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➢ Issues and Controversies under Section 56 (2) And Section 68 of Income-Tax Act,1961

The Finance Act 2012 introduced a new clause in the Income Tax Act, 1961, according to which, with effect from April 1, 2013, that portion of consideration received for the issue of shares of a public unlisted company or private company to an Indian resident that is in excess of the fair market value of those shares, will be subject to tax in the hands of the companies under the head "income from other sources". The aim of this paper is to examine the legal effect of amendment made by the Finance Act 2012 to Section 56(2) of the Income Tax Act, 1961 by introduction of clause (viib). It highlights the impact on angel investors in light of the SEBI (Alternative Investment Fund Regulations) 2012. The AIF Regulations have further made it difficult for these investors to invest in startups as stricter requirements have been laid down by SEBI. The paper attempts to explain clause (viib) and its ambit in light of its applicability to closely held companies, residents, receipt of consideration for shares and method of determination of the fair market value. Simultaneous application of Section 68 and Section 56(2)(viib) has also been discussed.

1. Provision under the Income Tax Act,1961

Section 56(2) lists incomes chargeable to income tax under the head 'Income from Other Sources.' Finance Act, 2012 inserts clause (viib), with effect from 1-4-2013(assessment year 2013-14) to include 'share premium' received by a company in excess of its fair market value , as its income chargeable under the head ' Income from other sources.' The clause is as follows:

“where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares, in such a case if the consideration received for issue of shares exceeds the fair value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income tax under the head “Income from other sources”.

Finance Act, 2012 simultaneously amends the definition of income in section 2(24) by inserting clause (xvi) to include the above consideration exceeding fair market value as ‘income’.

With a view to safeguard the genuine investment by bonafide companies it is provided that this clause will not apply to.

(i) A venture capital undertaking receiving the consideration for issue of shares from a venture capital company or a venture capital fund ; and

(ii) A company receiving the consideration from a class or class of persons (‘Notified persons’) as may be notified by Central Government.

The exception given to venture capital companies and venture capital funds appears to stem from the fact that these entities are regulated under the SEBI (Alternative Investment Fund) Regulations 2012 and hence there is some measure of scrutiny already in place over investments made by them. The explanation to Category I AIF under SEBI (AIF) Regulations provides that “Venture Capital Company” or “Venture Capital Fund” will be eligible for tax “pass through” benefits as per Section 10 (23FB) of the Income Tax Act, 1961.

As such this Clause (viib) introduced by the amendment will mainly affect the participation of private equity funds or high net worth individuals or risk capital. The clause will also impact genuine start-ups and other Small and Medium Enterprises (SMEs) looking to rapid growth particularly in the

services sector, as they depend upon angel investors or private equity funds for their funding as they are thinly capitalized. Such funding is normally at a substantial premium as the underlying assets of the startup do not support a higher fair market value. Thus, such funding normally depends on future prospects of the company rather than the current value of the assets of the company. This provision could destroy the developing culture of angel investors and private equity funds; funding promising entrepreneurs, who have the skills or intellectual property but very few tangible assets. The provisions may therefore encourage companies to form Limited Liability Partnerships, to raise foreign exchange from angel investors residing outside India, subject to applicable FDI requirements or to raise funds from individual Indian resident investors by issuing convertible debentures of the company.

With a view to address concerns raised by the Angel investors, exclusion has been granted from levy of such tax to certain notified class of persons by way of an enabling provision [i.e. Clause (viib) Proviso 1 & 2]. Government Of India - Ministry Of Commerce and Industry (Department Of Industrial Policy and Promotion) has now issued notification dated 17th February, 2016 and Ministry Of Finance also circulated notification dated 14th June,2016 so as to include startup company being excluded from the above provision.

2. SEBI AIF Regulations

The SEBI AIF Regulations 2012 even make it difficult for Angel investors to register as Venture Capital Funds with it. The Regulations mention that VCF's have positive spillover effects on the economy, and that it may, along with the government and other regulators, consider granting incentives or concessions based on the need of the funds. [Meaning of Angel investor as provided under Chapter III-A , Rule 19A (2) of SEBI (AIF) REGULATIONS , 2012]

The AIF Regulations have substantially increased the minimum fund size from INR 5 Crores to INR 20 Crores and the minimum amount that can be

accepted from an investor from INR 5 lakh to INR 1 crore. The increase is thus very significant and seems to be with a purpose. They may not be able to constitute such a large fund and to pool these amounts. Further, there are additional restrictions on the tenure of the fund (at least 3 years) and heavy disclosure and record keeping requirements that will significantly add to the costs of operating as registered entities.

3. **Importance of Section 56(2)**

Under this section 56 (2) certain receipts which are effectively capital receipt in nature shall be treated as income under the deeming fiction of Section 56 (2) of the income tax Act. These amendments with effect from A.Y. 13-14 and onwards have been made to curb the conversion of black money and therefore let us appreciate these amendments.

Let us examine the provisions in the amended Sections and the background behind the same.

56 (1) Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income e-tax under the head "Income from other sources" , if it is not chargeable to income-tax under any of the heads specified in section 14,

(2) In particular, and without prejudice to the generally of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely-

(i) to (iv) - Certain incomes to be taxed under the head Income from Other Sources.

(v) Gift received exceeding Rs. 25,000/-(from 1-9-2004 to 31-03-2006)

(vi) Gift received exceeding Rs. 50,000/- (from 1-4-2006 to 31-10-2009)

(vii) (a), (b) & (c) -

Section 56(2) (vii) applies when an Indi. / HUF in any previous year receives from any person or persons on or after 01.10.2009

Sum of money	**Amount liable under IFOS**
any sum of money without consideration, aggregate value of which exceeds Rs.50,000.	whole of the aggregate value of money received
any immovable property -	
*without consideration, the stamp duty value of which exceeds Rs.50,000;	Stamp duty value of immovable property
• for a consideration which is less than its stamp duty value by an amount exceeding Rs.50,000.	Difference between the stamp duty value and consideration
any property other than immovable property, -	
• without consideration, the aggregate FMV of which exceeds Rs.50,000;	whole of the aggregate of FMV (as per prescribed method) of movable property.
• for a consideration which is less than the aggregate FMV of the property by an amount exceeding Rs.50,000.	aggregate FMV (as per prescribed method) of movable property in excess of the consideration.

