. Cognizant India further submitted that contrary to Sec. 46A, there are specific provisions like Sec. 50CA, Sec. 56(2)(vii)(b), etc., which provides for determination of fair market value as the basis for taxation. Since, there is no provision under the IT Act, to substitute fair market value for full value of consideration in the context of a share buy-back, there is no scope for the Assessment Officer to go for determination of fair market value as against consideration paid by Cognizant India for buyback of shares and thus, the CIT cannot revise the assessment order on the issue of valuation of shares.

The ITAT held that the Assessment Officer did not carry out necessary enquiries that ought to have been carried out before allowing the claim of Cognizant India. Further, as per the facts brought out by the CIT, the ITAT found it abundantly clear that the Assessment Officer had failed to apply relevant provisions of the IT Act to the case, even though the consideration paid by Cognizant India for buyback of shares is exorbitantly on the higher side when compared to intrinsic value of shares as on the date of buyback of shares. Cognizant India has followed DCF method for valuation of shares and such valuation has been carried out by M/s. Ernst & Young, an independent valuer. Although, Cognizant India claimed that valuation carried out by the independent valuer is in accordance with standard procedure, but facts brought out by the CIT clearly indicate that there is an inflation of free cash flows considered by Cognizant India for subsequent FYs when compared to free cash flow determined during the FY 2016-17 for the purpose of a scheme of

[8] Section 46A of the IT Act relates to capital gains on purchase by company of its own shares or other specified securities.

arrangements and compromise approved by the Madras High Court for the purpose of purchase of its own shares from shareholders. As per the facts brought out by the CIT, there is a variation in free cash flow between FY 2013 & FY 2016, ranging between 71% to 84%., as per which, the correct fair market value of the share is only between Rs. 7,000/- and Rs. 8,000/-. Although, there is a lacuna in the fair market value determined by the assessee, the Assessment Officer accepted the valuation report furnished by Cognizant India without even examining the correctness of the said valuation report and fair market value determined by Cognizant India. The share capital of Cognizant India was held by 3 non-resident shareholders, out of which, Messrs. Cognizant (Mauritius) Ltd., a 100% subsidiary of M/s. Cognizant Technology Solutions Corporation, USA, is holding more than 76.68% equity shares. Further, Messrs. Cognizant (Mauritius) Limited, is enjoying the benefit of non-taxation in India because of treaty benefits available in terms of India Mauritius DTAA. According to the ITAT, when there is a restructuring of shareholding pattern of the company before buyback of shares and further, the major shareholding controlling more than 75% of share capital of the company is exempt from payment of capital gains tax in terms of Sec. 46A of the IT Act, the Assessment Officer ought to have examined the issue and consideration paid by Cognizant India for buyback of shares in light of provisions of Sec. 2(22)(a)/(d) of the IT Act.

2. ***Sri Sakthi Textiles Limited* v. *The Deputy Commissioner of Income Tax, Corporate Circle-1* (February 1, 2021- ITAT Chennai)**[9]

Background: Sri Sakthi Textiles Limited which was engaged in the business of manufacturing of yarn, filed its income tax returns for the assessment year 2013-14 ("**Relevant A.Y**") declaring a loss of Rs. 31,27,463/-. During the year under consideration, Sri Sakthi Textiles Limited, the assessee, had issued 7,69,260 equity shares having face value of Rs. 10/- at a premium of Rs. 142/- per share to a private company and thus, received total share premium of Rs. 10,92,34,920/-. The assessment for the Relevant A.Y was completed under section 143(3) of the IT Act on March 17, 2016, accepting the returns filed by the assessee. Subsequently, PCIT-1, Coimbatore initiated revision proceedings under section 263 of the IT Act, and set aside the order dated March 17, 2016 and sent the file to the Assessing Officer to redo the assessment afresh after verification of the issue of taxability of share premium collected by the assessee under section 56(2)(viib) of the IT Act. The Assessing Officer called upon the assessee to justify the issue of shares at premium of Rs. 142 per share/-. In response, the assessee filed a letter dated November 15, 2018 and submitted as follows:

(i) The value of shares had been arrived by considering fair market value of net asset of the assessee for which a valuation report had been obtained from an independent chartered accountant as well as from the statutory auditor of the assessee.

