

# Increase in scope of valuation under Section 56(2)(viib) of Income tax Act, 1961

## 1. Background

- The angel tax provisions which was introduced in 2012 under the Income Tax Act, 1961 ('the IT Act') to levy income tax on the excess of money received on allotment of shares over and above the fair market value ('FMV') of the shares, has undergone multiple changes over the years, including the recent amendment in the Finance Act, 2023 to extend these provisions to issue of shares to a non-resident.
- Central Board of Direct taxes ('CBDT') had issued a press release on 19 May 2023 to propose additional valuation methodologies for subscription of equity shares by non-residents investors. A safe harbour of 10% on account of forex fluctuations etc was also proposed to be introduced vide the revised rules. Further, the press release had also proposed for a deemed valuation methodology if the shares are issued to any person in par to the value of shares issued to notified persons.
- Taking into consideration the suggestions received and detailed interactions held with stakeholders in this regard, Rule 11UA of the Income Tax Rules, 1962 ('the IT Rules') for valuation of shares for the purposes of section 56(2)(viib) of the Act has been modified vide notification no. 81/2023 dated 25th September, 2023. Further, the amended Rule 11UA also prescribes for valuation methodology for issue of Compulsorily Convertible Preference shares ('CCPS'). The changes proposed vide the amended rules has been analysed and summarized in the below paragraphs:

## 2. Additional valuation methods proposed for equity shares

- Rule 11UA(2) of the IT Rules which deals with the valuation of shares at the time of issue, historically prescribed two methods of valuation viz, Net Asset Value ('NAV') and Discounted Cash flow ('DCF') method.
- The CBDT has now introduced additional valuation methods for computing the fair market value of equity shares / compulsorily convertible preference shares ('CCPS') issued by a Company and the same is elaborated below.
- In case of subscription of unquoted equity shares **by a non-resident** in a Company, the fair market value of the unquoted equity shares shall be determined by a merchant banker using any of the following methods (the manner of computation is yet to be provided):
  - Comparable Company Multiple Method
  - Probability Weighted Expected Return Method
  - Option Pricing Method
  - Milestone Analysis Method
  - Replacement Cost Method

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- The following valuation methodologies have been prescribed for subscription to unquoted equity shares by both **resident and non-resident investors**:
  - Investment in par with investment by notified persons:
    - The angel tax provisions under Section 56(2)(viib) of the IT Act are exempted for investment by notified entities<sup>1</sup> and recognised startups<sup>2</sup>.
    - Vide the revised rules, it has been prescribed that any company can issue shares to any person at the same valuation at which it was issued to aforesaid notified entities and recognised startups.
    - It is to be noted that investment by any person (resident or non-resident) in a startup recognised by DPIIT is exempt from angel tax provisions, provided the aggregate amount of paid up share capital and security premium reserve after issue or proposed issue of shares, if any in case of a start-up does not exceed INR 25 Cr. The start-up is required to fulfil few other conditions for getting exempted from the angel tax provisions, one of which is that no investment shall be made in shares or securities of any other entity by such startup. Therefore, this rule shall not apply to investment made by such recognised startups and shall apply only to investment made by notified entities.
    - In other words, the value at which the shares of a company were issued to the notified entities shall be deemed as the fair market value for the purpose of issuing shares to any other person. However, this is subject to the condition that the consideration received from any other investor does not exceed the consideration received from the notified entities and the consideration is received from the notified entities within a period of 90 days before or after the date of issue of shares to any other investor.
  - Investment in par with a venture capital fund/ company/ specified fund:
    - Any consideration received by a venture capital undertaking<sup>3</sup> for issue of shares, from a venture capital fund or a venture capital company or a specified fund are exempt from the angel tax provisions. Vide the revised rules, it is prescribed that the value at which the shares were issued by the venture capital undertaking to the venture capital fund / venture capital company / specified fund shall be deemed as the fair market value for the purpose of issuing shares to any other person.
    - However, the above is subject to the condition that the consideration received from any other investor does not exceed the aggregate of consideration received from the venture capital fund/ company / specified fund and the consideration is received from the venture capital fund/ company / specified fund within a period of 90 days before or after date of issue of shares to any other person.
    - For example, if a venture capital undertaking receives a consideration of Rs 50,000 from a venture capital company for issue of 100 shares at the rate of Rs. 500 per share, then such an undertaking can issue 100 shares at this rate to any other investor within 90 days before or after the receipt of consideration from venture capital company.

### **3. Illustration on valuation of equity shares:**

- The aforesaid amendments are lucidly explained in the below illustration. Assume that PQR Pvt Ltd has issued shares to multiple investors at different issue price and at various points of time during the year 2023-24.

