Amended Sec 56 might seriously hurt investments into private companies

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ONE major Budget proposal that has gone largely unnoticed is the amendment related to Section 56(2) of the Income tax Act. As per this amendment, on or after 1 June 2010, receipt of shares of a closely held/unlisted company by another closely held /unlisted company for "nil" or "inadequate" consideration would attract levy of income tax in the hands of the recipient of the shares, as "Income from other sources", to the extent of the difference between the fair market value and the actual consideration. In cases where the shares are received for nil value, the entire market value of the shares would, of course, be subjected to tax. This treatment would get triggered when the difference between the fair market value of such shares and the actual consideration exceeds Rs 50,000. The proposal states that the fair market value of the shares of the closely held company, for purposes of levy of income tax, would be determined as per the valuation methodology to be prescribed. Of course, transactions related to listed companies are outside the purview of this amendment.

Specific exemptions, thankfully, have been provided for shares received under the following circumstances..

++ amalgamation / demerger of a foreign company with another foreign company; or

++ business re-organization of co-operative bank ; or

++ transfer or issue of shares to the shareholders of amalgamating/demerged company by amalgamated / resulting company in consideration for the amalgamation / demerger

Needless to say, this new proposal would completely re-write the rules related to share transfers including acquisitions, governing private companies.

Here is an attempt to try and understand some of the implications that would arise, if the proposed amendments are carried out to Section 56.

This is perhaps, the first attempt, to levy income tax on share related transactions between unrelated parties. While the Income tax Act already has provisions to tax commercial transactions between related particles, in terms of the transfer pricing regulations, till now, the fundamental assumption has been that transactions between unrelated parties cannot be covered under the transfer pricing regime. Now, with this proposal, the Government is effectively trying to levy tax on share related transactions between unrelated prices. We can see, how this could work, in a typical scenario, involving, let's say, 100% of the shares held by the promoters of a closely held loss making company getting acquired by, a foreign company, for a total consideration of Rs 20 crores. It would now be open for the Income tax Department to value the shares transferred/acquired at, let's say, Rs 40 crores and ask the foreign company (which might have nothing to do with India, except for this acquisition) to pay income tax on the difference of Rs 20 crores, under 'Income from other sources'. Foreign companies acquiring shares of Indian private companies, whether wholly or in part, are going to have nightmares as the sword in terms of the possible additional tax liability based on the market value of the shares, might fall on their heads, any time.

The acquirer of the shares, would be required to pay tax under ‘Income from other sources’ and not under ‘capital gains’ or perhaps, ‘income from business or profession’. One is not able to understand the Government’s attempts to treat income arising on transfer of shares, which is essentially a transaction involving capital gains, under ‘income from other sources’. As we know, ‘Income from other sources’ is a residuary head to tax income which is used to tax receipts which cannot be fitted under any other head of income. Of course, capital gains can arise only in the case of the seller of the shares but the proposal talks of taxing the recipient. Notwithstanding this, considering the fact that the transaction is one involving sale of shares, the benefit of a lower taxation (of 20% for long term capital gains) ought to be extended to the buyer of the shares, even if the Government wants to go ahead with the amendment.

The Section uses words in a very broad manner and it is the receipt of the shares which is subjected to be taxes, in the hands of the purchaser. In the absence of a specific exemption, the amended Section will cover, within its sweep, even transfer of shares between the holding and wholly owned subsidiary company/companies and the receipt of shares of a closely held company in case of amalgamation / demerger by the amalgamated / resulting Indian company. Even transactions involving issuance of new shares against existing shares, in any scheme could also get covered including shares issued in lieu of lost share certificates, believe it or not.

At the cost of repetition, I would like to add that the proposed amendment would cover even cases involving issuance of by private companies under the preferential allotment route. Even rights issues at prices less than the fair market values, would be covered. Of course, the amendment in so far as it relates to rights issues would go against the accepted principle, agreed to by the CBDT that, no income arises or accrues to the shareholder in the case of allotment of rights shares at prices less than the fair market values.

In effect, all equity infusions into private companies including private placements, in any manner whatsoever, would get affected, in one way or the other. Even 100% acquisition of private companies by foreign investors including foreign equity and venture capital funds, a common feature nowadays, would get squarely attracted.

