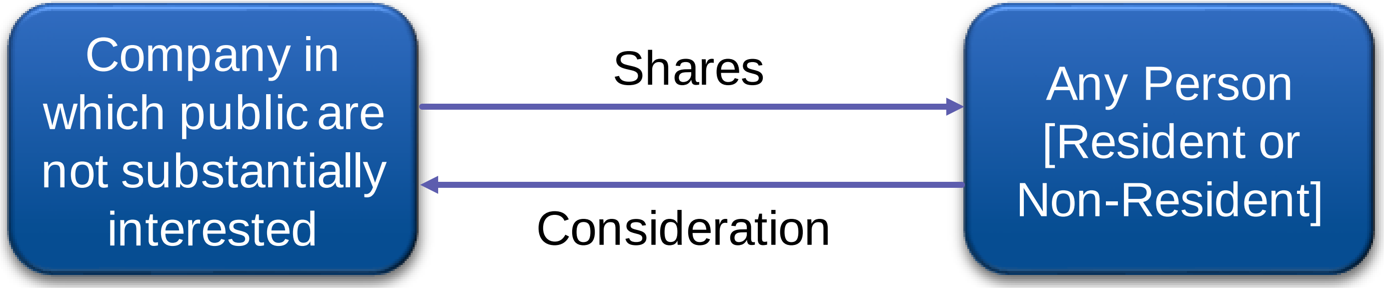
VALUATION OF SHARES UNDER INCOME TAX ACT AND FOREIGN EXCHANGE MANAGEMENT ACT

ISSUE OF SHARES – 56(2)(viib)



- Conditions for Trigger:
  - Issue of Shares by company in which public are not substantially interested
  - Issue of Shares at a premium
- Aggregate Consideration in excess of <u>Fair Market Value</u> of such shares will be taxable in hands of the company issuing shares.
- Exempt Persons, being recipient of Consideration
  - Venture capital undertaking receiving consideration from a venture capital company or a venture capital fund or a specified fund
  - Company receiving consideration from a class or classes of persons as may be notified by the Central Government in this behalf (Refer next slide)

ISSUE OF SHARES – 56(2)(viib)

- Class or classes of persons notified by Central Government, being exempt persons on receipt of consideration under 56(2)(viib):
  - Government and Government related investors including entities controlled by the Government or where direct or indirect ownership of the Government is seventy-five percent or more (Central banks, sovereign wealth funds, international or multilateral organizations or agencies).
  - Banks or Entities involved in Insurance Business, where such entity is subject to applicable regulations in the country where it is established/incorporated or is a resident
  - Any of the following entities, which is a resident of any country specified in the annexure, and such entity is subject to applicable regulations in the country where it is established/incorporated or is a resident
    - Entities registered with SEBI as Category-I Foreign Portfolio Investors;
    - Endowment funds associated with a university, hospitals or charities;
    - Pension funds created or established under the law of the foreign country or specified territory;
    - Broad Based Pooled Investment Vehicle or fund where the number of investors in such vehicle or fund is more than fifty and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies
- List of countries as per Annexure: Australia ; Austria ; Belgium ; Canada ; Czech Republic ; Denmark ; Finland ; France ; Germany ; Iceland ; Israel ; Italy ; Japan ; Korea ; New Zealand ; Norway ; Russia ; Spain ; Sweden ; United Kingdom ; United States ;

ISSUE OF SHARES – 56(2)(viib)

Methods of Valuation to determine the Fair Market Value u/s 56(2)(viib)	
• Determined in accordance with such method as may be prescribed - Rule 11UA(2) • Substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible asset	Which-ever is higher

FAIR VALUATION AS PER RULE 11UA(2)

As required under 56(2)(viib)

KEY TERMS – 11U

Valuation date

- Date on which property or consideration is received by the assessee
- Deemed Valuation Date – Rule 11UA(3) – Date of Merchant Banker's Valuation Report shall be deemed valuation date, if such date is not more than 90 days prior to date of issue of shares

Balance sheet

- Balance sheet drawn up on the valuation date and audited by the auditor of the company, appointed u/s 224 of Companies Act,2013.
- Where the balance-sheet on the valuation date is not drawn up, balance sheet preceding the valuation date, approved and adopted in AGM

UNQUOTED EQUITY SHARE VALUATION - RULE 11UA(2)(A)

A Unquoted Equity Shares

Consideration received from

- **Resident**
- **Non-Resident**

a Value of unquoted equity shares — OR — **b** Discounted Free Cash Flow Method — OR — **c** VCU transaction value — OR — **e** NE transaction value — OR — **d** Other Methods

Refer Next Slide

- Comparable Company Multiple Method
- Probability Weighted Expected Return Method
- Option Pricing Model
- Milestone Analysis Method
- Replacement Cost Method

1. VCU – Venture Capital Undertaking
2. NE – Entity notified under clause (ii) of first proviso to section 56(2)(viib)

FAIR MARKET VALUE– RULE 11UA(2)(A)(a)

	Particulars		Rs.
A =	Book value of all the assets		xx
Less:	Amount of income tax paid, less the amount of income-tax refund claimed		xx
Less:	Amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset		xx
		Total A	xx
			xx
L =	Book value of liabilities		xx
Less:	Paid-up capital in respect of equity shares		xx
Less:	Amount set apart for payment of dividends on preference shares and equity shares		xx
Less:	Reserves and surplus other than for depreciation (net off negative balance of P & L)		xx
Less:	Provision for taxation (excluding (advance tax- refund due, if any))		xx
Less:	Provisions for liabilities other than those for ascertained liabilities (General Contingency Provision)		xx
Less:	Contingent Liabilities other than cumulative preference shares		xx
		Total L	xx
		A - L	xx
	PE = Paid-up equity share capital as shown in Balance Sheet		xx
	PV = Paid-up value of equity share capital as shown in Balance Sheet		xx
	Value per share (in Rs.) = (A - L) * (PV) / (PE)		xx

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) DISCOUNTED CASHFLOW METHOD (DCF)

Approach based on future cash flows (not profits)

- Based on the present value of future estimated cash flows and terminal value using a risk-adjusted discount rate
- PV of expected future cash flows + PV of terminal value

Nominal or real Cash Flows

Free Cash Flow ('FCF')

- FCF to Firm
- FCF to Equity
- FCF to Firm Preferred

PROFORMA DCF STATEMENT

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

PARTICULARS	Year 1	Year 2	Year 3
Cash inflows			
Adjusted EBIDTA	XXX	XXX	XXX
Total (A)	**XXX**	**XXX**	**XXX**
Cash outflows			
Purchase / (Sale) of Fixed Assets	XX	XX	XX
Increase / (Decrease) in Net Current Assets	XX	XX	XX
Income Tax	XX	XX	XX
Total (B)	**XXX**	**XXX**	**XXX**
(C) Free Cash Flows to Firm [(A) – (B)]	**XX**	**XX**	**XX**
Add: Perpetuity Value			XX
(D) Free Cash Flows to Firm including perpetuity	**XX**	**XX**	**XX**
(E) Mid-year Discounting Factor	X	X	X
(F) Discounted Free Cash Flows to Firm [(D) * (E)]	**XX**	**XX**	**XX**
Total Discounted Cash Flows (Enterprise Value)			**XXX**

