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Sharp Insights

The Central Board of Direct Taxes ('CBDT') released [1]draft rules on valuation of unquoted equity shares

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[1] Amendment proposed in Rule 11UA(1)(c)(b) and introduction of Rule 11UAA in the Income-tax Rules, 1962

Background

- Under the Finance Act 2017, additional anti-avoidance measures were introduced in the Income-tax Act, 1961 ('Act'), regarding taxability on transfer of unquoted shares below the fair market value ('FMV'). Section 50CA was introduced to tax such cases by deeming the FMV to be the full value of consideration for the purpose of computing income under the head "capital gains" in the hands of the transferor.
- Further, in order to widen the scope of taxability of receipt of a sum of money or property without/inadequate consideration, clause (x) in Section 56(2) was introduced by Finance Act 2017, in place of clause (vii) and clause (viia). The earlier provisions were applicable only in case of individual or HUF and firm or company. The newly introduced clause (x) applies to all persons in relation to all properties defined therein. This clause brings to tax, the difference between the FMV of the covered property (including unquoted shares) and the actual consideration paid for it, in the hands of the recipient of the shares. This provision is triggered when the difference amount exceeds INR 50,000.
- The CBDT on May 5, 2017 issued a press release and a draft notification introducing the draft rules for calculating the FMV of unquoted equity shares in furtherance to newly introduced sections, 50CA and 56(2)(x).
- These draft rules are open for public comments till May 19, 2017 and once notified, will be applicable from assessment year 2018-19 onwards.

CBDT Draft Notification

Proposed Amendment in Rule 11UA

The CBDT proposes to amend existing Rule 11UA of the Income-tax Rules, 1962 ('Rules'), pertaining to valuation of the unquoted equity shares for the purpose of Section 56. As per the proposed amendment, the FMV of unquoted equity shares shall be determined in the following manner:

FMV of unquoted equity shares= (A+B+C+D-L)*(PV)/(PE)

Where,

A=book value of all assets (other than jewellery, artistic work, shares, securities and immovable property) as reduced by

(i) any amount of income-tax paid, if any, less the amount of income-tax refund claimed, if any, and

(ii) any amount shown as asset including the unamortized amount of deferred expenditure which does not represent the value of any asset;

B = 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;

C = fair market value of shares and securities as determined in the manner provided in this rule

D = the value adopted or assessed or assessable by any authority of the government for the purpose of payment of stamp duty in respect of the immovable property.

L= book value of liabilities, but not including the following amounts, namely:—

(i) the paid-up capital in respect of equity shares;

(ii) the amount set apart for payment of dividends on preference shares and equity shares;

(iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;

(iv) any amount representing provision for taxation, other than amount of income-tax paid, if any, less the amount of income-tax claimed as refund, if any, to the extent of the excess over the tax payable with reference to book profits in accordance with the law applicable thereto;

(v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;

(vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;

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

PV= the paid up value of such equity shares.

Proposed introduction of Rule 11UAA

Rule 11UAA has been proposed to be introduced to provide that for the purpose of Section 50CA, the fair value of share, not being a quoted share, shall be determined in the manner provided in Rule 11UA(1)(c)(b). This is in line with the valuation methodology proposed for Section 56 of the Act.

Conclusion

The draft rules propose a change in the current valuation norms for unquoted shares. These measures are proposed as anti-avoidance measures and targeted at limiting the potential tax arbitrage in transfer of investment holding companies with valuable passive assets like real estate.

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Contacts

Ahmedabad
19th Floor, Shapath - V
SG Highway,
Ahmedabad – 380 015.
Tel: + 91 (079) 6682 7300
Fax: + 91 (079) 6682 7400

Bangalore
Deloitte Centre, Anchorage II,
100/2, Richmond Road,
Bangalore 560 025.
Tel: +91 (080) 6627 6000
Fax: +91 (080) 6627 6010

Chennai
No.52, Venkatanarayana Road,
7th Floor, ASV N Ramana Tower,
T-Nagar,
Chennai 600 017.
Tel: +91 (044) 6688 5000
Fax: +91 (044) 6688 5050

Coimbatore
Shanmugha Manram
41, Race Course,
Coimbatore
Tamil Nadu - 641018
Tel: + 91 (0422) 439 2801
Fax: +91 (0422) 222 3615

Delhi/Gurgaon
Building 10,
Tower B, 7th Floor,
DLF Cyber City,
Gurgaon 122 002
Tel : +91 (0124) 679 2000
Fax : + 91 (0124) 679 2012

Hyderabad
1-8-384 and 385, 3rd Floor,
Gowra Grand S.P.Road,
Begumpet,
Secunderabad – 500 003.
Tel: +91 (040) 6603 2600
Fax:+91 (040) 6603 2714

Kolkata
Bengal Intelligent Park Building
Alpha, 1st floor, Block EP and GP
Sector V, Salt Lake Electronics
Complex,
Kolkata - 700 091.
Tel : + 91 (033) 6612 1000
Fax : + 91 (033) 6612 1001

Mumbai
Indiabulls Finance Centre,
Tower 3, 28th Floor,
Elphinstone Mill Compound,
Senapati Bapat Marg, Elphinstone
(W),
Mumbai – 400013
Tel: + 91 (022) 6185 4000
Fax: + 91 (022) 6185 4101

Pune
106, B-Wing, 7th Floor,
ICC Trade Tower,
Senapati Bapat Road,
Pune – 411 016.
Tel: + 91 (020) 6624 4600
Fax: +91 (020) 6624 4605

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