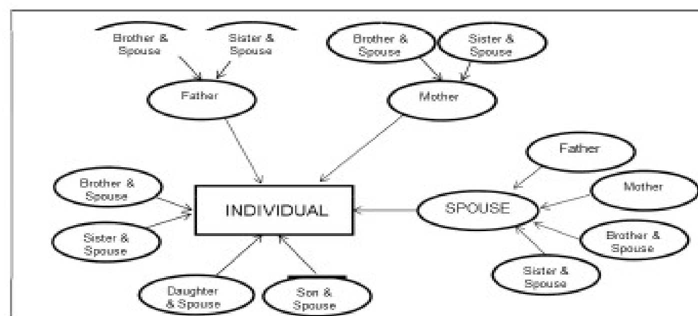
However there are six exemptions in this receipt of gift. The gift received form relative, on the occasion of marriage of an individual, or gift received under a Will / by way of inheritance or gift given in contemplation of death of the person i.e. Gift – Mortis Causa shall not be considered as income. The relative has been defined in the explanation and to understand the same, the chart given is as under:

List of Male Donors	**List of Female Donors**
Father (Papa or Pitaji)	Mother (Maa or Mummy)
Brother (Bhai)	Sister (Bahin)
Son (Beta or Putra)	Daughter (Beti or Putri)
Grand Son (Pota or Potra)	Grand Daughter (Poti or Potri)
Husband (Pati)	Wife (Patni)
Sister’s Husband (Jija)	Brother’s Wife (Bhabhi)
Wife’s Brother (Sala)	Wife’s Sister (Sali)
Husband’s Brother (Dewar)	Husband’s Sister (Nanand)
Mother’s Brother (Mama)	Mother’s Sister (Mausi)
Mother’s Sister Husband (Mausa)	Wife’s brother’s wife
Father’s Brother (Chacha or Tau)	Father’s Brother’s Wife (Chachi or Tai)
Father’s Sister’s Husband(Fufa)	Father’s Sister (Bua)
Grand Father (Dada, Pardada)	Grand Mother (Dadi, Pardadi)
Daughter’s Husband (Jawai)	Son’s Wife (Bahu or Putra Vadhu)
Spouse Father (Sasur)	Spouse Mother (Saas)
Spouse Grand Father (Dada Sasur)	Spouse Grand Mother (DadiSas)
	Mother’s Brother’s Wife (Mami) Husband’s Brother’s Wife (Devrani or Jithani)

‘Relative’…….

‘Relative’…

The relatives of an assessee who is an individual are very nicely explained by the following diagram from BCAS Referencer.



- **<u>56(2)(vii)(b)(i) – Analysis</u>**

Now most controversial sub section is 56 (2) (vii) (b) is discussed as under :

- **<u>GIFT RECEIVED IN FORM OF IMMOVABLE PROPERTY (WITHOUT CONSIDERATION)</u>**

<u>At the time of Making Gift :</u>

<u>Taxability in hands of Donee - Sec .56(2)(vii)(b)(i):</u>

If any individual/HUF receives any immovable property, without consideration, the stamp value of which exceeds Rs.50,000 then stamp duty value of such immovable property shall be taxable. If stamp duty value of

immovable property does not exceed Rs.50,000 then nothing is taxable in hands of Donee.

It is to be remembered that notwithstanding exemption or applicability of Section 56 (2) the provision of Section 54(1) and 64(1) and64(1A) shall continue to apply i.e. clubbing provisions.

Undoubtedly by inserting two provisos it has been intelligently provided that if the stamp duty value on the date of registration of sale deed is higher but the transferor had executed an agreement and sum has been paid by any mode other than cash then the stamp duty value shall be as per the date of agreement and not the date of registration.

Sub clause (c) of Section 56 (2)(vii) deals with the identical situation but in case of property other than immovable property the section as defined the term, fair market value, jewellery, property relatives, stamp duty and accordingly all such gifts in cash or in kind for a value exceeding Rs.50,000/- had been taken care of.

As the amendment was covering only Individual & HUFs vide this Amendment , the smart operators shifted the abuse by using the assessees in form of Partnership firms and Private Limited Companies. To cover such continuous abuse , further amendment has been made so as to cover such entities like Partnership firms and Private Limited Companies and Closely held companies.

The assessee like AOP are still not covered and one has to see whether such abuse is still continued by such smart operators.

- **Amendment from 1.6.2010:**

To curb the conversion of black money or other proceeding of income and wealth through media of firm and companies a new sub section (viia) have been introduced with effect from

(viia) where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year, from any person or persons, on or after the 1st day of June,2010, any property, being shares of a company not being a company in which the public are substantially interested,

(i) Without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

(ii) For a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration :

Provided that this clause shall not apply to any such property received by way of a transaction not regarded as transfer under clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of Section 47.

Section 47 -

(via) any transfer, in a scheme of amalgamation, of a capital asset being a share or shares held in an Indian company, by the amalgamating foreign company to the amalgamated foreign company, if—

(a) at least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company, and

(b) such transfer does not attract tax on capital gains in the country, in which the amalgamating company is incorporated;

(vic) any transfer in a demerger, of a capital asset, being a share or shares held in an Indian company, by the demerged foreign company to the resulting foreign company, if—

(a) the shareholders holding not less than three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

(b) such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated :

***Provided** that the provisions of sections 391 to 394 of the Companies Act, 1956 (1 of 1956) shall not apply in case of demergers referred to in this clause;*

(vicb) any transfer by a shareholder, in a business reorganisation, of a capital asset being a share or shares held by him in the predecessor co-operative bank if the transfer is made in consideration of the allotment to him of any share or shares in the successor co-operative bank.

Explanation.—For the purposes of clauses (vica) and (vicb), the expressions "business reorganisation", "predecessor co-operative bank" and "successor co-operative bank" shall have the meanings respectively assigned to them in section 44DB;

(vid) any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of demerger of the undertaking;

(vii) any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if —

(a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company except where the shareholder itself is the amalgamated company, and

(b) the amalgamated company is an Indian company;

This provision has been introduced to curb the practice of transferring the ownership of the company through shares at a price less than the fair market value and obtained the difference in cash. The receipt of such shares by individual is already covered the assessee like firm and companies this clause has been inserted.

To illustrate Mr.X sales his shares of a closely held company to a Partnership firm of Rs.50 lakhs, the fair market value as worked out under the definition provided to exception i.e. as per prescribed rules worked out to Rs.2 crore then the difference which is in excess of 50,000/- i.e. Rs.1.50 crore would be chargeable to tax in the hands of the Partnership firm M/s. X. Y, Z.

It is to be kept in mind that under this clause what is covered is only shares and not the Debentures, whether convertible or non convertible.

- The gift received on the occasion of the marriage of an individual is exempt. Therefore gift received during wedding or reception as 'Chandlo' are exempt but only in the hands of individual i.e. bride or bridge groom and cannot be taken as receipt of HUF i.e. of husband and wife after the marriage rituals are over. The term on the occasion of the marriage is very important. Therefore gift received on engagement or ring ceremony strictly will not quality as gift on the occasion of the marriage. It does not strictly mean on the date of

marriage but any gift received before or after some days which are associated with the event of marriage will certainly qualify for the exempted gift. If a relative from abroad or out of station sends the gift after some months/years even then it can be considered as gift received on the occasion of the marriage.

- Gift received by a person under a Will (or by inheritance) i.e. from the parents/relatives on inheritance are also capital receipt(2) (vi) of the Act. Such gifts by Will can take place only after the death of the person. Inheritance will be always form the family/relative but amount can be received under a Will from any person i.e. relative, friend or even unknown person. Hon'ble Supreme Court in case of K.K. Birla v. R.S. Lodha held that it is possible for a person to Will his/her property to any person including to anyone.

- Similarly gift received in contemplation of death, means the thought of dying, not necessarily from imminent danger but as the compelling reason to transfer property to another. It is known as Gift Maurtis Causa. This is different from the Will inasmuch as a gift is said to be made in contemplation of death where a person who is ill and expect to die very shortly of illness, delivers to another person the possession of any movable property to receive and keep as a gift in case the donor shall die of such illness.