(ii) Further, the valuation report issued by the independent chartered accountant was supported by a valuation report of a chartered engineer in respect of immovable properties owned by the assessee.

(iii) As per said valuation reports, fair market value of shares was more than the value at which shares were issued by the assessee. Hence, there was no need for invoking provisions of section 56(2)(viib) of the IT Act.

[9] ITA 1228/CHNY/2019, ITAT Chennai;

Relevant Provisions: Section 56 of the IT Act provides that Income of every kind which is not to be excluded from the total income under the IT Act shall be chargeable to income-tax under the head "Income from other sources", if it is not chargeable to income-tax under any of the heads specified in section 14, items A to E of the IT Act. Section 56(2) specifies some such sources of income. One such source of income, specified under Section 56(2)(viib) is "*where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares*." The explanation (a) to this provisions provides that the fair market value of the shares shall be the value: (i) as may be determined in accordance with such method as may be prescribed (Rules 11U and 11UA); or (ii) 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, licences, franchises or any other business or commercial rights of similar nature, whichever is higher.

Order of the Assessing Officer: The Assessing Officer was not convinced with explanation furnished by the assessee and held that neither during the course of the original assessment proceedings nor during the course of revision proceedings did the assessee submit the valuation reports or state that it had a valuation report from chartered accountant in support of the share price. The Assessing Officer held that at the time of issue of shares at premium, no valuation report was available. Therefore, the Assessing Officer opined that assessee had failed to substantiate the value of shares to the satisfaction of Assessing Officer and accordingly, rejected the valuation report furnished by the assessee. He adopted the net asset value method, as prescribed under Rule 11UA(2) of the IT Rules, to determine value of shares and found the assessee's net value to be negative. Accordingly, the Assessing Officer opined that the issue of shares at premium of Rs. 142 per share, did not support the asset value of the company and added the share premium amount of Rs. 10,92,34,920/- to the assessee's income, as per section 56(2)(viib) of the IT Act.

Order of CIT(A): The assessee preferred an appeal before CIT(A). Before the learned CIT(A), the assessee reiterated its submissions made before Assessing Officer and argued that if an assessee substantiates the fair market value of shares with necessary evidence, then there is no scope for determination of share price in accordance with the net asset value method. The CIT(A) however, was not convinced with explanation furnished by the assessee and held that the assessee had failed to substantiate the valuation of shares to the satisfaction of Assessing Officer, which is primary requirement of explanation (a)(ii) to Section 56(2)(viib) of the IT Act. Even the valuation report of chartered accountant did not substantiate the basis for the valuation. In such case, the only option for the Assessing Officer is to determine fair market value in accordance with method prescribed under Rule 11UA of IT Rules. Accordingly, CIT(A) confirmed the additions to income made by the Assessing Officer.

Order of the ITAT, Chennai: Thereafter, the assessee filed an appeal before ITAT, Chennai. The ITAT, Chennai held as follows:

> "*From the reading of provisions of section 56(2)(viib) and Explanation (a)(i) and (a)(ii), it is very clear that if premium charged on issue of shares exceeds the fair market value of the shares, then excess amount charged for issue of shares is treated as income of the assessee. Further, to determine fair market value of shares, it is for assessee to choose either a prescribed method which is Rule 11UA of the Act, or the assessee may arrive at fair market value, but such value should be substantiated to the satisfaction of the Assessing Officer based on the value on*

