Share Valuation Rules for Sec.56(2)(viib) - Overhauled!

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A] Background:

Ordinarily, capital receipts of a taxpayer are not taxable under the Indian tax laws, except where specifically provided under the provisions of the Income-tax Act, 1961 [**'Act'**]. One such provision is section 56(2)(viib) of the Act, which was inserted vide Finance Bill 2012 to bring to tax the excess share premium received by a company upon issuance of shares. The provisions of this section are applicable when a closely held company (i.e. a company in which public are not substantially interested) [referred to as **'Issuer Company'**] issues shares at a premium for a price which is more than the fair market value [**'FMV'**] of such shares. It provides that such excess of the issue price over and above the FMV of the shares shall be taxed in the hands of the Issuer Company. These provisions were inserted to *deter the generation and use of unaccounted money*, in the words of the then Finance Minister of India.

It is pertinent to note that, until financial year [**'FY'**] 2022-23, these provisions were applicable to an Issuer Company only if the shares were issued to an Indian resident shareholder. With effect from FY 2023-24, these provisions have been extended to cases where shares are issued to non-resident shareholders as well. Further, these provisions are applicable only in case of issue of 'shares' and not in case of issue of other 'securities' such as Debentures, Bonds etc.

B] Methods for computing the FMV of shares:

The methodology for computing the FMV of unquoted shares has been provided by the Central Board of Direct Taxes [**'CBDT'**] under rule 11UA(2) of the Income-tax Rules 1962 [**'Rules'**]. Further, an Issuer Company is also allowed to consider an FMV which is higher than that determined under rule 11UA(2), based on the value of its assets, subject to the satisfaction of the Indian Tax Authorities.

For the purpose of this Article, we have focused only on the valuation rules prescribed by CBDT under rule 11UA(2). In this context, CBDT has recently issued a notification[1] to amend the provisions of this rule with effect from **25 September 2023**. The amended provisions of this rule prescribe multiple options for valuation of unquoted equity shares and compulsorily convertible preference shares [**'CCPS'**] issued by an Issuer Company. In fact, for the valuation of CCPS, the amended provisions also allow the Issuer Company an option to either (a) independently carry out a valuation of such CCPS (considering specific terms of CCPS) as per prescribed methods or (b) determine the FMV of CCPS based on the FMV of equity shares as per the prescribed methods.

In this regard, the methods prescribed by CBDT for valuation of unquoted equity shares and CCPS are as follows:

Valuation Methodology	**(A) Unquoted Equity Shares**		**(B) Compulsorily Convertible Preference Shares**			
			Based on independent valuation of CCPS		**Based on FMV of Equity Shares**	
(*Explained in ensuing paragraphs*)	**Resident investor**	**Non-Resident investor**	**Resident investor**	**Non-Resident investor**	**Resident investor**	**Non-Resident investor**
Adjusted Net Assets Method	ü	ü			ü	ü
Discounted Free Cash Flow Method	ü	ü	ü	ü	ü	ü
International Methods		ü		ü		ü

***Note*:** A tolerance band of 10% is allowed for each of the above methods, explained in detail below.

1. Adjusted Net Asset Method:

- FMV of unquoted equity shares = (A – L) X [PV/PE] where,

A = Adjusted Book Value of Assets

L = Adjusted Book Value of Liabilities

PV = Total paid up equity share capital

PE = Paid value of each equity share

- Under this method, certain prescribed exclusions are made from the book value of assets and liabilities as per the audited balance sheet of the Issuer Company drawn as on the valuation date[2].
- In case the Issuer Company has not drawn up its balance sheet as on the valuation date then the balance sheet approved and adopted in the annual general meeting of shareholders of the Issuer Company on a date immediately preceding such valuation date shall be referred.
- It must be noted that this method is in alignment with the erstwhile provisions of rule 11UA(2) of the Rules.

2. Discounted Free Cash Flow Method:

- Under this method, FMV of the shares is determined by discounting the expected future cash-flows of the Issuer Company to arrive at the present value of such cash-flows. This present value of cash-flows represents the valuation of the Issuer Company and in-turn of the shares issued by such company.
- The provisions prescribe that such valuation must be undertaken by a qualified merchant banker and a valuation report must be obtained by the Issuer Company.
- If the date of such valuation report is not more than 90 days prior to the date of issue of shares then such date of the valuation report can be deemed to be the valuation date, at the option of the Issuer Company.
- It must be noted that this method is in alignment with the erstwhile provisions of rule 11UA(2) of the Rules.

3. International Methods:

- CBDT has, under the amended rules, provided a list of methods that can be used for valuation of

shares issued by the Issuer Company, in case of investors which are resident outside India. This is in line with the pricing guidelines prescribed under the Indian exchange control regulations which require the shares to be valued as per any internationally accepted pricing methodology.
- This list includes the following methods which are prominent for valuation of shares in foreign jurisdictions:
  - Comparable Company Multiple Method
  - Probability Weighted Expected Return Method
  - Option Pricing Method
  - Milestone Analysis Method
  - Replacement Cost Method

However, CBDT has not provided any explanation on the operation of these methods under the amended rules.

- The provisions prescribe that such valuation must be undertaken by a qualified merchant banker and a valuation report must be obtained by the Issuer Company.
- If the date of such valuation report is not more than 90 days prior to the date of issue of shares then such date of the valuation report can be deemed to be the valuation date, at the option of the Issuer Company.

