



## Angel Tax

Decoding CBDT's draft rules for the valuation of unquoted equity shares

June 2023



The Finance Act, 2023 (“FA 2023”) amended section 56(2) (viib) of the Income-tax Act, 1961 (“IT Act”) with effect from 1 April 2023, which brings the issue of shares to **non-resident investors** within the ambit of the aforesaid section. The Central Board of Direct Taxes (CBDT) vide draft notification dated 26 May 2023, has proposed amendments to Rule 11UA of the Income-tax Rules, 1962 for computation of fair market value (“FMV”) of unquoted equity shares for section 56(2) (viib) of the IT Act. Suggestions/comments on the same were invited.

## Background:

### Finance Act, 2023 (“FA 2023”)

FA 2023 amended section 56(2) (viib) of the Income-tax Act, 1961 (“IT Act”) with effect from 1 April 2023, which brings the issue of shares to **non-resident investors** within the ambit of the aforesaid section.

Section 56(2) (viib) of the IT Act before FA 2023, inter alia, provided that 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 would be taxable. In such a case, the aggregate consideration received

more than the FMV of the shares is taxable in the hands of the company issuing the shares.

The FA 2023 amended section 56(2) (viib) of the IT Act **by deleting the phrase ‘being a resident’** whereby consideration received from a non-resident would also be covered within the ambit of section 56(2) (viib) of the IT Act.

The CBDT, based on the above amendment introduced vide the FA 2023, received various representations, raising concerns that genuine non-resident investors may have to face undue hardship on matters such as the valuation of shares, etc. Hence the CBDT has issued two notifications on the same and proposed draft changes to Rule 11UA to ease the undue hardships.

## CBDT notifications

CBDT via notification numbers 29 and 30 of 2023 dated 24 May 2023 has notified a specified class of investors and startups (receiving consideration) which shall be exempted from the provisions of section 56(2) (viib) of the IT Act.

**Under notification 29**, the CBDT has listed three categories of investors whose investments in shares of a company, not being a company in which the public are substantially interested, shall not be covered under the ambit of section 56(2) (viib) of the IT Act:

1. Government and Government related investors or agencies including entities controlled by the Government
2. Banks or entities involved in the insurance business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident

3. Any of the following entities, which is a resident of any country or specified territory (from a list of 21 countries or specified territories as stated below), and such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident:
  - Securities and Exchange Board of India (SEBI) registered Category-I foreign portfolio investors
  - Endowment funds associated with a university, hospitals or charities
  - Pension funds created or established under the law of the foreign country or specified territory
  - Broad-based pooled investment vehicles or funds with more than 50 investors (not being a hedge fund or fund which employs diverse or complex trading strategies)

### List of countries:




**Notification 30** issued by the CBDT exempts start-up companies from the provisions of section 56(2) (viib) of the IT Act if the start-up qualifies under the conditions specified by the Department for Promotion of Industries and Internal Trade in para 4 of its Notification No. G.S.R 127(E) dated 19 February 2019. The exemption applies to start-ups for issuing shares to any investor (resident or non-resident). This notification shall be in effect, retrospectively from 1 April 2023 and it supersedes the earlier CBDT Notification No. 13/2019 which granted similar exemption to start-ups for issue of shares to resident investors only.


## Proposed Draft Amendments to Rule 11UA(2) of the Rules:

The CBDT has issued a draft Notification dated 26 May 2023 ('Notification') proposing to amend Rule 11UA of Income-tax Rules, 1962 (Rules), and had requested all stakeholders and the general public to provide suggestions/comments.

Rule 11UA, inter alia, provides for methods for computation of FMV of unquoted equity shares about aforesaid section 56(2) (viib) of the IT Act. Rule 11UA(2) of the Rules, currently prescribes only two valuation methods for a fair market valuation of unquoted equity shares as at the valuation date which is to be computed in the following manner:



As per the formula prescribed under clause (a) of sub-rule 2 of Rule 11UA (which is an asset-based method); or



As determined by a merchant banker as per the discounted free cash flow method.


## The proposed amendments to Rule 11UA of the Rules suggest the following:

### Additional valuation methods exclusively for non-resident investors:


CBDT proposes to add five more methods for fair valuation of equity shares to be determined by a merchant banker:



Comparable company multiple method




Probability weighted expected return method



Option pricing method



Milestone analysis method



Replacement cost method

### For resident & non-resident investors:

1. Value/Price matching (to the extent of consideration received from certain categories of investors).

New clauses (c) and (e) are inserted under sub-rule (2) whereby the company, for an issue of its unquoted equity shares, can opt to consider the FMV of equity shares of the company to be equal to the price at which equity shares are issued to a venture capital fund/company/specified fund or to the specified investors.