PROFORMA TOP SHEET FOR DCF WORKING

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

PARTICULARS	AMOUNT
Enterprise Value as per DCF Working	**XXX**
Less: Debt as at Valuation Date	(XX)
Less: Contingent Liabilities likely to crystallize	(XX)
	XXX
Add : Surplus Assets	XX
Business Value as at Valuation Date	**XXX**
Less: Fair Value of Preference Shares as at Valuation Date	(XX)
Business Value for Equity Shareholders	XXX
(÷) Number of Equity Shares	XX
Value per share	XX
Less: Illiquidity Discount	(XX)
Value per share after illiquidity discount	**X**

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

DISCOUNT RATE

Discount Rate for

- FCFF ~WACC
- FCFE ~ Cost of Equity

Weights used for WACC may be:

- Industry Debt Equity
- Market Debt Equity
- Target Debt Equity

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD COST OF EQUITY

Cost of Equity is generally computed using the CAPM Model (sometimes a risk premium may be added, say for size, called expanded CAPM)

ke = rf + β [E(rm) – rf]

- where,
- ke: Cost of equity
- rf: Risk-free rate of return
- β: Systematic risk of the equity
- E(rm): Expected rate of return on overall market portfolio
- [E(rm) – rf]: Market risk premium

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

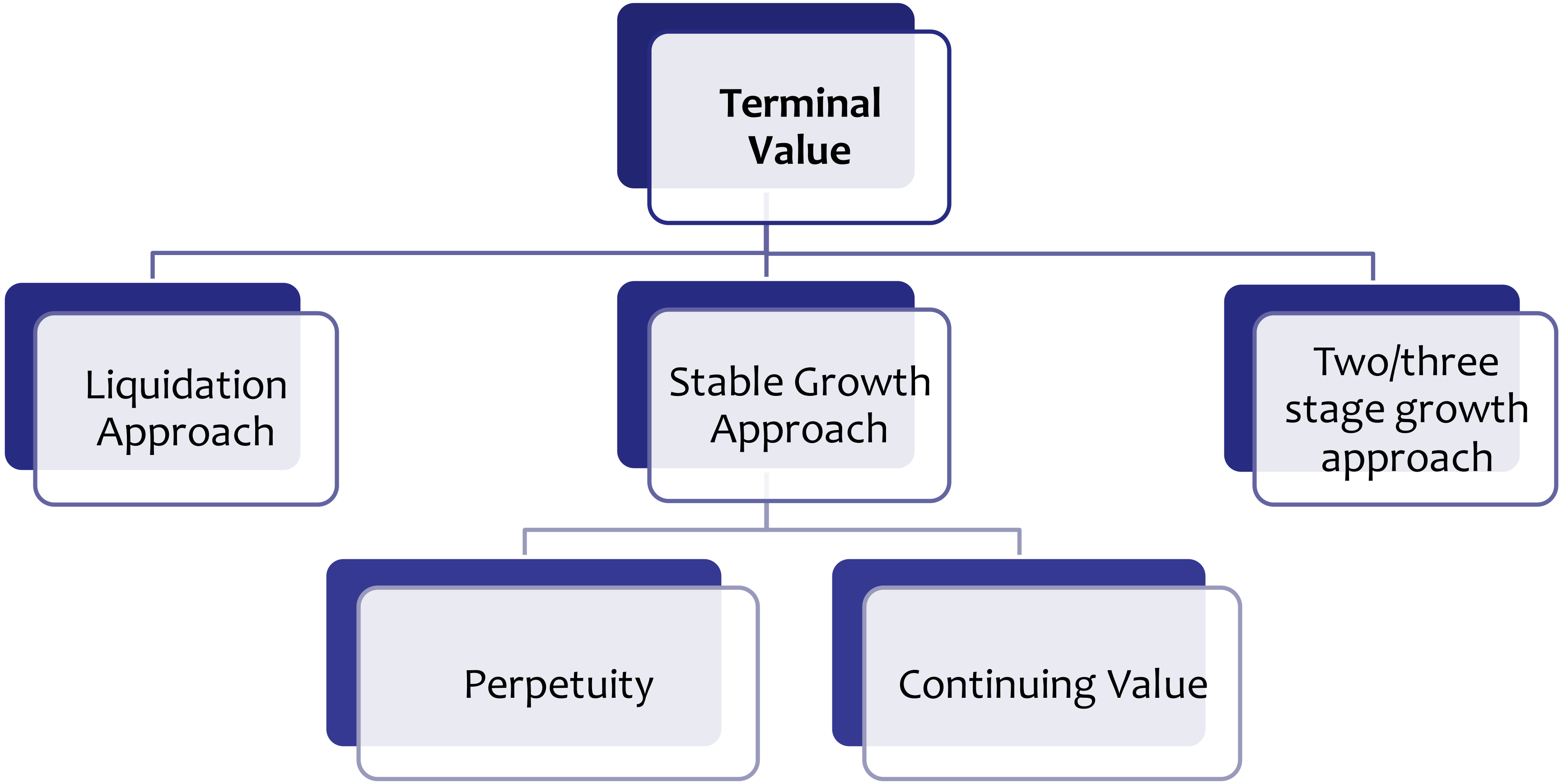
BETA - LEVERED

- Beta technically is estimated by regressing stock returns against market returns
- β_L = Slope of $\frac{\text{(\% change in Stock price)}}{\text{(\% change in Index)}}$
- If the Company is not listed, based on other comparable companies

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

TERMINAL VALUE FOR DCF

Terminal Value is the residual value of business at the end of projection period used in discounted cash flow method



FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

STABLE GROWTH APPROACH - PERPETUITY

- This model can be used to value a firm with free cash flows to the firm growing at a stable growth rate for perpetuity.
- The growth rate used in the model has to be reasonable, relative to the nominal growth rate in the economy.
- This formula is based on the Gordon's Growth Model.

Value of firm = FCFF1 / (WACC - g)

where,

FCFF1 = Expected FCFF next year

WACC = Weighted average cost of capital

g = Growth rate in the FCFF (in perpetuity)

COMPUTATION OF FCFE

Free Cash Flow to Equity should be discounted using the Cost of Equity

FAIR MARKET VALUE– RULE 11UA(2)(A)(b) – DCF METHOD

PARTICULARS	Year 1	Year 2	Year 3
Free Cash Flow to the Firm	XX	XX	XX
Less: Interest Cost (net of taxes)	XX	XX	XX
Add: Net Change in borrowings	XX	XX	XX
Free Cash Flow to Equity	**XX**	**XX**	**XX**

RULE 11UA(2)(A)(c) – FUNDING OF VENTURE CAPITAL UNDERTAKING

- Definitions as per clause (23FB) of Section 10 of Income Tax Act, 1961 :
  - “Venture Capital Fund“ (VCF) means such fund, operating under a trust deed registered under the provisions of the Registration Act, 1908, established to raise monies by the trustees for investments mainly by way of acquiring equity shares of a venture capital undertaking in accordance with the prescribed guidelines;
  - “Venture Capital Company“ (VCC) means such company as has made investments by way of acquiring equity shares of venture capital undertakings in accordance with the prescribed guidelines;
  - “Venture Capital Undertaking“(VCU) means such domestic company
    - whose shares are not listed in a recognised stock exchange in India; and
    - which is engaged in the business of generation or generation and distribution of electricity or any other form of power or engaged in the business of providing telecommunication services or in the business of developing, maintaining and operating any infrastructure facility or engaged in the manufacture or production of such articles or things (including computer software) as may be notified by the Central Government in this behalf;

RULE 11UA(2)(A)(c) – FUNDING OF VENTURE CAPITAL UNDERTAKING

- Exemption under 56(2)(viib) - Consideration for issue of shares is received by a venture capital undertaking (VCU) from a venture capital company (VCC) or a venture capital fund (VCF) or a specified fund (SF).
- Rule 11UA(2)(c) – Fair Market Value determination of shares for consideration received by VCU from other than VCC or VCF or SF.