the date of issue of shares, considering its assets including intangibles etc. In this case, assessee has chosen Explanation (a)(ii) to determine fair market value of shares and as such question of determination of share price in accordance with such method as may be prescribed does not arise and accordingly, Assessing Officer cannot go into Rule 11UA to determine share price in accordance with net asset value method. ….. As per valuation report of independent Chartered Accountant, value of per equity shares has been arrived at Rs. 152/- per share which was further supported by valuation report issued by statutory auditor of the company. The said valuation report is on the basis of valuation of land and industrial building possessed by Assessee Company at Sengampalayam village Pollachi Taluk, Coimbatore Dist, as per which assessee company owned more than 35.65 acres of land, and the present market value of said land is about 72 crores. The said valuation report further states that total value of asset including land, building and other assets is at Rs. 77.50 crores. From the above, it is very clear that assessee has filed necessary evidences including valuation report from independent Chartered Accountant to support fair market value of shares arrived at as on date of issue of shares as per explanation (a)(ii). Therefore, we are of the considered view that the assessee has substantiated fair market value of shares as on the date of issue of shares."

The ITAT also held that the observation of CIT(A) that relevance of valuation report of chartered accountant comes into play only when assessee chooses Explanation (a)(i) to determine fair market value of shares, but not when assessee has resorted to Explanation (a)(ii) to section 56(2)(viib) of the IT Act, was contrary to law and absurd, *because when share price is determined in accordance with explanation (a)(ii), fair market value of share should be substantiated to the satisfaction of Assessing Officer and such satisfaction may be by way of valuation report or asset value of the company*.

The ITAT held that the assessee had satisfied conditions prescribed under Explanation (a)(ii) to Section 56(2)(viib) of the Act since it had filed the valuation report to substantiate fair market value of shares as on the date of issue and such valuation report was based on assets of the company. In such a situation, there was no scope for the Assessing Officer to invoke provisions of Section 56(2)(viib) of the IT Act to tax share premium collected on issue of shares. The ITAT directed the Assessing Officer to delete additions made towards share premium on issue of shares u/s. 56(2)(viib) of the IT Act.

3. *ACIT, Circle-4(1)* v. *Y. Venkanna Choudary* (September 30, 2019 - ITAT Visakhapatnam)[10]

Y. Venkanna Choudary was a director of Sardar Projects Private Limited ("**SPPL**"). In the financial year 2013-14, Y. Venkanna Choudary an assessee subscribed to 4,25,000 shares of SPPL on April 5, 2013 and 9,05,000 shares on March 26, 2014 at its face value of Rs. 10/- per share. Along with the assessee, 28 other individuals subscribed to the shares of SPPL on April 5, 2013 and 14 other individuals subscribed to the shares of SPPL on March 26, 2014. All the subscribers were allotted the shares at face value of Rs. 10/- per share.

The Assessing Officer calculated the fair market value of the shares on the basis of the last audited balance sheets of SPPL, which was prior to the first allotment mentioned above. This meant that the total paid up capital and total number of paid-up equity shares of SPPL was much lesser than what it was after the assessee subscribed to the shares of SPPL. The Assessing Officer worked out the taxable income under Section 56(2)(vii)(c)(ii) of the Act, as per Rules 11U and 11UA of the IT Rules, which worked out to Rs. 706.51/-

[10] (2019) 180 ITD 166/ (2020) 186 DTR 239/ 203 TTJ 891 (Vishakha)(Trib.)

per share for the shares allotted to the assessee on April 5, 2013, and Rs. 12/- per share for the shares allotted to the assessee on March 26, 2014.

The Assessing Officer then called on the assessee to explain why the shares acquired should not be valued at the fair market value of the shares, as calculated by the Assessing Officer and why the resultant difference between the fair market value and the price of acquisition should not be taxed under Section 56(2)(vii)(c)(ii) of the Income Tax Act.

In response to the notice issued by the Assessing Officer, the assessee filed a detailed explanation submitting that for calculating the FMV of the shares of SPPL, the various fresh shares allotments made to the assessee and others should also be taken into consideration. However, this explanation offered by the assessee was not accepted by the Assessing Officer.

The CIT ruled that FMV had to be calculated on the basis of the actual paid up capital of SPPL after the allotment of shares to the assessee and not on the basis of the paid-up capital of SPPL shown in the last available audited balance sheet of SPPL. However the CIT agreed with the Assessing Officer on certain additions to the assessee's deemed income. Therefore, the income tax department appealed against the CIT's decision and the assessee also filed a cross-objection challenging the additions confirmed by the CIT.