The aforesaid benchmarking of the FMV of equity shares is subject to compliance with certain conditions viz.:

- i. Investment in venture capital undertaking:
  - FMV - the price at which equity shares issued to a venture capital fund/company/specified fund
  - Maximum investment - total consideration received from a venture capital fund/company/specified fund
  - Investment by a venture capital fund/company/specified fund - Within 90 days from the date of the new issue of shares which are the subject matter of valuation.

- ii. Investment in other companies:

- FMV - the price at which equity shares are issued to specified investors
- Maximum investment - total consideration received from specified investors
- Investment by specified investors - within 90 days from the date of the new issue of shares which are the subject matter of valuation.

2. Valuation date:

The CBDT has proposed to allow valuation reports issued up to 90 days before the date of issue of equity shares for computing the FMV of the equity shares. In such cases, the valuation date, at the option of the assessee, as per the aforesaid amendment shall be deemed to be the date of the valuation report.

3. Safe harbour rule of 10%:

Proposed amendments have introduced a safe harbour rule for price variations up to 10% from the FMV of equity shares on account of factors like forex fluctuations, bidding processes, other economic indicators, etc., which may affect the FMV of equity shares.<sup>1</sup>

<sup>1</sup> <https://pib.gov.in/PressReleasePage.aspx?PRID=1925651>

Comments:



**List of exempt countries does not cover certain frequently used jurisdictions/only certain categories of investors are covered in the exempt countries** - The relaxation granted by CBDT via notifications 29 and 30 are welcome moves, such relaxations will ease certain undue hardships imposed upon non-resident investors due to the FA 2023. However, certain prominent jurisdictions like Singapore, Netherlands, United Arab Emirates and Mauritius are missing from the exemption list. Additionally, only certain categories of investors in exempt countries have been provided with the relaxation.



**Certain commonly used valuation methods not covered** - The list of new methods could also include various commonly used and accepted valuation methods like - comparable transaction multiple method and net asset value based on replacement cost method/reproduction cost method/book value/realisable value.



**Availability of new valuation methods to residents** - As per the proposed amendment, it appears that the new additional methods for valuation are available only in respect of the issue of equity shares to non-residents. These could be made available for investments made by residents as well.



**Application of valuation methods in combination** - It appears from the current language that the company has a choice of only one method from among the various methods suggested including discounted cash flow method and net asset value. Generally, valuers look at the applicability of various methods and may choose to adopt a combination of methods either as primary methods or corroborative methods. Hence, it is suggested that one should be allowed to use one or more of the suggested methods for the valuation including the discounted cash flow method and net asset value methods already permitted by the existing rules.



**Valuation date** - The definition of valuation date per the proposed amendment is the date of the report - One may look at considering the 90-day window from the valuation date and not the date of the report.



**Valuation of unquoted shares and securities other than equity shares** - It appears that the fair market valuation for the issue of unquoted shares other than equity shares (eg. Convertible/non-convertible preference shares) in a company - which are covered by Section 56(2) (viib) - are not commented upon/covered by these draft rules. Accordingly, it appears that the fair market value of such instruments, for Section 56(2) (viib), shall continue to be estimated at the price that they would fetch if sold in the open market on the valuation date, in accordance with the provisions of Rule 11UA[1](c)(c). Additionally, it appears that the issue of securities (other than shares) - such as convertible/non-convertible debentures/bonds continue to be not covered by Section 56(2) (viib).



**Convergence with FEMA Regulations for convertible equity instruments** - As per the extant FEMA Regulations, (i.e. Foreign Exchange Management (Non-debt Instruments) Rules, 2019), "In case of convertible equity instruments, the price or conversion formula of the instrument should be determined upfront at the time of issue of the instrument. The price at the time of conversion should not, in any case, be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with these rules."

The applicability of the amended Rule 11UA to the issue of equity shares at the time of conversion of convertible equity instruments may cause difficulties at the time of conversion when such conversion is carried out in accordance with the above FEMA Regulations applicable to convertible equity instruments.

The applicability of the amended Rule 11UA to the issue of equity shares at the time of conversion of convertible equity instruments, issued to non-residents may be clarified or in the alternative, such Rule 11UA may not be made applicable at the time of conversion provided such conversion aligns with the FEMA Regulations.

## Connect with us

### **Pinkesh Billimoria**

Partner, Financial Advisory  
Deloitte India  
pbillimoria@deloitte.com

### **Amol Rane**

Partner, Financial Advisory  
Deloitte India  
arane@deloitte.com

### **David Panna**

Partner, Financial Advisory  
Deloitte India  
davidpanna@deloitte.com

### **Kapil Bellubi**

Partner, Financial Advisory  
Deloitte India  
kbellubi@deloitte.com

### **Nandita Pai**

Partner and CFO Programme Leader  
Deloitte India  
napai@deloitte.com

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