> ➢ Conditions for fair value determination as per Rule 11UA(2)(c)
>
> ❖ Consideration has been received by VCU from VCC or VCF or SF, within a period of ninety days before or after the date of issue of shares.
>
> ❖ Fair market value does not exceed the aggregate consideration received from VCC or VCF or SF

- Illustration : If a VCU receives a consideration of ₹50,000 [100 Shares @ ₹500] from a VCC, then VCU can issue 100 shares at this Rate (Not Higher) to any other investor within a period of ninety days, before or after receipt of consideration from VCC.

RULE 11UA(2)(A)(c) – FUNDING OF VENTURE CAPITAL UNDERTAKING

- Fair Valuation of Shares
  - Valuation under other methods higher than VCU Transaction Value
    - At the option of assessee, valuation as per other methods can be considered.
  - Valuation under other methods lower than VCU Transaction Value
    - At the option of assessee, valuation as per other VCU Transaction Value can be considered, subject to conditions.

Other Valuation Approaches

Market Approach

- Comparable Companies Multiple (CCM) Method

Cost Approach

- Replacement Cost Method

RULE 11UA(2)(A)(d) - COMPARABLE COMPANY MULTIPLE METHOD

MARKET APPROACH

Market approach is a valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities, such as a business.

CCM Method

- Also known as *Guideline Public Company Method*, involves valuing an asset based on market multiples derived from prices of market comparables traded on active market.

MULTIPLE BASED METHODS

- Normalized Earnings/Asset base are considered to arrive at a value under each of the above approaches
- An appropriate growth rate is considered to arrive at value under each of the above approaches

RULE 11UA(2)(A)(d) - COMPARABLE COMPANY MULTIPLE METHOD

Approach involves deriving value based on Earnings potential of the Business

EV/EBITDA Method

- When comparing companies with varying leverages.

PE Multiple Method

- Companies where earnings are positive, stable and predictable.

PB Multiple Method

- NBFC Companies
- Manufacturi ng Companies

Turnover Multiple Method

- Retail Companies
- Where earnings are negative
- Where earnings are transitory

FAIR MARKET VALUE– RULE 11UA(2)(A)(d) – PROBABILITY WEIGHTED EXPECTED RETURN METHOD

- Step 1: Determine the range of potential future outcomes
- Step 2: Estimate future equity value under each scenario and allocated to each share class
- Step 3: Probability weigh each outcome

Factors in favor

- Forward-looking concept which takes into account future possibilities and outcomes
- Relatively more transparent than the OPM as each outcome is explicitly defined
- Considers the rights and preferences accorded to each of the class of shares

Limitations

- Multiple assumptions about possible future outcomes
- Complexity of the process and consequently the cost involved
- Discrete set of outcomes rather than a full distribution of outcomes

FAIR MARKET VALUE– RULE 11UA(2)(A)(d) – OPTION PRICING METHOD

- Option pricing models are essential for valuing a company's financial instruments (options), and the Black-Scholes and Binomial models are two prominent methods.
- Black-Scholes Model: Assumes that stock prices follow a continuous geometric Brownian motion. Key variables include the stock price, strike price, time to expiration, volatility, and risk-free interest rate. Provides a closed-form solution for European-style options (can only be exercised at expiration).Doesn't account for dividends and assumes constant volatility and interest rates.
- Binomial Model: Utilizes a discrete-time framework, breaking down time into small intervals. Allows modeling of changing volatility and dividend payments over time. Approximates the continuous price movement by constructing a binomial tree of possible price paths. Particularly useful for valuing American-style options (can be exercised at any time before expiration).
- Flexibility: The Black-Scholes model is simpler but less flexible, as it assumes constant parameters. The Binomial model is more versatile, accommodating changes in market conditions and dividend payments.
- Accuracy: The Black-Scholes model is suitable when underlying asset prices follow continuous and predictable patterns. The Binomial model is more accurate when dealing with complex options and volatile markets.
- Computational Complexity: Black-Scholes offers a closed-form solution, making it computationally efficient.The Binomial model requires more calculations due to the construction of the price tree, making it computationally intensive for a large number of time steps.

FAIR MARKET VALUE– RULE 11UA(2)(A)(d) – MILESTONE ANALYSIS METHOD

- Milestone analysis is a method used for the valuation of a company, particularly in startup and early-stage business contexts.
- Assessment of Key Milestones: Milestone analysis involves identifying and assessing critical milestones in a company's development. These milestones can vary but often include product launches, user acquisition goals, revenue targets, or technology advancements.
- Quantifying Milestone Achievements: Each milestone is assigned a specific value or significance in terms of the company's overall valuation. These values are often based on historical data, industry benchmarks, or expert opinions.
- Risk Adjustment: Milestone analysis incorporates risk factors associated with achieving each milestone. Risks could include market competition, technology challenges, regulatory hurdles, or funding constraints. The valuation is adjusted to account for the likelihood of successfully reaching each milestone.
- Scenario-Based Valuation: Milestone analysis typically involves scenario-based valuation. Different scenarios are considered, reflecting various outcomes in terms of milestone achievement. This approach helps assess the company's value under different circumstances.
- Iterative Process: Milestone analysis is often an iterative process, especially in startups where uncertainties are high. Valuations are regularly updated as the company progresses and achieves or revises its milestones. This dynamic approach reflects changing circumstances.

FAIR MARKET VALUE– RULE 11UA(2)(A)(d) – REPLACEMENT COST METHODS

Value based on Cost to be incurred to set-up a Green field project with similar capacities

Consider the cost that would have to be incurred to set-up the plant

Add the realizable value of working capital and reduce the amount of debt and other liabilities

Add Surplus assets, reduce contingent liabilities likely to crystallise, to arrive at the Business Value

FAIR MARKET VALUE– RULE 11UA(2)(A)(e) – NOTIFIED ENTITY TRANSACTION VALUE

- Conditions for fair value determination as per Rule 11UA(2)(e)
  - Consideration has been received from any entity notified under 56(2)(viib) *first proviso clause*(ii), within a period of <u>ninety days</u> before or after the date of issue of shares.
  - Fair market value does not exceed the aggregate consideration received from notified entity
- Upon satisfaction of above conditions, at the option of such company, the consideration received form the notified entity shall be taken as the fair value of unquoted equity shares.

