Fair Market Value with reference to Section 55 A, Section 56 (2) and Valuation Rules

By Milin Mehta, Vadodara

Fair Market Value

Price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

The word "fair" imports the concept of a market which is not disturbed by factors similar to either transient boom or depression and where vendors, ready but not over anxious to sell, meet purchasers ready and able to buy. See Daly v Nau, (Ind.App.) 339 N.E.2d 71

The adjective "fair" visualises a value which is fair between the contesting parties. It means the value is not favourable to the revenue or the tax payer. Fair Value, therefore, means a value which is fair between the tax payer and the revenue. Joseph Velloram Vs. CIT 108 ITR (Ker) and CIT Vs. Vimlaben Patel 118 ITR 134 (Guj)

FMV… 2

It means the price that a willing purchaser would pay to a willing seller for a property having due regard to its existing condition, with all its existing advantages and its potential possibilities when laid out in its most advantageous manner excluding any advantages due to the carrying out the scheme for the purpose for which the property is acquired,

- Raghubans Narain Singh Vs. State of UP AIR 1967 SC 465

Price is a fact and value is an estimate of what price ought to be.

FMV - Components

- Price that property will sell
- Open Market
- Willing buyer
- Willing seller
- Nether being required to act [compulsion]
- Reasonable knowledge

FMV – Under the IT Act

- 2 (22B)

  FMV in relation to a capital asset means,

  (i) the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and

  (ii) where the price referred to in sub-clause (i) is not ascertainable, such price as may be determined in accordance with the rules made under this Act;

- Explanation to Section 17 (2) – with reference to Sweat Equity Shares or ESOPs – as per Rule 3(8)
- Explanation to Section 56 (2) – income tax on deemed gifts – as per Rule 11U and 11UA
- Section 269A – Acquisition

FMV and ITA

- "Salaries" – Perquisites – Sweat Equity Shares / ESOPs
  - Concession in purchase price over the FMV is chargeable to tax as perquisite on the date of allotment of Specified Securities or Sweat Equity Shares
- Capital Gains
  - FMV of asset received as compensation / consideration [U/s. 45 (1A) from insurer U/s 46 on liquidation of a company]
  - Conversion into stock-in Trade [45 (2)]
  - Transfer by way of distribution on dissolution or otherwise of a firm or AOP / BOI [45 (3)]
  - Substituted cost of acquisition when on receipt of such asset, tax is levied U/s. 17 (2) or 56 (2)
  - Substituted cost of acquisition as on 1.4.1981 [55(2)(b)]
  - Where cost of acquisition of previous owner cannot be ascertained [55(3)]
  - Deeming Fiction U/S. 50 C for land, building or both [Stamp duty Value or FMV]
  - Where cost is not ascertainable or cannot be determined, then FMV U/s. 50 D [Contingent consideration cases]

FMV and ITA … 2

- Profits and gains from Business or Profession
  - Deeming fiction U/s. 43CA for transfer of land, building or both [Stamp Duty Value / FMV] for determination of business income [w.e.f. 1.4.2014]
- Income from other Sources [56(2) r.w.r. 11U/11UA]
  - When an individual or a HUF receives
    - an immovable property without consideration or for a consideration which is less than stamp duty valuation [or FMV]
    - Property other than immovable property without consideration or for a consideration which is less than FMV
  - Where a firm or closely held company receives any shares of another closely held company without consideration or at a consideration which is less than the FMV
  - Where a closely held company receives from a resident any consideration for issue of shares at premium which exceeds the FMV of the shares.

FMV and ITA … 3

- Deeming fiction U/s. 69 / 69 A r.w.s. 115 BBE
  - Assessee has made investment / is found to be owner of certain investments / assets, then value of such investment or assets will be deemed to be income of the Assessee.
  - Section 69 / 69 A makes reference to Value of investment / asset, whereas Section 69 B & 69 C mention about the amount expended.
- Section 115 BBE w.e.f. 1.4.2013 levies tax at flat rate of 30 % [plus applicable surcharge and cess] on such deemed income

Section 17 (2)

- Applies to specified security or sweat equity shares allotted or transferred by employer or former employer free of cost or at concessional rate
  - Securities mean the security as defined under SCRA and includes securities offered under ESOP / ESOS
  - FMV is to be determined as on the date on which the option is exercised, but the amount is taxable when the shares are allotted / transferred
  - FMV to be determined in accordance with Rule 3 (8) for Equity Shares and Rule 3 (9) for other securities

