

VALUATION OF EQUITY SHARES – REQUIREMENTS UNDER VARIOUS STATUTES

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Presentation Overview

- Evolution of DCF into statutory requirements
 - Legislative History
 - Transition to DCF
 - Requirements under other Statutes
- Recent thought process in Taxmen's mind
- Recent cases
- Companies Bill, 2012

**Evolution Of
Dcf Approach
Of Valuation Into
Statutory Requirements**

LEGISLATIVE HISTORY

- Traditionally, the following statutes have required a valuation of shares as per the methodology given by them-
 - Wealth-tax Act, 1957
 - Gift Tax Act, 1958
 - Estate Duty Act, 1953
 - Income-tax Act, 1961
 - Foreign Exchange Management Act, 1999

LEGISLATIVE HISTORY

Wealth Tax

Act, 1957

(WT Act)

LEGISLATIVE HISTORY

Gift Tax Act, 1958 (GT Act)

LEGISLATIVE HISTORY

Certain Decisions:

- *CWT vs. Mahadeo Jalan and others (1972) 086 ITR 0621 (SC)*
 - Quoted shares : Based on actual price of the equity shares quoted on a recognised stock exchange
 - Unquoted shares of a public company or of a private company: Based on the dividends reflecting the profit-earning capacity on a reasonable commercial basis. But, where they do not, then the amount of yield on that basis will determine the value of the shares. Value can also be based on an intermediate approach for ascertaining the profit earning capacity after eliminating unreasonable expenses etc. and adopting a reasonable proportion of profits.

LEGISLATIVE HISTORY

Certain Decisions:

- CWT vs. Mahadeo Jalan and others (contd.)
 - Temporary set-back period : Discounting of yield value before set-back by a percentage corresponding to the proportionate fall in the price of quoted shares of companies which have suffered similar reverses.
 - Where the company is ripe for winding up or in case of fluctuating and uncertain profits : the break-up value.

To conclude, the yield method is the generally applicable method while the break-up method is the one resorted to in exceptional circumstances or where the company is ripe for liquidation but none the less is one of the methods

LEGISLATIVE HISTORY

Certain Decisions:

- *Attorney-General of Ceylon v. Mackie*
 - A valuation by reference to the assets would be justified, when the fluctuation of profits and uncertainty of the conditions at the date of the valuation prevented any reasonable estimation of prospective

LEGISLATIVE HISTORY

Certain Decisions:

- *CGT v. Kusumben Mahadevia (contd.)*

It is further held in this case as under –

- In fact, Adamson has criticised this combination of the two methods as unscientific in his book on "The Valuation of Company Shares and

LEGISLATIVE HISTORY

Certain Decisions:

- *Gautam Hari Singhania, 207 ITR 1 (SC)*
 - SC held that this case is in respect of years when rules for valuation of shares were prescribed under WT Rules.
 - Judgement in Mahadeo Jalan, though it was rendered in context of wealth tax, dealt with

LEGISLATIVE HISTORY

Certain Decisions:

- *Gautam Hari Singhania (Contd.)*
 - The Supreme Court distinguished the earlier three judgements in Mahadeo Jalan, Kusumben Mahadevia and Ambalal Sarabhai, on the ground that either no rules were prescribed for the relevant years or that in the later two judgements, issue was under Gift Tax Act where also no rules were prescribed. Therefore, principles laid down by the said three judgements,

LEGISLATIVE HISTORY

Certain Decisions:

- The issue was considered in a recent judgement in Wg. Cmdr. A. G. Mathews v. CGT, (2004) 134 Taxman 236 (Ker.). In the said case, the Kerala High Court, after considering all the judgements, held that as no rules similar to Rule 1D of Wealth Tax Act were prescribed under Gift Tax Act at the relevant time, valuation has to be carried out by yield method and not by break-up value method.