Refer notification dated May 24, 2023

PREFERENCE SHARE VALUE PROVISION – RULE 11UA(2)(B)

Compulsorily Convertible Preference Shares

Consideration received from

- **Resident**
- **Non-Resident**

a Value of unquoted equity shares

Refer Slide 7

OR

b Discounted Free Cash Flow Method

OR

c VCU transaction value

OR

e NE transaction value

OR

d Other Methods

- Comparable Company Multiple Method
- Probability Weighted Expected Return Method
- Option Pricing Model
- Milestone Analysis Method
- Replacement Cost Method

1. VCU – Venture Capital Undertaking
2. NE – Entity notified under clause (ii) of first proviso to section 56(2)(viib)

SAFE HARBOUR RULE - 11UA(4)

- **Where consideration is received from a RESIDENT**
  - As per Rule 11UA(4)(i) → if **the issue price of shares exceeds the FMV** determined according to
    - the NAV Method [Rule 11UA(2)(A)(a)] or
    - Discounted Free Cashflow Method [Rule 11UA(2)(A)(b)]

  by 10% of such FMV determined, then **such issue price** shall be **deemed to be FMV of shares** for purpose of section 56(2)(viib)

- **Where consideration is received from a NON-RESIDENT**
  - As per Rule 11UA(4)(ii) → if **the issue price of shares exceeds the FMV** determined according to
    - the NAV Method [Rule 11UA(2)(A)(a)] or
    - Discounted Free Cashflow Method [Rule 11UA(2)(A)(b)] or
    - Other Methods [Rule 11UA(2)(A)(d)]

  By 10% of such FMV determined, then **such issue price** shall be **deemed to be FMV of shares** for purpose of section 56(2)(viib)

CASE LAWS UNDER 56(2)(viib)

Challenging reliance on projections

Challenging the method of valuation adopted by the assessee

Vodafone M-Pesa Ltd Vs DCIT

(ITA No. 1073/Mum/2019) (Mum. Trib.)

- The CIT(A) and AO tried to compare the projections with the actual figures. AO rejected DCF and adopted only NAV as per 11UA(2) but CIT(A) considered only a % of the DCF value based on actual performance achieved compared to the projections.
- ITAT observed that no one can project with 100% accuracy. Also held that CIT(A) could not make adjustment to the value based on actual performance.

CIT vs VVA Hotels (P.) Ltd

[T.C.A No 670 of 2019] (Mad. HC)

- High Court ruled that taxpayer-company had an option to adopt NAV method or DCF Method to arrive at the valuation of unquoted shares. If the AO was unable to bring out any evidence of abuse of the provisions with an intention to defraud the revenue, the option accorded to the taxpayer-company to choose the method of valuation shall be held to be absolute.

Deputy Commissioner IT 6(2)(1), Mumbai v. Credtalpha Alternative Investment Advisors (P.) Ltd

- Where assessee company valued its shares by adopting DCF method, AO was required to examine method adopted by assessee and AO could not adopt NAV method merely for reason that there was deviation in actual figures from projected figures shown in DCF method, thus, additions made under section 56(2)(viib) on the ground that NAV and DCF methods for valuation of shares gave wide variation between them was to be set aside.

CASE LAWS UNDER 56(2)(viib)

AO can reject valuation but not allowed to change method of valuation

Innoviti Payment Solutions (P.) Ltd.

(175 ITD 10) (Bang. Trib.)

- The primary onus to prove the correctness of the valuation Report is on the assessee.
- If the projections are not proved as made on scientific basis, then the DCF value can be rejected

Vodafone M-Pesa Ltd vs PCIT.

(2018) 256 Taxman 240 (Bom. HC)

- The Assessing Officer is undoubtedly entitled to scrutinise the valuation report and determine a fresh valuation either by himself or by calling for a final determination from an independent valuer to confront the petitioner. However, the basis has to be the one which has been opted by the Assessee and it is not open for the AO to change the method of valuation.

CASE LAWS UNDER 56(2)(viib)

AO entitled to change method of valuation

Agro Portfolio (P.) Ltd. VS ITO

IT APPEAL NO. 2189 (DELHI) OF 2018 (trib)

- Where assessee allotted shares to a company and fair market value of shares was done by a Merchant banker on the basis of DCF method, only based on data supplied by assessee and no evidence was produced for verifying correctness of data supplied by assessee, Assessing Officer was justified in rejecting DCF method and adopting Net Asset Value method.

CASE LAWS UNDER 56(2)(viib)

Implication under Amalgamation-under erstwhile section 11UA(viia)

ACIT VS Vertex Projects LLP

IT APPEAL NO. 1187 (HYD.) OF 2018 (trib)

- Where pursuant to scheme of amalgamation several companies amalgamated with assessee-company in which public were not substantially interested and shares of amalgamating companies were received by assessee at a price lower than fair market value of shares, Assessing Officer had rightly charged difference on account of price paid by assessee and FMV of shares as income of assessee under section 56(2)(viia).

CASE LAWS UNDER 56(2)(viib)

Second Level Subsidiary of a company in which public was substantially interested

Apollo Sugar Clinics Ltd

[2019] 105 taxmann.com 254 (Hyderabad - Trib.)

- Second level subsidiary of a company in which public was substantially interested would also be a company in which public is substantially interested u/s. 2(18)(b)(B) of the Act and therefore, provisions of section 56(2)(viib) would not apply to such company.
- The AO accepted the said fact and made addition u/s. 56(1). However, the Tribunal held that the same would not fall within the definition of income and when there is a specific sub-section, it would not get covered general provision and deleted the addition.

CASE LAWS UNDER 56(2)(viib)

Implication at the time of Conversion of Compulsorily Convertible Debentures (CCDs)

Milk Mantra Dairy (P.) Ltd. VS DCIT

IT APPEAL NO. 413 (KOL.) OF 2020 (trib)

- Where assessee converted CCDs into equity shares in relevant assessement year and claimed that entire consideration was received at time of issuance of CCDs, since subsequent conversion entailed receipt of certain consideration by assessee in form of discharge of interest obligation, etc. Held that section 56(2)(viib) would be applicable in the instant case as the said section envisages wider outlook to receipt of any consideration which would not be limited to just receipt of money

WHETHER PREFERENCE SHARES ARE COVERED UNDER SECTION 56(2)(viib)?

Ginni Global (P) Ltd

(ITA No. 1009 of 2018) (Jai. Trib.)

- Preference Shares would also come within the purview of this sub-section as the words used in the section are "shares" and therefore, the scope is not restricted to "equity shares".

APPLICABILITY OF 56(2)(viib) WHERE ADDITIONAL SHARES ARE ISSUED ON A PRO RATA BASIS OF EXISTING SHAREHOLDING

Chhattisgarh Metaliks and Alloys (P.) Ltd. VS ITO

IT APPEAL NO. 102 (RPR.) OF 2019 ITAT

- Where additional shares were issued by assessee-company to its existing shareholders on a pro rata basis, on the basis of their existing shareholding, provisions of section 56(2)(viib) could not be invoked.

CASE LAWS UNDER 56(2)(viib) Intrinsic value of underlying assets

Unnati Inorganics (P.) Ltd

[2019] 109 taxmann.com 165 (Ahmedabad - Trib.)