- ***<u>After Making Gift:</u>***

<u>Clubbing of Income</u>

If transfer of immovable property is made to spouse, son's wife, or any other person for immediate/deferred benefit of spouse or son's wife of the Donor, then any income/benefit arise from the use/investment of such property will be clubbed in the hands of Donor (i.e. Transferor) proportionately. [Sec. 64(1)].

Further, if the donee is minor child of donor, then any income arising from the use/investment of such immovable property will be clubbed in the hands of Parents. [Sec. 64(1A)].

- ***<u>Taxability in hands of Donee at the time of sale of such immovable property - Sec. 49(1) & 49(4):</u>***

1. Cost of acquisition for the purpose of computation of Capital Gain will be Cost of previous owner if nothing has been taxable under sec.56(2)(vii). ***[Sec. 49(1)]***
   However, Where the capital gain arise from the transfer of a property, the value of which has been subject to income tax under section 56(2)(vii) or 56(2)(viia), the cost of acquisition of such property shall be deemed to be the value which has been taken into account for the purpose of the said section. ***[Sec. 49(4)].***

2. *Holding period for such asset will be counted from the date of acquisition of the previous owner [As per the decision by Bombay High Court in the case of Manjula J. Shah] ITA No.3378 of 2010, dt. 11.10.2011.*

Here Previous owner means – a person who have acquired such asset by way of otherwise than gift

- **IMMOVEABLE PROPERTY RECEIVED FOR INADEQUATE CONSIDERATION**

At the time of Making Gift :

Taxability in hands of Donee-Sec. 56(2)(vii)(b)(ii): [Amended by FA,2013, w.e.f. A.Y.2014-2015]

If any individual/HUF receive any immovable property, for a consideration which is less than Stamp duty value, and the difference between stamp duty value & consideration paid exceeds Rs.50,000, then difference between consideration paid and stamp duty value of such immovable property shall be taxable in the hands of donee.

However, If the difference between stamp duty value & consideration paid does not exceed Rs.50,000 then nothing is taxable in hands of Donee.

- **First / Second Proviso to Sec 56(2)(vii)(b)(ii) – Analysis**

Exceptions:

a) In case the assessee has –
b) entered into an agreement;
c) the agreement is for transfer of immovable property; and
d) the agreement fixes the amount of consideration;
e) the date of such agreement and the date of registration are not the same;
f) the amount of consideration referred to in the said agreement or

g) a part of the consideration has been paid by any mode other than cash on or before the date of the said agreement then, the stamp duty value on the date of the agreement may be taken for the purposes of S. 56(2)(vii)(b)(ii).

- **Extract of Object Memorandum of Finance Bill, 2012**

The new clause will apply where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares. In such a case if the consideration received for issue of shares exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head "Income from other sources". However, this provision shall not apply where the consideration for issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund.

Further, it is also proposed to provide the company an opportunity to substantiate its claim regarding the fair market value. Accordingly, it is proposed that the fair market value of the shares shall be the higher of the value—

(*i*) as may be determined in accordance with the method as may be prescribed; or

(*ii*) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value of its assets, including intangible assets, being goodwill, know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

This amendment will take effect from 1st April, 2013 and will, accordingly, apply in relation to the assessment year 2013-14 and subsequent assessment years.

Let us now understand Section 56(2)(viiib)

where a company,

- not being a company in which the public are substantially interested,
- receives,
- in any previous year;
- from any person being a resident,
- any consideration for issue of shares that exceeds the face value of such shares,
- the aggregate consideration received for such shares as exceeds the fair market value of the shares:

Provided that this clause shall not apply where the consideration for issue of shares is received –

(i) by a venture capital undertaking from a venture capital company or a venture capital fund; or

(ii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Explanation. – For the purposes of this clause, -

(a) The fair market value of the shares shall be the value –

Clause (i)

- as may be determined in accordance with such method as may be prescribed; or

Clause (ii)

- As may be substantiated by the company to the satisfaction of the Assessing Officer,

- based on the value,
- on the date of issue of shares,
- of its assets,
- including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature,
- whichever is higher.

(b)"venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in clause (a) (clause(b) and clause(c) of Explanation 1 to clause (23FB) of section 10,."

- Simultaneous amendment in definition of Income -

2(24)(xvi) any consideration received for issue of shares as exceeds the fair market value of the shares referred to in clause (viib) of sub-section(2) of section 56;

This clause has been inserted with effect from 1st April 2013 and is applicable form Assessment Year 13-14. It brings to tax the consideration received from resident by a company (other than a company in which public are substantially interested) which is in excess of fair market value. Such cases is to be treated as income of a closely held company which are normally received when shares are issued at a premium. In other words the shares issued by various companies (unlisted)/in which Public are not substantially interested) at a premium not justifying the same are hit by this clause. Of course with a view to encourage genuine companies two exceptions are provided. Normally it will not apply to shares received by a venture Capital undertaking receiving shares form Venture Capital Company/Venture Capital

Fund or (2) such class or classes of companies may be notified by the Central Government.

WHY SUCH AMENDMENT ?? :

With a view to convert the black money Companies were issuing share premium without justifying the reserve or market value of the shares. Therefore to curb such practice it has been provided that fair market value of the shares shall be in accordance with the method as may be prescribed or as may be substantiated by the company to the satisfaction of Assessing Officer based on the value of its assets including intangible assets. Out of the above two whichever is higher will be the maximum premium allowed.

The working of the fair market value as provided in the rules are given in the Appendix. Thus various practices of money laundering or conversion of black money are attempted to be curbed by these amendments. May be that in some exceptional cases genuine buyers or genuine sellers of closely held companies are adversely hit but subject to that this is a provision where unjustified premium and thereafter reducing the price of the shares and suffering short term or long term capital gain of shares etc. will be curbed.

5. The Game behind:

India is having one of the most reasonable tax structure with 30% maximum Income-tax and more than that as per latest report of Parliamentary Committee the effective tax rate in India is just around 20%. That is the reasons that in last budget , Hon'ble Finance Minister allows gradual reduction of Income Tax on companies up to 25%. Of Course , by removing/ withdrawing certain exemptions and tax benefits. However, most unfortunately millions of citizens in our country are still not paying the Tax or

are still not paying the true and correct tax honestly. Though avoidance of income tax is permissible under the law; but evasion certainly is illegal as well as immoral. Honest citizens paying true and correct tax notice that those who are dishonest citizens are able to generate unaccounted income and in turn plough them back in the Industry, and grow richer and richer and amas wealth as against they are at loss and they sometimes get frustrated. Definitely not in this part of the country i.e. in Gujarat / Maharashtra but in some of other States in of the country systematic chain and system is prevailing like parallel economy of black money for conversion of black money into white money. These kinds and modus operandi of conversion into white money by different modes were happening in front of the eyes /below the nose of Income tax Authorities. Even top most bureaucracy in Delhi and Finance Ministry and others are aware of all such practices. The Ministry having realized that Judicial Decisions and Executive actions are not sufficient to curb such rapid growth of conversion of unaccounted money into accounted one, Finance Ministry thought it fit and rightly so to make appropriate amendments to check and control such recognized approved and famous method of conversion of black money into white money popularly known as Calcutta Companies.

