

**IN THE INCOME TAX APPELLATE TRIBUNAL  
DELHI BENCH 'C', NEW DELHI**

**Before Sh. Amit Shukla, Judicial Member**

**Dr. B. R. R. Kumar, Accountant Member**

**(E-Court Module)**

**ITA No. 3925/Del/2018 : Asstt. Year : 2014-15**

Intelligrape Software Pvt. Ltd., Regus Elegance, 2F Elegance, Jasola District Centre, Old Mathura Road, New Delhi-110025	Vs	Income Tax Officer, Ward-12(3), New Delhi
<b>(APPELLANT)</b>		<b>(RESPONDENT)</b>
<b>PAN No. AABCI9247F</b>		

**Assessee by : Sh. Sanjiv Sapra, FCA**

**Revenue by : Sh. M. Baranwal, Sr. DR**

**Date of Hearing: 03.09.2020**

**Date of Pronouncement: 30.09.2020**

**ORDER**

**Per Dr. B. R. R. Kumar, Accountant Member:**

The present appeal has been filed by the assessee against the order of the Id. CIT(A)-4, New Delhi dated 15.03.2018.

2. Following grounds have been raised by the assessee:

*"That the Ld. CIT(A) has erred on facts and under the law in confirming the addition of Rs.1,59,39,863/- as made by the AO under section 56(2)(vii)(b) of the Income-tax Act on account of alleged excess value of share premium over fair value as determined for the unquoted equity shares as issued at premium by the Appellant to its Holding Co.*

*2. That the valuation exercise for valuing unquoted equity shares of a private Co. as undertaken by the specified valuer/independent expert in accordance with Rule 11UA of Income-tax Rules as per the valuation methodology opted for by the Appellant could not be disregarded by the authorities below.*

*3. That the AO/CIT(A) cannot be considered as the specified valuer/independent expert as per Rule UA of Income-tax Rules and accordingly, the AO has no jurisdiction or authority to substitute his own valuation of unquoted equity shares and reject the one as undertaken by the specified valuer/independent expert.*

*4. That without prejudice to Ground No. 1 to 3 above, the addition of Rs.1,59,39,863/- as made u/s 56(2)(vii(b) of Income-tax Act was very excessive. Various observations made by the authorities below in their respective orders while making the above additions/disallowances are either factually incorrect or legally untenable."*

3. The assessee is a Private Limited company registered under Companies Act, 1956 with Registrar of Companies Vide CIN U72300DL2008PTC179627. The company's main object is to provide Software Development/IT services in India and abroad. Most of the clients of assessee are based outside India. Directors of assessed company have valuable professional background from reputed educational institutions like IIT-Delhi and Amity University etc.

4. In the Assessment order, the AO has rejected the valuation report given by Chartered Accountant as per compliance procedure of Section 56(2)(viib) of Income Tax Act of by comparing EBITDA of future years with actual profit.

5. The AO has made the addition amounting to Rs.1,59,39,863/- in terms of the provisions of Section 56(2)(viib) of the Act in view that the company has issued the equity shares at a price more than the fair market value of the shares. Before the AO, the assessee company did submit a valuation report as per discounted cash flow method substantiating its fair market value of equity share being Rs. 6175/- per share. However, the AO rejected the valuation report

furnished by the assessee on the ground that year-wise results projected are far from the actual results declared in the final accounts. The same has been dealt in para 5 & 6 of the assessment order. The AO, therefore, recomputed the value of the shares of assessee company by net worth method which came to be at Rs. 23.21. The AO thus made the addition of premium amount of Rs 1,59,39,863/- received in excess of net worth of shares determined at fair value of Rs 23.21 per share.

