Taxsutra Special

Rule 11UA Compilation - Unraveling Important Facets of Share Valuation Norm, Significant Rulings & More!

I. Valuation Rules – Understanding the intricacies

The Income Tax Act emphasizes on the requirement of 'Fair Market Value' in numerous provisions. Rule 11UA / 11UAA prescribes valuation methodology for arriving at FMV of immovable property, jewellery, shares – both quoted and unquoted etc, for the purposes of anti-abuse provision contained in Sec. 56(2)(viib)/56(2)(x).

While determination of fair market value of quoted shares is directly linked to the stock exchange price, the income tax rules prescribe the following formulae for the valuation of unquoted shares:

Rule 11UA(1) reads as under: [*relevant for Sec. 56(2)(x)*]

(c) valuation of shares and securities, —

(a) ….;

(b) the fair market value of **unquoted equity shares** shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner, namely: -

> In this regard, it is pertinent to note that for the value of the share is to be determined based on the book value of assets **as on the valuation date** and not the balance sheet date. **Manish Shah** (Senior Partner at Sudit K Parekh & Co in 2019) in his article Delving into the Practical Difficulties in Applying Rule 11UA Valuation remarked that closing the financials and audit thereof alongside the transaction closing date is practically a task impossible to perform.

Formula: **(A+B+C+D -L) × (PV)/(PE),** where,

A= book value of all the assets (other than "**specified assets" namely** jewellery, artistic work, shares, securities and immovable property) in the balance-sheet as reduced by income tax paid and any deferred expenditure.

> On whether deferred tax asset [DTA] should form part of 'assets' while arriving at FMV calculation, **Mr. Gautam Doshi** in the recent webinar hosted by **Taxsutra** clarified that though the income tax paid is to be excluded, there is no specific reference to DTA. Mr. Doshi then hinted towards the reference to a "notional asset" which doesn't represent any asset and opined that "*one may bring DTA within that…*"

B = Market value of jewellery and artistic work on the basis of the valuation report obtained from a registered valuer.

C = **fair market value** of shares and securities as determined in the manner provided in this rule; [See sub rule (c)]

Prior to amendment to Rule 11UA w.e.f 1st April 2017, book value was adopted even for shares and securities for computing FMV of unquoted equity shares. However, pursuant to CBDT notification dated 13th July 2017, fair market value of shares and securities held by the company is to be adopted.

In this regard, it is pertinent to note that in case of [TS-598-ITAT-2018(Mum)] Mumbai ITAT had rejected substitution of book value with fair value of shares while valuing unquoted shares for AY 2013-14 [pre-amendment].

Discussing the practical difficulties that one may encounter while determining the FMV of shares & securities (for Sec.56(2)(x) purposes), **Tax Wizard Gautam Doshi,** in the webinar hosted by **Taxsutra,** illustrated that while valuing share value of A, where A owns shares of B, B owns shares of C, which in turn owns an immovable property, first the immovable property is to be valued to determine share value of C, required to value shares of B and ultimately shares of A. **Mr. Doshi** remarked that "*It is an extremely difficult exercise….*" Further, Mr. Doshi also highlighted that "*the rule would fail in case of cross holdings*"

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) Equity Paid up Capital;

Highlighting the practical difficulties arising after the introduction of Ind-AS, **Hiten Kotak** (M& A Tax Leader in 2019 for PWC India) and **Nilesh Mody** (Partner, M&A Tax) explained that under the Ind AS regime, part of compound financial instruments such as compulsorily convertible debentures (CCDs) are disclosed under "other equity." However, under the Indian GAAP, the CCDs would be considered as debt and disclosed under liability till they are converted. In their article, they explained that such disclosure variance would impact the valuation under Rule 11UA.

(ii) Amount set apart for dividend for preference and equity shares;

(iii) reserves and surplus, other than reserve set apart towards depreciation;

(iv) Provision for tax;

(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;

In this context, Delhi ITAT in [TS-799-ITAT-2019(DEL)] clarified that 'Total liabilities' included preference share capital for valuation of unquoted equity share under Rule 11UA.