Section 17 (2) – Rule 3

- Listed Equity Shares– Rule 3 (8)(ii)
  - Average of the opening and closing price on the date of exercise
    - If more than one SEs where listed then average of the opening and closing price of the SE where highest volume is recorded [period not specified]
  - If no trading on the date of exercise, then closing price on a date closest to the date of exercise immediately preceding such date
    - If more than one exchange then the principle of highest volume will also apply
- Unlisted Equity Shares – Rule 3 (8)(iii)
  - if not listed on the date of exercise, then FMV shall be such value as determined by the merchant banker category I
  - Value to be determined for the date of exercise or any date earlier than the date of exercise being a date which is not more than 180 days earlier from such date
- Other Securities
  - FMV shall be such value as determined by the merchant banker category I
  - Value to be determined for the date of exercise or any date earlier than the date of exercise being a date which is not more than 180 days earlier from such date

Section 56 (2) & Valuation Rules

Asset Class	Valuation Method
Land, Building or both	Stamp Duty Value or Market value as determined U/s. 55A, whichever is lower
Jewellery, Archaeological collections, drawings, paintings, sculptures or any work of art	• If purchased from a dealer registered under CST or State Sales Tax Laws then the invoice value • Otherwise as per report of registered valuer in respect of price it would fetch if sold in the open market on the valuation date.
Listed Shares / Securities	• If purchased by way of transaction through SE, then transaction value as recorded in such SE • Otherwise, lowest price quoted on any such SE on that date or nearest date immediately preceding such date, if not quoted on the date of receipt
Unlisted Securities	Separately discussed

56 (2) – Unlisted Equity Shares

- For Section 56 (2)(vii) and (viia)
  - Book Value [Modified]
- For Section 56 (2)(viib)
  - Three methods prescribed for valuation of unlisted Equity shares
    - Book Value Method [modified]
    - Discounted Free Cash Flows Method [DFCF]
    - [Market] Value of assets [including intangibles] [only for 56 (2)(viib)]
  - Highest of the three to be considered.

Rule 11 UA (1)(c)(b) / 11UA (2)(a)

- Formula of
  - Concept of PE and PV used for brining in the concept of partly paid shares and accordingly, partly paid shares will be valued proportionately lower than the fully paid shares.
  - Can have some issue, where partly paid shares are allotted at premium and amount is received towards premium
  - If a Company is 100,000 Equity Shares of Rs. 10 each fully paid up and 50,000 Equity Shares of Rs. 10 each paid up to the extent of Rs. 6 per share, then value of partly paid up shares will be 3/13 [~ 23 %] of “net worth” as computed under Rule and not 1/3rd [33.3 %]

Assets [A] and Liabilities [L]

- Book Value of Assets [A] in the balance sheet
  - Reduced by
    - Tax paid as TDS / TCS / Advance Tax [not self assessment tax] net of tax claimed as refund [therefore actual tax liability to the extent paid as TDS / TCS / Advance Tax]
    - Amount shown in the balance sheet as asset which does not represent the value of any asset including unamortized amount of deferred expenditure [Misc. expenditure and losses not written off]
- Book Value of Liabilities [L] shown in the balance sheet
  - Not including
    - Paid up capital for equity shares [and not preference]
    - Dividend payable, provided dividend not declared before the date of transfer
    - Reserves and surplus [other than amount set apart towards depreciation] by whatever name called, even where the resulting figure is negative
    - Provision for taxation, other than paid tax liabilities, in excess of MAT
    - Provisions other than for ascertained liabilities
    - Contingent liabilities, other than arrears of preference dividends as shown in the balance sheet

Tax Adjustments

Particulars		Amount [Rs in Cr]	Alternative
Provision for Tax [Liabilities in Balance sheet]		2.00	
Comprising of the following components			
Tax as per MAT	7.00		
Tax as per other provisions	10.00		
Tax paid as Advance Tax / TDS / TCS	8.00		
Book Value of the Assets		50.00	50.00
Reduced by Tax Paid as Advance Tax, etc.		(8.00)	
Total Liabilities [other than NW Related]	35.00		35.00
Not Including provision for tax other than tax paid as advance tax, etc. in excess of MAT Liabilities	2.00	33.00	2.00
A – L for formula		9.00	17.00
Actual Book Value without tax adjustment	[50 – 35]	15.00	15.00