- The FMV of all the assets whether recorded in the books or not, appearing in the books at their intrinsic value or not, is a sufficient warrant to value the premium on issue of unquoted equity shares by closely held company. Explanation (a)(ii) itself implies that book entry for recognition of intrinsic value is not necessary at all.

CASE LAWS UNDER 56(2)(viib)

Cinestaan Entertainment (P.) Ltd.

(2019) 177 ITD 809 (Del. Trib.)

- The arguments of the assessee that the provision cannot be invoked on a normal business transaction of issuance of shares unless it has been demonstrated by the Revenue authorities that the entire motive for such issuance of shares on higher premium was for the tax abuse with the objective of tax evasion by laundering its own unaccounted money was accepted by the members. Further, where nothing was brought on record that it is unaccounted money of assessee company routed through circuitous channel or any other dubious manner through these accredited investors, the addition was deleted.

CASE LAWS UNDER 56(2)(viib)

Issue of shares by amalgamated company to shareholders of amalgamating company outside the purview of 56(2)(viib)

Ozone India Ltd.

[2021] 126 taxmann.com 192 (Ahmd. Trib.)

- Section 56(2)(viib) when read in conjunction with Memorandum Explaining Finance Bill, 2012 and CBDT Circular No. 3/2012 dated 12-6-2012 is a measures to tax hefty or excessive share premium received by private companies on issue of shares without carrying underlying value to support such premium and thereby enriching itself without paying taxes legitimately due to them. Therefore, issue of shares by amalgamated company to shareholders of amalgamating company in pursuance to scheme of amalgamation does not fall under section 56(2)(viib).

RECEIPT OF SHARES – 56(2)(x)

Receipt of any "Property", other than immovable property:

1. Received for consideration

Difference more than Rs. 50,000

Fair market value > Consideration for transfer

Taxability : The aggregate fair market value of such property as exceeds such consideration shall be taxable in hands of the recipient

2. Received without consideration

Aggregate Fair market value of property > Rs. 50,000

Taxability : The whole of the aggregate fair market value of such property shall be taxable in hands of the recipient

FAIR VALUATION AS PER RULE 11UA(1)

As required under 56(2)(x)

KEY TERMS – 11U

Valuation date

- Date on which property or consideration is received by the assessee

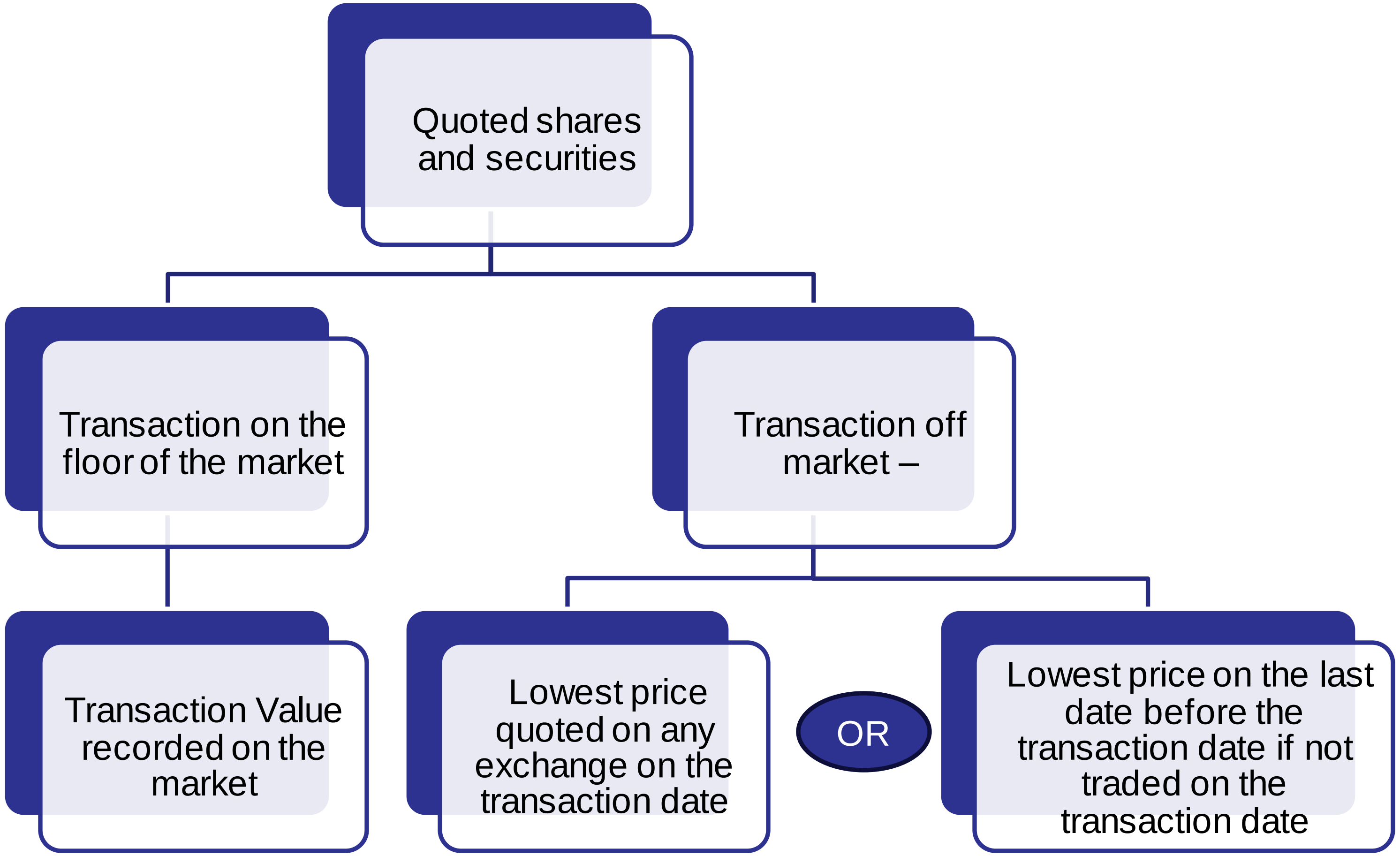
Balance sheet

- Indian Company - balance-sheet on the valuation date, audited as per laws relating to companies in force
- Other than Indian Company - balance-sheet on the valuation date, audited by the auditor (if any), under the laws in which company is registered or incorporated

Quoted equity shares

- Shares quoted with regularity on a recognised stock exchange [does not refer frequently traded]
- Quotation based on current transaction in ordinary course

VALUATION OF SHARES AND SECURITIES – RULE 11UA(1)(c)(a)



VALUATION OF SHARES AND SECURITIES – RULE 11UA(1)(c)(b)

Also deemed income in the hands of seller u/s.50CA

Unquoted equity shares

- Book value of assets other than specified under
- Jewellery artistic work at open market value (Valuation Report by Registered Valuer)
- Shares and securities as per this rule
- Stamp duty value for immovable properties

Less:

- Liabilities (minus- paid up capital, amount set apart for payment of dividend, reserves and surplus, provision for tax in excess of tax paid, provision for unascertained liabilities, liabilities that are contingent)

UNQUOTED EQUITY SHARES VALUATION– RULE 11UA(1)(c)(b)