Illustration:

Let us understand what was hitherto happening. A person who is in control of such funds will incorporate and have his company the following assets and liabilities with duly audited accounts, directors' reports etc., as under:-

Assets	Amount	Liabilities	Amount
Equity share capital 1 crores shares of Rs.10 each. (Reserves & Surplus	10 crores 2 crores	Net Assets	12 crores

Total	12 crores	Total	12 crores.

The entire paid up share capital of the company is held by Mr.A and his family members.

Mr. B. (or his group) subscribes to 10 lakh shares of A Pvt. Ltd. of face value of Rs.10 each at Rs. 200 per share at a premium of Rs.190 per share. Therefore, Mr. B gives cheques of Rs.20 crores to the company and he is allotted 10 lakh shares of A. Pvt. Ltd. Mr. A in turn gives cash i.e. black money of Rs.20crores to Mr. B.

Assets	Amount	Liabilities	Amount
Equity share capital 1.10 crores shares of Rs.10 each. Share Premium Reserves & surplus	11 crores 19 crores 2 crores	Bank Balance Other Net Assets	20 crores 12 crores
Total	32 crores	Total	32 crores.

Now Balance Sheet of Company A Pvt. Ltd., is as under:-

Mr. A and his family have successfully converted black money of Rs.20 crores into white money of Rs.20 crores in the hands of their company. The share premium received is on capital account and being share capital receipt not taxable in the hands of company.

The shareholding pattern is:

Mr. A & his family		1 crores shares of Rs.10 each.
Mr. B.& his family		10 lakh share of Rs.10 each.
	Total	110 lakh shares of Rs.10 each.

Mr. A and his family still have control over the company since shareholding pattern is as under:-

Mr. A & Family 90.91 %
Mr. B. & family. 9.09%

Practically, what was happening was that instead of Mr. B, there would be let's say 40 persons who have white money of Rs.50 lakhs, each then these 40 persons subscribes to 25,000 share each of Rs. 200 and A & Family gives black money of Rs.50 lakhs each to these 40 persons.

After this, the fair market value of shares of the company is derived as under;

Assets – Liabilities x Paid up value of unquoted equity share Paid up equity share capital 32,00,00,000 x 10= Rs. 29.00.

1,10,00,000 shares

Thereafter, Mr. B /40 people would sell their shares to A & family @ Rs.29.00 per share and there was no gift implications under section 56(2)(vii). Mr. B /40 people book loss under the head Capital Gains of Rs.200 – Rs.29.00 = Rs.171.00 per share. Mr. A and family purchases these 10,00,000 shares @ Rs.29.00 using their white money ofRs.2,90,90,000. Therefore, Mr. A and his family have effectively converted Rs.17,09,10,000/- black money into white money and having 100% control over the company Mr. B/ 40 people are able to book loss of Rs.17,09,10,000 under the head Capital Gains either Short term or Long term as per their need / planning.

This kind of dubious planning has been nullified by introducing section 56(2)(viib) by Finance Act,2012. Section 56(2) (viib) provides as under:

Where a closely held company receives in any previous year from any person, being a resident any consideration for issue of shares that exceeds the face value of such shares then

- Aggregate consideration – Fair market value of the shares received for such shares shall be income from other sources in the hands of the company.

In the example given above the fair market value of shares before issue of 10 lakh shares is :

$\frac{12 \text{ crore}}{10 \text{ crore}} \times 10 =$ Rs. 12 per share

Therefore, Rs.20 crores – Rs.12 x 10 lakhs shares

Rs.20 crores – 1.20 crores = Rs.18.80 crores is taxable as income from other sources in hands of the company.

- **Effects Now:**

  - The above modus-operandi has been broken by introducing section 56(2) (viib) Therefore, now companies will stop issuing shares in the aforesaid manner.

  - This section does not apply if a widely held company issues shares at a premium. The section applies only if a closely held company issues shares at a premium. The reason for not applying this section to a widely held company is that SEBI monitors and approves the price at which shares are issued by a widely held company.

- This section does not apply where a closely held company issues shares to a Non-Resident at a premium in excess of FMV. The reason seems to be that non-resident will not like to convert his white money abroad in dollars into black money in India. Moreover, the money received from non-resident is regulated by FEMA and also by rules of RBI.

In the example given above, the company is having net assets of Rs.12 crores. Let us say, the break-up of net assets is as under:-

Assets	Book value	Value substantiated by company to the satisfaction of A.O. on the date of iussue of shares.
Land	2 crores	14 crores
Building	1 crore	13 crores
Goodwill	2 crores	5 crores
Know-how	1 crore	2 crores
Patents	1 crore	4 crores
Copyright	1 crore	7 crores
Trademarks	1 crore	2 crores
Licenses	1 crore	1 crores
Franchisees	2 crores	2 crores
Total	12 crores	50 crores

Fair market value works out to be:

50 crores x 10
10 crores = Rs. 50 per shares.

The FMV shall be taken to be Rs.50 per share.

Income from other sources in hands of company shall therefore be Rs.150 x 10 lakhs= Rs.15 crores.

The implications of proposed amendments-new clause (*viib*) and new first proviso to section 68 have been illustrated in the following Table:

	Face value of shares	***Consideration received***	***FMV of shares determined***	***Whether and how much taxable under proposed new clause (viib) of Section 56(2) ?***	***If new first proviso to section 68 attracted***
Case 1	Rs. 10	Rs. 100	Rs. 120	Since consideration received does not exceed FMV, question of taxability under clause (*viib*) does not arise.	Entire amount of Rs. 100 taxable under section 68
Case 2	Rs. 10	Rs. 100	Rs. 80	Rs. 20 taxable[excess of consideration (Rs. 100) over FMV (Rs. 80)]	Entire amount of Rs. 100 taxable under section 68.
Case 3	Rs. 10	Rs. 10	Rs. 8	Although consideration exceeds FMV, nothing is taxable since consideration does not exceed face value and so shares not	Entire amount of Rs. 10 taxable under section 68

				issued at a premium.	
Case 4	Rs. 10	Rs. 9	Rs. 8	Here shares are issued at a discount and not a premium. So, question of taxability under clause (*viib*) does not arise.	Entire amount of Rs. 9 taxable under section 68.

- **Issues Arising from section 56(2) (viib)**

1**.** There are certain issues that arise as regards new clause (*viib*) which are dealt with as under:

(i)Share application money received on 30-3-2012, but allotment of shares made on 30-4-2012. Whether any amount taxable under new clause (viib)? - It appears that taxability will arise in the year of receipt of consideration for issue of shares(and not year of allotment) since the words "receives" is used in new clause (*viib*). Since, new clause comes into operation from A.Y. 2013-14, it appears that it will apply only if consideration is received on or after 1-4-2012. Hence, no question of taxability under new clause (*viib*).

