The importance of adopting the correct approach for share valuation in India

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In a recent ruling, the Mumbai Income-tax Appellate Tribunal (the "**Mumbai Tribunal**"), relying on the *Tally Solutions* case, has held that when the future cash flow or revenue stream projections of a private investment company are uncertain, the shares cannot be valued by adopting the discounted free cash flow ("**DCF**") method. In such cases, the provisions of the ICAI Valuation Standards 2018 (issued by the Institute of Chartered Accountants of India) should, ideally, be followed.

This case, once again, brings to the fore the importance of an appropriate valuation of shares or business in a transfer pricing matter or M&A transaction.

Background

Essar Investment Limited (the "**Taxpayer**") had undertaken an international transaction of the sale of 50,000 equity shares of Essar Capital Limited ("**ECL**") at INR10 per share to its associated enterprise, Essar Capital Holdings Limited, Mauritius ("**ECHL Mauritius**"). As per the valuation report obtained by the Taxpayer from an independent valuer, the value of each share of ECL was determined at INR4.97 using the net asset value ("**NAV**") method as per the guidelines issued by the erstwhile Comptroller of Capital Issues. The independent valuer also assessed the valuation using the profit earning capacity value ("**PECV**") method, but as the per share value using the PECV method reflected a nil value, it was ignored.

During the assessment proceedings, the transfer pricing officer ("**TPO**") rejected the NAV method adopted by the Taxpayer without providing any reasons or identifying any infirmity in the data used or the valuation method adopted. The TPO simply concluded that the DCF method was the correct method for this transaction given the facts and circumstances of the case. Not just that, but the TPO treated the difference between the arm's length price ("**ALP**") (as determined by the Taxpayer) and the ALP (as determined by the TPO based on the DCF method) as a loan and imposed onerous transfer pricing adjustments.

Mumbai Tribunal Ruling

The Mumbai Tribunal (based on a review of facts and details provided by the Taxpayer) held that ECL being a private investment company had inconsistent streams of revenue over the years, and even though the investments made by ECL increased from time-to-time, no interest income was received during the financial year in question. Thus, applying the DCF method was incorrect and the provisions contained in the ICAI Valuation Standards 2018 should have been followed. The Mumbai Tribunal, *inter alia*, recommended that a valuer can consider using other valuation approaches, instead of the income approach or in combination with the income approach, in cases where the asset has not yet started generating income or cash flows, e.g., projects under development or where there is significant uncertainty on the amount and timing of income or future cash flows.

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Our Comments

Generally speaking, the following valuation methods are applied to determine the fair market value of a business:

- Net Asset Method;
- Discounted Free Cash Flow Method;
- Earnings Capitalisation Method;
- Enterprise Value/EBIDTA (Earnings Before Interest, Depreciation, Tax and Amortization) Multiple Method;
- Comparable Uncontrolled Method; and the
- Market Price Method.

Each method proceeds on different fundamental assumptions that have greater or lesser relevance, as for example, if the valuation is for the purpose of liquidation, the valuer may use the realisable value of the Net Assets Method and not the Earnings Capacity (as in this example the company will cease to exist and the shareholders will be left with the net assets only). Similarly, for a merger, a valuer may choose a method or a combination of methods best suited to the type of business and the information available. Earnings-based methods are used for businesses that generate reasonable profits and whose value is greater than that of their net assets alone. Other methods can be the capitalized cash flow method when cash flow is expected to remain stable in future years or the DCF method if cash flow is expected to fluctuate in future years, such as when a company is growing rapidly. To a considerable extent various other factors such as industry and location, market conditions, sales trends, multiples used by comparable businesses, size of the company, customers, goodwill and intellectual property, owners and key employees, and workforce engagement are important considerations in a valuation.

Valuation issues have long posed challenges for taxpayers in India. A key problem for the Indian revenue is that taxpayers often come up with self-serving valuations, which compels the revenue to take a position that the valuation provided by the management of a company is without proper justification. As a result, the revenue takes a position that it is appropriate for them to determine the fair value on the basis of the audited financial statements before them.

The Mumbai Tribunal's ruling emphasises the fact that due consideration needs to be given to independent valuation reports and the ICAI Valuation Standards 2018.

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