C] Tolerance Band:

In order to arrive at the FMV of shares, certain assumptions and projections are required to be made, which are subjective in nature. Any change in the assumption and projection from one valuer to another can impact the FMV so determined. Such change in FMV could lead to additional tax liability in the hands of the Issuer Company. This becomes a recipe for a long-drawn litigation on the value of shares.

In acknowledgement of these difficulties, CBDT has now allowed a flexibility in such cases by way of a tolerance band of 10% for all of the above methods prescribed under the amended rule 11UA(2). That is, in case the actual issue price of shares exceeds the price so determined under the above methods but by not more than 10% of the price so determined then the actual issue price of the shares shall be deemed to be the FMV of the shares.

D] Special provisions for Venture Capital Undertakings and Startups:

The provisions under section 56(2)(viib) of the Act (which provide for the taxation of excess share premium received) prescribe an exemption from the said provisions for Venture Capital Undertakings and Startups[3] (as presently notified) in following cases:

a. Shares issued by a venture capital undertaking [‘VCU’] to a

1. venture capital company;
2. venture capital fund;
3. Cat I and Cat II Alternate Investment Funds

[collectively referred to as ‘**Specified VCU Investors’**]; or

- This exemption shall not apply when shares are issued by VCU to entities other than Specified VCU Investors

b. Shares issued by a Startup company to any resident person [**‘Specified Startup Investors’**] as notified presently.

- This exemption shall not apply when shares are issued by a Startup to entities other than Specified Startup Investors (which would essentially include non-resident investors)

In the above cases, where the exemption does not apply to VCU and Startups, in addition to the methods prescribed above, CBDT has prescribed certain special provisions for valuation of shares as follows:

1. Venture Capital Undertaking:

- As explained above, any consideration received by a VCU upon issuance of shares to Specified VCU Investors [**'Primary Issue (VCU)'**] shall be exempt from the provisions of section 56(2)(viib) of the Act.
- However, when such VCU issues shares to any entity other than the Specified VCU Investors [**'Secondary Issue (VCU)'**] then the value at which shares are issued to Specified VCU Investors in a Primary Issue (VCU) may, at the option of the VCU, be considered as the FMV of the shares issued under Secondary Issue (VCU).
- For opting this method of valuation, the consideration for Primary Issue (VCU) must be received within 90 days before or after the date of issue of shares under Secondary Issue (VCU).
- Further, the consideration determined at such FMV for the Secondary Issue (VCU) must not be more than the aggregate consideration received/receivable by the VCU from the Primary Issue (VCU).
- Illustratively, if a VCU receives a consideration of INR 50,000 from a Specified Investor (VCU) for issue of 100 shares at the rate of INR 500 per share under a Primary Issue (VCU), then such VCU can issue 100 shares at this rate to any other investor under Secondary Issue (VCU) within a period of 90 days before or after the Primary Issue (VCU).

2. Startup:

- In this case too, as explained earlier, any consideration received by a Startup upon issuance shares to the Specified Startup Investors [**'Primary Issue (Startup)'**] shall be exempt from the provisions under section 56(2)(viib) of the Act.
- However, when such Startup issues shares to entities other than Specified Startup Investors (which would essentially include non-resident investors) ['**Secondary Issue (Startup)'**], then the value at which shares are issued to Specified Startup Investors in a Primary Issue (Startup) may, at the option of the Startup, be considered as the FMV of the shares issued under Secondary Issue (Startup).
- Again, for opting this method of valuation, the consideration for Primary Issue (Startup) must be received within 90 days before or after the date of issue of shares under Secondary Issue (Startup)
- Further, the consideration determined at such FMV for the Secondary Issue (Startup) must not be more than the aggregate consideration received/ receivable by the Startup from the Primary Issue (Startup).

CBDT has not allowed any tolerance band for valuation of shares in accordance with the above special provisions, in case of VCU and Startups.

Summarily, at the time of issue of shares to entities other than the Specified VCU Investors and Specified Startup Investors respectively, the VCU and Startups have following options for not attracting tax liability:

a. Issue shares at a value determined as per the methodologies explained in earlier paragraphs (along with the tolerance band); or

b. Issue shares at a value determined in accordance with the above special provisions, subject to fulfillment of the conditions mentioned above (without tolerance band).

E] Remarks:

This amendment to the valuation rules is a welcome move allowing a wide flexibility in determining the FMV of shares for closely held companies intending to raise capital from Indian as well as non-resident investors. It is expected to reduce protracted litigation on the valuation of unquoted shares.

The Indian exchange control regulations require an Indian company to issue shares to non-resident investors at a price which is equal to or more than the FMV. On the other hand, shares issued at a price above the FMV result in a tax liability in the hands of the Issuer Company under section 56(2)(viib) of the Act. This resulted in an impractical scenario wherein such Indian company was required to issue shares to non-resident investors at a price which is exactly equal to the FMV of the shares, in order to comply with the tax and exchange control provisions. However, with the advent of tolerance band of 10% under the amended provisions of rule 11UA(2), such Indian company will have a flexibility in issuing shares to non-resident investors at a price which is in compliance with the exchange control regulations without being subjected to any undue tax liability. This practical approach for valuation of shares is likely to provide impetus to the foreign investors exploring investment opportunities in India.

The views expressed in this article are the individual views of the authors.

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[1] Notification No. 81 of 2023

[2] Valuation date is the date on which the consideration against issue of shares has been received by the Issuer Company

[3] A company certified as a 'Startup' by the Department for Promotion of Industry and Internal Trade on compliance of the prescribed conditions.