Comprehensive Study of Taxation on Transfer of Unquoted Shares (Sec 50CA)

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The Union Budget 2017 was one of the most anticipated budgets in recent times. Coming on the back of the demonetisation drive, expectations were high and the Finance Act, 2017 duly delivered on many aspects. Anti-abuse provisions received a big face lift and provisions were introduced to incentivise tax-payers to adopt digital and banking channels for transactions. One of such anti-abuse provisions introduced is Sec 50CA.

50CA was introduced in addition to a few anti-abuse measures already in place with respect to curbing the practise of avoiding tax through transfer of shares and will be in effect for any transfer of unquoted shares after 1st April, 2017.

The section provides that where consideration for transfer of share of a company (other than quoted share) is less than the FMV of such shares determined in accordance with the manner to be prescribed, the FMV shall be deemed to be the full value of consideration for computing capital gains.

Why this provision for Unquoted Shares

A quoted share is one where "*the share is quoted on any recognised stock exchange with regularity from time to time, where the quotation of such share is based on current transaction made in the ordinary course of business*".

A value of a share is reflective of the net book value and fair market value of the assets, the potential of the company and the products and lineage of the company. Therefore, where a share is quoted, the quoted value on the stock exchange will be the fair market value of the share with little scope of manipulation. The value, therefore, taken as sale consideration u/s 48 for the purpose of computation of capital gains, will be this fair market value.

This benefit however, in unavailable to unquoted shares. Unlike quoted shares, which are freely traded on the stock exchange, unquoted shares are largely unregulated and there existed no restriction on the pricing and valuation of these shares. This led to utilisation of the provisions to abusive practices where companies attempted to avoid capital gains tax on transfer of shares, by valuing the shares very low and escaping tax.

Illustration of what was being done

Company X & Co Pvt Ltd., holds multiple assets in the form of land and buildings worth Rs. 500 crores. The company has a Share Capital of Rs.10,00,000 – 10,000 shares at Rs.100 Face Value per share. The shareholder sells the share for Rs.10 per share to the buyer.

The underlying value of the shares in the company are significantly higher than the face value, due to the assets which are present in the company and their fair market value. Here, the seller/transferor of the shares, has sold the shares at a nominal value of Rs.10/-, and the buyer gets to enjoy assets worth Rs.500 crores at that rate.

Given the sham nature of the transaction and the understatement of value, significant taxes in the form of capital gains are avoided and in some cases, the seller even enjoys the benefit of a capital loss that can be set-off against other capital gain incomes earned.

50CA is the Guideline Value for Shares

Section 50C was introduced by Finance Act 2003 and was a game-changing provision. Where an immoveable property was transferred for a value less than the value adopted or assessable by any authority of the State Government, i.e. Stamp Value/Guideline Value, the, such value will be adopted for the purposes of Sec 48, while computing the capital gains.

As per the Act, income chargeable under the head 'Capital gains' is computed by taking into account the amount of full value of consideration received or accrued on transfer of a capital asset. In order to ensure that the full value of consideration is not understated, the Act stipulated certain safety mechanisms, such as deeming of stamp duty value as full value of consideration for transfer of immovable property in certain cases. The proposed section 50CA has been introduced to rationalise the extant provisions of the Act to cover in its ambit the transfer of unquoted shares on a value less than the FMV.

How will the Fair Market Value be calculated?

The CBDT have issued draft rules for the calculation of Fair Market Value under rule 11UA r.w.s Sec 56(2)(x) dated 5th of May, 2017. The same has been detailed in Annexure 1 of this Article.

50CA r.w.s 56(2) will lead to Double Taxation

Section 56(2)(vii) and 56(2)(viia) provided that where any person received any shares without adequate consideration for an amount exceeding Rs.50,000/-, then such amount will be brought to tax as income from other sources.