6. The Id. CIT (A) confirmed the addition holding as under:

- *The valuation report submitted does not provide for the date of the valuation. It is difficult to understand how a valuation exercise is conducted without a valuation date in place. Under DCF method, date of valuation is very important as projections of free cash flows, terminal value, discounting etc. will all flow from the date of valuation.*

*Date of Valuation is also very important in the projections and estimating the growth rate of the business. Supposedly on Day 1, there is a news that the industry of the appellant is booming at a rate of 20% but suddenly on Day 2 there is major fraud or recession or because of any other reason the industry in which the appellant is declines drastically. Thus, if the valuation date is on Day 1, projections would be different, however, if the same is on Day 2, the projections would be entirely different.*

*Further, in Technical Guidance on Share Valuation issued by Institute of Chartered Accountants of India published in 2009, the Institute have clearly stated that as the valuation is time-specific, the date of valuation is critical for the report. The valuation is pertinent to a particular point of time.*

- *While computing the cost of Equity, through Capital Asset Pricing Model, Beta coefficient i.e. unsystematic risk has been estimated at 1.23. Beta measures how much a company's share price reacts against the market as a whole. A beta of one, for example, suggests that the company moves in line with the market. If the beta is in excess of one, the share is exaggerating the market's movements, if less than one, it means share is more stable. A reliable beta cannot be established with insufficient price history. The trouble is that betas are merely rear-view mirrors, reflecting very little of what lies ahead. For traders looking to buy and sell stocks within short time period, beta is a fairly good risk metric. However, for long term investor, it is not that useful.*

*There is no reason stated in the report why it is estimated at 1.23 and why not .75 or why not 1.45. Details of Beta are generally available on the website of NSE, BSE or other websites of different companies. The basis of estimating Beta has been stated to be CA's understanding of the risk in the similar industries. Which similar industries and how this estimate is prudent and reasonable has not been explained. A slight difference in BETA can have drastic impact on Cost of Equity which can effect the valuation completely.*

- *The cost of Equity has been increased by 1.7% because of lack of marketability. Again, the valuer has undertook an estimation without any basis. Having said so, to my understanding, as per the valuation principles, any adjustment for lack of marketability or liquidity is made in the final valued price and not in the cost of equity.*

- *As per the Balance Sheet submitted by the appellant company, there is no debt taken by the appellant company. However, while computing the weighted average cost of capital in the valuation*

*report, Cost of Debt is also considered and a debt equity ratio of 30:70 is taken.*

*There is no basis for the same. Weighted Average Cost of Capital (WACC) is computed on the basis of the actual debt equity ratio in the balance sheets which is applied to the cost of equity and cost of debt. However, in such a scenario, where there is no debts, the ratio of 70:30 taken in the balance sheet is against the principles of valuation.*

- For the purpose of calculating terminal value of the business, the valuation report suggests that a growth rate of 3% is taken. Again, it is an assumption. DCF method is more of a science rather than art. It is imperative to understand that growth rate should be correlated with the date of valuation and the industry in which the appellant is operating as on the date of valuation.*

- Further, the report also encapsulates the computation of Free Cash Flows. As per the Free Cash Flows chart there is a projection that Capex would be only required in first year and then no capex would be required even though the sale increases from 97 crores to 284 crores.*

*It is impossible to understand that the sale increases three-fold but there is no requirement of capital asset, even when the appellant is in the business of technology and computers etc. capex in are required with increasing work force and sales.*

- The valuation report has taken a growth rate of 25% in revenue after second year. In a scenario where the growth rate is taken at 25% year after year uptill 2018 projections, a growth rate of 3% only was taken for terminal growth.*

- *Further, there is no basis for projecting the results for future years, be it sales, cost, depreciation, capex or Net Working Capital. No basis is provided at all.*
- *Also, the company is a private limited company and is not a listed company. The value which has been determined is not a fair estimated value also because of the fact that the shares of private limited company are discounted for lack of liquidity and marketability. However, the valuer has not considered the same at all.”*

7. Before us during the arguments, the Id. AR argued that the shares have been issued to one entity namely, Tangerine Digital Entertainment Pvt. Ltd. on 10.09.2013 of 2591 shares at premium of Rs.6165/-. He explains the reasons for such premium as the assessee company help Internet-based businesses and product companies design and develop cloud-native web and mobile solutions. It drives digital transformation for businesses by helping them provide a rich, seamless experience to their customers across digital channels resulting in higher engagement, efficiency and profitability.