LEGISLATIVE HISTORY

Certain Decisions:

- *Hindustan Lever Employees Union v. Hindustan Lever Ltd. And Others 1995-(083)-COMPCAS -0030 –SC*
 - In the given case Tata Oil Mills Co. Ltd. ("TOMCO") was merged into **Hindustan** Lever Ltd. ("HLL"), a subsidiary of Unilever ("UL"), a London based multinational company.
 - The valuation of the shares for exchange ratio was determined by combining three well-known methods, namely, the net worth method, the market value method and the earning method.

LEGISLATIVE HISTORY

Certain Decisions:

- *Hindustan Lever Employees Union v. Hindustan Lever Ltd. And Others (contd.)*

- The contentions of the case were

LEGISLATIVE HISTORY

Certain Decisions:

- *Hindustan Lever Employees Union v. Hindustan Lever Ltd. And Others*
(contd.)

(4) The past history of the prices of the shares of the two companies.

LEGISLATIVE HISTORY

Certain Decisions:

- *Bihari Mills Ltd. (58 Company Cases 6)*

Gujarat High Court had held that -

- In mergers and takeovers, since the entity is dissolved, the use of Break-up value method is justified; and
- If the entity has been incurring losses in past, the valuation based on Break-up method is justified.

- The transferee and the transferor companies should in a relative

LEGISLATIVE HISTORY

- Income-Tax Act, 1961 (IT Act)

In the IT Act, valuation of shares primarily finds mention at the following sections -

- Section 50B – For the purpose of determining “networth” for calculating taxable gains on a slump-sale, the methodology given by section 50B refers to considering book networth that is, the book value should be considered for this purpose.
- Section 56 – Discussed in detail later in this presentation

LEGISLATIVE HISTORY

- Foreign Exchange Management Act, 1999 (FEMA)
 - FEMA regulates the issue and transfer of shares by a person resident outside India (NR) to a person resident in India (R) and vice-versa.
 - FEM (Transfer or issue of security by a person resident outside India) Regulations, 2000 (“FEMA-20”) – purchase from and sale to a person resident outside India of shares of an Indian Company to follow the pricing guidelines listed therein.
 - Earlier, Schedule 1 of FEMA-20 and Master Circular issued by the Foreign Exchange Department of RBI for FDI in India required shares of an Indian company issued/transferred by –

LEGISLATIVE HISTORY

- FEMA (contd.)

- an R to an NR to be priced minimum at –

- ❖ Quoted shares:

Based on ruling market price of the equity shares on a recognised stock exchange

- ❖ Unquoted shares:

-Based on CCI guidelines –

Average of – NAV [Book value/book networth of the equity shares (break-up value of shares)] and

PECV [Profitability capitalisation value]

-If PECV is nil or negligible - fair value is half of the NAV or two-third of NAV if net assets comprise mainly of liquid assets.

LEGISLATIVE HISTORY

- FEMA (contd.)

- An NR to an R to be to be priced maximum at –

- ❖ Quoted shares:

Based on ruling market price or average quotations (with a control premium upto 25%) as the case may be, of the equity shares on a recognised stock exchange

- ❖ Unquoted shares or thinly traded shares:

i) if the consideration payable for the transfer does not exceed Rs. 20 lakh per seller per company, at a price mutually agreed to between the seller and the buyer, based on any valuation methodology currently in vogue, on submission of a certificate from the statutory auditors of the Indian company whose shares are proposed to be transferred, regarding the valuation of the shares, and

LEGISLATIVE HISTORY

- FEMA (contd.)

ii) if the amount of consideration payable for the transfer exceeds Rs.20 lakh per seller per company, at a price arrived at, at the seller's option, in any of the following manner, namely:

A) a price based on EPS linked to the P/E multiple, or a price based on the NAV linked to book value multiple, whichever is higher, or

B) the prevailing market price in small lots as may be laid down by the RBI so that the entire shareholding is sold in not less than five trading days through screen based trading system, or

C) where the shares are not listed on any stock exchange, at a price which is lower of the two independent valuations of share, one by statutory auditors of the company and the other by a Chartered

LEGISLATIVE HISTORY

- FEMA (contd.)

