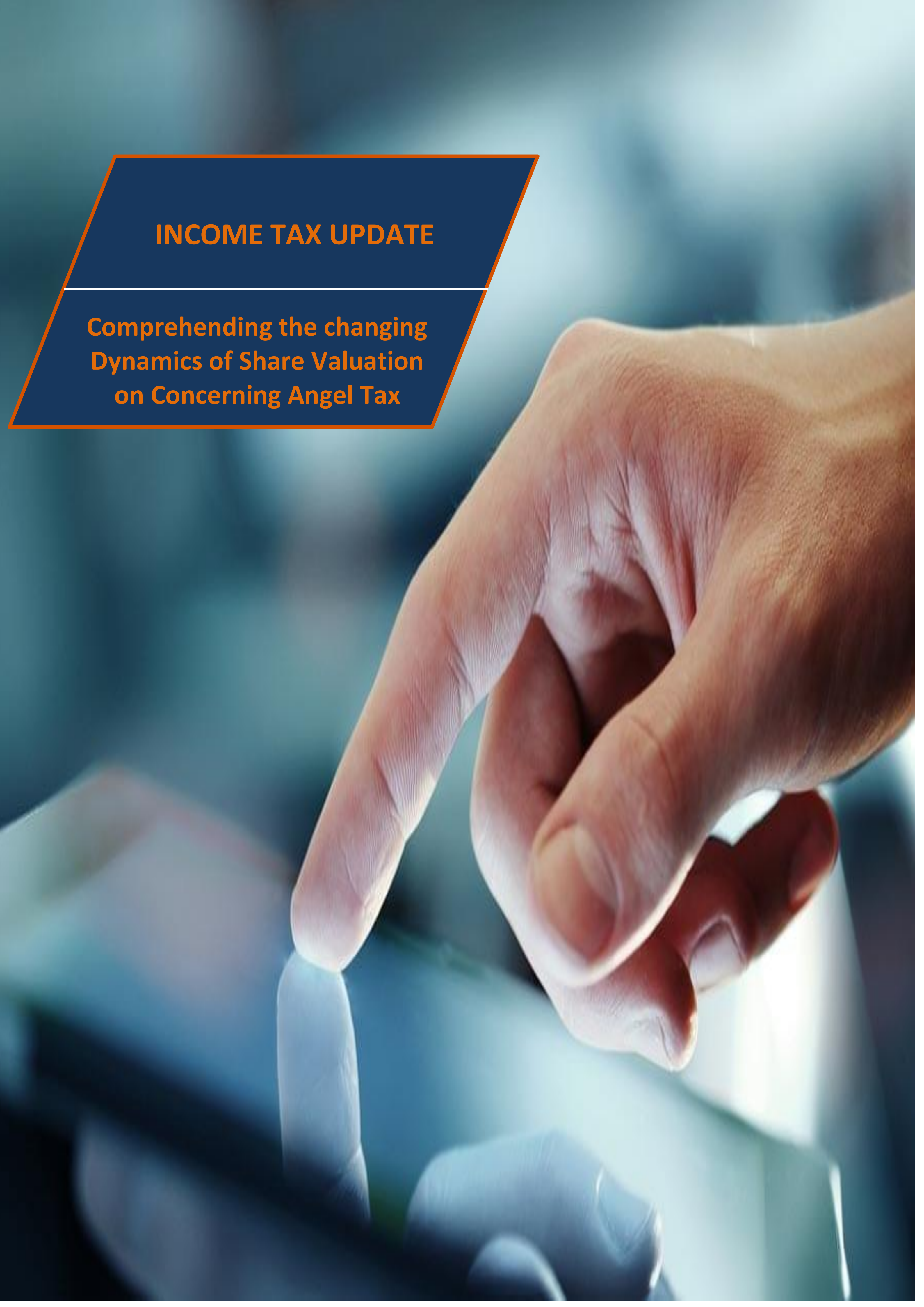
INCOME TAX UPDATE

Comprehending the changing Dynamics of Share Valuation on Concerning Angel Tax



Comprehending the Changing Dynamics of Share Valuation Concerning Angel Tax

A. Background and Introduction

Finance Act, 2012 introduced a tax on closely held companies under Section 56(2)(viiib) of the Income Tax Act, 1961 (the Act) when it received consideration from resident investors on issue of shares at a value that exceeded fair market value.

Further, the Finance Act, 2023 widened the scope of these provisions and included taxation of excess premium received by closely held companies from non-resident investors.

The FMV is to be calculated in accordance with Rule 11UA of the Income Tax Rules, 1962 (the Rules). These guidelines were to be modified to incorporate valuation principles relevant to non-resident investors' investments.

CBDT issued draft rules for public comment and notified the class or classes of persons for the inapplicability of Section 56(2)(viib) in May 2023; thereafter, CBDT notified the Income-tax (Twenty-First Amendment) Rules, 2023, amending Rule 11UA vide Notification No. 81/2023, dated 25th September, 2023.

