Executive summary

This Tax Alert explains the final valuation rules (the Rules) published by the Central Board of Direct Taxes (CBDT) for determining the fair market value (FMV) of unquoted shares for the purpose of new provisions inserted by the Finance Act 2017 (FA 2017) to curb abusive practices resulting in the avoidance of capital gains tax on transfer of shares. According to the provisions, transfer of shares at less than the FMV triggers taxation of shortfall in the hands of both the transferor and the transferee, with effect from 1 April 2017 (as against the erstwhile provision which triggered taxation in the hands of only the transferee).

The provisions delegate the methodology for the determination of FMV through rules to CBDT.

[1] Apex administrative body for direct taxes in India
In this regard, the CBDT has issued the Rules vide Notification[2] dated 12 July 2017 for valuation of unquoted equity and preference shares. The Rules seek to substitute the existing valuation rules for unquoted equity shares, which shall apply for taxation in the hands of the transferor (capital gains tax) as well as the transferee (gift taxation) if the transfer or acquisition of shares is at less than the FMV determined as per the Rules. The Rules seek to determine the FMV of unquoted equity shares of the company by adopting the independent fair valuation of jewelry, artistic work, immovable property and shares and securities held by such company while all other assets and liabilities of such company would continue to be valued at book value as per existing rule.

Further, the Rules also provide that FMV of unquoted preference shares would be the price such preference shares would fetch in the open market for which the taxpayer may obtain valuation report from merchant banker[3] or an accountant[4].

The Rules are applicable from 1 April 2017 (ie Tax Year 2017-18)

Background

Widening of gift tax provisions by FA 2017

- Prior to the amendment by the FA 2017, as an anti-abuse measure, the Indian Tax Laws (ITL) taxed receipt of specified property[5], without consideration or for inadequate consideration, by individuals and Hindu Undivided Families. Partnership firms/limited liability partnerships or closely-held companies[6] were also liable to tax, but in respect of receipt of shares of closely-held companies only.

- With effect from 1 April 2017 (i.e., tax year 2017-18 onwards), the FA 2017 widened the scope of the above anti-abuse provision by covering all taxpayers which are in receipt of specified property without consideration or for an inadequate consideration.

Notional taxation in the hands of the transferor for transfer of unquoted shares at less than the FMV

- Prior to the FA 2017, there was no provision for notional capital gains taxation on transfer of shares at less than the FMV in the hands of the transferor. The actual sale price was adopted for computing capital gains tax liability in the hands of the transferor, irrespective of the FMV of the shares, though, as aforesaid, such transfer at less than the FMV triggered taxation in the hands of certain transferees.

- In order to curb abusive practices resulting in the avoidance of capital gains tax on transfer of shares, the FA 2017 inserted a new anti-abuse provision for deeming the FMV of unquoted shares (i.e., other than quoted shares[7]) to be the full value of the consideration in lieu of the consideration actually received or accruing as a result of the transfer. The new provision is effective from 1 April 2017 (i.e., tax year 2017-18 onwards)

- The new provision delegated the methodology for determination of the FMV, through rules, to the CBDT.


- The CBDT, vide Notification No. 61/ 2017/ F. No. 149/ 136/ 2014-TPL dated 12 July 2017, has notified the Final Rules for valuation of unquoted equity and preference shares, which shall be effective from 1 April 2017 (i.e., tax year 2017-18 onwards).

Scope of the Rules – Determination of the FMV of unquoted equity shares

- The Rules seek to substitute the existing valuation rules for unquoted equity shares, which shall apply to both taxation in the hands of the transferor (capital gains tax), as well as the transferee (gift taxation) in case of transfer or acquisition of equity shares at less than the FMV determined as per the Rules.

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[4] Accountant means a chartered accountant, as defined under the Chartered Accountant Act, who holds a valid certificate of practice and fulfils certain conditions as prescribed under the provisions of the ITL.

[5] Specified property covers sum of money, immovable property, being land or building or both, shares and securities, jewellery, archaeological collections, drawings, paintings, sculptures, any work of art, bullion.

[6] A company which is not widely held is regarded as closely-held. Scope of widely-held and closely-held companies is determined as per specific provisions of the ITL.

[7] Quoted shares means the share quoted on any RSE with regularity from time to time, where the quotation of such share is based on current transaction made in the ordinary course of business.

The Rules provide that the FMV of unquoted equity shares, as on the valuation date\(^9\), shall be equal to \((A+B+C+D-L) \times (PV/\text{PE})\).

- A is book value of all assets other than jewelry, artistic work, shares, securities and immovable property in balance sheet, as reduced by:
  - Any amount of income tax paid, if any, as reduced by the amount of tax claimed as refund, if any; and
  - Any amount shown as an asset, including the unamortised amount of deferred expenditure which does not represent the value of any asset.

