VALUATION OF EQUITY SHARES – REQUIREMENTS UNDER VARIOUS STATUTES

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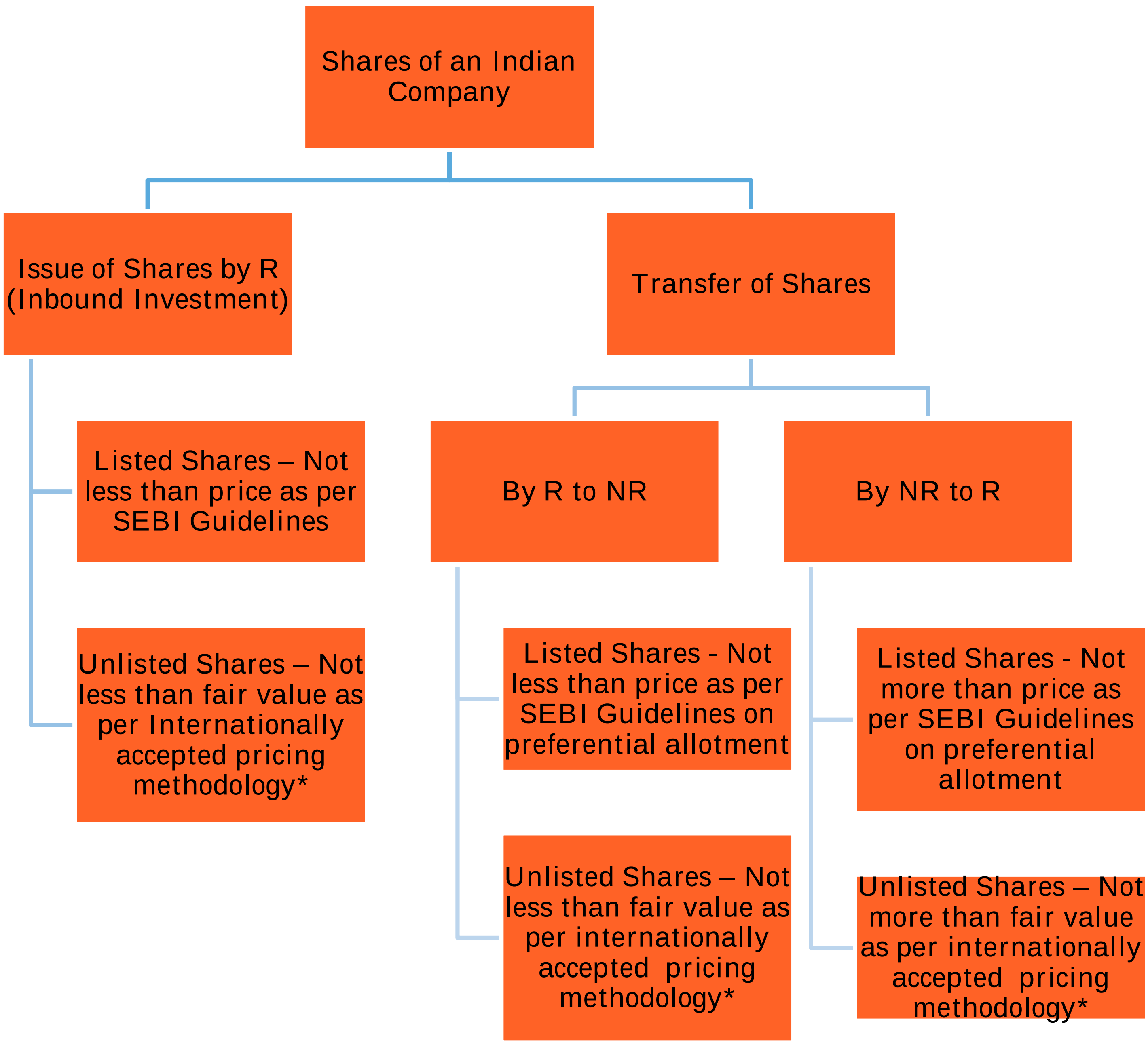
Presentation Overview