8. It was submitted that the assessee company's promoter is from IIT Delhi and they have business plans to expand their operations in Domain in which they are working and needed capital to fund and meet the business objects. Investor showed interest to fund the start up so as to preventing dilution of control among shareholders by reducing no of shares issued, the assessee company needed more capital for investments and meet its plan for future business expansion and to reduce finance charges by using less external funds

9. The company has issued 2591 shares at a premium of Rs. 6165.22 per share to Tangerine Digital Entertainment Private Limited which is the group company of the assessee company. Copy of valuation certificate obtained from the chartered accountant was also submitted in the paper book.

10. He also filed the details of CCDs issued to its existing non-resident debenture holder namely, Four Cross Holdings Cypress Ltd. and the corresponding investment made by such company in the equity shares of the assessee company. Thus, not only the source but the source of such source of shares subscription money has received by the assessee company have been proved.

11. Regarding the fair market value, the Id. AR explains that the prescribed method of 11UA(2) of IT Rules or DCF method as per Clause (b) of Rule 11A(2) can be adopted at the option of the assessee and the assessee has opted for DCF method of valuation. He argued that the action of the Id. CIT (A) disregarding the valuation report submitted is against the provisions of the Act.

12. The Id. DR supported the order of the authorities below.

13. Heard the arguments of both the parties and perused the material available on record.

14. We have gone through the valuation report submitted by the assessee. The same is as under:

“The Fair value is determined based, on the Discounted Free Cash Flow method of the projected financials and other details

furnished by the company. Discounted Free Cash Flows (DCF) entails estimating future free cash flows of the business and discounting them using an appropriate rate of return to arrive at the net present value of the net cash flows.

The valuation has been carried out on a going concern basis presuming that the company will continue its business operation in the current financial year and will continue to do business in the foreseeable future, wherein the potential investor will evaluate the expected returns and associated risks on continuing basis.

### **BASIS OF VALUATION**

The Fair Value is based on the following:

- a. Financials forecasts made by the management of the company for 5 years and provided to us.
- b. Information gathered based on the discussions with the management and representatives of the company.
- c. The assumptions which we feel are prudent to determine the 'Pre Money valuation.

All the above information and facts have been relied on without auditing and verification.

### **DISCOUNTED CASH FLOWS:**

The financials forecasts provided by the management form the basis for our DCF analysis and assumptions based on the perception of attendant circumstances of the case.

Value of Firm: The value of the firm is obtained by discounting expected cash flows after meeting all operating expenses and

taxes but prior to any payments either debt or equity holders, at the weighted average cost of capital, which is the cost of the different components of financing used by the firm, weighted by their market value proportions.

Cost of Equity or the Discounting Factor: Discounting rate is the rate of return that a willing buyer would expect to receive from an investment to compensate the inherent risks involved and for the time value of money. The cost of equity is calculated on the basis of Capital Asset Pricing Model (CAPM).

Cost of Equity = Risk free rate + [Beta \*(Market risk premium)]

- Risk free rate is considered as 4 percent and market risk, premium is considered to be 7.1 percent.
- Beta has been estimated at 1.23 based on our understanding of the business risk in the similar industries.

On the above basis the cost of equity is arrived as follows:

Cost of Equity = 4 Percent + (1.23 \* 7.1 percent) = 12.73 percent

Further, as the privately held shares are not traded in public, the shares of these companies are not generally as liquid as those of public companies. The lack of marketability increases the cost of equity also by another 1.7 percent accordingly the Cost of Equity becomes 14.4 percent.

