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IMPORTANT PROVISIONS OF INCOME TAX ACT IMPACTING VALUERS AND VALUATION OF SHARES AND SECURITIES

INTRODUCTION:-

Valuation under Income Tax is often quoted as the numbers ahead of the story-telling whereas other forward looking valuations often dwell more on stories which are supported by numbers. This is often seen as at time of assessment, the Income tax officer has the luxury of last 2/3 years financials whereas not so in case of the valuer projecting the same at that point in time when he values the asset.

BACKGROUND:-

There have been many areas where the Income tax valuation rules were either impractical or ambiguous leading to lot of litigation, for e.g. requirement of audited accounts on date of transaction in certain cases whereas statutorily audit is only an annual exercise.

Coupled with this fact since time immemorial, there have been various ways in which assesses tried to plan or dodge income tax some legal as in tax planning, while others taking the unscrupulous form of tax evasion. This took various forms such as multiple layer subsidiary companies of a holding company, lack of transparent structure of formation, holding shares of property company as opposed to holding property itself all designed to minimise taxes or stamp duty or in few cases to evade taxes etc. Towards plugging these loopholes, Government did lot of amendments and is still amending every year in particular the Income tax sections/rules. For example the rules for determining FMV were notified under Finance Act, 2010, wherein Section 56(2) clause (viia) was introduced to include receipt of shares also as a mechanism for taxing shares transferred without adequate consideration, even angel tax was sought to be introduced, though later it was withdrawn only to be made applicable to only residents later on. The valuation rules were sought to be amended recently to include 5 more methods in addition to the Net Asset Value method the mainstay method under Income tax and DCF method, being only allowed hereupto. Also angel tax on non-residents was again proposed to be introduced in 2023 to make them on par with residents

NEED:-

For completion of assessment of a taxpayer or for purpose of determining value of any capital asset, Income Tax Authorities seek to arrive at the Fair Value of any capital asset. In such a case, the tax authorities can make a reference to the valuation officerfor ascertaining the value of the capital asset.

- Section 55A Provision relating to the power of the tax authorities for making a reference to the valuation officer for ascertaining the value of a capital asset.

- Section 142A section 142A also empowers the Tax Authorities to make a reference to a Valuation Officer. The Assessing Officer for the purposes of assessment or reassessment can make a reference to a Valuation Officer to estimate the value, including fair market value, of any asset, property or investment.

- "Valuation Officer" same meaning as in clause (r) of section 2 of the Wealth-tax Act, 1957 (*) Other important definitions:-

The word fair value means the expected value a willing buyer expects to get from a purchase transaction juxtaposed with cost is the price which he has to pay for getting such value.

“Fair Price” means a price that a willing purchaser would pay to a willing seller for a property having due regard to its existing condition, with all its existing advantages and its potential possibilities when laid out in the most advantageous manner excluding any advantages due to carrying out the scheme for the purpose for which the property is acquired - Raghubans Narain Singh Vs. State of UP 1967 AIR 465 SC

2 (22B) FMV in relation to a capital asset means, (i) the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and (ii) where the price referred to in subclause (i) is not ascertainable, such price as may be determined in accordance with the rules made under this Act;

SNAPSHOT of inter-play of important sections of Income tax and valuation rules.

SR NO	Income tax section	Reference	Particulars	How valued
(1)	Section17(2)- Explanation	Sweat Equity/ ESOP shares	Excess of FMV over purchase price as on date of allotment	FMV to be determined as per Rule 3(8)-Equity Shares:- and 3(9)-Other securities~
(2)	Capital gains on sale of ESOP- Section 45	Sweat Equity/ESOP shares	On Sale of Shares more than one year holding- Long term/ Else Short term	In case of (listed securities- market price and unlisted- equity- transfer value) as on date of transfer less FMV as on date of exercise (as in (1) above).
(3)	Capital Gains on transfer of unlisted shares of any company- Section 56(x)(c)	Transfer of unlisted whether Foreign Co or Indian Co Shares at a price lower than FMV or without consideration. Not applicable for gifts of shares from a)Relative, b)Marriage gifts c)Will /inheritance	On difference between FMV (as per Rule 11U/11UA(1)(c)(b)) and transfer price if transfer price is lower. This rule is despite FMV obtained under FEMA matching the transfer price in case of foreign Co shares. In hands of receipient upto Rs.50000 exempt.	Section 50CA -the value to be determined as per the Income Tax Rules as per Section 11UA/11 UAA which prescribe valuation methodology for arriving at fair value (FMV) of immovable property, jewellery, shares – both quoted and unquoted etc (specified assets) ^, for the purposes of anti- abuse provision contained in 56(2)(x)(c) known as Adjusted NAV method* (Base NAV as calculated in (5)(1)(a) below) For Indian Coshares- Audited balance sheet as on valuation date and for Foreign Co the balance sheet as on valuation date audited by auditor of company if any, appointed under laws in force of the country in which the entity is registered/ incorporated.

Fair Market Value –
Listed and Unlisted Shares

Rule 3(8)– FMV listed equity shares on exercise date- If listed on any recognized stock exchange as per section 2(f) of the Securities and Contract Regulation Act = average of opening and the closing price. If listed more than one exchange = average of opening and the closing price on the recognised stock exchange having highest trading volume. While taking either the opening or the closing price, the first settlement or the last settlement, both 'buy' and 'sell' quotes are available. Where no trading, closing price on the recognised stock exchange or recognised stock exchange with highest trading volume - closest date immediately before exercise date. Closing price but not average of opening and closing price considered for regularly traded shares.

Rule 3(9) -FMV Unlisted and other securities on the date of exercise – If unlisted or listed outside Indianot treated as listed on recognised stock exchange and treated as unlisted shares. The FMV -Valuation as determined by Category 1 Merchant Banker (registered with SEBI). FMV either on the exercise date but not more than 180 days any case of the valuation date.

Fair value of specified assets

Jewellery/Artistic work – Price it would fetch if sold in open market on the basis of the valuation report obtained from a registered valuer.

Fair market value of shares and securities - the method as provided in pt 5(1).

Immovable property - The value adopted/assessed/assessable by any Government authority for purpose of stamp duty payment.

Concluding Summary:- Valuations under the Income Tax Act, mostly with few exceptions as enlisted above are as per a strait jacket formula and while these may not be suitable for all valuations as the valuation art v science arguments illustrate a minimal random probability that 2 valuers will have exact same values. However, for standardizing purposes and to have accurate assessments without scope for bias, it's quite acceptable that the numbers are placed ahead of story writing in the Income tax valuation rules and these do serve a basic purpose for the Income Tax department in that it is aiding the valuation officer as and when need be to stand without fear or fervor. Even so, most of these definitions which could not stand up to the test of time are being amended and lately the trend is of more and more methods being allowed to give expression to the valuers' apple v apple comparisons. This is a welcome trend!