(ii)Company is widely held company at the time of receipt of consideration but is converted to a closely held company at the time of allotment of shares -It appears that status of company at the time of

receipt of consideration is relevant and not its status at the time of allotment of shares .Therefore, since company was not closely held co. at the time of receipt of consideration, no question of taxability under new clause (*viib*) arises.

(*iii*)*Company is closely held company at the time of receipt of consideration but is converted to a widely held company at the time of allotment of shares -* It appears that status of company at the time of receipt of consideration is relevant and not its status at the time of allotment of shares .Therefore, since company was closely held co. at the time of receipt of consideration, question of taxability under new clause (*viib*) arises.

(*iv*)*Consideration was received from a non-resident who became a resident at the time of allotment -* Since clause (*viib*) applies to consideration received from a resident, the residential status at the time of receipt of consideration by company and not residential status at the time of allotment is relevant. Therefore, as person from consideration was received is non-resident at the time of receipt of consideration, no question of taxability under new clause (*viib*) arises.

(*v*)*Whether consideration received in kind taxable under new clause(viib)? –*New clause *(viib*) refers to "any consideration for issue of shares". The word "any" is very wide in scope and will take in its scope consideration received in kind also. However, new clause (*viib)* only speaks of how FMV of shares will be determined. It does not say how consideration in kind will be valued for comparison with FMV of shares. Since provision does not say how consideration in kind will be valued, a view is possible that it is not intended to apply where part or whole of consideration is received in kind. The object seems to be to target cash transactions as black money is generated through cash transactions as can be seen from new proviso to section 68.

Thus it can be seen that the clear intention behind this Amendment is to control the unwarranted or bogus or unjustified subscription to share premium. As explained in the example, it will certainly control and stop the menace of black money or unaccounted money being rotated and channelized through this mode of Companies. But while doing this controlling exercise it may hit certain genuine transactions of bonafide share premium also. There may be companies who cannot justify the share premium on the basis of existing valuation even if done on global valuation concept. The Rules of Valuation are clearly prescribed in Rule 11U and 11UA (See Appendix 3 & 4). Therefore, any other global valuation done by best of the firm of Chartered Accountant or a Management Consultant may not be accepted by the Income Tax Authorities if not done strictly as per the Rules. Particularly in cases of companies where software innovations are being conducted and are on pipeline or in cases where technology up gradation or a secret formula is planned to be sold through heavy share premium may be adversely affected by this Amendment.

- **Simultaneous Amendment in Section 68**

- ***SECTION 68: CASH CREDITS.***

Where any sum is found credited in the books of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the sum so credited may be charged to Income-tax as the income of the assessee of that previous year.

- **Proviso added by Finance Act, 2012 w.e.f. Assessment Year 2013-14.**

[Provided that where the assessee is a company,(not being a company in which the public are substantially interested) and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless –

(a) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and

(b) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:

Provided further that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (23FB) of section 10.]

- **Let us understand what was happening and why such amendment: Company XYZ Pvt. Ltd. used to adopt the following modus operandi to convert black money into white money:**
  - 100 slum dwellers were contacted and their PAN cards were made and their bank accounts were opened. In the previous year 31-03-2011, Rs. 2,00,000 each cash was deposited in their bank accounts and cheque of Rs.2,00,000 was taken from them in the name of the company XYZ Pvt. Ltd. They were made to sign share application form that they are applying for 10,000 shares of 10 each face value at a premium of 10. They were also made to sign blank transfer deeds for share transfer. Each slum dweller's return was filed showing income of Rs. 2,00,000/- for previous year 31-03-2013 and tax thereon is NIL. For this process each slum dweller was paid Rs.2,000 in cash i.e. unaccounted money.
  - In the above process company XYZ Pvt. Ltd. has deposited unaccounted cash of Rs.2,00,000 x 100 = Rs.2 crores. In the slum dwellers' bank account and received cheques of Rs.2 crores as share application money in the company XYZ Pvt. Ltd.
  - The Fair Market Value/ issue price of shares of company XYZ Pvt. Ltd. is Rs. 20 per share.
  - The company XYZ Pvt. Ltd. either shows Rs.2 crores as Share Application Money or allots 10,000 shares of Rs.10 each at a premium of Rs.10 to the slum dwellers however, physical custody of these shares

is not given to the slum dwellers and company retains the same. The company is safeguarded by the blank share transfer deeds.

- Now the Assessing Officer takes the case of the company in the scrutiny assessment u/s. 143(3) for the above mentioned previous year. The Assessing Officer asks the explanation from the company for the nature and source of sum of Rs. 2 crores credited by the company in its books as share application money or asks share capital introduced and premium thereon. The A.O. asks for;
- (i) bank pass books of these 100 slum dwellers.
- (ii) personal appearance of these 100 slum dwellers

The company simply produces to the A.O.;

- (i) Name and address of slum dweller
- (ii) PAN of slum dweller
- (iii)ITR of slum dweller.
- The company does not produce the pass books of these slum dwellers and does not produce them personally before A.O. Assessing Officer to investigate the case and finds that cash of Rs. 2,00,000 was deposited in bank account of each slum dweller and finds that slum dweller has no financial standing. Slum dweller is not able to offer explanation about the source of Rs.2,00,000 or the explanations offered by him are found to be unsatisfactory by Assessing Officer.

The Assessing Officer invokes section 68 and adds Rs.2 crores to the income of the company as unexplained cash credits because the persons from whom share application money came were not able to prove the source of money in their hands. Such additions u/s.68 so made in the hands of the comp[any was not being sustained in Appeals because Hon'ble Supreme Court Lovely Exports (P) Ltd. [(2008) 216 CTR 195], has held as under:

"If the share application money is received by the assessee-company from alleged bogus shareholders, whose names are given to the Assessing Officer, then the department is free to proceed to reopen their individual assessments in accordance with law but this amount of share money cannot be regarded as undisclosed income under section 68 of the assessee-company. ***The Supreme Court held that there is no onus on the company to prove the source of money in the hands of shareholder or the persons making payment of share application money.*** *If company identifies the persons from whom money has been received, then section 68 cannot be involved in the hands of company."*

- Thus, by virtue of above Supreme Court Judgment, no income was possible to be added in hands of company under section 68.
- In hands of slum dwellers, the Assessing Officer applies section 68 as Rs.2,00,000 credited in bank account is unexplained. The slum dweller is not able to offer any explanation about the source of Rs.2,00,000 or the explanation offered by him are found to be unsatisfactory. But since the slum dwellers had no other source of income, the only income assessed was Rs.2 lakhs under section 68. Considering the slab limit of Rs.2,00,000 no tax/interest/penalty could be levied on the above slum dwellers.
- Thus, Rs.2 crores black money thus was possible to be converted into white money by the company with no tax implication.
- However, it is important to note the recent decision of Hon'ble High Court of Delhi in case of CIT vs. Nova Promoters & Finlease (P) Ltd. [(2012) 18 taxmann 217] wherein Hon'ble Justice Mr. R.V. Easwar held that "there is ample authority for the position that where an assessee fails to prove satisfactorily the source and nature of certain amount of cash received during the accounting year, the Income tax Officer is entitled to draw the inference that the receipt are of an assessable