Weighted Average cost of Capital - The weighted average cost of capital (WACC) is the rate that a company is expected to pay on average to all its security holders to finance its assets. The WACC is calculated taking into account the relative weights of each component of the capital structure of the Company. In

the instant case of the cost of equity and cost of debt is weighted in the ratio of 70:30. Accordingly,

$$\text{WACC} = (70 \text{ percent} \times 14.4 \text{ percent}) + (30 \text{ percent} \times (1 - 30 \text{ percent}) \times 14 \text{ percent}) = 13 \text{ percent}$$

**Terminal Value:** The Terminal Value of the Company is calculated based on the perpetuity growth model assuming a growth factor of 3 percent which is considered to be appropriate in the light of past trend and growth.

**Equity Value:** The Free Cash Flow and Terminal value are discounted to their present values at the valuation date by applying the discounting rate of 13 percent as determined above. Thereafter, after netting off the cash and cash equivalents with the loan liability as on the date of the valuation. Since, we are doing Pre Money Valuation, no calculations are considered for deriving the Post Money Equity value.

### **Fair Value Calculation**

Allocating the total Pre Money Equity Value of the company arrived using the DCF valuation method of Rs 61.74 crores among the issued equity i.e. 100000 shares, the fair value of the share is Rs.6,175.00 ( Rupees Six Thousand One Hundred and Seventy Five).

#### **Enterprise value**

Present value of Free cash Flow	164
Terminal Value	878
Discount Factor	0.51
Present Value of Terminal Value	448
% of Enterprise Value	73%

Enterprise Value	612
Less: Total debt	0
Plus: Cash and Cash Equity	5
Net Debt	-5
Implies Equity Value	6174,87,612
Outstanding shares	1,00,000
Implied share price	6,174.88
<b>Implies Multiple</b>	
Enterprise Value	612
SALES 2013	97
EBITDA 2013	37
Implied EV/SALES	6.3x
Implied EV/EBITDA	16.6x

The Annexure to this Certificate contains the basis for arriving at the Fair Value of equity shares.

## **LIMITATIONS**

1. All financial statement and other data pertaining to the Company have been provided by the management of the company and we have accepted and relied on without further verification, including conformity or non-conformity with generally accepted accounting principles and/or other guidelines established by regulatory bodies.
2. All reported facts, comments, estimates, opinions and statistical information set forth in the valuation exercise have been obtained from sources believed to be accurate and reliable. No liability is assumed for the content or accuracy of the data furnished by others, including all information and representations provided by the management.

3. No attempt has been made to verify and audit the estimates and assumptions made by the management of the company.

4. The valuation of the company is been done solely at the request of the management and in our opinion may be considered as fair value for the purpose of fair valuation under section 56 of the Income Tax Act,1961.”

15. In this background, the rationale of the Assessing Officer and the figures adopted by the AO while making the disallowance is examined. The same are as under:

EBITDA	13-14	14-15	15-16	16-17	17-18
Actual Profit/Loss as reported in ITR/Final Accounts	Not reported	3.7 cr.	6.8 cr.	8.4 cr.	10.1cr.
		-33.54 lacs	95.94lacs	4.06 cr.	-----

16. The AO computed the EBITDA with actual profit in the ITR. The correct figures to be used for comparison are as under:

Particulars	2013-14	2014-15	2015-16	2016-17
Sales	13	28	59	92
Expenses (Excluding Depreciation, Interest & Tax)	12	26	58	85
EBITDA	0	2	2	7
As per Valuation Certificate	4	7	8	10

17. Further, we have also gone through the statement of projected revenues and revenue earned as per the audit report. The same are as under:

“As per certificate dated 30 May, 2013 projected turnover was taken INR 97 Million for FY 2013-14 whereas company has

achieved a turnover of INR 126 Million for FY 2013-14. Comparison in this regard for three years is as under:

<i>FY</i>	<i>Projected Revenue</i>	<i>Revenue as per Audited Financial Statement</i>
<i>2014-15</i>	<i>145 Million</i>	<i>285 Million</i>
<i>2015-16</i>	<i>182 Million</i>	<i>594 Million</i>
<i>2016-17</i>	<i>227 Million</i>	<i>920 Million</i>

18. From the above table, it is glaring to observe that the actual revenues are far more than the projected revenue. Hence, the valuation cannot be faulted with.