- FEM (TRANSFER OR ISSUE OF ANY FOREIGN SECURITY) REGULATIONS, 2004 (“FEMA - 120”) regulates transfer and issue of foreign securities by a person resident in India.
- Regulation 6 of FEMA – 120 refers to direct investment outside India in a WOS/JV by an entity registered in India.
- Regulation 6 (6)(a) - Where remittance for investment is made in an existing company, valuation of shares of the company outside India is required as follows –
 - ❖ Investment > USD 5 million by a Category I Merchant banker registered with SEBI / Investment banker or Merchant banker

LEGISLATIVE HISTORY

- FEMA (contd.)

- Regulation 6 (6)(B) - Where payment for investment is made in an existing company by way of issue of fully/partly paid up shares of investing entity, valuation of shares of the company outside India is required by a Category I Merchant banker registered with SEBI / Investment banker or Merchant banker registered with appropriate authority in the host country.

- Proviso to Regulation 16 of FEMA – 120 - Where shares or securities of an existing foreign company which is not listed on any stock exchange are sold by an Indian entity to another specified Indian entity by a private arrangement, value of shares should not be less than value certified by a CA or CPA

LEGISLATIVE HISTORY

- An intriguing conclusion from the above provisions of various statutes worth noting is that –
 - all of them prescribed valuation methodologies based on book value, past profitability or market value of shares or the combination of the above.
 - DCF was not a preferred/prescribed method on the statutory front till recently.

LEGISLATIVE HISTORY

- Indeed, in the case of Dr. Mrs. Renuka Datla vs. Solvay Pharmaceutical B.V. & Ors [2003] RD-SC 544 (30 October 2003), the valuer rejected DCF method of valuation by rejecting the projections. The SC observed –

“When there are vast discrepancies between the projection given by the parties and independent projections have not been provided, the Valuer has chosen the best possible method of evaluation by capitalizing the past earnings.”

TRANSITION TO DCF APPROACH

- First notable statutory recognition to DCF Approach - on April 07, 2010, RBI under FEMA issued a circular whereby the pricing guidelines for issue /transfer of shares from both R to NR and NR to R were revised to provide the benchmark price as-

- Quoted shares:

- ❖ Price worked out in accordance with SEBI guidelines

- Unquoted shares:

- ❖ Fair value to be determined by a SEBI registered Category – I - Merchant Banker or a Chartered Accountant as per the discounted free cash flow method.

- Allotment of shares on preferential basis by an R to an NR:

TRANSITION TO DCF APPROACH

- Income Tax

Act, 1961 (IT

Act)

TRANSITION TO DCF APPROACH

- Income Tax Act, 1961 (IT Act)
 - ❖ However, the rules for determining FMV were not notified at that time. Therefore, there was no mechanism for taxing shares transferred without adequate consideration .
 - ❖ The Finance Act, 2010 introduced clause (viia) to section 56(2) to include under its purview receipt of shares of a company in

TRANSITION TO DCF APPROACH

- Income Tax Act, 1961
(IT Act)

❖ Therefore, there was a mismatch between FEMA requirements for pricing of shares on their transfer and

REQUIREMENTS UNDER OTHER STATUTES

- The following statutes have also made a reference to valuation requirement; -

- Valuation requirement under Regulation 10 of the Takeover code for infrequently traded shares –

Price determined by the acquirer and manager to open offer taking into account valuation parameters including –

- ❖ Book value;
- ❖ Comparable trading multiples;
- ❖ Others.

