

VALUATION OF UNQUOTED EQUITY SHARES

By- CA Premlata Daga Saboo
B.Com, FCA, LCS, DISA (ICAI), Registered Valuer (SFA)

RELEVANT SECTIONS

Particulars	Section 56 2(vii)	Section 56 2(vii a)	Section 56 2(vii b)	Section 56 2(x)
Applicable to	Individual/ HUF	Firm/ Company (closely held)	Company (closely held)	Person as per section 2(31) of the IT Act, 1961
Applicable on	<ul style="list-style-type: none"> • Money • Immovable Property • Property other Immovable Property 	<ul style="list-style-type: none"> • Shares of closely held company 	Issue of Shares	<ul style="list-style-type: none"> • Money • Immovable Property • Property other Immovable Property
Applicable date	From 1st October, 2009 to 31st March, 2017	From 1st June, 2010 to 31st March, 2017	From 1st April, 2013	From 1st April, 2017

SECTION 56 (2) (vii b)

Where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any *person being a resident*, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value shall be deemed to be the income of that company.

Ex: Face Value of share Rs.10/-, Issue Price Rs.50/- and fair Value Rs.30/-. Taxable under this section Rs.20/-(50-30).

Provided that this clause shall not apply where the consideration for issue of shares is received—

- (i) by a venture capital undertaking from a venture capital company or a venture capital fund ⁹[*or a specified fund*]; or
- (ii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf

Explanation.—For the purposes of this clause,—

- (a) the fair market value of the shares shall be higher of the two:
 - (i) as may be determined in accordance with such method as may be prescribed i.e (Rule 11 UA)
 - (ii) as may be substantiated by the company to the satisfaction of the Assessing Officer.

Lets discuss few important question

Q1: Is this section applicable when the amount is received from a Non Resident ?

**Answer: No, this section is applicable only if received from a RESIDENT
(Amended w-e-f 1/4/2024 to include Non-Residents as well)**

Q2: Is this section applicable to issue of Preference Shares ?

Answer: Yes, as the word used in the section is “SHARE” hence it includes all the types of shares.

Q3: What are the exceptions to the section ?

Answer: The provisions of section 56(2)(viib) are not applicable where the consideration for the issue of shares is received:

1. by a venture capital undertaking from a venture capital company or a venture capital fund.
2. by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Q4: What do you mean by venture capital undertaking, venture capital company and Venture Capital Fund

Answer: Venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in Explanation to clause (23FB) of section 10

Q5: Is there any central government notification stating that the provisions of section 56(2)(viib) are not applicable to any particular class/classes of the companies?

Answer: Notification 24/2018 dated 24th May, 2018, read with notification G.S.R. 364(E), subject to the fulfilment of specified conditions.

(Eligible start-up for the purposes of deduction under section 80-IAC)

Q6: Which are the prescribed methods for determination of FMV of shares?

Answer: As per Rule 11UA(2), the FMV can be determined under:

- 1) Net asset value Method(as specified under Rule 11UA(2)(a)) or
- 2) Discounted cash flow method, at the option of the assessee.

Rule 11UA(2),

FMV of unquoted equity shares = (A-L) x 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 unamortized amount of deferred expenditure which does not represent the value of any asset;

L - Book value of liabilities, excluding paid up equity share capital, amount set apart for undeclared dividend, reserves and surplus, provision for tax, provisions for unascertained liabilities and contingent liabilities

PV - Paid up value of such equity shares.

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

NOTE: FOR THIS SECTION THE ASSETS ARE NOT REQUIRED TO BE TAKEN AT FAIR VALUE.

Q7: Who is authorized to issue the valuation report under DCF method for the purpose of section 56(2)(viib)?

Answer: As per Rule 11UA(2)(b) of Income Tax Rules, read with Notification No.23/2018, dated 24th May, 2018, only Merchant Bankers are now authorized to issue valuation reports as per DCF method for the purpose of section 56(2)(viib).