- FEMA
- The Income Tax Act, 1961
- SEBI Regulations
- The Companies Act, 2013
- Stamp Duty
- Estate Duty
- Other Exposures

REQUIREMENTS UNDER FEMA

- Issue or transfer of shares requires valuation
- RBI vide RBI/201415/129 A. P. (DIR Series) Circular No. 4 dated15th July, 2014 has replaced DCF methodology with internationally accepted pricing methodology.
- The valuation needs to be duly certified by a CA or a SEBI registered merchant banker.
- The revised pricing guidelines for issue/transfer of shares follow.



Shares of an Indian Company
Issue of Shares by R (Inbound Investment)
Transfer of Shares
Listed Shares – Not less than price as per SEBI Guidelines
Unlisted Shares – Not less than fair value as per Internationally accepted pricing methodology*
By R to NR
By NR to R
Listed Shares - Not less than price as per SEBI Guidelines on preferential allotment
Unlisted Shares – Not less than fair value as per internationally accepted pricing methodology*
Listed Shares - Not more than price as per SEBI Guidelines on preferential allotment
Unlisted Shares – Not more than fair value as per internationally accepted pricing methodology*

- Foreign Security (Direct Investment in JV/WOS- Outbound Investments)
  - Investment by R
    - Investment > Rs. 5 Mio – Merchant Banker/Investment Banker
    - Investment=< Rs. 5 Mio – CA/CPA
  - Transfer by R
    - Listed Security – Price in Stock Exchange
    - Unlisted Security – Not less than price determined by CA/CPA