PV= the paid up value of such equity shares;

PE = total amount of paid up equity share capital as shown in the balance-sheet;

(c) the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of which such valuation.

<u>11UA(2) reads as under *[relevant for Sec. 56(2)(viib)]*:</u>

Notwithstanding anything contained in sub-clause (b) of clause (c) of sub-rule (1), the fair market value of unquoted equity shares for the purposes of sub-clause (i) of clause (a) of Explanation to clause (viib) of sub-section (2) of section 56 shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner under clause (a) or clause (b), **<u>at the option of the assessee</u>**, namely:—

Mumbai ITAT in case of [TS-608-ITAT-2019(Mum)] held that the method of valuation i.e. NAV method or Discounted Cash Flow (DCF) method to determine the FMV has to be adopted at assessee's option and the AO cannot change the method of valuation opted by the assessee.

(a) the fair market value of unquoted equity shares

$$(A–L) \times (PV)/(PE)$$

where,

A = book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;

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) Amount set apart for dividend for preference and equity shares

(iii) reserves and surplus, other than reserve set apart towards depreciation;

(iv) Provision for tax

(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; or

(b) the fair market value of the unquoted equity shares determined by a merchant banker or an accountant* as per the Discounted Free Cash Flow method.

*The word 'accountant' was omitted w.e.f 24th may 2018.

Bangalore ITAT in [TS-4-ITAT-2019(Bang)] laid down guidelines regarding application of DCF method of share valuation. Further, Mumbai ITAT in case of [TS-831-ITAT-2019(Mum)] held that comparison of actuals against projections while valuing shares under DCF method as 'harsh' and 'not proper'.

In 2018, Bangalore ITAT in case of [TS-762-ITAT-2018(Bang)] had held that the auditor cannot be an accountant for the purposes of Rule 11UA(2) for AY 2015-16.

The difference in method of valuation of equity shares u/s 56(2)(viib) and 56(2)(x) can be tabulated as under:

Section	Sec.56(2)(viib)	Sec.56(2)(x)
Applicable Rule	Rule 11UA(2)	Rule 11UA(1)(c)(b)
Transaction	In case of fresh issuance of shares	Any person receiving the share or security
Method prescribed for computation of FMV	DCF Method or Book value (NAV) calculated without adjusting for specified assets, at the option of the assessee	Book Value calculated after adjusting for specified assets
Valuer	Only Merchant Banker for DCF, NAV method not prescribed	Not prescribed
Valuation to be done based on -	Balance sheet drawn on the valuation or the last drawn balance sheet which is approved at the AGM by the shareholders	Balance sheet drawn up on the valuation date, duly audited by the auditor of the company

Another interesting issue was highlighted by **Tax Wizard Gautam Doshi** in his recent Webinar hosted by **Taxsutra** relating to interplay of Sec.56(2)(viib) and Sec.56(2)(x). Illustrating with an example, Mr. Doshi explicated that a situation may arise whereby value determined for the purpose of Sec.56(2)(x) using NAV after adjusting value of specified assets may be higher (say 200) than the value determined for the purpose of Sec.56(2)(viib) [without adjusting for the value of specified asset as envisaged in the rule], say 150. This would mean that if the company issued shares at a value more than 150, the company would be liable to tax on the excess and if the shareholder receives a share at a price lower than FMV 200, such shareholder would be liable to tax on the differential.

