

Fair market value of shares of a private company, for recipient taxation, to be computed as per the rule prescribed even if shares are transferred at a different value

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In brief

The Hyderabad Income-tax Appellant Tribunal (Tribunal) in a recent case has held that the Tax Officer (TO) has to necessarily compute the fair market value (FMV) as per Rule 11UA of the Income-tax Rules, 1962 (the Rules) irrespective of the market value of the shares transferred while applying section 56(2)(viiia) of the Income-tax Act, 1961 (the Act) in the hands of the purchaser.

In detail

Facts

- During the relevant financial year the taxpayer¹ purchased shares of its group company (both closely held companies).
- The taxpayer purchased some shares from unrelated parties at INR 75 per share and from some other shareholders at INR 1 per share.
- The FMV of the shares as per Rule 11UA was INR -64 (sic) per share.
- The TO disregarded the FMV computed as per Rule 11UA and treated the amount of INR 75 per share as “FMV” for determining the amount of deemed gift as per provisions of section

¹ TS-129-ITAT-2016(Hyderabad-Tribunal)

56(2)(viiia) of the Act, and computed deemed income accordingly.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the TO’s order and ruled in favour of the Revenue.

Issue before the Tribunal

- Whether the TO has to compulsorily compute the FMV as per Rule 11UA of the Rules for applying section 56(2)(viiia) of the Act, or whether any other available value can be adopted by him?

Taxpayer’s contentions

- The taxpayer contended that the taxability under section 56(2)(viiia) of the Act would not arise in the present case, as the FMV calculated as per Rule 11 UA of the Rules of the shares on the transaction date was negative.

- Neither section 56(2)(viiia) of the Act nor the Rules prescribed adoption of the market value of shares as the FMV of equity shares while calculating income as deemed gift, disregarding the value as computed as per Rule 11 UA of the Rules.

- Further, the taxpayer contended that where a specific method had been prescribed in the Act for computation of FMV of shares, the TO was precluded from adopting any other method. The taxpayer relied on several earlier judgements² to support this contention.

² Bharat Hari Singhania & Others v. Commissioner of Wealth Tax [1994] 207 ITR 1 (SC); Mrs. Prem Shamsher Singh v. Commissioner of Wealth Tax [1994] 210 ITR 233 (Delhi); Chandra Kishore Jha v. Mahavir Prasad & Ors. [1999] 8 SCC 266 (SC)

- Hence, the taxpayer urged that the TO had erred in considering the market value of shares as the FMV for the purpose of computation of “deemed income” under section 56(2)(viiia) of the Act.

Revenue’s contentions

- The TO observed that the valuation of any property was based on what value it would fetch if sold in the open market, but generally the details of how much value an unlisted share would fetch was not available, and hence the formula was given to overcome this deficiency.
- The TO also observed that where the market price of the shares on the very same day of purchase by the taxpayer was available, the same should be used for the determination of the FMV of the shares.
- The TO further contended that the transaction was done at an abnormally low price by the taxpayer to defraud the Revenue.
- The TO therefore held that “deemed income” provisions under section 56(2)(viiia) of

the Act applied in this case, and that INR 75 per share paid to unrelated parties was the market price of the unquoted equity shares. Accordingly, the TO treated the difference of INR 74 per share as “Income from other sources.”

Tribunal’s ruling

- Where a method had been prescribed by the legislature, that method alone should be followed for computation of FMV. Accordingly, adoption of “market value” of shares in place of “FMV” as per Rule 11UA of the Rules for the purpose of section 56(2)(viiia) of the Act was incorrect. The Tribunal relied on legal principles laid down in earlier judgments³.
- It further held that where the legislature in its wisdom had given a formula for computation of FMV, the same could not be ignored by the lower authorities.
- Accordingly, it concluded that section 56(2)(viiia) of the Act could be applied only in accordance with the prescribed rules, and therefore, the TO ought to

have necessarily computed the FMV in accordance with Rule 11UA of the Rules.

The takeaways

- The Tribunal has reaffirmed a very important judicial principle that where computation mechanism is prescribed by the Rules, the same has to be mandatorily followed by the TO.
- Accordingly, in the context of application of section 56(2)(viiia) of the Act, the TO has to necessarily compute the FMV as per Rule 11UA, irrespective of the market value of the shares transferred.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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³ Same as those relied upon by the taxpayer.

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