Income Tax Act

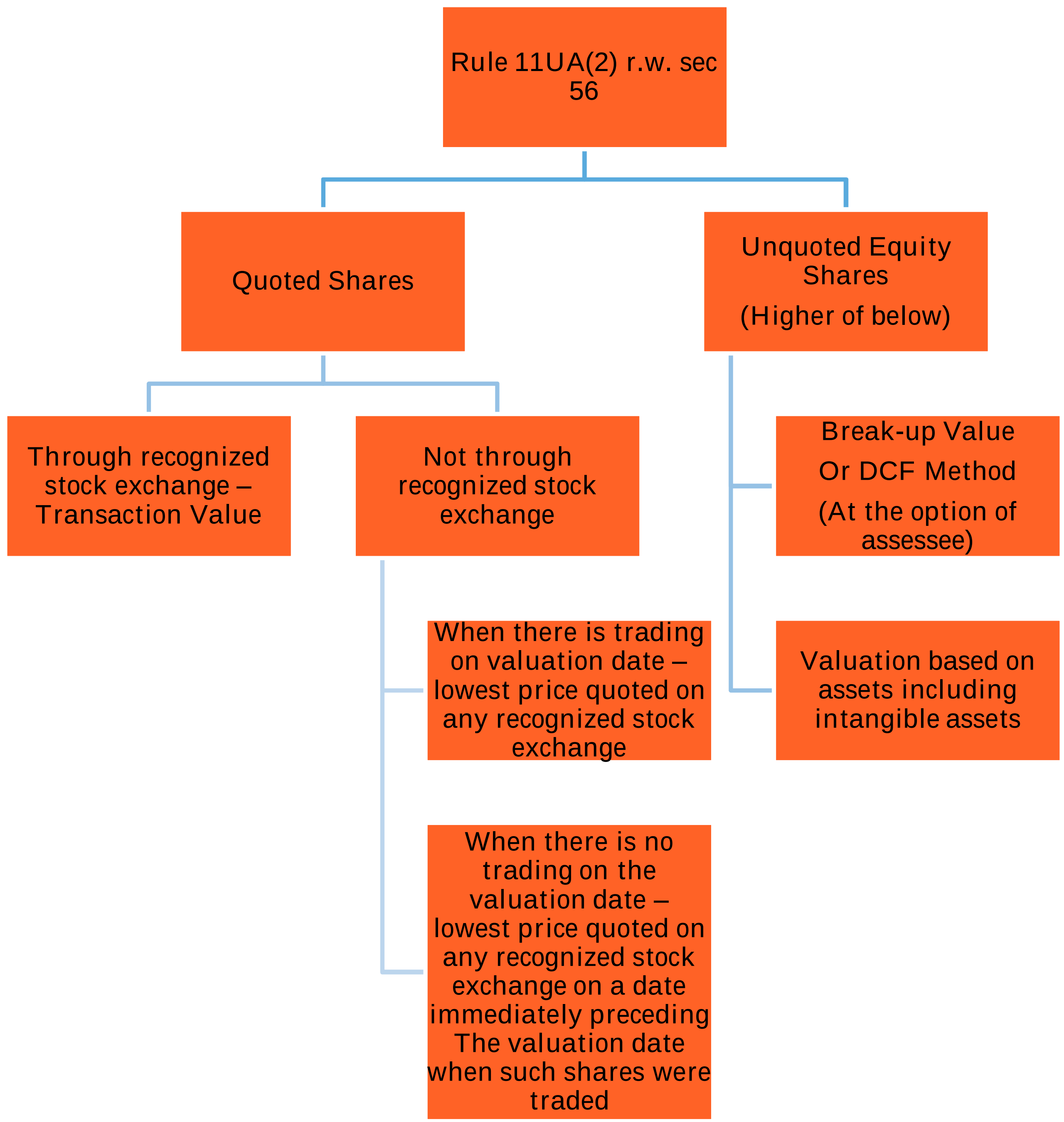
SECTION 56 – VALUATION OF SHARES

- **Section 56**
  - 56(2)(vii)-Where individual and HUF receives
    - shares without consideration (aggregate FMV of which exceeds Rs. 50000) - FMV of shares is taxable
    - shares for consideration less than aggregate FMV of the shares by Rs. 50,000 – FMV of shares in excess of consideration
  - 56(2)(viia) - Where firm or company in which public are not substantially interested receives
    - shares* without consideration (aggregate FMV of which exceeds Rs. 50000) - FMV of shares is taxable
    - shares* for consideration less than aggregate FMV of the shares by Rs. 50,000 – FMV of shares in excess of consideration
  - 56(2)(viib) – Where company in which public are not substantially interested receives consideration for issue of shares that exceeds face value of shares
    - Consideration in excess of FMV shares

SECTION 56(2)(VII) AND 56(2)(VIIA)