Q8: Whether the AO can disregard the method adopted by the assessee and carry out the valuation of shares using a different method.

In the case of **Innoviti Payment Solutions Private Limited**, the Bangalore Tribunal addressed the issue on the application of DCF methodology and the powers of the AO to inquire into it. In the said case, the assessee could not conclusively establish that the projections used for DCF valuation were prepared scientifically. The Tribunal referred to the Technical Guide on share valuation by a research committee of the ICAI, wherein it was stated that the DCF value is good as the assumptions used in developing the projections, and these projections should consider various factors affecting the business. The Tribunal held that if the assessee has opted for the DCF method, the AO cannot discard it and adopt another method; however, the **AO is well within his rights to examine the methodology adopted by the assessee and the underlying assumptions and if he is not satisfied, he can challenge the same and suggest necessary modifications.**

Decision of the Delhi Tribunal in the case of Agro Portfolio Pvt Ltd :

It was held that since there was no possibility of verifying the correctness of the data supplied by the assessee to the merchant banker, the correctness of the result of DCF method could not be verified. Hence, the AO had no option but to reject the DCF method and to go by the NAV method to determine the FMV of the shares.

Q9: What are the rules for Valuation of Preference Shares ?

Answer: Rule 11UA(2), which is specifically applicable for the valuation of shares for the purpose of section 56(2)(viib) covers only unquoted equity shares within its ambit and there is no reference to the preference shares. Thus, the only method for determining the FMV of the preference shares is Rule 11UA(1)(c)(c), which is reproduced herein below:

"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.

In case of 2M Power Health Management Services Pvt Ltd, the assessee allotted *compulsory convertible preference shares at a premium* and the holders of these preference shares had the *right to attend the general meetings of the company and vote on resolutions directly affecting their interest*. The Tribunal held that with regard to the facts of the case, the nature of the issued share is actually that of an equity share and not preference share. It is important to decide, based on the evidence, if the share premium received is for equity shares to be issued later or for preference shares issued now. If the premium received is mainly for conversion of preference shares into equity, Rule 11UA may not be applicable. From the above judgement, one can infer that *it is very important to identify the basic nature of the securities being issued and the rights attached to it, to determine the valuation methodology under Rule 11UA.*

The Finance Act, 2017 had brought into force two major amendments in the Income Tax Act:

1. Insertion of clause (x) in section 56(2) that replaced clauses section (vii) and (viia) of Section 56(2). This sections provides that receipt of money or specified property by any person for inadequate consideration or without consideration from any person shall be subject to tax.
2. Introduction of section 50CA to provide that where consideration for transfer of shares of a company other than a quoted share is less than the 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.”

Background of Section 50 CA:

Prior to introduction of section 50CA, where shares were sold by the assessee for a consideration, which is not in conformity with the fair-market value of the shares, there was no mechanism available under the Act to substitute the full value of consideration as disclosed by the assessee by any other value, for the purposes of computation of capital gains. Section 50C dealt with transfer of capital asset being land or buildings or both, which is not applicable in case of shares. To plug this loophole section 50CA was introduced.

Important points related to Section 50 CA

- Applicable to all assessee (Resident, Non-resident, Related and unrelated entity)
- Applies to all shares whether equity or preference.
- Unquoted Shares should be capital asset
- Not applicable with respect to gains from transfer of an interest in a partnership, trust where the property of such entities consists, directly or indirectly of immovable property
- May cover even some quoted shares based on the definition of “quoted share”

Explanation.—For the purposes of this section, "quoted share" means the share quoted on any recognized stock exchange with regularity from time to time, where the quotation of such share is based on current transaction made in the ordinary course of business.

- Where unquoted equity shares are contributed by a partner to a firm, the question will arise whether the provisions of section 50CA would override section 45(3) or vice-versa.
- No tolerance band provided. Thus, FMV as per the new formula method will be taken as full value of consideration, even if difference in FMV and the sale consideration is marginal.
- In case of sale consideration being less than FMV, the seller will be taxed under section 50CA on the ground that he has not declared true consideration. On the other hand, the buyer will be taxed under section 56(2)(x), on the ground that he has understated the purchase consideration.

