Tax Insights

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Draft rules for the valuation of unquoted equity shares

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In brief

The Central Board of Direct Taxes (CBDT) has recently issued draft rules for determining the fair market value (FMV) of unquoted equity shares for the purposes of section 56 (2)(x) and section 50CA of the Income-tax Act, 1961 (the Act) and it has invited comments from the public on the same. The last date for the receipt of comments by CBDT is 19 May, 2017.

In detail

Background

- The Finance Act, 2017 inserted clause (x) in section 56 of the Act to widen the scope of taxability of receipt of a sum of money or property without or with for inadequate consideration. Clause (x) applies to all the persons in relation to all the properties defined therein. Thus, the scope of taxability was widened but the valuation rules continued without any change. Valuation rules are prescribed under rule 11UA of the Income-tax Rules, 1962 (Rules).
- Further, a new section 50CA was inserted to provide that where consideration for transfer of the unquoted equity share of a company is less than the FMV of such a share, the FMV shall be deemed to be the full value of consideration for the purposes of computing income under the head "capital gains". The section further provides that FMV should be determined in the prescribed manner.
- In relation to jewellery and artistic work received by a person, Rule 11UA provides FMV to be same as price at which such assets can be sold in the market. In relation to securities other than unquoted shares the rule 11UA provided different valuation methods. Similarly, section 56(2)(x) provided that in case of immovable properties, FMV should be equal to stamp duty valuation. However, the value of unquoted equity shares FMV was determined by taking into consideration the book value of all the assets of a company, including Jewellery, artistic works etc.
- The CBDT has proposed to amend the Rule 11UA in relation to valuation of the unquoted equity shares by replacing sub clause (b) of clause (c) of sub-rule (1) of rule 11UA to remove valuation difference between direct acquisition of assets and indirect acquisition of the same as part of acquisition of unquoted equity share. It is also proposed to insert new rule 11UAA for valuation in relation to section 50CA.

Draft Valuation Rules

- As per the Proposed Rule 11UA(1)(c)(b), the FMV of the unquoted equity shares is to be computed as under:

$$\text{FMV} = (\text{A+B+C+D-L}) \times \frac{(\text{PV})}{(\text{PE})}$$

where,

A = book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) 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, 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;

(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;

PV= the paid up value of such equity shares;

- Proposed new Rule 11UAA provides that for the purposes of section 50CA, the FMV of a share, not being a quoted share, shall be determined in manner provided in proposed Rule 11UA (1)(c)(b), explained above.

The takeaways

- The proposed rules provide clarity on the valuation methodology to be adopted for section 50CA.
- Earlier, the FMV of unquoted shares was based on the book value; however, the proposed rules seek to ensure that the shares of a company are valued based on the underlying assets of the company and thus bring parity in the method of valuation when such assets are transferred directly, or via its holding company.
- In the proposed rule, there is no reference to balance sheet in relation to assets and liabilities. This seem to be an inadvertent omission. Because without such reference, it will not be possible to identify assets and liabilities for the purpose of valuation.
- The rules are proposed to be effective from 01 April 2018 and be applicable for AY 2018-19. *Prima facie*, rule seem to be applicable retrospectively to transactions which are completed before the notification of rule, i.e. transaction entered after 01 April, 2017. Considering that current government is against retrospective amendments, this seem to be a mistake which should get corrected while notifying final rules. However, in absence of such correction, there seems to be an issue in relation to completed transactions between 01 April 2017 and the date of notification of final Rules, which may need representation before the CBDT

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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