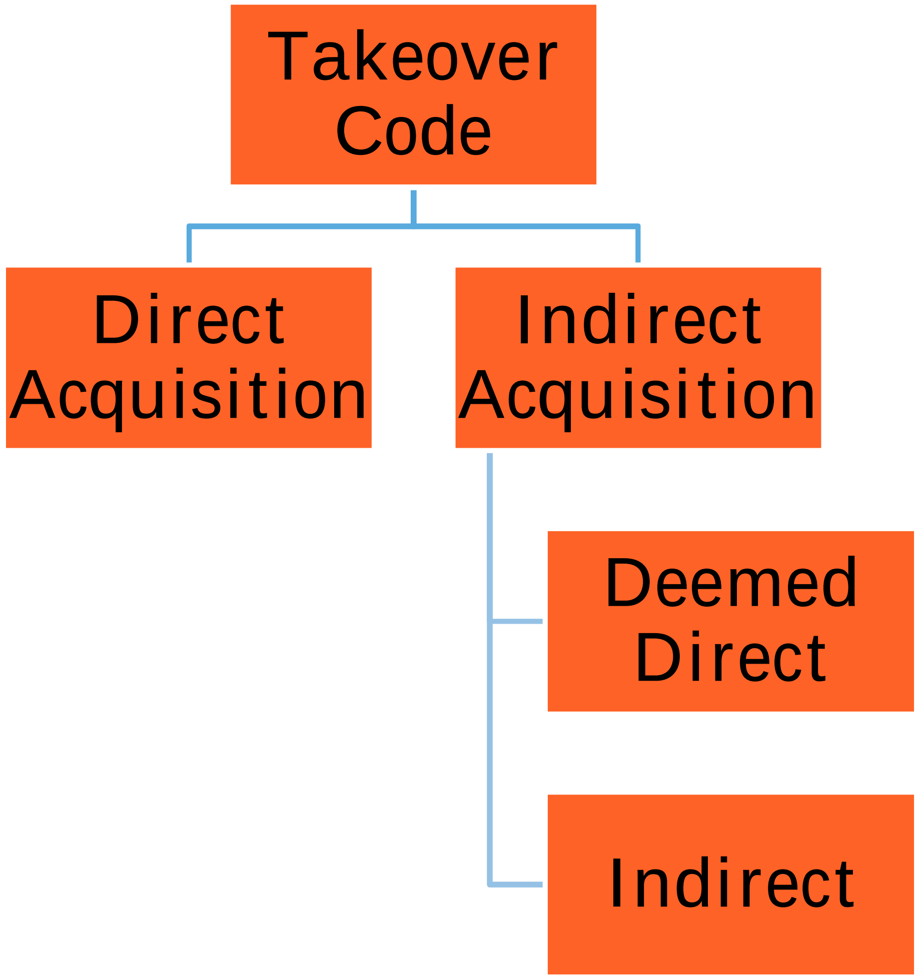
- Rule 11UA(1)
  - Quoted Securities
    - Through recognized stock exchange – Transaction Value
    - Not through recognized stock exchange
      - When there is trading on valuation date – lowest price quoted on any recognized stock exchange
      - When there is no trading on the valuation date – lowest price quoted on any recognized stock exchange on a date immediately preceding The valuation date when such securities were traded
  - Unquoted Equity Shares
    - Break-up Value
  - Other Unquoted Securities
    - Price that would be fetched in open market as determined merchant banker or CA

SECTION 56(2)(VIIB)



SEBI Regulations

TAKEOVER CODE



DIRECT ACQUISITION

Highest of

- Highest negotiated price under agreement attracting open offer
- VWAP paid by the acquirer or PAC during 52 weeks preceding date of PA
- VWAP paid by the acquirer or PAC during 26 weeks preceding date of PA
- If frequently traded, VWAP for 60 trading days preceding date of PA
- In case of infrequent trading, valuation based on parameters including book value, comparable trading multiples
- Substantial Indirect acquisition - per share value of target company taken into account for acquisition

Indirect Acquisition

Highest of

- Highest negotiated price under agreement attracting open offer
- VWAP paid by the acquirer or PAC for preceding 52 weeks*
- Highest price paid by acquirer or PAC during preceding 26 weeks*
- Highest price paid by acquirer or PAC between defined date and date of PA of open offer
- If frequently traded, VWAP for preceding 60 trading days
- Substantial Indirect acquisition - per share value of target company taken into account for acquisition

In case value cannot be determined under any of the above, offer price shall be determined based on valuation parameters including book value, comparable trading multiples

PREFERENTIAL ALLOTMENT

- Pricing of Equity Shares
  - Frequently Traded
    - Where shares have been listed for 26 weeks preceding relevant date – Higher of
      - Average of weekly high-low of VWAP during 26 weeks preceding relevant date
      - Average of weekly high-low of VWAP during 2 weeks preceding relevant date
    - Where shares have been listed for less than preceding 26 weeks – higher of
      - Price in IPO or value in scheme of arrangement
      - Average of weekly high-low VWAP during the listed period preceding relevant date
      - Average of weekly high-low of VWAP during 2 weeks preceding relevant date
  - Infrequently Traded
    - Valuation based on parameters including book value, comparable trading multiples

OTHER REQUIREMENTS

- <u>Fairness Opinion requirement under Listing Agreement</u>

  Fairness opinion refers to an opinion from another expert when justification is required on whether the values quoted by the expert valuer represent true values of the company.

