Newsflash: Final Rules notified for valuation of unquoted equity share for the purposes of Section 56 and Section 50CA of the Income-tax Act, 1961

CBDT Notification No. 61 of 2017 dated 12 July 2017

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1.0 Background

- Valuation of Shares is not a science and hence determining the fair market value (FMV) of shares can be challenging particularly in case of unquoted equity shares. To deal with this, the Income-tax Department had prescribed a specific formula based on "Net Asset Value Approach" under rule 11UA of the Income Tax Rules, 1962. However, the said formula took into account the book value of the asset rather than current market value, or FMV. Recently, the Finance Act, 2017 inserted Section 56(2) (x) so as to widen the scope of taxability of receipt of sum of money or property without/inadequate consideration.

- The latest in the series of Specific Anti-Avoidance Provisions ('SAAR') is section 50CA as introduced by the Finance Act, 2017. This amendment has been introduced for the purpose of taxing the "indirect" sale of immovable property.

- Considering the context and objective of section 56(2)(x) and section 50CA, the CBDT had come out with Draft Rules earlier (May 2017). It suggested amendment in the method of valuation of unquoted equity share by taking into account the FMV of jewellery, artistic work, shares & securities and stamp duty value in case of immovable property and book value for the rest of the assets.

- After considering the comments and suggestion, recently, the CBDT has notified final rules on 12 July 2017 which is largely in line with the draft rules.

2.0 New Valuation Guidelines (Amended Rule 11UA and New Rule 11UAA)

■ Year of applicability

The valuation guideline is applicable from assessment year 2018-19 (i.e. financial year 2017-18). As the rules have been notified by the CBDT only on 12th July 2017, it seems to be retrospective in respect of transactions which have already taken place in the intermittent period i.e. between 1 April 2017 to 11 July 2017.

■ Court Decisions which might have triggered introduction of section 50CA and changes in the valuation rules

Bhoruka Engineering Inds. Ltd. Vs. DCIT [2013] 36 taxmann.com 82 (Karnataka High Court]

In this case, Revenue contended that transaction of sale of shares was a colourable device and virtually immovable property had been transferred.

While rejecting such argument the High Court observed as follows: *"The assessee by resorting to such a tax planning has taken advantage of the benefit of the law or the loopholes in the law, which had enured to his benefit. After seeing how this loophole has been exploited within four corners of the law, it is open to the Parliament to amend the law plugging the loophole."*

DCIT vs. Maya Appliances (P.) Ltd [2017] 82 taxmann.com 447 (Chennai - Trib.)

In this case, according to Revenue, the assessee sold the actual land and building in the guise of sale of shares and thus the provisions of the section 50C is applicable.
However, the Tribunal declined to adopt this argument and held that no question of invoking the provisions of the section 50C of the Act as there is no direct transfer of land or building or both.

Medplus Health Services P. Ltd vs. ITO [ITA.No.871/Hyd/2015] dated 8th March 2016

In this case, the Revenue adopted the market value of unquoted equity shares ignoring the valuation methodology given in Rule 11 UA as it was based on Book Value of the assets.
The Tribunal held that *"A.O. has to compute the fair market value in accordance with the prescribed method but cannot adopt the market value as fair market value under section 56(2)(viia) of the Act. The legislature in its wisdom has also given a formulae for computation of the fair market value which cannot be ignored by the authorities below."*

■ Method for working out FMV of unquoted equity shares

Existing formula (upto FY 2016-17)	New formula (from FY 2017-18 and onwards)
The FMV of unquoted equity shares on the valuation date = (A–L)× (PV) /(PE)	**The FMV of unquoted equity shares on the valuation date = (A+B+C+D - L)× (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 unamortized amount of deferred expenditure which does not represent the value of any asset;	where, **A**= book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) in the balance-sheet as reduced by,- i) any amount of income-tax paid, if any, less the amount of income-tax refund claimed, if any; and ii) any amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset; **B** = the price which the jewellery and artistic work would fetch if sold in the open market on the basis of the valuation report obtained from a registered valuer; **C** = FMV of shares and securities as determined in the manner provided in this rule; **D** = the value adopted or assessed or assessable by any authority of the Government for the purpose of payment of stamp duty in respect of the immovable property;
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 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**	**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 income-tax paid, if any, less the amount of income-tax claimed as refund, if any, 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	PE = total amount of paid up equity share capital as shown in the balance-sheet
PV = the paid up value of such equity shares	PV = the paid up value of such equity shares

Notes

1. **Fair market valuation of certain specified assets [Part B,C,D, of above formula]**

Part of formula	Type of asset	Method to arrive at FMV	Supported by Valuation Report
B	Jewellery and artistic work	Amount which would be fetched if sold in the open market based on the valuation report	Registered valuer
C	Quoted shares and securities	If received by way of transaction through recognized stock exchange the FMV would be the transaction value as recorded on such recognised stock exchange.	NA
		If received by way of transaction carried out other than through any recognised stock exchange, the FMV would be: a) Average of the lowest and the highest price of the shares or securities quoted on recognised stock exchange on the valuation date; b) Where shares or securities are not traded on recognised stock exchange on the specified date, average of the lowest and the highest price of the shares or securities quoted on recognised stock exchange on a date immediately preceding the valuation date	
C	Unquoted equity shares	(A +B+C+D – L) x (PV) / (PE) (i.e., same valuation approach as described herein above)	NA
C	Unquoted shares and securities (other than unquoted equity shares)	Amount which would be fetched if sold in the open market on the specified date	Merchant banker or an chartered accountant
D	Immovable property	Stamp duty value assessed or assessable in respect of the immovable property	NA

2. **Balance sheet**

The balance-sheet of company (including the notes annexed thereto and forming part of the accounts) as drawn up **on the valuation date** which has been audited by the auditor appointed under section 224 of the Companies Act, 1956*;*

3. Valuation Date

Valuation date means the date on which the property or consideration, as the case may be, is received by the assessee.

