Tax alert: CBDT prescribes final rules for valuation of unquoted equity, compulsory convertible preference shares

27 September 2023

The Central Board of Direct Taxes (CBDT) vide notification dated 25 September 2023, has amended Rule 11UA of the Income-tax Rules, 1962 for computation of fair market value of unquoted equity shares and compulsory convertible preference shares (CCPS) for the purposes of section 56(2)(viib) of the Income-tax Act, 1961 (ITA). The CBDT had earlier issued a draft notification on 26 May 2023 for public suggestions/comments.

In a nutshell

Section 56(2)(viib) of the ITA provides for taxation of consideration received (on issuance of certain shares at premium) in excess of fair market value of such shares.

In addition to equity shares, the amendments to Rule 11UA of the Income-tax Rules, 1962 also provides for valuation of CCPS.

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Background:

- Finance Act, 2023 (FA 2023) amended section 56(2)(viib) of the Income-tax Act, 1961 (ITA) [relating to taxation of income from other sources] with effect from 1 April 2023, to include taxation on issuance of certain shares to **non-residents** (at premium) in excess of Fair Market Value (FMV).

  Further, Rule 11UA of the Income-tax Rules, 1962 (Rules), *inter alia*, provides for methods for computation of FMV of shares in relation to aforesaid section 56(2)(viib) of the ITA.

- The Central Board of Direct Taxes (CBDT) had issued a draft notification dated 26 May 2023 proposing to amend Rule 11UA of the Rules ('draft rules') and requested all stakeholders and the general public to provide suggestions/comments on the proposed amendment to Rule 11UA of the Rules. Please refer to our below alert in relation to the said draft notification:

  https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-CBDT-prescribes-draft-rules-for-valuation-of-unquoted-equity-noexp.pdf

- The CBDT has now issued a notification[1], dated 25 September 2023 ['Notification'] notifying the final rules under Rule 11UA of the Rules, after certain amendments to the draft rules.

Summary of the Notification in terms of the changes vis-à-vis the draft rules:

We have summarised below key changes/amendments/additions to the draft rules.

Rule 11UA(2) of the Rules to be applied for valuation of Compulsory Convertible Preference Shares (CCPS) along with applicability of safe harbour threshold:

- A new clause has been provided to compute the FMV of CCPS on the valuation date as determined in following manner:

  Consideration received from resident

  (i) As per clause (b) or clause (c) or clause (e) of Rule 11UA of the Rules **or based on the FMV of the unquoted equity shares** in accordance with clause (a) or clause (b) or clause (c) or clause (e), at the option of the taxpayer where the consideration received by the taxpayer is from a **resident**;

  Consideration received from non-resident

  (ii) As per clause (b), clause (c), **clause (d)** or clause (e) of Rule 11UA of the Rules **or based on the FMV of the unquoted equity shares** in accordance with clause (a) to clause (e), at the option of the taxpayer, where the consideration received by the taxpayer is from a **non-resident.**

  The valuation as per the above clauses could be referred to in our earlier alert (there are a few edits as referred to in this alert).

- The final rules also provide that the safe harbour threshold of 10% under Rule 11UA(4) of the Rules shall also apply in determination of FMV of CCPS. Further, the new rules define the term 'issue price' to mean the consideration received by the company for one share.

Valuation as per clause (c) and Clause (e) of Rule 11UA of the Rules

- Proviso to method of valuation prescribed under clause (c) and (e) of Rule 11UA of the Rules states that issue price corresponding to consideration received by certain entities, for issue of shares, from certain specified funds or notified entities, **within a period of 90 days before or after the date of issue of shares** which are the subject matter of valuation, may be taken as the FMV of the shares issued.

[1] Notification No. 81 /2023/F. No. 370142/9/2023-TPL Part (1)

- Clause (c) of Rule 11UA(2) of the Rules states as under:

  (c) where any consideration is received by a venture capital undertaking[2] for issue of unquoted equity shares, from a venture capital fund or a venture capital company or a specified fund, the price of the equity shares corresponding to such consideration may, at the option of such undertaking, be taken as the fair market value of the equity shares to the extent the consideration from such fair market value does not exceed the aggregate consideration that is received from a venture capital fund or a venture capital company or a specified fund :

  Provided that the consideration has been received by the undertaking from a venture capital fund or a venture capital company or a specified fund, **within a period of 90 days before or after the date of issue of shares which are the subject matter of valuation.**

  Illustration: If a venture capital undertaking receives a consideration of INR 50,000 from a venture capital company for issue of 100 shares at the rate of INR 500 per share, then such an undertaking can issue 100 shares at this rate **to any other investor within a period of 90 days before or after the receipt of consideration from the venture capital company.**

- Similarly, clause (e) of Rule 11UA(2) of the Rules states as under:

  (e) where any consideration is received by a company for issue of unquoted equity shares, from any entity[3], the price of the equity shares corresponding to such consideration may, at the option of such company, be taken as the fair market value of the equity shares to the extent the consideration from such fair market value does not exceed the aggregate consideration that is received from the notified entity:

  Provided that the consideration has been received by the company from the aforesaid entity, **within a period of 90 days before or after the date of issue of shares which are the subject matter of valuation.**

Proviso added under Rule 11UA(3) of the Rules on determination of 'valuation date':

- Rule 11UA(3) of the Rules introduced vide the draft rules provide that where the date of valuation report by the merchant banker for the purposes of Rule 11UA(2) of the Rules is not more than 90 days prior to the date of issue of shares which are the subject matter of valuation, such date at the option of the taxpayer, be deemed to be the valuation date.
- Rule 11UA(3) now has added a proviso as per which if such option is exercised, the provisions of Rule 11U(j) of the Rules [defining 'valuation date' as the date on which the property or consideration is received by the taxpayer], shall not apply.

Comments:

The new rules shall come into force from the date of publication of the Notification in the official gazette.

Separately, it may be noted that CBDT had also issued notifications wherein certain investors as well as investee companies were notified to exclude them from the purview of the provisions of section 56(2)(viib) of the ITA. Please refer to our below alert on the same:

https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert//in-tax-gbt-CBDT-notifies-Income-tax-act-noexp.pdf

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[2] 'venture capital undertaking', 'venture capital fund', 'venture capital company' and 'specified fund' shall be as per the Explanation to section 56(2)(viib) of the ITA

[3] notified under clause (ii) of the first proviso to section 56(2)(viib) of the ITA which reads as follows:

"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 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:"