Rules for Valuation of Unquoted Equity Shares

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Background

Finance Act, 2017 came up with two major amendments in the Income Tax Act, 1961, in order to curb malpractice of avoidance of capital gains tax on transfer of shares, taxing the shortfall in FMV & sale consideration in the hands of both transferor and transferee by way of:

- Inserting clause (x) under Section 56(2) to provide that receipt of money or specified property by any person for inadequate consideration or without consideration from any person shall be chargeable to tax in the hands of transferee.
- Introducing Section 50CA to provide that where consideration for transfer of shares of a company other than a quoted share is less than the Fair Market Value (FMV) of such a share, the FMV determined as per the Rules shall be deemed to be the full value of consideration for computing income under the head Capital Gains in the hands of transferor.

For the purpose of computing the FMV of unquoted shares of company under Section 56(2)(x) and Section 50CA respectively, the CBDT issued a draft set of amended Rule 11UA and new Rule 11UAA on 5th May, 2017 inviting public comments. After analysis of various pros and cons based on feedbacks received on draft valuation rules, the CBDT has notified the final rules vide Notification No. 61 dated 12th July, 2017, which are largely similar to draft rules and shall be effective from 1st April, 2018 and shall apply in relation to assessment year 2018-19 and subsequent years.

Final Valuation Rules

The Final Rule 11UA(1)(c)(b), replaces the existing Rules, prescribes valuation methodology to be adopted for the ascertaining FMV, as on the valuation date, as specified under section 50CA

FMV of Unquoted Equity Shares = (A + B + C + D - L) * (PV)/(PE)

Where A represents,

Book Value of all assets (other than jewellery, artistic work, shares, securities and immovable property) in the Balance Sheet as reduced by:

- Any amount of income-tax paid, less the amount of income-tax refund claimed, if any; and
- Any amount shown as asset including the unamortised deferred expenditure which do not represent the value of any asset

Where B represents,

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.

Where C represents,

a) In respect of Quoted Shares / Securities:
  - Transaction Value recorded on such Recognised Stock Exchange (RSE) if received by way of transaction through RSE.
  - Average of lowest and highest price of shares/securities quoted on recognised stock exchange on valuation date or date preceding valuation date (if shares not traded on valuation date) if received by way of transaction carried out other than through RSE.

b) Unquoted Equity Shares – Value as determined by this Rule

c) Unquoted Shares / Securities (other than Equity shares) - Amount that would be fetched if sold in open market based on valuation report, certified by Merchant Banker or a Chartered Accountant.

Where D represents,

Stamp duty value assessed or assessable by any Government Authority

Where L represents,

Book Value of liabilities in the Balance Sheet, excluding the following amounts:
- The paid-up capital in respect of equity shares;
- The amount set apart for payment of dividends on preference shares and equity shares only if such dividends are not declared before date of transfer, at a general body meeting of the company;
- Reserves and surplus, by whatever name called, even if the resulting figure is negative, other than amount set apart towards depreciation;
- Any amount representing provision for taxation, other than amount of income-tax paid net of 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;
- Any amount of provisions made for meeting unascertained liabilities;
- Any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares

Where PV represents,

The paid-up value of such equity shares

Where PE represents,

Total amount of paid-up equity share capital as shown in the Balance Sheet

Valuation Date and Audit

It is to be noted that the valuation date represents the Date of transfer/receipt of equity shares and the Balance Sheet as on valuation date needs to be audited by the Statutory Auditors of the Company.

Key Pointers

- The amended Rule 11UA(1)(c)(b) has removed the inconsistency in erstwhile rule (which was based on book value of assets and liabilities) by considering valuation adjustment of such assets for which specific valuation rules were provided for determination of FMV while valuation of other assets and liabilities continues to be at book value.
- The erstwhile valuation rules permitted the use of the Balance Sheet adopted in the last concluded Annual General Meeting (AGM) before the date of transfer. However, the final valuation rules does not contain such provision, rather it requires the Balance Sheet at each valuation date (i.e. date of transfer/receipt) to be audited by Statutory Auditors of the Company. Though this requirement will create additional compliance difficulties, it will be beneficial as it will help in determining FMV based on actual situation of the Company.

Shortcomings to be addressed

Though the final rules have incorporated certain changes by addressing some crucial issues arising from draft rules, they have failed to address some key issues for which clarifications / further updates are anticipated from the CBDT:

- Adoption of actual fair value of immovable property, in case actual FMV is less than the Stamp Duty Value.
- Practical difficulty (or even impossibility) in determining the FMV in case of Cross-holdings of unquoted shares/securities among the companies.
- Difficulty in determining fair value in case of shares/securities held in foreign companies including those listed on Recognised Stock Exchanges overseas.
- There would be practical difficulties in having audited balance sheet as on each date of transaction in case of multiple transfers during the year.
- Valuation methodology with respect to sale of unquoted investment in shares of inter-group companies in case of Real Estate/Infrastructure Industry as Stamp Duty Valuation clause w.r.t. immovable properties will have severe financial impact on their business.
- In case of company having investments in Partnership Firms/LLPs, valuation in such investments still to be done as per book value, which will still be inconsistent with the current set of rules failing to give the actual valuation.

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