- B, C and D represent various assets held by the company whose unquoted equity shares are the subject matter of the transfer. Valuation of such components is as per the table below:

> Valuation date for computing capital gains in the hands of transferor would be the date of transfer of shares while valuation date for gift taxation in the hands of transferee is likely to be date of receipt of shares.

> \(\text{PV}\) means the paid-up value of equity shares

> \(\text{PE}\) means the total amount of paid-up equity share capital as shown in the balance sheet.

<table>
<thead>
<tr>
<th>Component</th>
<th>Type of asset</th>
<th>Method of determining the FMV</th>
<th>Valuation by</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Jewelry and artistic work</td>
<td>► Amount which would be fetched if sold in the open market based on the valuation report</td>
<td>Registered valuer(^{12})</td>
</tr>
</tbody>
</table>
| C         | Quoted shares and securities\(^{13}\) | ► If received by way of transaction through a RSE, the FMV would be the transaction value as recorded on such RSE.  
► If received by way of transaction carried out other than through any RSE, the FMV would be:  
► Average of the lowest and the highest price of the shares or securities quoted on the RSE on the valuation date  
► Where shares or securities are not traded on the RSE on the specified date, average of the lowest and the highest price of the shares or securities quoted on the RSE on a date immediately preceding the valuation date | NA |
<p>| C         | Unquoted equity shares | ((A+B+C+D-L) \times PV/\text{PE}) (i.e., same methodology as described herein for unquoted equity shares which are the subject matter of the transfer) | NA |</p>
<table>
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<tr>
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<th>Method of determining the FMV</th>
<th>Valuation by</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>Unquoted shares and securities (other than unquoted equity shares)</td>
<td>Amount which would be fetched if sold in the open market on the specified date</td>
<td>Merchant banker[^15] or an accountant[^16]</td>
</tr>
<tr>
<td>D</td>
<td>Immovable property</td>
<td>Stamp duty value assessed or assessable in respect of the immovable property[^17]</td>
<td>NA</td>
</tr>
</tbody>
</table>

- **C** is book value of liabilities shown in the balance sheet, as reduced by:
  - **B** Paid-up capital in respect of equity shares.
  - **B** Amount set apart for payment of dividend on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company.
  - **B** Reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart toward depreciation.
  - **B** Any amount representing provision for taxation other than the amount of income tax paid, if any, less the amount of income tax claimed as refund, if any, to the extent of excess over tax payable with reference to the book profits, in accordance with the tax law applicable thereto.
  - **B** Any amount representing provisions made for liabilities other than ascertained liabilities.
  - **B** Any amount representing contingent liability other than arrears of dividends payable in respect of cumulative preference shares.

The valuation date for computing capital gains in the hands of transferor would be the date of transfer of shares while valuation date for gift taxation in the hands of transferee is likely to be the date of receipt of shares.

**Scope of the Rules – Determination of the FMV of unquoted preference shares**

The Rules provide that the FMV of unquoted preference shares would be the price that such preference shares would fetch in the open market for which the taxpayer may obtain a valuation report from a merchant banker[^18] or an accountant[^19].

[^12]: Registered valuer means the valuer who is eligible to be appointed as a registered valuer under the Wealth Tax Act, 1957
[^13]: Quoted shares and securities in relation to shares or securities means shares or securities quoted on any RSE (stock exchange recognized by the Central Government) with regularity from time to time, where the quotation of such shares or securities are based on current transactions made in the ordinary course of business.
[^14]: Unquoted shares or securities means shares or securities which are not quoted shares or securities.
[^15]: Merchant banker is defined to mean Category I Merchant Banker registered with the Securities and Exchange Board of India (SEBI) Accountant means a chartered accountant, as defined under the Chartered Accountant Act, who holds a valid certificate of practice and fulfils certain conditions as prescribed under the provisions of the ITL.
[^16]: Stamp duty value means value adopted or assessed or assessable by any authority of the Central Government or a State Government for the purpose of payment of stamp duty in respect of an immovable property.
[^17]: Merchant banker means Category I merchant banker registered with SEBI established under Section 3 of the Securities and Exchange Board of India Act, 1992.
[^18]: Accountant means a chartered accountant, as defined under the Chartered Accountant Act, who holds a valid certificate of practice and fulfils certain conditions as prescribed under the provisions of the ITL.
Comments

Valuation of unquoted equity shares as per the Rules is along the lines of the Draft Rules which were published for consultation. For the purpose of computation of capital gains liability, the Rules now provide a mechanism for valuing preference shares by adopting the principle of determination of the FMV based on the expert valuation report, being the same mechanism which applies for gift taxation in the hands of the recipient.