COMPANIES ACT, 2013

COMPANIES ACT, 2013

The rules on Registered Valuers have not yet become effective

Following cases require report of registered valuer on valuation of equity shares

<u>Preferential Allotment (Section 62)</u>

- Value of shares shall be determined by a registered valuer in accordance with Companies (Share Capital and Debenture) Rules, 2014.
- This requirement does not apply to listed shares

COMPANIES ACT, 2013 (CONTD...)

Offer to Minority Shareholders (Section 236**)[not yet operative]-**

- Section applies when :
  - acquirer or PAC or any person
  - becomes holder of 90% or more of the issued equity share capital
  - By virtue of amalgamation, conversion of securities or any other reason
- Such acquirer or person to notify company of their intention to buy remaining equity shares
- The price of shares to be determined by registered valuer

COMPANIES ACT, 2013 (CONTD…)

- **Requirement of registered valuers (section 247) [not yet operative]**

  <u>Valuation by registered valuers</u>

  - As per Draft Rules, a CA/SEBI registered merchant bankers among others can be registered as valuers.
  - 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

COMPANIES ACT, 2013 (CONTD…)

- 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 ACT, 2013 (CONTD…)

- 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.

Valuation Approaches prescribed in Draft Rules

- Draft rules on registered valuers prescribe the following approaches for valuation:
  - Asset based
  - Income based
    - Yield method or Profit earning capacity method – capitalization of average of past 3 years' after-tax profits (any other period requires justification)
    - Comparable Companies Multiple – appropriate discount/premium to be applied
  - Market Value based
  - DCF Method
  - Comparable Transaction multiple
  - Price of Recent Investment
- Valuation date means date on which estimate of value is available; it may be different from the date of valuation report
- Appropriate weights to be applied where different approaches are adopted

STAMP DUTY

Value on which stamp duty is 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.

STAMP DUTY (CONTD.)

- 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.

STAMP DUTY (CONTD.)

- Under Article 25 (da) of Schedule I to the Maharashtra Stamp Act ("the Stamp 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
- Market Value of transferee company's shares where :
  - Share are listed : market value as on the appointed date
  - Shares are not listed : market value of transferee company's shares shall be computed with reference to the market value of transferor company's shares or determined by the collector

STAMP DUTY (CONTD.)

- Where shares of the Transferee Company are not actively traded on any Stock Exchange:
  - the Stamp Act or the rules there under do not prescribe any rules for valuations
  - Market value has to be determined according to acceptable legal principles of valuation

- However, as regards the method of 'valuation', there is no clear methodology prescribed 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.

ESTATE DUTY

- 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.

SPECIAL CASES

BUYBACK OF SHARES

- Regulatory framework consists of Companies Act, 2013 and where the company is listed SEBI (Buyback of Securities) Regulations, 1998
- Buyback can take place through 3 routes –
  - Through tender offer – price determined by the company which is usually at a premium to the prevailing market price
  - From open market through-
    - Book-building process - Price is discovered by bids invited from security holders
    - Stock exchange – at the prevailing market prices
  - From odd lot holders – price determined in manner similar to tender offer
- Fair valuation not required.

RIGHT ISSUE

- Companies Act, 2013 – Fair valuation not required
- No pricing regulations under FEMA in case of a right issue
- Income Tax Act, 1961 - There are no tax implications under section 56(2)(vii) when right issue is done at a discounted price. The following case laws support the view:
  - Sudhir Menon HUF (148 ITD 260)(Mum Trib)

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.

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. [Ascendas (India) Pvt Ltd. Chennai Tribunal]
- 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.

THANK YOU