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<sup>1</sup> Includes government and related investors such as central banks, sovereign wealth funds etc wherein government has 75% or more ownership, banks or insurance entities which are regulated in respective countries, SEBI registered FPIs and certain other funds if they originate from specified countries such as Australia, UK, US, Canada etc.

<sup>2</sup> Notification No. S.O. 1131(E) dated 5th March 2019 read with Notification No. G.S.R. 127(E), dated 19th February, 2019 issued by Ministry of commerce and Industry

<sup>3</sup> "Venture capital undertaking" means any domestic company whose shares are not listed on a recognized stock exchange in India, which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf.

(Amount in INR)

S No	Proposed investor	Date of investment	Amount of investment	Issue price per share	Whether valuation report is required?	Remarks
1	A Ltd (75% owned by government)	01 Apr 2023	2 crores	190	NA	Section not applicable to notified persons
2	ABC Pvt Ltd	01 May 2023	1.5 crores	190	No	Within the timeline of 90 days and within the value at which notified person has invested ('deemed FMV')
3	PRQ Fund (Venture capital fund)	01 Jun 2023	3 crores	210	NA	Section not applicable for investment by venture capital fund
4	Mr. B	01 May 2023	1.2 crores	205	No	Though the value per share exceeds the value at which shares were issued to notified person, since amount was raised from venture capital fund within 90 days after this investment at a price higher than the current issue price, issue price is at fair market value.
5	XYZ Inc (US investor)	12 Jun 2023	2.5 crores	200	No	Though investment amount exceeds the total consideration at which notified entity had invested, the same is within the value at which venture capital fund has invested.
6	Mr. C	20 Jul 2023	1 crore	220	Yes	The value is not within the value at which the investment was raised from notified person/ venture capital fund. Further, there is no safe harbour applicable for this method of valuation.
7	DEF LLP	01 Aug 2023	45 lakhs	200	Yes	Exceeds 90 days from the date of receipt of consideration from venture capital fund/ notified persons.

- It is to be noted that where the date of valuation report issued by merchant banker is not more than 90 days prior to the date of issue, then such date at option of assessee shall be deemed to be the valuation date<sup>4</sup>.

<sup>4</sup> "Valuation date" under clause (j) rule 11U means the date on which the consideration is received by the assessee. Provided the assessee exercised the option under this rule, the provision under clause (j) of rule 11U shall not apply.

- Further, a 10% safe harbour is provided i.e., issue price can exceed the fair market value by 10%, for valuation arrived by a merchant banker under NAV or DCF method for a resident investor and under NAV, DCF and other 5 valuation methods prescribed for a non-resident investor. No such safe harbour has been provided for the valuation under any other methods.

#### 4. Valuation for compulsory convertible preference shares

- The determination of FMV of CCPS has been newly introduced and the same shall be as follows:

<b>Resident investor</b>	<b>Non-resident investor</b>
<ul style="list-style-type: none"> <li>• DCF method</li> <li>• Valuation equivalent to the price at which investment was raised from Venture capital fund/ venture capital company or notified entities.</li> </ul>	<ul style="list-style-type: none"> <li>• All the valuation methods as prescribed in Rule 11UA(2) except for NAV method.</li> </ul>

#### 5. Our remarks/ comments:

- A very short time period of 90 days has been prescribed for utilising a valuation report, which could result in undue hardship of obtaining valuation report on a frequent basis by the company for every tranche of issue of shares/ CCPS, especially for fund raise from the parent entity.
- Recently there have been judicial precedents (**Delhi ITAT** in the case of **BLP Vayu (Project -1 )(P). Ltd v. Principal Commissioner of Income-tax** [2023] 151 taxmann.com 47 (Delhi - Trib.), **Ahmedabad ITAT** in the case of **Dy. CIT v. Ozone India Ltd. [2021]** 126 taxmann.com 192/189 ITD 476 (Ahd. - Trib.) etc) in favour of the assessee wherein it was held that the provisions of Section 56(2)(viib) shall not be applicable for shares issued to the parent entity where no income could be said to accrue to ultimate beneficiary. However, there has not been specific amendment/ clarification on this aspect by the CBDT.
- With the increase in scope of valuation provisions, investment by non-residents in India would become a challenging affair considering that the valuation requirements under FEMA (shares cannot be issued less than FMV) and Income tax (shares cannot be issued more than FMV) would be different and both needs to be satisfied. Further, the valuers are also not uniform across various regulations leading to increase in cost and compliance.
- The additional valuation methodologies prescribed for investment by a non-resident helps in valuation of new age businesses. However, justification would have to be provided to the assessing officer.

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