VALUATION OF UNQUOTED SHARES - CBDT ISSUED AMENDED RULE - 11UA - UNDERSTANDING THE IMPACT

CMA MRITYUNJAY ACHARJEE
Associate Vice President, Tax and Chief Internal Auditor, Balmer Lawrie Ltd.

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.

The Central Board of Direct Taxes ('CBDT') has, vide Notification No. 620 dated 12.07.2017, notified the much-awaited amended Rule-11UA providing for rules for valuation of unquoted equity shares relevant for section 56(2)(x) and also, inserted new Rule-11UAA providing for rules for determination of Fair Market Value ('FMV') for unquoted shares relevant for section 50CA of the Income tax Act, 1961.

The aforesaid notified rules are broadly inline with the draft rules issued by CBDT in May, 2017 for the Public Comments. The notified rules have undoubtedly provided the much-needed guidance for the taxpayers with respect to valuation of unquoted equity shares yet certain issues still remain unanswered in these Rules as highlighted infra.

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

1. **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 ensured 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."

2. **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.

3. **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."

Background

Finance Act, 2017 inserted two new provisions under the Act – clause (x) under section 56(2) and section 50CA. The said sections were inserted to deal with a situation where the property, including unquoted shares, are being transacted for inadequate consideration much below the FMV of such property.

The Finance Act, 2017 had brought into force two major amendments in the Income Tax Act: - Insertion of clause (x) in section 56(2) to provide that receipt of money or specified property by any person for inadequate consideration or without consideration from any person shall be subject to tax. - Introduction of section 50CA to provide that where consideration for transfer of shares of a company other than a quoted share is less than the FMV of such a share, the FMV determined as per the Rules shall be deemed to be the full value of consideration for computing income under the head "capital gains."

While clause (x) under section 56(2) provided for taxability in the hands of the purchaser of property, including shares, the differential amount of consideration and FMV of such property, section 50CAof the Act, on the other hand, for the purposes of computing capital gains, seeks to substitute, in the hands of the seller of the property being the unquoted shares, the FMV of the such property in place of the amount of inadequate consideration.

The CBDT on o5 May, 2017 issued a draft notification that proposed to amend Rule 11UA and introduce Rule 11UAA for computing the FMV of unquoted shares of a company for the purpose of sections 56(2)(x) and 50CA respectively. • Recently, on 12 July 2017, the CBDT has issued final notification in this regard. The final rules are largely similar to the draft rules and are applicable to all transactions taxable during financial year's ending commencing on or after 01 April, 2017.

Thus, in case of transaction involving transfer of unquoted shares, the aforesaid computational mechanism seeks to tax the same differential amount of consideration and FMV in hands of both tax payers i.e., the transferor and transferee.

It is further important to note that clause (x) under section 56(2) has widened the scope of the provisions as the same becomes applicable for all taxpayers unlike provisions of clauses section (vii) and (viia) of section 56(2) of the Act which were applicable to selected taxpayers.

Valuation of unquoted shares

For valuation of the unquoted shares, clause (x) under section 56(2), even after insertion, continued to make reference to provisions of Rule-11UA as was applicable for clauses section (vii) and (viia) of section 56(2) of the Act. The CBDT, however, came out with the drafted amended Rule-11UA which were at variance with the erstwhile Rule-11UA.

The CBDT has now notified the amended Rule-11UA which provides for valuation of unquoted equity shares. Final Valuation Rules • Final Rule 11UA (1)(c)(b) replacing the existing rule prescribes computation of FMV of the unquoted equity shares as follows:

FMV of unquoted equity shares = (A+B+C+D-L) x PV/PE, where

A - Book value of all the assets (except those mentioned at B, C and D below) as reduced by income tax paid (net of refund) and unamortized deferred expenditure
B - Fair market value of jewellery and artistic work based on the valuation report of a registered valuer
C - Fair market value of shares or securities as determined according this rule
D – Stamp duty valuation in respect of any immovable property
L - Book value of liabilities, excluding paid up equity share capital, amount set apart for undeclared dividend, reserves and surplus, provision for tax, provisions for unascertained liabilities and contingent liabilities
PV - Paid up value of equity shares
PE - Total amount of paid up equity share capital as shown in the balance sheet.

Further Explanation

B = the price that 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 according to 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 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;
vii) PE = total amount of paid up equity share capital as shown in the balance-sheet;
viii) PV= the paid up value of such equity shares;

The New Rule 11UAA prescribes that for the purposes of section 50CA, the FMV of the share of a company other than a quoted share, shall be determined as provided in Rule 11UA (1)(c)(b)/(c), and that the reference to valuation date in the rule 11U and rule 11UA shall mean the date on which such shares are transferred.

Understanding the provisions of 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.

Comparative Review

The Erstwhile Rule 11UA (1)(c)(b) determined FMV of unquoted equity shares wholly on the basis of book value of the company without considering valuation impact relating to assets for which specific valuation rules were provided and thus, there was an inconsistency in direct and indirect valuation of certain assets. The amended rule 11UA(c)(b) removes above inconsistency and provides valuation adjustment for such assets in valuation of unquoted equity shares of company holding such assets. Valuation of rest of the assets, including assets such as intangible assets, business undertaking, investment held in Limited Liability Partnership or partnership firm etc., and liabilities of the company continues to be valued at book value.

- Newly inserted Rules 11UAA provides valuation methodology to be adopted for the purpose of new section 50CA. It provides that equity shares covered there under should be valued as per above Rule 11UA (1)(c)(b) and preference shares should be valued as per Rule 11UA(1)(c)(c) which provides for valuation it will fetch if sold in open market.

The Final Rules have not addressed some issues which were necessary and were expected to be addressed: – Adoption of actual fair value, in case the FMV of immovable property is less than the Stamp Duty Value; – Reduction in relation to securities premium payable on redemption of preference shares, – Rules being notified on 12th July, 2017 and being made effective from 01 April, 2017, relaxation should have been provided to transactions entered between 01 April, 2017 and 12 July, 2017.

Conclusion

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.

– 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.