- **Summary of valuation methods to be followed in case of receipt /transfer unquoted shares**

Event	Valuation
a. Transfer of unquoted equity shares (In the hands of seller under section 50CA)	New formula method
b. Transfer of unquoted preference shares (In the hands of seller under section 50CA)	FMV as certified by a merchant banker or an chartered accountant
c. Receipt of unquoted equity shares (In the hands of recipient under section 56(2)(x))	New formula method
d. Receipt of unquoted preference shares (In the hands of recipient under section 56(2)(x))	FMV as certified by a merchant banker or an chartered accountant

Section 56(2)(x)

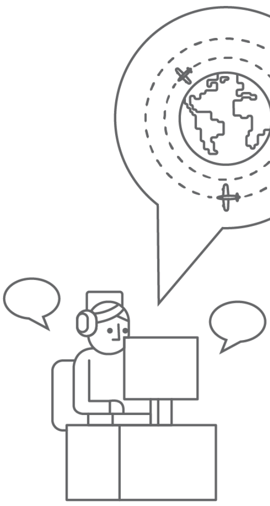
- Scope widened to cover Firm, LLP, AOP, BOI, and Company including foreign company
- Though the definition of property under section 56(2) (x) remains similar to that of Section 56(2)(vii)
- Method of valuation shall be governed by Rule 11U/ 11UA
- Income charged to tax under section 56(2)(x) shall form part of the cost at the time of transfer of assets acquired under section 49(4)
- Certain exclusions have been provided
- Transaction covered under section 47 shall be outside the scope of section 50CA and but may be covered under section 56(2)(x) in some cases. For instance, transfer of shares from Wholly owned subsidiary to holding or vice versa exempt under section 47(iv)/ 47(v), has not been excluded from the scope of section 56(2)(x).

Section 50CA

- Prior to introduction of section 50CA, where shares were sold by the assessee for a consideration, which is not in conformity with the fair-market value of the shares, there was no mechanism available under the Act to substitute the full value of consideration as disclosed by the assessee by any other value, for the purposes of computation of capital gains. Section 50C dealt with transfer of capital asset being land or buildings or both, which is not applicable in case of shares. To plug this loophole section 50CA was introduced.
- Applicable to all assessee (Resident, Non-resident, Related and unrelated entity)
- Applies to all shares whether equity or preference.
- Unquoted Shares should be capital asset
- Not applicable with respect to gains from transfer of an interest in a partnership, trust where the property of such entities consists, directly or indirectly of immovable property
- May cover even some quoted shares based on the definition of “quoted share”
- Where unquoted equity shares are contributed by a partner to a firm, the question will arise whether the provisions of section 50CA would override section 45(3). In this respect one may take guidance from the decision in the case of Canoro Resources Ltd., In re [2009] 180 Taxman 220 (AAR) and decision in the case of Carlton Hotel (P.) Ltd. v. Asstt. CIT [2010] 35 SOT 26 (Lucknow Tribunal)
- No tolerance band provided. Thus, FMV as per the new formula method will be taken as full value of consideration, even if difference in FMV and the sale consideration is marginal.
- In case of sale consideration being less than FMV, the seller will be taxed under section 50CA on the ground that he has not declared true consideration. On the other hand, the buyer will be taxed under section 56(2)(x), on the ground that he has understated the purchase consideration.

Our Comment:

- The new method of calculation of FMV of unquoted equity shares is based on adjusted Net Asset value Method with certain assets on FMV and remaining assets based on book value. Thus, now one will have to take into account the FMV of jewellery, artistic work, shares & securities and stamp duty value in case of immovable property.
- Interestingly, where value of unquoted equity shares are mainly derived from intangibles assets such as goodwill, trademark or other intangible assets, this approach of valuation will not reflect the true value of the shares of the company.
- The prescribed method of valuation fails to give weightage to the fact as to whether shares being subject matter of transfer are of minority interest or majority interest. Normally, asset values are out of the reach of the minority shareholder.
- The prescribed method of valuation is specific for section 50CA and section 56(2)(x) and cannot be applied in other sections even though FMV is a term which has been used various places in the Act.
- In case of non-resident, three could be chances of conflict between normal provisions i.e. section 50CA and section 56(2) (x) and the provisions of transfer pricing.
- There could be difficulty at the time of withholding tax. Suppose a non-resident seller transfers certain unquoted equity shares to a resident at Rs. 100 per share whereas the FMV of such share as per new valuation method is Rs. 500 per share. Assuming that cost of share acquired by a non-resident is Rs. 50 per share, the capital gain would be Rs. 50 per share (if actual sale consideration is considered) or Rs. 450 per share (if FMV of share is considered). In this respect, it is as yet unclear whether resident payer shall withhold tax under section 195 on Rs. 50 or Rs. 450.
- Issue of shares at premium wherein the provisions of section 56(2)(viib) is applicable, the tax authority is already empowered to consider the market Value of underlying assets including Intangible assets.



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