- Fairness Opinion requirement under Listing Agreement -

Fairness opinion refers to an opinion from another expert when

REQUIREMENTS UNDER OTHER STATUTES

- Stamp Duty

As regards the value at which stamp duty would be payable –

- Both the Bombay High Court in *Li Taka* (supra) and the Delhi High Court in *Delhi Towers* (supra) held that since under a scheme of arrangement, what is transferred is a going concern and not assets and liabilities separately, the value of the property which is to be taken into consideration would normally be reflected by the shares allotted to the shareholders of the transferor-company.
- Supreme Court in *Hindustan Lever and Another* and the Bombay High Court in *Li Taka Pharma* have further held that valuation in respect of the “instrument” of the amalgamation after due verification, is to be determined by the stamp authorities on the basis of the price of the shares allotted to the transferor company and other consideration, if paid, but not by separately valuing the assets and the liabilities.
- Thus, Courts have held that in the transactions for merger/demerger involving the transfer of assets as well as liabilities, stamp duty is leviable on the value of net assets (i.e. assets less liabilities).
- Where the consideration is discharged by allotting shares, the consideration would be determined based on the fair market value of such shares.

REQUIREMENTS UNDER OTHER STATUTES

- Stamp Duty

- Also, under Article 25 (da) of Schedule I to the Bombay Stamp Act, 1958 (“the 1958 Act”) stamp duty is to be computed, inter alia, @ 10% of the aggregate of the market value of the shares issued or allotted in exchange or otherwise

- The term “market value” has been defined u/s. 2(na) of the 1958 Act as under:

“(na) ‘market value’ in relation to any property which is the subject matter of an instrument, means the price which such property would have fetched if sold in the open market on the date of execution of such instrument or the consideration stated in the instrument whichever is higher.”

- In case shares of the Transferee Company are not actively traded on any Stock Exchange and since the 1958 Act or the rules there under do not

REQUIREMENTS UNDER OTHER STATUTES

- Stamp Duty

- However, as regards the method of 'valuation', there is no clear methodology prescribe by the stamp laws.
- The Bombay High Court has held in the case of Madhusudan Dwarkadas Vora vs. Superintendent of Stamps (141 ITR 802) that for the purposes of the Bombay Court Fees Act, 1959, for grant of probate, value of a house shall be determined as per the rules prescribed under the Wealth Tax Rules, 1957.

REQUIREMENTS UNDER OTHER STATUTES

- In the context of the Estate Duty Law it has been held by
 - Mysore High Court in the case of CED vs. J. Krishna Murthy (96 ITR 87) and
 - Bombay High Court in the cases of CED vs. R. M. Subhadvala (192 ITR 389)

That where there are no rules under the Estate Duty Act for determining the value of a house, the rules prescribed under the Wealth tax Act, 1957 for the purpose of determining such value should be adopted.

**Recent
thought process in
the Taxmen's mind**

Recent thought process in the Taxmen's mind

- The Income-tax Department has recently started giving importance to adoption of DCF approach for valuation of equity shares wherever a valuation is required.
- So much so that transactions relating to assessment years where DCF was not recognised are also cross checked by the DCF approach especially in the case of cross-border transactions.
- Therefore, increasingly, valuation based on DCF approach is gaining recognition and will have to be adopted or atleast used as a cross check by valuers for transactions in India and cross-border transactions which are nowadays being eyed by the Tax Department for rigorous scrutiny.

Recent Cases

Recent Cases

- Royal Dutch Shell group has over the last few years made significant investments in India by way of equity injection to fund the ordinary business activities of Shell India.
- In a huge blow to global energy giant Royal Dutch Shell group's domestic operations, the income tax department has slapped a draft assessment order on 29 March 2013 on an inter-group issue of shares which pegs Shell India's tax liability at nearly Rs. 5,000 crores.
- The transfer pricing order related to the issue of 87 crore shares by Shell India to an overseas group entity, Shell Gas BV, in March 2009. The shares were issued at Rs. 10/share; which taxmen in Mumbai now claim was in fact worth approximately Rs. 180 per share. The order therefore, alleges under-pricing of Rs. 15,220 crore by Shell India and the consequent tax liability would be 30% of the such under-pricing.
- The income tax department challenged the valuation methodology of Shell India. Interestingly, in this case, the assessing officer has adopted DCF approach of valuation at a time when the same was not the requirement and what was required by RBI for issue of shares to an NR was that the valuation of shares be guided by erstwhile CCI guidelines.
- Ironically, the tax authorities have raised a tax demand of \$1 billion (about Rs. 5,400 crore) on an equity infusion of \$160 million (about Rs. 870 crore) made four years ago.

