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The CBDT notifies valuation under the Net Asset Value method or Discounted Free Cash Flow method, at the option of the assessee, as the FMV for the transactions falling under section 56(2)(viib) of the Act

In brief

The Central Board of Direct Taxes ('CBDT') has issued notification no. 52/2012[1], amending rules 11U and 11UA of the Income-tax Rules, 1962 (the Rules). The Rule 11UA of the Rules deals with the determination of fair market value (FMV) for the purpose of section 56 of the Income-tax Act, 1961 (the Act), whereas Rule 11U of the Rules defines certain terms used in Rule 11UA of the Rules.

Sections' 56(2)(vii) and 56(2)(viia) of the Act provides that in case an assessee receives specified properties without consideration or at a consideration lower than FMV, then such difference should be considered as income in his hands and taxed under the head "Income from Other Sources", provided such difference exceeds INR 50,000.

The Finance Act, 2012, inserted clause (viib) into section 56(2) of the Act, which states that if any closely held company issues shares to a resident person for a consideration higher than the FMV of such shares, then the difference between the FMV and the consideration shall be considered as income and taxed in the hands of such company.

[1] [CBDT Notification No. 52/2012, F.No.142/19/2012-SO(TPL) S.O 2805(E) dated November 29, 2012]

While the Rule 11UA of the Rules had applied to sections' 56(2)(vii) and 56(2)(viia) its applicability to section 56(2) (viib) was not certain. The Rule 11UA of the Rules has now been amended to specifically cover valuation of unquoted equity shares for the purpose of section 56(2)(viib) of the Act. Further, amendments have been made to certain definitions under the Rule 11U of the Rules.

Key Changes

1. As per the amended Rule 11UA of the Rules, the assessee company has the option to choose from the following methods for the purpose of section 56(2)(viib) of the Act:

   - Net Asset Value method as per prescribed formula (same as applicable to sections' 56(2)(vii) and 56(2)(viia); or

   - Discounted Free Cash Flow (DCF) method as determined by a merchant banker or an accountant

2. The definition of the term 'balance sheet' has been amended as follows:

   - For the purpose of sections' 56(2)(vii) and 56(2)(viia) of the Act, the term 'balance sheet' means the balance sheet of the company as audited by its statutory auditor as on the date of receipt of property or consideration by the assessee.

   - For the purpose of section 56(2)(viib), 'balance sheet' refers to the audited balance sheet available on the date of receipt of consideration by the assessee, if any; otherwise, it refers to the balance sheet of the company adopted in its annual general meeting immediately preceding the date of receipt of consideration by the assessee.

3. There is a change in the definition of the term 'accountant' as applicable to section 56(2)(viib) of the Act. Accordingly, the DCF valuation of shares shall be carried out by a Fellow Chartered Accountant, who is not a statutory auditor or tax auditor of the company.

Our Comments

The CBDT notification provides clarity on the valuation methodology to be adopted for determining the FMV of equity shares for the purpose of section 56(2)(viib) of the Act. It is a welcome move as it provides the closely held company an option to issue equity shares to a resident person on a premium based on future cash flows.

Further, the amendment to the definition of the term 'balance sheet' has placed an additional requirement on the assessee to whom sections' 56(2)(vii) and 56(2)(viia) of the Act are applicable. Whereas until now, a balance sheet as on the date of receipt of property or consideration would have sufficed, now the same needs to be audited by the statutory auditor as well.

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