For example, 'X' transfers his unquoted shares purchased at a cost of Rs.8 lakhs to 'Y' at Rs. 10 lakhs whereas the Fair Market Value of the shares as determined in the prescribed manner is Rs.50 Lacs. Then in this situation, the provisions of Section 50CA would be attracted in the hands of the seller, whose full value of consideration for computation of capital gains would be Rs.50 Lacs. Further, 'Y' who is purchaser would be liable to tax under section 56(2)(x)(c) on Rs. 40 lakhs (i.e. Rs.50 Lacs less Rs.10 lakhs) as income from other sources.

Hence, the difference of Rs. 40 lakhs between the fair market value and the actual consideration will be taxable:

under section 50CA, in the hands of seller; and

under section 56(2)(x), in the hands of recipient.

Illustration to explain the tax planning before amendment in Rule 11 UA.

ABC PVT LTD
Balance Sheet as at 31st March 2010

Liabilities	Amount	Assets	Amount
Share Capital		Immovable Property	
Mr. Sharma	50,00,000	Land	1,00,00,000
Mrs. Sharma	50,00,000		
Total	1,00,00,000	Total	1,00,00,000

ABC PVT LTD
Balance Sheet as at 31st March 2016

Liabilities	Amount	Assets	Amount
Share Capital		Immovable Property	
Mr. Verma	50,00,000	Land	1,00,00,000
Mrs. Verma	50,00,000		
Total	1,00,00,000	Total	1,00,00,000

Court Decisions which might have triggered introduction of Section 50CA and changes in the Valuation Rules

Bhoruka Engineering Inds. Ltd. Vs. DCIT [2013] 36 taxmann.com 82 (Karnataka High Court)

In this case, Revenue contended that transaction of sale of shares was a colourable device and virtually immovable property had been transferred. While rejecting such argument the High Court observed as follows: “The assessee by resorting to such a tax planning has taken advantage of the benefit of the law or the loopholes in the law, which had ensured to his benefit. After seeing how this loophole has been exploited within four corners of the law, it is open to the Parliament to amend the law plugging the loophole.”

DCIT vs. Maya Appliances (P.) Ltd [2017] 82 taxmann.com 447 (Chennai - Trib.)

In this case, according to Revenue, the assessee sold the actual land and building in the guise of sale of shares and thus the provisions of the section 50C is applicable. However, the Tribunal declined to adopt this argument and held that no question of invoking the provisions of the section 50C of the Act as there is no direct transfer of land or building or both.

Medplus Health Services P. Ltd vs. ITO [ITA.No.871/Hyd/2015]

In this case, the Revenue adopted the market value of unquoted equity shares ignoring the valuation methodology given in Rule 11 UA as it was based on Book Value of the assets. The Tribunal held that “A.O. has to compute the fair market value in accordance with the prescribed method but cannot adopt the market value as fair market value under section 56(2)(viia) of the Act. The legislature in its wisdom has also given a formulae for computation of the fair market value which cannot be ignored by the authorities below.”

ABC PVT LTD

Balance Sheet as at 31st March 2010

Liabilities	Amount	Assets	Amount
Share Capital		Non Current Assets	
Mr. Sharma	50,00,000	Investment in XYZ Pvt Ltd	1,00,00,000
Mrs. Sharma	50,00,000		
Total	1,00,00,000	Total	1,00,00,000

ABC PVT LTD

Balance Sheet as at 31st March 2016

Liabilities	Amount	Assets	Amount
Share Capital		Non Current Assets	
Mr. Verma	50,00,000	Investment in XYZ Pvt Ltd	1,00,00,000
Mrs. Verma	50,00,000		
Total	1,00,00,000	Total	1,00,00,000