II. Case Laws

Sl.No	Case Law	Citation
1	ITAT: Subsequent share-purchase by NR at higher price justifies assessee's share valuation; Deletes addition u/s 56(2)(viib)	[TS-3-ITAT-2020(DEL)]
2	ITAT: Revenue's 'projections vs. actuals' comparison for verifying rights-shares valuation - 'improper'; Deletes addition u/s 56(2)(viib)	[TS-831-ITAT-2019(Mum)]
3	ITAT: Total liabilities include preference share capital for unquoted equity share valuation under Rule 11UA	[TS-799-ITAT-2019(DEL)]
4	ITAT: Rejects FMV substitution on share-sale pre- AY 2018-19; Sec.50CA applicable prospectively	[TS-790-ITAT-2019(Ahd)]
5	ITAT: Deletes Rs.100 cr. addition u/s. 56(2)(viia); Rule 11U inapplicable to foreign co. shares pre-2019 amendment	[TS-674-ITAT-2019(Mum)]
6	ITAT: AO can't change assessee's share-valuation method for Sec. 56(2)(viib) purposes, remits matter for FMV re-computation	[TS-608-ITAT-2019(Mum)]
7	ITAT: Fair value, not book value relevant for share-valuation under second limb of Sec. 56(2)(viib) Explanation (a)	[TS-594-ITAT-2019(DEL)]
8	ITAT: Assessee's share-valuation 'well-substantiated'; Deletes Sec.56(2)(viib) addition by invoking Rule 11UA	[TS-568-ITAT-2019(Ahd)]
9	ITAT: Revaluation reserve not to be deducted while calculating share FMV as per Rule 11UA(2)	[TS-348-ITAT-2019(Kol)]
10	ITAT: AO can't question ace Investors' wisdom; Tinkering with assessee's DCF Valuation method unwarranted	[TS-347-ITAT-2019(DEL)]
11	ITAT: No provision in IT-Act to round-off share valuation to next rupee u/s Sec 56(2)(viib)	[TS-335-ITAT-2019(Kol)]
12	ITAT: Date of issuing preference shares, relevant for NAV valuation for Sec. 56(2)(viib) purposes	[TS-275-ITAT-2019(JPR)]
13	ITAT: AO cannot whimsically decline assessee's valuation-method, accepted in succeeding AY for Sec.56(2)(viib) purposes	[TS-262-ITAT-2019(ASR)]
14	ITAT: CIT(A) can't impose Rule 11UA when taxpayer 'substantiated' higher valuation u/s. 56(2)(viib) before AO	[TS-130-ITAT-2019(DEL)]
15	ITAT: No Sec. 68 addition for share premium charged in excess of FMV valuation as per Rule 11UA	[TS-110-ITAT-2019(Mum)]
16	ITAT: Share-allotment date, not share-application, relevant for angel tax trigger u/s. 56(2)(viib)	[TS-93-ITAT-2019(DEL)]

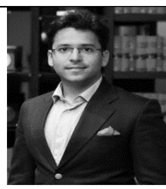
Sl.No	Case Law	Citation
17	ITAT: Discards DCF valuation for Sec.56(2)(viib) purposes as actuals 'long long away' from projections	[TS-92-ITAT-2019(Bang)]
18	ITAT: Lays down guidelines regarding application of DCF method of share valuation for Sec 56(2)(viib)	[TS-4-ITAT-2019(Bang)]
18	ITAT: Allows loss claim on 'listed' shares sold off-market; Rejects 'Colorable device' plea	[TS-769-ITAT-2018(Ahd)]
19	ITAT: Auditor not 'accountant' for share valuation under Rule 11UA; Affirms AO's NAV based valuation	[TS-762-ITAT-2018(Bang)]
20	ITAT: Remands convertible preference shares valuation for taxation u/s. 56(2)(viib) by determining 'true' nature of shares	[TS-756-ITAT-2018(Bang)]
21	ITAT: Deletes Sec 68 addition representing excess price over DCF-Valuation, 'nature & source' established	[TS-628-ITAT-2018(Mum)]
22	ITAT: Directs 'objective' evaluation of share valuation report for examining taxability u/s 56(2)(viib)	[TS-616-ITAT-2018(DEL)]
23	ITAT: Rejects Revenue's unquoted shares valuation by substituting book value with fair value pre-2017	[TS-598-ITAT-2018(Mum)]
24	ITAT: Rejects NAV based valuation for preference shares; Deletes excess premium addition	[TS-541-ITAT-2018(Mum)]
25	ITAT: Deletes share-premium addition u/s 56(2)(viib); AO cannot change assessee's valuation method	[TS-523-ITAT-2018(JPR)]
26	ITAT: Deletes Rs 69 cr TP-adjustment on AE-share sale; Rejects Revenue's 'perpetual growth rate' based valuation	[TS-7-ITAT-2018(Mum)]
27	ITAT: AO can reject the DCF method and go by NAV method to determine the FMV of the shares.	[TS-7311-ITAT-2018(DELHI)-O]
28	ITAT: Assessee entitled to choose method of share valuation under Rule 11UA; AO cannot insist otherwise	[TS-6963-ITAT-2018(MUMBAI)-O]
29	ITAT: Deletes Sec. 56(2)(viib) addition on preference shares; Approves valuer's FMV calculation	[TS-587-ITAT-2017(Kol)]
30	ITAT: Deletes 'deemed-gift' addition u/s 56(2)(viia); Higher of share-purchase prices, not FMV	[TS-129-ITAT-2016(HYD)]
31	ITAT: Share valuation under FEMA irrelevant for computing capital gains	[TS-146-ITAT-2013(DEL)]
32	SC: Valuation of shares to be done as per market value and not face value	[TS-4-SC-1971]