The assessee argued before the ITAT that, in computing the fair market value, the Assessing Officer had relied on the previous year's balance sheet and divided the net book value by the paid up share capital prior to the allotment. This had resulted in the valuation of SPPL rising to almost Rs. 260,00,00,000/- at a price of Rs. 676.55 per share. The assessee argued that in order to arrive at the fair market value, the fresh allotment of shares to the assessee and others needed to be included in the existing paid up share capital which would become the denominator to the net book value of the assets.

The ITAT relied on the order of the Income Tax Appellate Tribunal, New Delhi in the case of Sadhvi Securities Limited[11] and ruled against the assessee. The ITAT interpreted Rule 11UA of the IT Rules strictly by the letter and ruled that though as per Rule 11UA of the Income Tax Rules, the valuation date means the date on which the property or consideration was received, computation of the fair market value of shares needs to be done on the basis of a balance sheet approved in the annual general meeting of SPPL.

Since SPPL's last audited balance sheet which had been approved in its annual general meeting was prior to the allotment of shares, the Assessing Officer was right to rely on the balance sheet drawn up prior to the date of allotment.

We understand that this ruling by the ITAT has been further appealed against in the Andhra Pradesh High Court and a decision is awaited.

4. Karmic Labs Pvt. Ltd. vs. ITO, Ward-15(2)(1) (July 28, - ITAT Mumbai)[12]

Background: In this case, the assessee company had issued some shares at a premium and applied the discounted free cash flow method ("**DCF Method**") to ascertain the market value of the shares so issued, as permitted under Rule 11UA(2)(b) of the Income Tax Rules, 1962. As discussed above, the DCF method relies on the projections of future free cash flows and discounts them and thus, the valuation is based on the projected financials of the company. The Assessing Officer concluded that the valuation report produced by the assessee is not realistic as the cash flow projections made to value the assessee company through the DCF Method were not achieved in actuality in the subsequent years.

[11] ITA No. 1047/Del/2019
[12] Karmic Labs Private Limited v. ITO, Ward – 15(2)(1), ITA No.3955/Mum/2018

The Assessing Officer calculated the value of the shares of the company as per the method provided under Rule 11UA(2)(a) of the IT Rules. The Assessing Officer's decision was upheld by the CIT on appeal. Thereon, the assessee filed an appeal against the CIT's decision before the ITAT.

Relevant Provisions: The Explanation (a) to Section 56(2)(viib) of the IT Act provides that the fair market value of the shares shall be the value: (i) as may be determined in accordance with such method as may be prescribed (Rules 11U and 11UA); or (ii) 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, licences, franchises or any other business or commercial rights of similar nature, whichever is higher.

The Rule 11UA(2) of the IT Rules prescribes the method(s) for ascertaining the fair market value of unlisted equity shares for the purpose of Explanation (a) of Section 56(2)(viib). As per the rule, it fair market value shall be the value of the unlisted equity shares as determined, at the option of the assessee, either in accordance with the formula provided in sub-clause (a) of Rule 11UA(2) or as per the fair market value of the unquoted equity shares determined by a merchant banker as per the DCF method.

Judgment: The ITAT considered whether the Assessing Officer has the power under Rule 11UA of the IT Rules to discard the valuation method adopted by an assessee and calculate the value of the assessee's shares using a different method . Rule 11UA(2) of the IT Rules states that the value of unlisted shares shall be determined, at the option of the assessee, either as per the formula[13] given in the Rule 11UA(2)(a) of the IT Rules or by a merchant banker as per the DCF method. The ITAT perused prior decisions of the ITAT as well as the Supreme Court of India and held that the IT Rules allow assesses to adopt either the formula given in the IT Rules or apply the DCF Method. Consequently, it was held to be beyond the authority of the Assessing Officer to insist on the application of the formula given in the Rule 11UA(2)(a) of the IT Rules by the assessee company for determining the value of its shares. The ITAT further held that the Assessing Officer cannot change the method of valuation adopted by the assessee on the basis that the projections under DCF Method were not achieved by the Company.