XYZ PVT LTD
Balance Sheet as at 31st March 2010

Liabilities	Amount	Assets	Amount
Share Capital		Non Current Assets	
ABC Pvt Ltd	1,00,00,000	Land	1,00,00,000
Mr. Sharma	10	Cash	10
Total	1,00,00,010	Total	1,00,00,010

XYZ PVT LTD
Balance Sheet as at 31st March 2019

Liabilities	Amount	Assets	Amount
Share Capital		Non Current Assets	
ABC Pvt Ltd	1,00,00,000	Land	1,00,00,000
Mr. Verma	10	Cash	10
Total	1,00,00,010	Total	1,00,00,010

Rule 11 UA after amendment applicable from 1st April 2017

$$\text{FMV of unquoted equity shares} = (\text{A+B+C+D-L}) \times \text{PV/PE}$$

Where,

A - Book value of all the assets (except those mentioned at B, C and D below) as reduced by income tax paid (net of refund) and unamortized deferred expenditure

B - Fair market value of jewelry and artistic work based on the valuation report of a registered valuer

C - Fair market value of shares or securities as determined according this rule

D - Stamp duty valuation in respect of any immovable property

L - Book value of liabilities, excluding paid up equity share capital, amount set apart for undeclared dividend, reserves and surplus, provision for tax, provisions for unascertained liabilities and contingent liabilities

PV - Paid up value of such equity shares.

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

ON GROUND CHALLENGES IN IMPLEMENTATION OF THE RULE

Valuation Date:

In case of 56(2)(x), FMV is to be determined basis audited financials as on the date of transaction. Closing the financials and audit thereof along side the transaction closing date is practically a task impossible to perform, particularly when the transfer is happening at the instance of the shareholder - how can a shareholder insist the company to get its account audited in the middle of the year when he is transferring the shares ? While for determining FMV in case of Section 56(2)(viib), there is categorical mention that if the financials as on valuation date are not drawn up, the last drawn financials may be referred, there is no similar relaxation for this provision.

To overcome the hardship, a similar relaxation could be provided for 56(2)(x).

ON GROUND CHALLENGES IN IMPLEMENTATION OF THE RULE

Valuing investments held by the entity - A challenge!

The mechanism for determining FMV for 56(2)(x) provides for valuing even the investments held by the entity as per Rule 11UA. *This requires even the financials of those entities to be drawn and audited !!*. This becomes a real challenge as the investee entity would not be ideally ready to draw and share its financials of any particular date with the investors on demand.

ON GROUND CHALLENGES IN IMPLEMENTATION OF THE RULE

Cross Holding:

The issue becomes even grave in case of cross holdings or circular chain holdings scenario. The rule is completely silent on the method to be adopted in such scenarios. As such adopting any particular approach may not be free from litigation.

ON GROUND CHALLENGES IN IMPLEMENTATION OF THE RULE

Investment in foreign subsidiaries:

The Rule states that “*fair market value of shares or securities as determined according to this rule*” shall be considered. Hence, for any investment in subsidiaries, the value of such investments will be computed by doing the same FMV exercise under the Rule by using the balance sheet of the subsidiary. However, how should the valuation of such shares be done if such investment is in a foreign subsidiary?

ON GROUND CHALLENGES IN IMPLEMENTATION OF THE RULE

Underlying investments valuation - whether pre or post tax value?

Another critical aspect here is whether the valuation of the investee company should be considered on a pre-tax or post tax basis? Ideally, the investor is entitled to realise his investment only after suffering a DDT or capital gains tax. Hence, imputing full value of the investee company may result in double taxation.

Applicability of Section 56(2)(viia) & 56(2)(x) of the Income Tax Act, 1961 on Fresh /Bonus/Right Issue & Buy Back of Shares

The Central Board of Direct Taxes had issued [Circular No. 10/2018 dated 31.12.2018](#) to clarify that provisions of section 56(2)(viia) of the Income-tax Act, 1961 being anti-abuse provisions shall not be applicable in cases of receipt of shares by the specified company or firm as a result of fresh issuance of shares including by way of bonus shares, rights shares and preference shares or transactions of similar nature by the specified company.