III. Notifications and Circulars

ICAI: Urges CBDT to reconsider notification making CAs ineligible for determining unquoted shares FMV
Unquoted shares valuation guidance largely similar to draft rules
CBDT releases draft rules prescribing 'unquoted shares' valuation for purposes of Sec. 56(2)(x)/50CA
CBDT notifies fair valuation guidelines for private co's share allotment

IV. Expert Columns

2019

Share Transactions Taxability - A Daunting Affair to Manoeuvre around Deeming Provisions?

Vishwas Panjiar (Partner, Nangia Advisors [Andersen Global]) and Chirag Nangia (Director)

Exploiting Loopholes in Unquoted Share Valuation under Rule 11UA

Smarak Swain (IRS officer)


Interplay between Tax and Ind- AS

Sec. 56(2)(viib) on Excess Share Premium Taxability - as the Dust Settles.....

Hiten Kotak (Leader, M&A Tax, PwC India) and Nilesh Mody (Partner)

Angel Tax Issue - Are Grey Clouds Meandering the 'Valuation' Horizon?

Delving into the Practical Difficulties in Applying Rule 11UA Valuation....

Manish Shah (Senior Partner, Sudit K Parekh & Co)

Anatomizing Bangalore ITAT's Innoviti decision on angel tax

K.K. Chythanya (Advocate)

2018

[Angel Tax for Start-ups - DCF creating a hullaballoo?]

Smarak Swain (IRS officer)

2017

[CBDT's final rules for unquoted shares - Do they give a 'fair' picture for valuation?]

Hemal Zobalia (Partner, Deloitte Haskins and Sells LLP) and Jimit Devani (Partner)

[Valuation of unquoted shares- Amended Rule - 11UA- An analysis]

Rohit Garg (DMD Advocates)

[Transfer of shares below FMV - a double taxation enigma]

Nilesh Vichare (Executive Director, EY)

[Draft rules for 'unquoted' shares valuation - Outlining the grey areas]

K R Girish (KR Girish & Associates)

[Valuation norms for unquoted stock - Book value no longer "fair"]

Hiten Kotak (Leader, M&A Tax, PwC India) and Falguni Shah (M&A Tax Partner)

2015

[Taxing share transfers within closely held companies u/s 56: Double edged sword – Part 1] and [Part 2]

K R Girish (Senior partner, LeapRidge Advisors)

2014

  [Share issue by unlisted companies - Decoding the provisions] **Sridhar Raman (VP Taxation, Hindustan Coca-Cola Beverages Pvt Ltd) and Rahul Goenka (Corporate Manager Tax)**	 [Issuing share capital - Danger Ahoy!] **N.C. Hegde (Partner) & Sandeep Dasgupta (Senior Manager), Deloitte Haskins & Sells**

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