19. With regard to section 56(2)(viib) as applied by the AO for making the addition on account of alleged excess share premium, reference is made to Explanation (a)(i) of such Section which states that fair market value of the shares shall be the value "as may be determined in accordance with such method as may be prescribed'. It is not in dispute that such method is prescribed in specific Rule 11UA(2) of I.T. Rules as applicable for issue of unquoted equity shares, which states that fair market value of unquoted equity shares is to be determined as per clause (a) or clause (b) of Rule 11 UA(2) at the option of the Assessee. Clause (a) refers to book value method whereas clause (b) refers to DCF method as supported by valuation report of a merchant banker or a chartered accountant. In the instant case, the assessee had opted for clause (b) of Rule 11UA(2) of I.T. Rules by applying DCF method and obtained valuation report form a chartered accountant thereby fulfilling both the requirements of such specific Rule.

20. When the assessee Company had opted for valuation of unquoted equity shares in accordance with DCF method as prescribed under clause (b) of specific Rule 11UA(2) as applicable, the AO/CIT(A) had no power/authority to change such valuation methodology and adopt a different book value method as prescribed under clause (a) of such Rule and hence such action of the authorities below was arbitrary.

21. It is trite law that "when a statute requires, a thing to be done in a certain manner, it shall be done in that manner alone and not otherwise" (CIT vs. SPL'S Siddhartha Ltd. 345 ITR 223).

22. Unlike Explanation (a)(ii) of section 56(2)(viib), where it has been specifically provided that valuation is to be substantiated to the satisfaction of the AO, there is no such provision specified therein in Explanation (a) (i) of section 56(2)(viib) as opted for by the assessee for substantiating its valuation to the satisfaction of the AO. Hence, on the facts of assessee's case, the AO was not empowered to disregard the DCF valuation as carried out by the valuer and such action of the authorities below of rejecting such valuation report cannot be upheld. (Rameshwaram Strong Glass P Ltd., ITAT Jaipur)

23. The AO was not able to pinpoint any specific inaccuracies or short comings in the DCF valuation report of the Chartered Accountant/Valuer other than stating that year-wise results as projected are not matching with the actual results declared in the final accounts. Before the Id. CIT(A), reasons for variation between projected and actuals were duly explained. The Id. CIT(A) has accepted such explanation but rejected the DCF valuation report as submitted by the assessee. Accordingly, in

the absence of any defect in the valuation of shares arrived by the assessee on the basis of DCF method, impugned addition as made on the basis of net asset value method is liable to be deleted. The rejection is unjustified as the valuation report is required under Rule 11UA of The Income Tax rules is based on the future aspects of the company at the time of issuing the shares, it may vary from the actual figures depending on the market condition at the present point of the time.

24. Thus, keeping in view the entire facts of the case, the reports of the valuer, the comparison of the actual and projected revenues, provisions of Section 56(2)(viib) and keeping in view the order of Co-ordinate Bench of ITAT in the case of Cinestaan Entertainment Pvt. Ltd. 177 ITD 809 wherein it has been held that the Assessing Officer cannot substitute his own value in place of the value determined either on DCF method or NAV method, the appeal of the assessee is hereby allowed.

25. In the result, the appeal of the assessee is allowed.  
Order Pronounced in the Open Court on 30/09/2020.

Sd/-

**(Amit Shukla)**  
**Judicial Member**

**Dated: 30/09/2020**

\*Subodh\*

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT(Appeals)
5. DR: ITAT

Sd/-

**(Dr. B. R. R. Kumar)**  
**Accountant Member**

**ASSISTANT REGISTRAR**