However, on reconsideration it was observed by CBDT that the matter relating to interpretation of the term 'receives' used in section 56(2)(viia) of the act is pending before judicial forums and stakeholders have sought clarifications on other similar provisions in section 56 of the Act. Accordingly, with the idea of issuing a fresh comprehensive circular on the subject, the said CBDT [Circular no. 10/2018](#) was withdrawn by CBDT [Circular no. 02/2019 dated 04.01.2019](#). While withdrawing the [circular no. 10/2018](#), it was also clarified that the said circular shall be considered to have never been issued.

The Explanatory Memorandum to Finance Bill 2010 explaining the rationale of introduction of the said section 56(2)(viia), interalia provided that,

“In order to prevent the practice of transferring unlisted shares at prices much below their market value, it is proposed to amend Section 56(2) to also include within its ambit, transactions undertaken in shares of a company (not being a company in which public are substantially interested) either for inadequate consideration or without consideration where recipient is a Firm or a Company”.

Thus it is amply clear and duly evident from above that the legislative intent of introduction of section 56(2)(viia) was to prevent the practice of transferring of unlisted shares at prices below their fair market value. The expression “transfer” has altogether different connotation and meaning than the expression “issuance” and as such the provisions of said section 56(2)(viia) were meant to be applicable in cases of receipt of shares by a company or a firm on subsequent transfer of unlisted shares after their initial issuance by the issuing company.

Allotment Of Shares To Existing Shareholder At Less Than Market Value Not Taxable Under Section 56(2)(vii)

Sudhir Menon HUF v. Assistant Commissioner of Income-tax held that additional allotment of shares to an existing shareholder of a company at less than fair market value ("**FMV**") as part of a genuine business transaction should not be subject to section 56(2)(vii)(c) of the (Indian) Income Tax Act, 1961 ("**ITA**"), where the *allotment is not higher than the proportion of existing shareholding.*

ABC PVT LTD
Balance Sheet as at 31st March 2010

Liabilities	Amount	Assets	Amount
Share Capital		Non Current Assets	
Mr. Sharma	50,00,000	Investment in XYZ Partnership	1,00,00,000
Mrs. Sharma	50,00,000		
Total	1,00,00,000	Total	1,00,00,000

ABC PVT LTD
Balance Sheet as at 31st March 2016

Liabilities	Amount	Assets	Amount
Share Capital		Non Current Assets	
Mr. Verma	50,00,000	Investment in XYZ Partnership	1,00,00,000
Mrs. Verma	50,00,000		
Total	1,00,00,000	Total	1,00,00,000

XYZ Partnership Balance Sheet as at 31st March 2010

Liabilities	Amount	Assets	Amount
Partners Capital		Non Current Assets	
ABC Pvt Ltd	1,00,00,000	Land	1,00,00,000
Mr. Sharma	10	Cash	10
Total	1,00,00,010	Total	1,00,00,010

XYZ Partnership Balance Sheet as at 31st March 2019

Liabilities	Amount	Assets	Amount
Partners Capital		Non Current Assets	
ABC Pvt Ltd	1,00,00,000	Land	1,00,00,000
Mr. Verma	10	Cash	10
Total	1,00,00,010	Total	1,00,00,010

INTEREST IN PARTNERSHIP FIRM IS TO BE TAKEN AT BOOK VALUE

Term “Shares” is not defined in Income Tax Act hence will be taken from Companies Act where the share is defined as share in a share capital of the company.

Hence fair value valuation is not applicable with respect to gains from transfer of an interest in a partnership where the property of such entities consists, directly or indirectly of immovable property.

WE CAN STAY CONNECTED THROUGH

www.linkedin.com/in/premlatadaga

Mail:

premlata.s.daga@gmail.com