	Particulars		Rs.
A =	Book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property)		xx
Less:	Amount of income tax paid, less the amount of income-tax refund claimed		xx
Less:	Amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset		xx
		Total A	xx
			xx
B =	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		xx
C =	FMV of shares and securities as determined in the manner provided in this rule		xx
D =	Value adopted or assessed or assessable by any authority of the government for the purpose of payment of stamp duty in respect of the <u>immovable property</u>*		xx
L =	Book value of liabilities		xx
Less:	Paid-up capital in respect of equity shares		xx
Less:	Amount set apart for payment of dividends on preference shares and equity shares		xx
Less:	Reserves and surplus other than for depreciation (net off negative balance of P & L)		xx
Less:	Provision for taxation (excluding (advance tax- refund due, if any))		xx
Less:	Provisions for liabilities other than those for ascertained liabilities (General Contingency Provision)		xx
Less:	Contingent Liabilities other than cumulative preference shares		xx
		Total L	xx
	A + B + C + D - L		xx
	PE = Paid-up equity share capital as shown in Balance Sheet		xx
	PV = Paid-up value of equity share capital as shown in Balance Sheet		xx
	Value per share (in Rs.) = (A + B + C + D - L) * (PV) / (PE)		xx

*Refer next slide

WHETHER LEASEHOLD RIGHTS ARE CONSIDERED AS IMMOVABLE PROPERTY UNDER 56(2)(x) ?

- Definition of property under 56(2)(x) includes:
  - Immovable Property being land or building or both;

- Hence, leasehold rights or right of use should not be considered as immovable property for 56(2)(x).

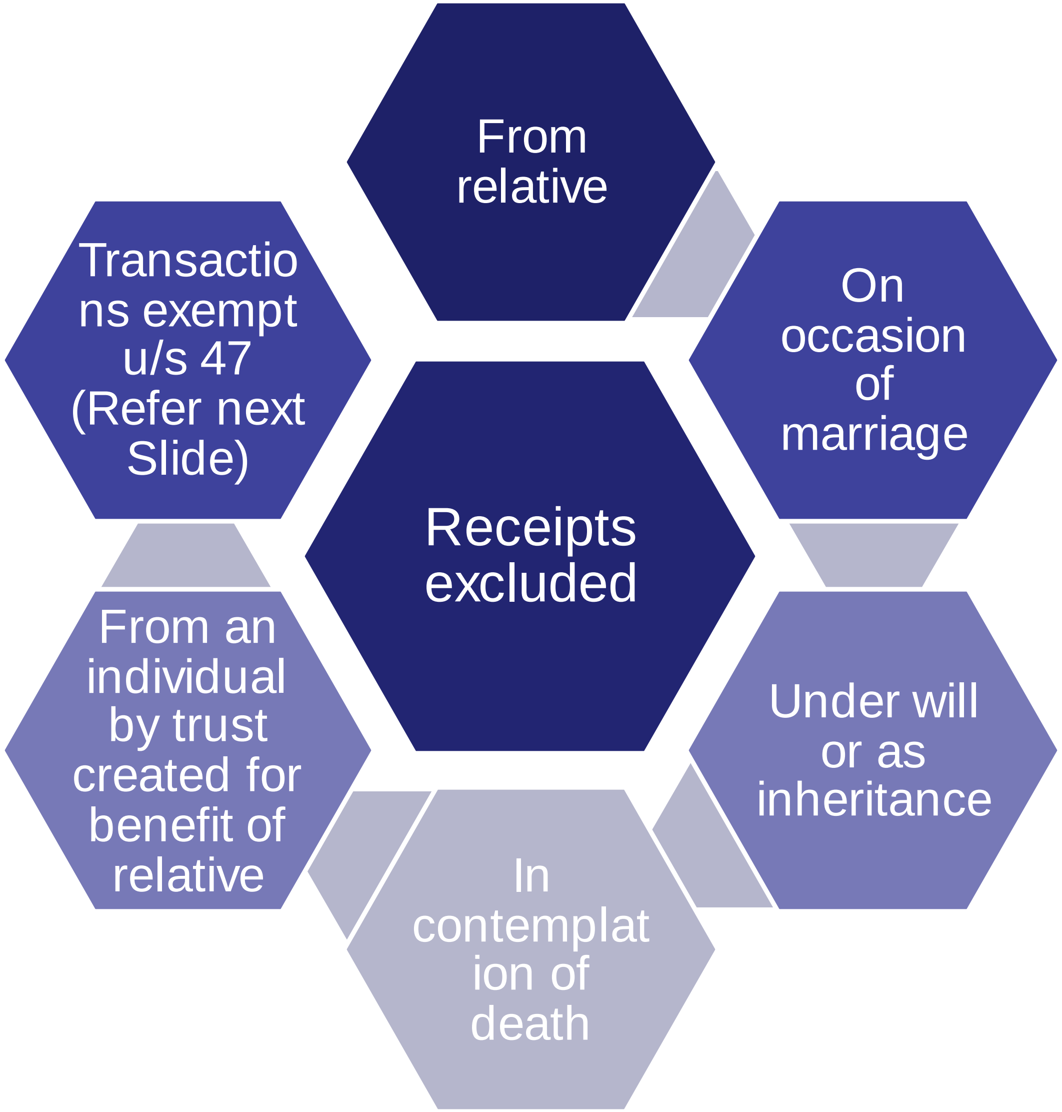
➢ Implication: Fair Valuation or Revaluation of Leasehold rights or Right of use asset will not be required for determination of fair value of unquoted equity shares under Rule 11UA.

VALUATION OF SHARES AND SECURITIES – RULE 11UA(1)(C)

Unquoted shares and securities other than equity shares

- Price it would fetch if sold in the open market on the valuation date
- Assessee to obtain a report from a merchant banker or an accountant in respect of such valuation

RECEIPTS EXCLUDED UNDER 56(2)(x)



Relative:

In case of an individual—

(*A*) spouse of the individual;

(*B*) brother or sister of the individual;

(*C*) brother or sister of the spouse of the individual;

(*D*) brother or sister of either of the parents of the individual;

(*E*) any lineal ascendant or descendant of the individual;

(*F*) any lineal ascendant or descendant of the spouse of the individual;

(*G*) spouse of the person referred to in items (*B*) to (*F*); and

In case of a Hindu undivided family, any member thereof;

TRANSACTION NOT REGARDED AS TRANSFER UNDER SECTION 47 – RELEVANT FOR 56(2)(x)

- Any distribution of capital assets on the total or partial partition of a Hindu undivided family [47(i)]
- Transfer of a capital asset between holding company and wholly owned subsidiary (Indian Co.) [47(iv) and 47(v)]
- Any transfer ,in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company [47(vi) and 47(via)]
- Any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a shares held by him in the amalgamating company (Indian), if the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company [47(vii)]
- Any transfer, in a demerger, of a capital asset by the demerged company to the resulting company [47(vib) and (vic)]
- Any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of demerger of the undertaking [47(vid)]
- Any transfer in a business reorganisation, of a capital asset by the predecessor co-operative bank to the successor co-operative bank [47(vica)]
- Any transfer by a shareholder, in a business reorganisation, of a capital asset being a share or shares held by him in the predecessor co-operative bank, if the transfer is made in consideration of the allotment of any shares in the successor co-operative bank [47(vicb)]
- Any transfer, in a relocation, of a capital asset by the original fund to the resulting fund [47(viiac)]
- Any transfer by a shareholder or unit holder or interest holder, in a relocation, of a capital asset being a share or unit or interest held by him in the original fund in consideration for the share or unit or interest in the resultant fund [47(viiad)]
- Any transfer of capital asset by India Infrastructure Finance Company Limited to an institution established for financing the infrastructure and development, set up under an Act of Parliament and notified by the Central Government [47(viiae)]
- Any transfer of capital asset, under a plan approved by the Central Government, by a public sector company to another public sector company notified by Central Government or to Central Government or to a State Government [47(viiaf)]