nature. Section 68 recognizes the aforesaid legal position. The view taken by the Tribunal on the duty cast on the Assessing Officer by section 68 is contrary to the law laid down by the Supreme Court in the judgment cited above. Even if one were to hold, albeit erroneously and without being aware of the legal position adumbrated above, that the Assessing Officer is bound to show that the source of the unaccounted monies was the coffers of the assessee, we are inclined that in the facts of the present case such proof has been brought out by the Assessing Officer. The statements of Mukesh Gupta and Rajan Jassal, the entry provides, explaining their modus operandi to help assessee's having unaccounted monies convert the same into accounted monies affords sufficient material on the basis of which the Assessing Officer can be said to have discharged the duty. The statements refer to the practice of taking cash and issuing cheques in the guise of subscription to share capital, for a consideration in the form of commission. As already pointed out, names of several companies which figured in the statements given by the above persons to the investigation wring also, figured as share-applicants subscribing to the shares of the assessee-company. These constitute materials upon which one could reasonably come to the conclusion that the monies emanated from the coffers of the assessee-company. The Tribunal, apart from adopting an erroneous legal approach, also failed to keep in view the material that was relied upon by the Assessing Officer. The CIT (Appeals) also fell into the same error. If such material had been kept in view, the Tribunal could not have failed to draw the appropriate inference.

- Finance Act, 2012 nullifies the above tax planning. Proviso to section 68 has been added by Finance Act, 2012 which over-rules the Supreme Court judgment in Lovely Exports (P) Ltd. as mentioned on the earlier page.

Thus, as per the Proviso inserted by Finance Act, 2012; in Section 68

- If in case of a closely held company any sum is found credited in its books of account as share application money, share capital, share premium or any such amount by whatever name called (Rs.2 crores in above example in case of XYZ Pvt. Ltd.) the explanation given by these residents (slum dwellers in above example) to the Assessing Officer is found to be unsatisfactory, then, it shall be deemed that the explanation offered by the assessee company about the sum so credited (Rs.2 crores in our example) is not satisfactorily explained and consequently Rs.2 crores shall be deemed to be income of the company as unexplained credit under section 68.

- The crux of amendment is that the closely held company receiving share application money/share capital/share premium/any such amount has to prove the source of funds in the hands of shareholder/person giving the share application money/share capital/share premium/any such amount.

  i.e. Now source of source is also required to be proved to the satisfaction of the A.O. Thus all the earlier decisions of several Tribunals and High Courts are nullified.

- The Finance Act, 2012 has placed onus of proof on the closely held company receiving the share application money/share capital/ share premium/any such amount has to prove that such money which is invested in the company belongs to the person who has given the money to the company. Otherwise, the money so received shall be taxable in hands of company as unexplained cash credit under section 68.

  Further section 115BBE has been introduced by Finance Act, 2012 which provides as under:

1. Where the total income of an assessee includes any income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D, the income-tax payable shall be the aggregate of—
   - The amount of income-tax calculated on income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D, **at the rate of thirty per cent**; and
   - **Normal tax rate on the balance income.**
2. Notwithstanding anything contained in this Act, no deduction in respect of any expenditure or allowance shall be allowed to the assessee under any provision of this Act in computing his income referred to in clause (a) of sub-section (1).
   - The effect of section 115BBE will be that these 100 slum dwellers who have unexplained cash credit of Rs.2,00,000 will not get slab benefit of Rs. 2,50,000 and Rs. 200,000 shall be taxable at a flat rate of 30.90%. Therefore, each slum dweller will have to pay tax of Rs.61,800
   - Section 115BBE hits these slum dwellers who were a party to the transaction of converting black money into white money.
   - No expenditure shall be allowed from the income so deemed under section 68 and deductions under Chapter VI-A shall also be not allowed from such deemed income.

- **The proviso to section 68 added by Finance Act, 2012 and section 115BBE also nullifies the following tax planning:**

Cash of Rs.2,00,000 was deposited in account of a non-earning member of family or servant/driver in the house and it was shown as income from tuitions / boutique. Income tax returns were filed for these non-earning members/servant/driver showing income of Rs.2,00,000 and Nil tax thereon.

Then, this Rs.2,00,000 was taken as a loan into the business from these people. Now, the Assessing Officer has the power to ask the source of Rs.2,00,000 from the non earning members/servant/driver being credited to their bank account. Assessing Officer will ask for name and addresses of student's to whom tuitions were given and names and addresses of persons to whom Ambroidery / Vadi / Papad / Khakhra services provided. If no explanation is given or explanation is found to be unsatisfactory by Assessing Officer, then, Rs.2,00,000 will be added as income from unexplained credit under section 68 in hands of non-earning member / driver / servant. As per section 115BBE this income will be taxed @ 30.90% without the slab of Rs. 2,50,000 i.e. tax of Rs. 61,800. Thus, the practice of converting black money into white money has been attacked.

Notes:

1. **Proviso to section 68 introduced by Finance Act, 2012 is not applicable to money received from non-residents since money received from non-residents is regulated by FEMA and rules of RBI.**

2. **Proviso to section 68 introduced by Finance act, 2012, is not applicable to money received from Venture Capital Company and Venture Capital Fund since they are regulated by SEBI.**

➢ So far as section 68 is concerned there are now numerous decisions of Hon'ble Tribunals and High Courts clearly holding that when such amounts are found credited in the books of accounts in the names of persons whose identity, genuineness and creditworthiness cannot be explained by the assessee to the satisfaction of the Assessing Officer then such sum so

credited can be charged to Income Tax as income of the assessee of that previous year. But the decision of Hon'ble Supreme Court in case of Lovely Export (supra) came to the rescue of operators which were in a position to introduce unaccounted or black money in the modus operandi as illustrated above. By making amendment in the proviso of this section now it will be almost impossible to introduce unaccounted money in this manner. In a way it is a very welcome amendment as it is to curb introduction of black money in the guise of companies share capital. In view of this now every company (other than public company) in which public are not substantially interested shall have to maintain and in turn produce before the Income tax authorities the genuineness and creditworthiness besides the identity of the investors/shareholders in share capital. No doubt , there are numerous decisions of Tribunals as well as High courts , that even if additions are made u/s 68 of the I.T. Act , on account of such unexplained deposit/ Credits , penalty of concealment / inadequate particulars of income u/s 271(1)(c) is not leviable.

Decisions :

i. DCIT Vs. M/s. K. Bhanji Vanmalidas & Co. – ITA No. 743/RJT/2010 (ITAT Rajkot)

ii. ITO Vs. Shri Haribhai Devrajbhai Babariya – ITA No. 96/AHD/2011 (ITAT Ahmedabad)

iii. Mohd Haji Adam & Co, Vs. DCIT - ITA No.4341/Mum/2009 (ITAT Mumbai)

Now Section 271(1)(c) further amended for levy of penalty and Section 270A has been inserted vide Finance Act, 2016 defining Under Reported / Misreporting income.

Penalty for under reporting and misreporting of income.