Book Value – Some issues

- Large contingent liability of tax / customer claim / warranty obligation / environmental damage, etc.
  - It may be necessary to draw up the balance sheet and make provision for the liabilities / impairment losses, etc.
- Cases where the Company may have valuable asset but very low future cash flows giving valuation below book value
  - There are several companies which are quoted below book value
  - An enterprise is not necessarily valued based on value of its asset but by its ability to generate cash flows.
  - This would be a case where the assets have been revalued as the provision does not include adjustment of revaluation of assets
- Typical cases of delayed allotments

DFCF / DCF [Only for 56 (2)(viib)]

- Discounted Free Cash Flow Method
  - Determination of the Free Cash Flows based on projections
    - Cash Generated from operations
    - Non-Cash adjustment in the working capital
    - Capital expenditure / other cash outflow for obligations
  - Determination of Discount Factor
    - Cost of Debt – post tax
    - Cost of Equity [Rf + B X (Rm – Rf) + SCRP + CSRP]
    - WACC [Weighted Average Cost of Capital]
  - Determination of Terminal Value
    - Predicted Period Cash Flows
    - Terminal Cash Flows [Maintenance CapEx]
    - Perpetual Growth Factor
    - Terminal Value / Discounted Terminal Value
- Report to be obtained from a merchant banker category I or from an Accountant. Accountant for this purpose to be a FCA not being tax auditor or statutory auditor of the Company

Market Value of underlying assets

- FMV of shares
  - Based on value [market value?] of assets of the company on valuation date;
  - as may be substantiated by the company
  - To the satisfaction of the AO
- Assets of the Company to include
  - All its assets including intangible assets being goodwill, know-how, patents, copyrights, trademarks, license, franchises or any other business or commercial rights of similar nature

Challenges in valuation

- The provisions talk about three distinct methods without there being any interplay between the three methods
  - In most cases the valuation is based on combination of methods.
    - Productive assets based on DFCF and to that value the MV of the surplus land is added.
    - In such a scenario, the aggregate value of the company and therefore its shares could be more than all the three methods
- Strategic stake in supplier, customer, competitor, etc. at a very high value or a nominal value
  - If it is at a very high value, it would be difficult to justify the same based on DFCF or [to the satisfaction of the AO] on value of the assets including intangibles
  - If the stake is given for business consideration, below book value, may be with restrictions for call options / put options, etc. can give rise to unintended tax liabilties

Reference to Valuation Officer

- Reference at the instance of the AO
  - Value of the assets as claimed by the Assessee is in accordance with the estimate made by RV, but if AO is of the view that such value is at variance with its FMV [55A (a)]
  - If no RV's opinion and AO is of the opinion that
    - FMV exceeds the value claimed by the assessee by more than 15 % / Rs. 25,000
    - having regard to the nature of the asset or other relevant circumstances, it is necessary to make a reference
- Reference at the instance of the Assessee
  - When the stamp duty value is more than the consideration paid / received for transaction in land, building or both and the Assessee has not disputed this value before the stamp duty authorities, but objects to adopting this value for tax purposes
    - Capital gains Section 50 C
    - Deemed gift U/s. 56 (2)
    - Business income U/s. 43 CA
  - For section 56 (2) and 43 CA reference date to be date of agreement fixing the consideration provided consideration otherwise than in "Cash" paid on or prior to the date of such agreement

50 C / 142 A references

- Once the Assessee objects to adoption of stamp duty value to be adopted for capital gains or section 56 (2) purposes, a reference is required to be made by the AO to the Valuation Officer U/s. 55 A / 142 A.
- In such a valuation it would not be appropriate to make again a reference to the stamp duty valuation. [Krishna Kumar Rawat 214 ITR 610 (Raj). Also refer to 249 ITR 424 (Mad)]
- This valuation has to be based on conventional methods of valuation including
  - Location; Including specific advantages and disadvantages
  - relying on comparable cases;
  - timing of such instances,
  - Size of the Plots or property
  - belting, etc.

Thank You

milin.mehta@kcmehta.com