INTERPLAY BETWEEN SECTION 56(2)(x) AND 50CA

Property	Scenario	In the hands of the transferor	In the hands of the transferee
Unquoted share	Transferred below FMV as per Rule 11UA	Section 50CA Deemed Capital Gains = Fair Market Value - Consideration	Section 56(2)(x) Deemed IFOS = Fair Market Value - Consideration

Incidence of double taxation – Same amount taxed in the hands of transferor as well as transferee
However, the value considered for 56(2)(x) shall be allowed as cost of acquisition u/s 49(4) when the asset is subsequently transferred

INTERPLAY BETWEEN SECTIONS 56(2)(x), 50CA AND 45(3)

Individual → Firm

Introduction of shares as capital contribution ; Recorded in books of the firm at less than FMV

45(3)/50CA- ?

56(2)(x)- ?

ITO VS Shrilekha Business Consultancy (P.) Ltd

IT APPEAL NOS. 1371 OF 2018 AND 1041 (HYD.) OF 2019

- The term "consideration" represents amount lying at the disposal of the assessee firm to do whatever it wants and is not repayable to any person in any manner whatsoever, however shares introduced by partner is repayable by the firm as and when the partner retires. Hence, shares cannot be equated with the term "consideration" within the meaning of section 56(2)(viia).
- The provisions of section 56(2)(viia) deals with transaction/contract between the existing 'firm' and 'any person' which are not in the nature of capital contribution. Hence, "any person" mentioned in section 56(2)(viia), does not cover the partner in respect of his capital contribution.
- The provisions of section 45(3) is a special provision, whereas the provisions of section 56(2)(viia) is a general provision.

WHETHER BONUS SHARES ARE COVERED UNDER SECTION 56(2)(x)?

When there is an issue of bonus shares, money remains with company and nothing comes to shareholders as there is no transfer of property, and thus, provisions of section 56(2)(x) are not attracted

PCIT vs. Dr. Ranjan Pai

[(2021) 431 ITR 250 (Karnataka)]

DCIT vs. Smt. Mamta Bhandari

[IT Appeal No. 5681 (Delhi) of 2016 (Delhi Trib.)]

WHETHER RIGHT SHARES ARE COVERED UNDER SECTION 56(2)(x)?

Sudhir Menon vs ACIT

IT APPEAL NO. 4887(MUM.) OF 2013

- Where additional shares of a company were allotted pro rata to shareholders including assessee based on their existing shareholding, there was no scope for any property being received on said allotment of shares and, consequently, provisions of section 56(2)(vii)(c) did not apply

IT APPEAL NO. 5748 (MUM.) OF 2017 ITO VS Rajeev Ratanlal Tulshyan

- Where shares of a company were allotted proportionately to assessee shareholder based on its existing shareholding, there was no scope for any property being received on said allotment of shares and, consequently, provisions of section 56(2)(vii)(c) did not apply to difference in book value and face value of such shares allotted

REPORT UNDER RULE 11UA– MERCHANT BANKER OR CHARTERED ACCOUNTANTS

- Report by Merchant Banker
  - Valuation under Rule 11UA (1)
  - Valuation under Rule 11UA (2)(a) – NAV Method
  - Valuation under Rule 11UA (2)(A)(b) – DCF Method
  - Valuation under Rule 11UA (2)(A)(d) – Other methods as specified

- Report by Chartered Accountants
  - Valuation under Rule 11UA (1)
  - Valuation under Rule 11UA (2)(a) – NAV Method

INDIRECT TRANSFER UNDER SECTION 9(1)(i)

- All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India
- As per explanation 5, an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India
- The value of an asset shall be the fair market value as on the specified date, of such asset without reduction of liabilities, if any, in respect of the asset, determined in such manner as may be prescribed – Rule 11UB

KEY TERMS UNDER SECTION 9

- **Assets** – For the purpose of Sec 9, asset shall include value of asset (tangible and intangible) which shall be FMV as on specified date without reduction of liabilities in respect of the asset [gross assets]
- **Specified date** means the –
  i. date on which the accounting period of the company ends preceding the date of transfer of a share or an interest; or
  ii. date of transfer, if the book value of the assets of the company on the date of transfer exceeds the book value of the assets as on the date referred to above, by 15%.