B. Summary

Basis	Pre-amendment	Post-amendment
Applicability	Resident	Resident and Non-resident
Valuation Date	As on the date consideration is received	Upto 90 days prior to issue of share
Safe harbour	Not Available	10% band is provided
Price Matching Method*	Not Available	Provided w.r.t specified investment
Valuation of CCPS	No specific rule for same.	As per prescribed method or based on value of unquoted equity shares
Valuation of Unquoted Equity Shares	DCF or NAV method	DCF or NAV method for both residents and non-residents, or five new methods specified for non-residents

C. Pre-amendment Valuation Methods

1) For unquoted equity shares
    i. NAV Method (as prescribed under erstwhile Rule 11UA(2)(a) of the Rules)
    ii. Discounted Free Cash Flow Method (as prescribed under erstwhile Rule 11UA(2)(b) of the Rules)

D. Post-amendment Valuation Methods

1) FMV of unquoted equity shares as per the NAV method as prescribed (for resident and non-resident investor)

2) FMV of unquoted equity shares as per the Discounted Free Cash Flow method (for resident and non-resident investor)

3) Price matching*with VC or Specified Fund (for resident and non-resident investor)

   Where a venture capital undertaking receives a consideration for issue of unquoted equity shares, from a venture capital fund/company or a specified fund, the price of the equity shares corresponding to such consideration may be taken as the FMV of the equity shares for any other investor (resident or non-resident)

   Provided

   - The consideration from such FMV does not exceed the aggregate consideration that is received from a venture capital fund/company or a specified fund
   - The consideration has been received within a period of ninety days

   Illustration

   If a venture capital undertaking receives INR 40,000 from a venture capital company for the issuance of 100 shares at INR 400 per share, the undertaking may issue 100 shares at this rate to any other investor within 90 days of receiving consideration from the venture capital company.

4) Price matching* with notified entities (for resident and non-resident investor)

   Where consideration is received from the notified entities for issue of unquoted equity shares the price corresponding to such consideration may be taken as FMV of the equity shares for any other investor (resident or non-resident)

   Provided

- The consideration from such FMV does not exceed the aggregate consideration that is received from notified entities
- The consideration has been received within a period of ninety days

5) Other Valuation methodology for unquoted equity shares (only for Non-resident investor)
   i. Comparable Company Multiple Method;
   ii. Probability Weighted Expected Return Method;
   iii. Option Pricing Method;
   iv. Milestone Analysis Method;
   v. Replacement Cost Methods;

E. Valuation of Compulsorily Convertible Preference Shares (CCPS) for resident investor

Such valuation can be determined using the DCF method, price matching with the VC, Specified Fund or notified entities. Alternatively, the FMV of CCPS can be determined based on the FMV of the unquoted equity shares determined by the prescribed methods for residents.

F. Valuation of Compulsorily Convertible Preference Shares (CCPS) for non-resident investor

Such valuation can be determined using the DCF method, price matching with the VC, Specified Fund or notified entities, or five additional methods for non-residents. Alternatively, the FMV of CCPS can be determined based on the FMV of the unquoted equity shares determined by the prescribed methods for non-residents.

G. 90 Days window for Valuation Report

The valuation report of the merchant banker for Rule 11UA(2) of the Rules can be obtained upto 90 days prior to the date of issue of shares

H. Safe Harbor margin

If the consideration received for issue of unquoted equity shares or CCPS does not exceed 110% of the price determined using NAV or DCF methods (or other method prescribed for non-resident investor), then issue price will be considered as the FMV for tax purposes.

I. Class or classes of persons for inapplicability of Section 56(2)(viib) of the Act

CBDT had issued notification no. 29 dated 24.05.2023 notifying the class or classes of persons for inapplicability of Section 56(2)(viib) which are:

a) Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75% or more,

b) Banks or Entities involved in Insurance Business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident,

c) Any of the following entities, which is a resident of any country or specified territory listed in Annexure, and such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident:

- Entities registered with SEBI as Category-I FPIs,
- 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 Vehicle or Fund where the number of investors in such vehicle or fund is more than 50 and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

The countries notified in the Annexure are - Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, UK and USA

Conclusion

The valuation of shares and securities has long been a source of contention between the taxman and the assessee. With expanding the scope of taxation and providing the new valuation methodology may lead to increased litigation as the valuation of securities is based on a set of judgments that can differ from valuer to valuer for the same valuation method and can even differ when different valuation methods are used by the same valuer. As a result, the value determined by the authorities and the assessee may differ.

Further clarification is needed on whether two separate valuation methodologies can be utilised in the event that shares are simultaneously issued to residents and non-residents, as this will result in two different values.

* Name used for reference purpose only

Disclaimer

For details, please refer CBDT Press Release dated 24.05.2023 and 25.09.2023:

Notification No. 29/2023:
https://incometaxindia.gov.in/communications/notification/notification-29-2023.pdf

Notification No. 30/2023:
https://incometaxindia.gov.in/communications/notification/notification-30-2023.pdf

Notification No. 81/2023:
https://incometaxindia.gov.in/communications/notification/notification-81-2023.pdf

The information herein is based on CBDT notifications no. 29/2023, 30/2023 and 81/2023 dated 24.05.2023 and 25.09.2023. While the information is believed to be accurate, we make no representations or warranties, express or implied, as to the accuracy or completeness of it. Readers should conduct and rely upon their own examination and analysis and are advised to seek their own professional advice. This note is not an offer, advice or solicitation. We accept no responsibility for any errors it may contain, whether caused by negligence or otherwise or for any loss, howsoever caused or sustained, by the person who relies upon it.