Sec 56(2)(vii) and (viia) will no longer be applicable after 1st April, 2017. Instead, a new section Sec 56(2)(x) has not been introduced. This section provides for taxability in the hands of the purchaser of shares2, if the purchase is made without consideration or for consideration less than the FMV of such property. Further, in line with the extant provision of the Act, this provision would only trigger if the difference between the consideration paid and the FMV exceeds INR 50,000. With the introduction of this clause, the scope of the extant provision has been expanded to all the tax payers.

In substance, Sec. 56(2)(vii) and (viia) are still enshrined in Sec 56(2)(x). However, the important point to note is that the income is taxed twice, once in the hand of the seller and the second time in the hands of the buyer. This is demonstrated in the illustration below.

<u>Illustration</u>

A acquired 100,000 shares of Winners Pvt Ltd. for Rs.5 per share. The shares were sold to B at Rs.8 per share. The Fair Market Value on date of the transfer was Rs.10/- per share. The following will be the impact of both Sec 50CA and Sec 56; under old provisions and as per the amended provisions:

	Old Provisions		**Amended Provisions**	
Details	**Transfer of shares**	**Sec 56(2)(vii)**	**Sec 50CA**	**Sec 56(2)(x)**
Computation of Capital Gains – Seller/Transferor is taxed				
Sale consideration	Rs.8,00,000		Rs.10,00,000	
Less: Cost of acquisition	(Rs.5,00,000)		(Rs.5,00,000)	
Capital Gains	**Rs.3,00,000**		**Rs.5,00,000**	
Income from Other Sources – Buyer/Transferee is taxed				
FMV of shares (Rs.10 * 1,00,000 shares)		Rs.10,00,000		Rs.10,00,000
Less: Actual cost of acquisition (Rs.8 * 1,00,000 shares)		(Rs.8,00,000)		(Rs.8,00,000)
Income from other sources		**Rs.2,00,000**		**Rs.2,00,000**

As it can be seen, the overall tax effect of both Buyer and Seller is higher under the new provisions by Rs.2,00,000/-.

Accordingly, the amount of INR 200,000 would have been taxed in the hands of the transferee under the extant provisions. Similar provision are stipulated under the proposed section 56(2)(x) of the Act, and consequentially the clause (viia) of section 56(2) of the Act is proposed to be made inapplicable with effect from 1 April 2017. Therefore, the amount of INR 200,000 would be taxed in the hands of transferee under the proposed provisions as well.

From the above example, it may be seen as per the extant provisions of the Act, the amount of INR 200,000 was being taxed in the hands of transferee. However, the section 50CA proposes to tax the amount of INR 200,000 in the hands of transferor. Consequently, the amount of INR 200,000 is being taxed in the hands transferor as well as transferee.

Wrap up Point:

The Finance Act, 2017 has introduced some excellent provisions to curb black money and crack down on tax evaders. The measure to curb transfer of shares at value less than FMV has been introduced with the same intent. However, due to the double taxation effect, Sec 50CA and Sec 56(2)(x) provisions, while are anti-abusive, are also difficult for tax-payers to bear.

Further, the proposed rules for valuing the Fair Market Value of unquoted equity shares of investment holding companies wherein downstream investments would now need to be valued applying the proposed valuation approach, as against valued at cost currently. The similar impact would be there on mere property holding companies where the stamp duty value of property would be considered now. This is an excellent move at curbing the practice of transferring shares of companies at nominal value, when the have assets of substantial value and their underlying value of the share is much higher than the carrying value.

THANK YOU

THOUGHTS? Let’s Discuss

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Annexure:

How to calculate the FMV?

The FMV of unquoted equity share = (A+B+C+D - L) × (PV)/(PE)

A = book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) as reduced by,-

(i) any amount of income-tax paid, if any, less the amount of income-tax refund claimed,
(ii) if any amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;

B = the price which the jewellery and artistic work would fetch if sold in the open market on the basis of the valuation report obtained from a registered valuer;

C = fair market value of shares and securities as determined in the manner provided in this rule;

D = the value adopted or assessed or assessable by any authority of the government for the purpose of payment of stamp duty in respect of the immovable property.

L= book value of liabilities, 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;
(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 income tax paid, if any, less the amount of income-tax claimed as refund, if any, 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;

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;”