TT Alert

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Applicability of S. 56(2)(viib) to the Non-Resident Investor and amendment to Rule 11UA

- The Finance Act 2023 has amended the provisions of S. 56(2)(viib) of the Income tax Act, 1961 ('ITA') and has widened the applicability of provision to cover even non-residents (excluding select entities as notified by CBDT[1]). Accordingly, the share premium received from a non-resident investor is also required to be justified with the valuation report as per Rule 11UA which computes the Fair Market Value ('FMV').

- In order to compute the FMV for non-resident shareholders, CBDT has issued a draft notification on 26 May 2023 proposing amendments to Rule 11UA which have been invited for public comments. Amendments proposed in the aforesaid notification has been encapsulated as under:

1. New Valuation methods for non-resident investors

Non-resident investors can invest in shares of closely held Indian company if it is backed by a valuation report obtained from the merchant banker and the FMV is computed basis the additional methodologies prescribed hereunder:

- Comparable Company Multiple Method;
- Probability Weighted Expected Return Method;
- Option Pricing Method;
- Milestone Analysis Method;
- Replacement Cost Method.

2. FMV computed for notified entities can be treated as FMV for other companies

It has been proposed that if a company receives any consideration for the issue of shares from notified entity, the price of the equity shares corresponding to such consideration, may be taken as the FMV of the equity shares for other investors, subject to fulfillment of below mentioned conditions:

- The above benchmarking applies only to the extent of aggregate consideration that is received from the notified entity; and
- The company has received consideration from the notified entity within 90 days of the date of the issue of shares.

On similar lines, venture capital undertaking can use the price of equity shares issued to a venture capital fund, venture capital company or specified fund.

For example, if a venture capital undertaking receives a consideration of INR 50,000 from a venture capital company for the issue of 100 shares at the rate of INR 500 per share, then such an undertaking can issue 100 shares at this rate to any other investor within 90 days of the receipt of consideration from venture capital company.

3. Merchant Banker report to not be older than 90 days

It has also been proposed that the valuation report by the Merchant Banker would be acceptable if it is of a date not more than 90 days prior to the date of issue of shares which are the subject matter of valuation.

4. Safe harbor limit introduced

Further, the price at which shares are issued is higher than the value determined per Rule 11UA, by not more than 10%, the issue price will be held as the FMV. This would take into account the foreign fluctuations, bidding processes and variations in other economic indicators, etc. which may affect the valuation of the unquoted shares.

RBSA Comments

The proposed amendment by CBDT to allow the same valuation report to be used if it is not older than 90 days will ease the multiple rounds of fund raising. Further, providing the safe harbor limit of 10% will reduce the litigation pertaining to the valuation. CBDT should establish means to compute FMV under each of the prescribed valuation method to bring about uniform approach in its application.

[1]Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75% or more;

The Banks or entities involved in Insurance Business where such entity is subject to regulations in the country where it is established or incorporated or is a resident;

Any of the following entities, which is a resident of a specified countries / territories and such entity is subject to applicable regulations in the country where it is incorporated or is a resident:

- Entities registered with SEBI as Category-I Foreign Portfolio Investors.
- Endowment Funds associated with a university, hospitals or charities,
- Pension Funds created or established under law of the foreign country or specified territory,
- Broad Based Pooled Investment Vehicle or Fund where the number of investors in such vehicle or fund is more than 50 and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

The specified countries / territories as per the notification are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, United Kingdom and United States.

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