Institutional Framework for Regulation and Development of Valuation Professionals

(i) Report of the Committee of Experts to Examine the Need for an Institutional Framework for Regulation and Development of Valuation Professionals;

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[13] The formula given in the Rule 11UA(2)(a) of the IT Rules is as follows:

$$\textit{The fair market value of unquoted equity shares} = \frac{(A-L)}{(PE)} \times (PV)$$

where,

A = book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;

L = book value of liabilities shown in the balance-sheet, but not including some amounts as listed in the Rule 11UA(2)(a)

PE = total amount of paid up equity share capital as shown in the balance-sheet;

PV = the paid up value of such equity shares; or

On April 14, 2020, the Ministry of Corporate Affairs, Government of India published a report of the committee of experts ("**CoE**") which had been constituted to examine the need for an institutional framework for regulation and development of valuation professionals, *vide* order No.12/9/2019-PI dated August 30, 2019.

The CoE has recommended that the regulation of valuation should be streamlined and that could be achieved best by consolidating the regulatory framework into a single statute for which, the CoE prepared a draft Valuers Bill, 2020 (the "**Bill**"), which has been annexed to its report.

Among the various recommendations contained in the report and the Bill, the most significant recommendation pertains to the setting up a National Institute of Valuers ("**NIV**") which would administer the provisions of the proposed new law and regulate the industry as an apex professional body.

(ii) The Valuers Bill, 2020

The Bill seeks to provide an all-round to regulate and organise the profession of valuers and the market for valuation services, through establishment of registered associations, increase business opportunities for valuers as well as promote the profession of valuation by establishing educational institutions for training valuers. The Bill also seeks to protect the interests of users of valuation services in India.

The Bill defines "Valuation Services" as services relating to valuation of any asset or liability and limits it to valuation services required under 15 (fifteen) statutes in force in India including the Companies Act, 2013, The Insolvency and Bankruptcy Code, 2016, The Securities Contracts (Regulation) Act, 1956 as well as the Securities and Exchange Board of India Act, 1992. The Bill also specifies that the Valuation Rules effectuated under Section 247 of the Companies Act will stand rescinded from the date the Bill comes into force.

The Bill defines a valuer as a person registered under Section 50 of the Bill and includes four classes of valuers, namely – a *valuation entity*, an *associate valuer*, a *fellow valuer* and a *honorary valuer*. Furthermore, the Bill seeks to provide for separate valuers across asset classes with separate eligibility criteria for registration as a valuer under each asset class. Initially, registration as a valuer is available under three asset classes, namely, (i) land and building, (ii) plant and machinery, and (iii) securities and financial assets.

The proposed regime provides for a three-tier structure for regulation of the valuers' profession. The structure is headed by the NIV which is responsible for promotion, development and regulation of the profession of valuers and market for valuation services. The NIV is also responsible for recognition of universities, institutes and professional organisations in the area of valuation services.

The second leg of the proposed three-tier structure for regulation of the valuers' profession entails a *valuer institute* which shall be responsible to deliver educational courses in accordance with the syllabus and manner of delivery as may be specified, charge fee for provision of such courses, arrange financial support for deserving students who cannot afford education in the area of valuation.

The third leg of the regulatory structure entails the creation of *valuation professional organisations, which shall be* registered under the proposed new law, responsible to promote the professional development of its members, promote professional and ethical conduct amongst its members, monitor the activities of its members to ensure compliance with the proposed new law, safeguard the rights of its members and carry out any other functions as may be specified by NIV from time to time.

The Bill also prescribes the essentials of a valuation report and provides for penalties in case of professional misconducts by valuers.

This paper has been written by Vinod Joseph (Partner) and Smriti Tripathi (Senior Associate), and Aryan Mohindroo (Associate).

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