Repurchase and buyback of shares by private companies would get covered under the amended Section 56 and the Company re-purchasing its own shares could be asked to pay tax on the difference between the fair market values and the buy back price.

Instances of two foreign companies gettting involved in M & A transactions, which could also involve shares of an Indian Company, would also attract the amended Section. Till now, the law has been that, such an M & A transaction is not chargeable to capital gains in India, subject to certain conditions being met including the one on the continuance of the present shareholders. The proposed amendment to Section 56 would include under its sweep, this kind of a transaction as well, resulting in the levy of tax on the foreign company/companies.

Promoters of private companies have this habit of selling a part of their equity to their employees as part of a strategy go incentivise the deserving employees and nobody has, till date, cared about the valuation of these shares. Post the amendment, these transfer would result in these employees being asked to pay income tax on the differential prices.

It is a normal feature for acquirers of companies to have differential pricing for acquisition of shares from the different groups of shareholders and promoters of private companies and in typical deals, the minority shareholder will get the highest price. There is a real possibility of this price being taken the fair market value of the shares and the same acquirer being asked to pay income tax on the purchase of shares from the other shareholders.

Now, the most important issue is… what is this fair market value of the share? No rules have been prescribed till now, to deal with this. How can fair market values be worked out for software and technology companies? Most acquisitions of private companies happen on the basis of mutual discussions between the acquirer and the current shareholders. It is fair for the Income tax Department to sit on judgment over these deals and demand tax from the acquirer? And, how can the fair values of shares of technology companies be arrived at? No standard formula can be used as valuation of technology is a very complex subject and the methodology could vary from company to company..

Before concluding……

As we know, it was Mr Yashwant Sinha who abolished the levy of gift tax effective September 30, 1998. In 2004, a provision taxing that recipient of gifts from unrelated parties was introduced. But, this was restricted to cash gifts, with marriage gifts being exempted. The Finance Act of 2009 expanded the scope of the levy of tax on the recipients, to include gifts in kind of immovable properties and certain other specified movable properties, if received from non-relatives without or, for inadequate consideration. We now have the Budget 2010-11 proposal further tightening these provisions. So far, the deeming provisions were applied only when natural persons i.e. individuals or HUFs were the recipients. Transfer of shares to a firm or company at less than market values was not covered. Perhaps, to prevent the practice of transferring shares of unlisted companies at much below the market prices to associate companies, the Bill has proposed to extend the deeming provisions in such cases where the recipients are firms or companies in which the public are not substantially interested. It is therefore, the return of the gift tax regime, in a full fledged manner.

One saving grace, however, in terms of the provisions related to transfer of immovable properties is that, the new amendment would cover cases only when the transfer of immovable property has been executed for nil consideration. In other words, transfer of immovable property for inadequate consideration is proposed to be taken out of the ambit of deemed income .

Needless to say, the fixation of the fair market value of shares of private companies at different points of time in a year could be a very big challenge. Most valuation methods are based on the analysis of balance sheets of companies and in the cases where transactions occur on multiple dates, within the same year, valuation could become very difficult.

The most significant fall out would be the uncertainty linked to the acquisition and transfer of shares. Most foreign companies would be averse to the idea of their share related transactions getting re-opened at subsequent periods of time and they being asked to pay taxes. The Government could think of a Advance Pricing or Advance Ruling mechanism wherein the acquirer of the shares can get the fair market value, in advance, before entering into the purchase transaction.

In terms of the acquisition and/or transfer of shares of Indian private companies to non-residents, the FEMA insists that the shares cannot be sold/transferred at less than the fair market values worked out on the basis of the valuation guidelines issued by the erstwhile office of the Controller of Capital Issues, which are to be certified by Chartered Accountants. Can we have a similar provision for acquisition of shares covered by the amended Section 56?

There can be little doubt that the amendment proposed to Section 56 would drastically affect the rules governing the flow of equity funds into the private companies. While the intention of the Government seems to be, to be able to essentially tax transfer of shares of private companies for inadequate consideration, the way the proposed amendment is worded would ensure that most acquisitions and allotment of shares including preferential and rights issues would get covered. One sincerely hopes that the Government would not bring about any drastic changes in the tax regime, which could seriously restrict the flow of equity into private companies.

(The Author is Director, S3 Solutions Pvt Ltd, Bangalore)