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

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Manish Shah
Senior Partner, Sudit K Parekh & Co

With an intent to curb the menace of circulation of black money, Income-tax Act, 1961 (ITA or the Act) has introduced various anti-abuse provisions within its fold. Provisions of Section 50CA, 56(2)(viib), 56(2)(x) are some such examples. These provisions aim at preventing the transfer of shares or issuance of shares at less or more than its fair value

Section 56(2)(x) of the Act deals with taxability of the receipt of shares of a closely held company by any person for a consideration lower than the fair market value (FMV). Similarly, Section 56(2)(viib) of the Act seeks to tax the premium received on issue of shares in excessive of the FMV. The mechanisms for computing the FMV has been prescribed under the Rule 11UA of the Income Tax Rules, 1962 (Rule).

While the provisions are objectively inserted, there are practical challenges faced in effective implementation especially the requirement of the Rule 11UA. This article attempts to highlight these aspects and it is hoped that CBDT takes them into consideration and would issue suitable clarifications on the same.

1. Valuation - as on date of transaction - practically an act impossible to perform

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).

2. 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.

3. 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.

One of the old instructions[1] in the context of Estate Duty provided for arriving at the value in such scenario was by solving simultaneous equations. While a cue may be taken from the same, simultaneous

equation may result in a valuation which is higher than the aggregate FMV of all the entities put together. This may arise essentially due to the fact that the entity's self-valuation may get re-imputed while resolving the circular reference through simultaneous equation.

To address this issue, an appropriate method should be prescribed for working out the valuation in such complex scenarios. The CBDT may invite recommendation from various stake holders on this aspect.

4. 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.

5. Ambiguity on date of applicability

There is also a controversy as to whether the date of valuation for Section 56(2)(viib) has to be date of receipt of application money or date of allotment of shares. Presently there are judicial position favouring both treatments[2], thus, opening the litigation box in either case. Clarity on this aspect is need of the hour.

6. Applicability on conversion of Preference shares into equity shares?

The Rule 11UA is applicable even in case of issue of preference shares. In case of convertible preference shares, there is no clarity whether the 11UA needs to be checked at the time of issue of such shares as well as at the time when equity shares are issued in lieu of preference shares on conversion.

While logically, once the said requirement is met while issuing preference shares, testing the same again on conversion should not be required. However, in absence of any categorical exemption in this regard, the chances of the tax authorities examining the same at both the stages cannot be ruled out. To avoid this, a specific exemption should be provided in the provision.

7. Reinstatement of permissibility to Chartered Accountants for undertaking the valuation:

While in case of unquoted shares and securities (other than equity shares), the valuation could be obtained either from a Chartered Accountant or a Merchant Banker, at the option of the taxpayer, Rule 11UA valuation in case of fresh issue of shares now permits only a Merchant Banker to undertake valuation of shares. This is not in sink with other regulations (Companies Act, Foreign Exchange Management Act or even other provisions of Income Tax Act) where even a Chartered Accountant's certificate holds good.

Similar to shares and securities other than equity shares, the Chartered Accountant should again be permitted to undertake the valuation. The tax authorities in any case have the authority to question the basis for projections and examine whether due diligence was applied by the valuer. Thus, the concern with which Chartered Accountants were omitted from undertaking the valuation can stand addressed then.

All the above aspects are posing real difficulties practically when one is contemplating a group restructuring. This needs immediate attention and needs to be addressed sooner than later.

The article has been co-authored by Shraddha Shah.

[1] Instruction: No. 835 [F. No. 313/88/74-ED], dated 24-5-1975

[2] M/s. Cimex Land and Housing Pvt. Ltd. v ITO (ITA No. 5933/ Del/ 2018) / [TS-93-ITAT-2019(DEL)]

ACIT v. M/s. Diach Chemicals & Pigments Pvt. Ltd. (ITA No. 546/ Kol/ 2017) / [TS-355-ITAT-2019(Kol)]