270A. *(1) The Assessing Officer or the Commissioner (Appeals) or the Principal Commissioner or Commissioner may, during the course of any proceedings under this Act, direct that any person who has under-reported his income shall be liable to pay a penalty in addition to tax, if any, on the under-reported income.*

(2) A person shall be considered to have under-reported his income, if—

(a) the income assessed is greater than the income determined in the return processed under clause (a) of sub-section (1) of section 143;

(b) the income assessed is greater than the maximum amount not chargeable to tax, where no return of income has been furnished;

(c) the income reassessed is greater than the income assessed or reassessed immediately before such reassessment;

(d) the amount of deemed total income assessed or reassessed as per the provisions of section 115JB or section 115JC, as the case may be, is greater than the deemed total income determined in the return processed under clause (a) of sub-section (1) of section 143;

(e) the amount of deemed total income assessed as per the provisions of section 115JB or section 115JC is greater than the maximum amount not chargeable to tax, where no return of income has been filed;

(f) the amount of deemed total income reassessed as per the provisions of section 115JB or section 115JC, as the case may be, is greater than the deemed total income assessed or reassessed immediately before such reassessment;

(g) the income assessed or reassessed has the effect of reducing the loss or converting such loss into income.

(7) The penalty referred to in sub-section (1) shall be a sum equal to fifty per cent of the amount of tax payable on under-reported income.

(8) Notwithstanding anything contained in sub-section (6) or sub-section (7), where under-reported income is in consequence of any misreporting thereof by any person, the penalty referred to in sub-section (1) shall be equal to two hundred per cent of the amount of tax payable on under-reported income.

(9) The cases of misreporting of income referred to in sub-section (8) shall be the following, namely:—

(a) misrepresentation or suppression of facts;

(b) failure to record investments in the books of account;

(c) claim of expenditure not substantiated by any evidence;

(d) recording of any false entry in the books of account;

(e) failure to record any receipt in books of account having a bearing on total income; and

(f) failure to report any international transaction or any transaction deemed to be an international transaction or any specified domestic transaction, to which the provisions of Chapter X apply.

- It shall be the duty of a Chartered Accountant also to ensure that such kind of unscrupulous practice of introduction of black money in the guise of share capital is not allowed to be slipped through. The Government is aware of almost parallel economy of black money and has its limitation to control and curb. The citizens are aware that the tax rate and structure is quite moderate in India and therefore, it is the duty of Chartered Accountants and professionals to join the hands and see that as a professional activism we all must try to stop such kind of abuse or dubious tax planning. It is equally our role like that of government/ Finance ministry, when we claim to be **partners in Nation Building** that circulation of Black Money is minimized and tax planning in the grab of avoidance done by giants through foreign companies and tax heaven entities are also controlled and checked.

I adore my Profession.

I salute my Institute.

I respect my Council.

I am proud to be a Chartered Accountant.

- **<u>APPENDIX-1</u>**

Definition of Sec. 68

Section 68. Where any sum is found credited in the book of an assessee maintained for any previous year, and the assessee offers no explanation

about the nature and source thereof or the explanation offered by him is not, in the opinion of the [Assessing] Officer, satisfactory, the sum so credited may be charged to income-tax as the income of the assessee of that previous year :

[**Provided** *that where the assessee is a company (not being a company in which the public are substantially interested), and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless—*

*(*a*) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and*

*(*b*) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:*

Provided further *that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (*23FB*) of Section 10.*]

Clause 22 of the Bill seeks to amend section 68 of the Income-tax Act relating to cash credits. The existing provisions of the aforesaid section 68 provide that where any sum is found credited in the books of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the Assessing Officer

- **Section 115BBE.** *(1) Where the total income of an assessee includes any income referred to in section 68, section69, section 69A, section 69B, section 69C or section 69D, the income-tax payable shall be the aggregate of—*

  (a) *the amount of income-tax calculated on income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D, at the rate of thirty per cent; and*

  (b) *the amount of income-tax with which the assessee would have been chargeable had his total income been reduced by the amount of income referred to in clause (*a*).*

(2) Notwithstanding anything contained in this Act, no deduction in respect of any expenditure or allowance shall be allowed to the assessee under any provision of this Act in computing his income
*referred to in clause (*a*) of sub-section (1).*

- **<u>APPENDIX-2</u>**.

- **RULE 11U – Income Tax Rules**.

Meaning of expressions used in determination of Fair market value.

11U. For the purposes of this rule and rule 11UA –

[(a) "accountant"

(i) for the purposes of sub-rule (2) of rule 11UA, means a fellow of the Institute of Chartered Accountants of India within the meaning of the Chartered Accountants Act,1949 (38 of 1949) who is not appointed by the company as an auditor under sec.44AB of the Act oir under section 224 of the Companies Act,1956 (1 of 1956); and

(ii) in any other case, shall have the same meaning as assigned to it in the Explanation below sub-section (2) of section 288 of the Act;

(b) "balance-sheet", in relation to any company, means, -

(i) For the purposes of sub-rule (2) of rule 11UA, the balance sheet of such company (including the notes annexed thereto and forming part of the accounts) as drawn up on the valuation date which has been audited by the auditor of the company appointed under sec.224 of the Companies Act,1956 (1 of 1956) and where the balance sheet on the valuation date is not drawn up, the balance-sheet (including the notes annexed thereto and forming part of the accounts) drawn up as on a date immediately preceding the valuation date which has been approved and adopted in the annual general meeting of the shareholders of the company; and

(ii) In any other case, the balance sheet of such company (including the notes annexed thereto and forming part of the accounts) as drawn up on the valuation date which has been audited by the auditor appointed under Sec. 224 of the Companies Act,1956 (1 of 1956);]

(c) "merchant banker" means category I merchant banker registered with Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(d) "Quoted shares or securities" in relation to share or securities means a share or security quoted on any recognized stock exchange with regularity from time to time, where the quotations of such shares or securities are based on current transaction made in the ordinary course of business;

(e) "recognized stock exchange" shall have the same meaning as assigned to it in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);

(f) "registered dealer" means a dealer who is registered under Central Sales Tax Act,1956 or General Sales Tax Laws for the time being in force in any State including value added tax laws;

(g) “registered valuer” shall have the same meaning as assigned to it in section 34AB Wealth Tax Act,1957 (27 of 1957) read with rule 8A of Wealth tax Rules,1957;

(h) “securities” shall have the same meaning as assigned to it in clause (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);

(i) “unquoted shares and securities”, in relation to shares or securities, means shares and securities which is not a quoted shares or securities;

(j) “valuation date” means the date on which the property or consideration, as the case may be, is received by the assessee.].