KEY TERMS UNDER SECTION 9

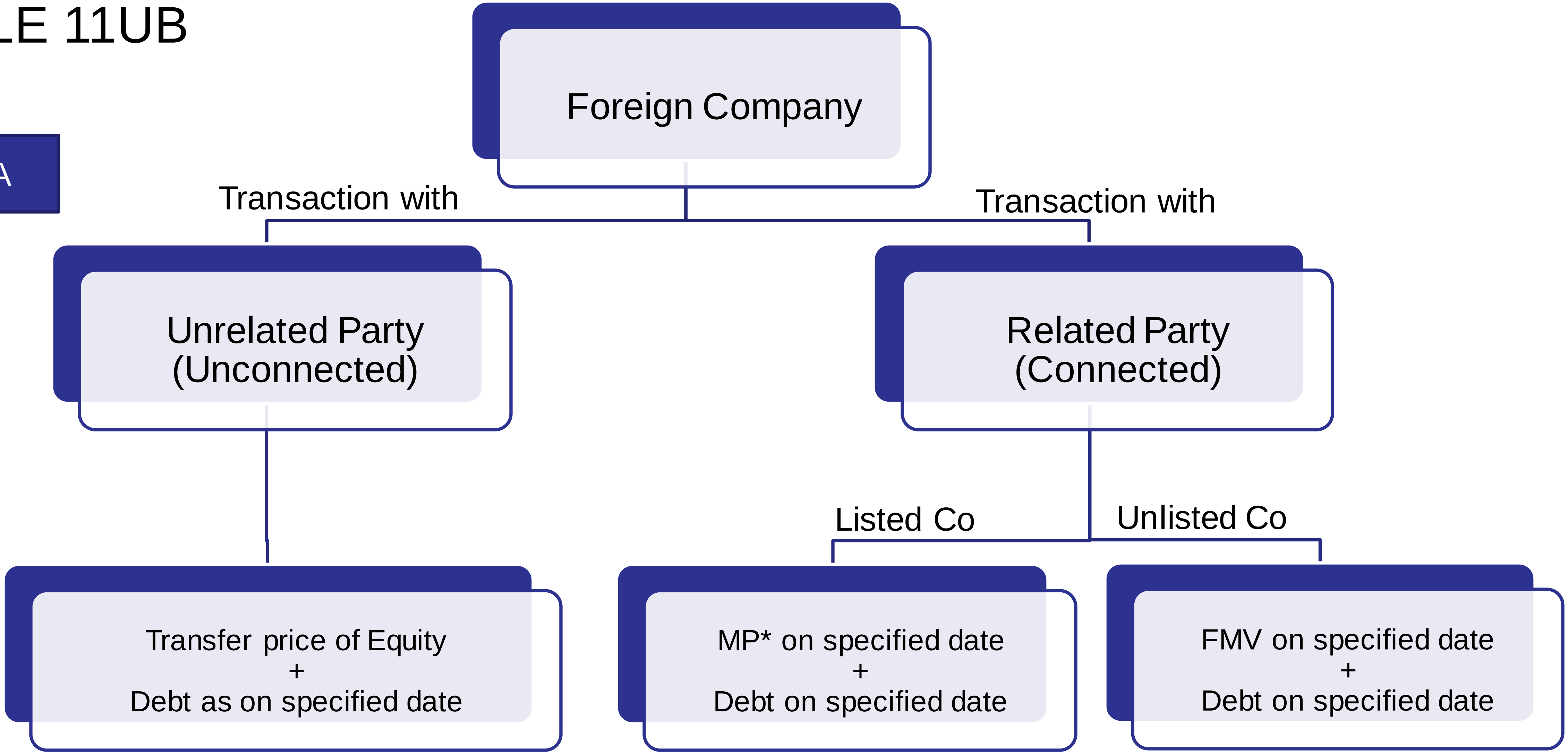
Specified Date

- BV* of assets on date of transaction > (By more than 15%) BV of assets on date of last balance sheet → Date of Transfer
- Other than above → Date of last Balance Sheet

BV stands for Book Value of Assets

RULE 11UB

A



*MP- Market Price

RULE 11UB

B

Indian Company (per share)

- **If Equity is listed**

$$\frac{\left(\text{MV on spot date} + \text{Debt on spot date}\right)}{\text{No. of Shares}}$$

- **If not listed**

$$\frac{\left(\text{FMV on specified date} + \text{Debt on specified date}\right)}{\text{No. of Shares}}$$

RULE 11UB

$$\frac{\mathbf{(B)}\ \text{X no. of shares}}{\mathbf{(A)}} > \text{50\% then 9(1)(i)}$$

It may herein be noted that Numerator shall be the value of Indian Assets held by Foreign Company and the denominator shall be the value of Foreign Company (grossed-up);

VALUATION REQUIREMENTS UNDER INCOME TAX ACT,1961

Valuation Reference	Valuation Requirement
Issue of shares (from Issuer perspective)	Valuation of shares and securities u/s 56(2)(viib) of the Income-tax Act, 1961 and Rule 11UA(2) of Income Tax Rules, 1962
Transfer of shares (from subscriber's perspective)	Valuation of shares and securities u/s 56(2)(x) of the Income-tax Act, 1961 and Rule 11UA(1)(c) of Income Tax Rules, 1962
Slump sale of business	Section 50B Rule 11UAE
Income deemed to accrue or arise in India in case of indirect transfer of Shares	Valuation of shares and securities u/s 9(1)(i) of the Income-tax Act, 1961 and Rule 11UB and 11UC of Income Tax Rules, 1962
Valuation of perquisites in respect of ESOPs / sweat equity shares	Valuation of shares and securities u/s 17(2)(vi) of the Income-tax Act, 1961 and Rule 3(8) and 3(9) of Income Tax Rules, 1962

FEMA

R - Resident
NR - Non-Resident

Shares of an Indian Company

Issue of Shares to NR

- **Listed Shares**
  Not less than price as per SEBI Guidelines or SEBI (Delisting of Equity Shares) Regulations, 2009
- **Unlisted Shares**
  Not less than fair value as per Internationally accepted pricing methodology on an arm's length basis*

Transfer of Shares

By R to NR

- **Listed Shares**
  Not less than
  1) price as per SEBI Guidelines
  2) SEBI Guidelines on preferential allotment
- **Unlisted Shares**
  Not less than fair value as per Internationally accepted pricing methodology on an arm's length basis*

By NR to R

- **Listed Shares**
  Not more than
  1) price as per SEBI Guidelines and
  2) SEBI Guidelines on preferential allotment
- **Unlisted Shares**
  Not more than fair value as per internationally accepted pricing methodology on an arm's length basis*

** By a certified Chartered Accountant/ SEBI registered Merchant Banker/ Practising Cost Accountant*

JV – Joint Venture
WOS – Wholly Owned Subsidiary

Foreign Security

Direct Investment in JV / WOS - Outbound Investments

- **Investment by R**
  - Investment > USD 5 Million – Category I Merchant Banker registered with SEBI or Merchant banker / Investment Banker with appropriate authority in host country
  - Investment =< USD 5 Million – CA/CPA
- **Transfer by R**
  - Listed Security: Price on Stock Exchange
  - Unlisted Security: Not less than price determined by CA/CPA

VALUATION REFERENCE	VALUATION REQUIREMENT
Acquisition through rights issue issue	Listed Indian Co. – Shall be at a price determined by the company Unlisted Indian Co. - Shall not be at a price less than the price offered to persons resident in India
Issue of shares by an Indian Company to a person resident outside India	For Listed Entities – As per SEBI Regulations For Unlisted Entities - As per any internationally accepted pricing methodology by a Chartered Accountant or a Merchant Banker or a practising Cost Accountant
Transfer of shares from a person resident in India to a person resident outside India	For Listed Entities – As per SEBI Regulations For Unlisted Entities - As per any internationally accepted pricing methodology by a Chartered Accountant or a Merchant Banker or a practising Cost Accountant
Transfer of shares by a person resident outside India to a person resident in India	For Listed Entities – As per SEBI Regulations For Unlisted Entities - As per any internationally accepted pricing methodology by a Chartered Accountant or a Merchant Banker or a practising Cost Accountant
Swap of capital instruments	Merchant Banker / Investment Banker
Fresh Issue of Indian Company Shares by subscription to Memorandum of Association to a Person Resident outside India	Can be done at face value subject to entry route and sectoral caps. Valuation report is not required.
Issue of warrants/convertible instruments	To be determined upfront at the time of issuance
Outbound Investments	Based on limit of USD 5mn

SUMMARY OF IMPLICATIONS UNDER FEMA

Valuation Purpose	Valuation Professional	Valuation Approach
Issue of shares by an unlisted Indian Company to a person resident outside India	Chartered Accountant / Merchant Banker / a practising Cost Accountant	As per any internationally accepted pricing methodology
Transfer of shares from a person resident in India to a person resident outside India by an unlisted company	Chartered Accountant / Merchant Banker / a practising Cost Accountant	As per any internationally accepted pricing methodology
Transfer of shares by a person resident outside India to a person resident in India	Chartered Accountant / Merchant Banker / a practising Cost Accountant	As per any internationally accepted pricing methodology
Swap of equity instruments	Merchant Banker / Investment Banker outside India	No specific methodology prescribed
Outbound Investments of more than USD 5mn	Merchant Banker / Investment Banker outside India	No specific methodology prescribed
Outbound Investments of less than USD 5mn	Chartered Accountant / CPA	No specific methodology prescribed

THANK YOU