While the normative Rules provide certainty, they are likely to create conflict in respect of transactions which are covered by other provisions of the ITL, such as transfer pricing or indirect transfer taxation provisions or where the applicable regulatory provisions which provide for different basis of FMV determination. Also, a virtual look-through approach for determination of the FMV of unquoted equity shares may add to the complexity, and consequential litigation.

The Rules fail to address multiple concerns as were raised before the CBDT. To illustrate, the Rules make no provision for discount in the valuation attributable to non-transferability of unquoted shares. Also, a look-through approach requires substitution of market value of all assets even when they are held for industrial, commercial or business purpose or are held as stock-in-trade. There is no corresponding adjustment provided in respect of corporate tax and dividend distribution tax liability in respect of such fair value substitution.

Furthermore, the Rules also make no carve-out for small value transactions or small shareholders. Notional taxation on account of normative applicability of the Rules may also get triggered even in a situation where the transaction is entered into after regulatory approval or is entered into with the Government of India (GOI) or a public financial institution. Additionally, applicability of the Rules to foreign companies, including those listed on overseas RSEs, is ambiguous and may lead to significant complexity and litigation.

Furthermore, since the Rules are made retroactively applicable from 1 April 2017, they may create unintended consequences for parties to the transaction. This may not only affect taxpayers with primary tax liability, but also persons liable to withhold tax or representative assesses who carry vicarious liability in respect of transactions consummated after 1 April 2017, but prior to the finalization of the Rules. This is contrary to the professed tax policy of the current GOI of not introducing retroactive amendment which creates higher tax burden.

The taxpayers likely to be impacted by the Rules may need to undertake careful analysis in respect of transactions which are entered into on or after 1 April 2017.
Our offices

Ahmedabad
2nd floor, Shivalik Ishaan Near C.N. Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: +91 79 6608 3800
Fax: +91 79 6608 3900

Bengaluru
6th, 12th & 13th floor “UB City”,
Canberra Block No.24 Vittal Mallya Road Bengaluru - 560 001
Tel: +91 80 4027 5000
+91 80 6727 5000
+91 80 2224 0696
Fax: +91 80 2220 6000

Ground Floor, ‘A’ wing Divyasree Chambers
#11, O’Saughnessy Road Langford Gardens Bengaluru - 560 025
Tel: +91 80 6727 5000
Fax: +91 80 2222 9914

Chandigarh
1st Floor, SCO: 166-167 Sector 9-C, Madhya Marg Chandigarh - 160 009
Tel: +91 172 331 7800
Fax: +91 172 331 7888

Chennai
Tidel Park, 6th & 7th Floor
A Block (Module 601,701-702) No.4, Rajiv Gandhi Salai Taramani, Chennai - 600 113
Tel: +91 44 6654 8100
Fax: +91 44 2254 0120

Delhi NCR
Golf View Corporate Tower B Sector 42, Sector Road Gurgaon - 122 002
Tel: +91 124 464 4000
Fax: +91 124 464 4050

3rd & 6th Floor, Worldmark-1 IGI Airport Hospitality District Aerocity, New Delhi - 110 037
Tel: +91 11 6671 8000
Fax: +91 11 6671 9999

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
NOIDA - 201 304
Gautam Budh Nagar, U.P.
Tel: +91 120 671 7000
Fax: +91 120 671 7171

Hyderabad
Oval Office, 18, iLabs Centre Hitech City, Madhapur Hyderabad - 500 081
Tel: +91 40 6736 2000
Fax: +91 40 6736 2200

Jamshedpur
1st Floor, Shantiniketan Building
Holding No. 1, SB Shop Area Bistupur, Jamshedpur - 831 001
Tel: +91 657 663 1000
BSNL: +91 657 223 0441

Kochi
9th Floor, ABAD Nucleus NH-49, Maradu PO
Kochi - 682 304
Tel: +91 484 304 4000
Fax: +91 484 270 5393

Kolkata
22 Camac Street 3rd Floor, Block ‘C’ Kolkata - 700 016
Tel: +91 33 6615 3400
Fax: +91 33 2281 7750

Kolkata
14th Floor, The Ruby
29 Senapati Bapat Marg Dadar (W), Mumbai - 400 028
Tel: +91 22 6192 0000
Fax: +91 22 6192 1000

Mumbai
5th Floor, Block B-2 Nirlon Knowledge Park
Off. Western Express Highway Goregaon (E)
Mumbai - 400 063
Tel: +91 22 6192 0000
Fax: +91 22 6192 3000

Pune
C-401, 4th floor Panchshil Tech Park Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: +91 20 6603 6000
Fax: +91 20 6601 9900

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