❖ APPENDIX-3

➢ Rule 11UA – Income-Tax Rules

Determination of fair market value

[11UA]. (1)] For the purposes of section 56 of the Act, the fair market value of a property, other than immovable property, shall be determined in the following manner, namely,--

(a) valuation of jewellery.—

(i) the fair market value of jewellery shall be estimated to be the price which such jewellery would fetch if sold in the open market on the valuation date;

(ii) in case the jewellery is received by the way of purchase on the valuation date, from a registered dealer, the invoice value of the jewellery shall be the fair market value;

(iii) in case the jewllery is received by any other mode and the value of the jewellery exceeds rupees fifty thousand, then assessee may obtain the report of registered valuer in respect of the price it would fetch if sold in the open market on the valuation date;

(b) valuation of archaeological collections, drawings, paintings, sculptures or any work of art,--

(i) the fair market value of archaeological collections, drawings, paintings, sculptures or any work of art (hereinafter referred as artistic work) shall be estimated to be price which it would fetch if sold in the open market on the valuation date;

(ii) in case the artistic work is received by the way of purchase on the valuation date, from a registered dealer, the invoice value of the artistic work shall be the fair market value;

(iii) in case the artistic work is received by another mode and the value of the artistic work exceeds rupees fifty thousand, then assessee may obtain the report of registered valuer in respect of the price it would fetch if sold in the open market on the valuation date;

(c) valuation of shares and securities, --

(a) the fair market value of quoted shares and securities shall be determined in the following manner, namely,--

(i) if the quoted shares and securities are received by way of transaction carried out through any recognized stock exchange, the fair market value of such shares and securities shall be transaction value as recorded in such stock exchange;

(ii) if such quoted shares and securities are received by way of transaction carried out other than through any recognized stock exchange, the fair market value of such shares and securities shall be,--

(a) the lowest price of such shares and securities quoted on any recognized stock exchange on the valuation date, and

(b) the lowest price of such shares and securities quoted on any recognized stock exchange on a date immediately preceding the valuation date when such shares and securities were traded on such stock exchange, in cases where on the valuation date there is no trading in such shares and securities on any recognized stock exchange;

[(b) *the fair market value of unquoted equity shares shall be the value, on the valuation date, of such unquoted equity shares determined in the following manner, namely:--*

The fair market value of unquoted equity share = $\frac{(A - L)}{(PE)} \times (PV)$

Where,

A = *book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance sheet as asset including the unamortized amount of deferred expenditure which does not represent the value of any asset;*

L = *book value of liabilities shown in the balance-sheet, but not including the following amounts, namely:--*

(i) the paid-up capital in respect of equity shares;

(ii) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;

(iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;

(iv) any amount representing provision for taxation, other than amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income tax Act, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;

(v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;

(vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;

PE = total amount of paid up equity share capital as shown in the balance-sheet;

PV = the paid up value of such equity shares;

(c) the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of such valuation.]

(2) Notwithstanding anything contained in sub-clause (b) of clause (c) of sub-rule (1), the fair market value of unquoted equity shares for the purposes of sub-clause (i) of clause (a) of Explanation to clause (viib) of sub-section (2) of section 56 shall be the value, on the valuation date,

of such unquoted equity shares as determined in the following manner under clause (a) or clause (b), at the option of the assessee, namely:--

(a) *The fair market value of unquoted equity share* $= \frac{(A - L)}{(PE)} \times (PV)$

Where,

A = book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortized amount of deferred expenditure which does not represent the value of any asset;

L = book value of liabilities shown in the balance-sheet, but not including the following amounts, namely:--

(i) the paid-up capital in respect of equity shares;

(ii) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;

(iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;

(iv) any amount representing provision for taxation, other than amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act, to the extent of the excess

over the tax payable with reference to the book profits in accordance with the law applicable thereto;

(v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;

(vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;

PE = total amount of paid up equity share capital as shown in the balance-sheet;

PV = the paid up value of such equity shares; or

(b) the fair market value of unquoted equity shares determined by a merchant banker or an accountant as per the Discounted Free Cash Flow method]

❖ **<u>APPENDIX-4</u>**

Examples on Calculation of Fair Market Value.

➢ Balance Sheet of Company the shares of the same are unquoted as on 31st March 2013.

Liabilities	**Amount (in Rs.)**	**Assets**	**Amount (in Rs.)**
20,000 Eq. Shares of Rs.10 each fully paid Revenue Reserves Secured Loan Trade Creditors Provision for Taxation	2,00,000 5,95,000 1,50,000 1,35,000 45,000	**Fixed Assets- Net Block** Land & Building Plant & Machinery Motor Vehicles Stock In Trade Sundry Debtors Cash at Bank Preliminary Expenses	5,00,000 2,75,000 55,000 1,33,000 1,45,000 15,000 2,000

	11,25,000		**11,25,000**

Assume After Tax Cost of Capital to be 17.5% and Normal Rate of Return of Industry is 10.85%. The net cash flow of the company after taking into consideration taxation and capital expenditure over next five years are as follows:

Year	2014	2015	2016	2017	2018
CF (Rs.)	100000	120000	140000	10000	150000

Calculation of Fair Market Value of Unquoted Shares **as per Rule 11UA of Income Tax Rules** as well as **DCF Approach**

1) **Net Assets Approach**

Particulars	Amount in Rs.	Amount in Rs.
Land And Building	500000	
P & M	275000	
Motor Vehicles	55000	
Stock in Trade	133000	
Sundry Debtors	145000	

Cash at Bank	15000	
Total Assets(A)		**11,23,000**
Less: Outside Liabilities		
Secured Loans	(150000)	
Sundry Creditors	(135000)	
Total Liabilities(L)		**(2,85,000)**

NET ASSETS(A-L)		**8,38,000**

Fair Market Value per Equity Share = (A-L)/ (PE)*(PV)

Where PE= *total amount* of Paid up Equity Share capital as shown in Balance Sheet. (i.e Rs. 200000)

PV= *the paid up value* of equity share i.e. *Rs. 10*

= [Rs. 1123000-Rs.285000 X Rs 10]
Rs. 2, 00,000

= **Rs. 41.9**

2) **Net Assets Approach** (***Revalued Figures of Balance Sheet***)

Particulars	Value without Revaluation in Rs.	Upward Revaluation Rs.	Revalued Amounts Rs.
Land And Building	500000	110000	610000

P & M	275000	13000	288000
Motor Vehicles	55000	47000	102000
Stock in Trade	133000	0	133000
Sundry Debtors	145000	0	145000
Cash at Bank	15000	0	15000
Total Assets(A)	**11,23,000**		**12,85,000**

Less: Outside Liabilities			
Secured Loans	(150000)	0	(150000)
Sundry Creditors	(135000)	0	(135000)
Total Liabilities(L)	**(2,85,000)**		**(2,85,000)**
NET ASSETS	**8,38,000**		**10,00,000**

Fair Market Value per Equity Share = (A-L)/ (PE)*(PV)

Where PE= *total amount* of Paid up Equity Share capital as shown in Balance Sheet. (i.e Rs. 200000)

PV= *the paid up value* of equity share i.e. *Rs. 10*

= [Rs. 1285000-Rs.285000 X Rs 10]

Rs. 2, 00,000

= **Rs. 50**

3) Discounted Cash Flow Approach

Year	PVF @ 17.5%	Cash Flows	Discounted Cash Flow
2014	0.85	Rs. 100000	Rs. 85000
2015	0.72	Rs. 120000	Rs. 86400
2016	0.62	Rs. 140000	Rs. 86800
2017	0.52	Rs. 10000	Rs. 5200
2018	0.45	Rs. 150000	Rs. 67500
2019 onwards	0.45	Rs.150000/10.85*100 = Rs. 13,82,488	Rs. 622120
Total Discounted Cash Flows till Perpetuity			**Rs. 953020**
Value Per Share (Rs. 953020/20000 Shares)			**Rs. 47.65**