Companies Bill, 2012

COMPANIES BILL, 2012

The provisions of the proposed Companies Bill, 2012 as applicable in the case of a valuation are -

- **Requirement of a valuation report from a registered valuer -**
 - Price of issue of further Shares by a company having share capital subject to such conditions as may be prescribed.
 - While disclosing to the Tribunal any compromise or arrangement by an affidavit, the consented scheme of corporate debt restructuring should include a valuation report in respect of the shares and other tangible and intangible property of the company by a registered valuer. Such report will also be circulated along with the notice of the meeting of shareholders/creditors, other key personnel.
 - Where the transferor company is a listed company and the transferee company is an unlisted company if shareholders of the transferor company decide to opt out of the transferee company, payment of the value of shares held by them and other benefits should be in accordance with a pre-determined price formula or after a valuation is made. Such amount of payment or valuation under this clause for any share shall not be less than

COMPANIES BILL, 2012

The provisions of the proposed Companies Bill, 2012 as applicable in the case of a valuation are -

- **Purchase of minority shareholding**

The acquirer or persons being shareholders to the extent of 90% or more shall buy the remaining equity shares held by minority shareholders by giving them notice at a price determined on the basis of valuation by a registered valuer.

- **Requirement of registered valuers**

Valuation by registered valuers

- Where a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets (herein referred to as the assets) or net worth of a company or its liabilities, it shall be valued by a person having such qualifications, experience and registered as a valuer as prescribed and appointed by the audit committee or the Board of Directors of that company.

COMPANIES BILL, 2012

- The valuer appointed under sub-section (1) shall,—
 - (a) make an impartial, true and fair valuation of any assets which may be required to be valued;
 - (b) exercise due diligence while performing the functions as valuer;
 - (c) make the valuation in accordance with such rules as may be prescribed; and
 - (d) not undertake valuation of any assets in which he has a direct or indirect interest or becomes so interested at any time during or after the valuation of assets.
- If a valuer contravenes the provisions of this section or the rules, he shall be punishable with fine from Rs. 25,000 to Rs. 1 lakh.
- However, if the intention to defraud the company or its members, he shall be punishable with imprisonment for a term which may extend to one year and with fine from Rs. 1 lakh to Rs. 5 lakh.

Companies Bill, 2012

- Also, the valuer will have to
 - ❖ refund the remuneration received by him to the company; and
 - ❖ pay for damages to the company or to any other person for loss arising out of incorrect or misleading statements of particulars made in his report.
- A company administrator, appointed by the Tribunal for the revival and rehabilitation of a sick company, may cause to be prepared with respect to the company—
 - a valuation report in respect of the shares and assets in order to arrive at the reserve price for the sale of any industrial undertaking of the company or for the fixation of the lease rent or share exchange ratio;
 - an estimate of the reserve price, lease rent or share exchange ratio.

Certain Exposures

- Section 2 (24)(iv) of the IT Act –

This section covers within the ambit of the term ‘income’, the value of any benefit or perquisite obtained from a company either by a director or his relative or by a person who has a substantial interest in the company or his relative, and any sum paid by any such company in respect of any obligation which would have been payable by the director or other person aforesaid.

- Section 28 (iv) of the IT Act –

This section charges to tax under the head ‘profits and gains from business or profession’, the value of any benefit or perquisite arising from business or the exercise of a profession.

Certain Exposures

- Section 50D of the IT Act

As per this section, in case the consideration received or accruing as a result of the transfer of a capital asset by an assessee is not ascertainable or cannot be determined, then, for the purpose of computing income chargeable to tax as capital gains, the fair market value of the said asset on the date of transfer shall be deemed to be the full value of the consideration received or accruing as a result of such transfer.

THANK YOU