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The Share Valuation Conundrum - Unease of Doing Business!

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Introduction

There are various provisions under Companies Act, FEMA and the Income-tax Act where valuations are required. Some of these valuations are required commercially and justifiable, such as schemes of arrangement where a swap of shares or where acquisition of shares/ business is involved. However, there are a whole host of provisions which appear to be complete outlier provisions in the context of valuations i.e. valuations requirements are needlessly put in the law, to the huge detriment of Ease of Doing Business (EODB).

Additionally, there is also a disconnect among different laws regarding the 'type' of valuer from whom the valuation report is to be obtained, leading to confusion and further impacting EODB.

The purpose of this article is mainly to deal with the interconnect and the conflicts in the context of valuation vis-à-vis transfer and issue of shares under various such regulations and the enormous needless compliance burden, with very little benefit from a regulatory standpoint.

The Big Picture on Share Valuations

Valuation of shares and businesses is highly subjective; behind the seemingly scientific facade of numbers and excel spreadsheets, there is an enormous amount of subjectivity. The heart of any valuation is future earnings, since most businesses are bought for the future prospects. There is also the issue of "scarcity" value, market fancy and several other aspects, which may make the valuations seem absurd when compared with future income streams; probably, the biggest example of this century is Amazon – from its IPO market value of $438 million in 1997, it now stands at about $1.9 trillion! The valuation of fintech or e-commerce companies in India, including the IPO of Zomato, the impending IPO of Paytm, and many others, are classic examples where traditional models of valuation seem irrelevant and the valuations seem to defy logic.

The above background is important to bear in mind, and a striking example of how absurd provisions are triggered by an outlier situation, and which require companies to justify valuations at the risk of "excessive" share premiums being taxed as income; such outlier provisions are an enormous and unjustifiable burden, totally contrary to EODB. Also, in the context of share acquisitions/ preferential

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share allotment, usually, there are protracted negotiations which often go on for months before a deal is struck; and often, it is then that a valuation is done to meet the regulatory requirements! However, most deals are not based on valuations, but are based on commercial considerations, such as synergy, desire for listing by an unlisted acquirer or indeed an acquirer perspective of value. Unfortunately, though, we have an absurd situation of valuation reports being done on the basis of actual deals done – it is such kind of situations triggered by outlier examples that badly impact EODB.

Share Valuation Requirements under the Regulatory Framework

Companies Act provisions

- **Provision regarding registered valuers**

Section 247 of the Companies Act, 2013 (‘Companies Act’) provides that when a valuation is to be made in respect of, *inter alia*, shares, debentures or securities, it shall be valued by a person having qualifications and experience and registered as a valuer, in such manner on such terms and conditions as may be prescribed. In pursuance of the powers under Section 247, rules have been prescribed titled “The Companies (Registered Valuers and Valuations) Rules 2017”; in these Rules, the term “valuer” has been defined therein as a person registered with the “authority” in accordance with these rules and the term “registered valuer” shall be construed accordingly.

The term “authority” has been defined as the authority specified by the Central Government under Section 458 of the Companies Act and vide MCA notification of 23rd October 2017, the Central Government has delegated the powers vested in it under Section 247 to the Insolvency & Bankruptcy Board of India (‘IBBI’). Thus, for a valuer to be eligible to issue a valuation report required under the Companies Act provisions, he should be registered with IBBI.

- **Further issue of shares by way of preferential allotment**

The requirement of a valuation, is not applicable if the shares are only issued to existing shareholders i.e. rights issue. However, in relation to preferential allotment of shares for cash or consideration other than cash, one of the requirements for such preferential allotment under Section 62(1)(c) of Companies Act, is determination of the price of such shares based on a valuation report issued by a “registered valuer”. Unlike Section 81 of the 1956 Act, which applied only to private companies, Section 62 applies to private and public companies; of course, the valuation requirement does not apply to listed companies, as expressly provided in Rule 13(1) of the Companies (Share Capital and Debentures) Rules, 2014.

While the second proviso to Rule 13(1) of the Companies (Share Capital and Debentures) Rules, 2014 exempts a listed company from determining the price based on a valuation report of a “registered valuer”, it may be better to ensure that there is no such requirement in the company’s Articles of Association (‘AOA’) ; as readers would be aware, in the recent controversy in the case of PNB Housing Finance Limited, where a preferential allotment was sought to be made to Carlyle and other investors, SEBI has challenged this on the basis that the preferential allotment did not conform to its AOA and also challenged the valuation report obtained, which only computed the floor price as per the SEBI (Issue of Capital and Disclosure Requirements) Regulations. The matter is now pending before Securities Appellate Tribunal.

Where a preferential allotment of shares is made, compliance of the provisions dealing with private placement of shares also becomes applicable.

The process of issuing shares or any other securities to a select group of persons (identified by the Board) is governed by the process laid down under Section 42 of the Companies Act. While the section does not specify anything regarding the pricing for shares issued under private placement, Rule 14 of Companies (Prospectus and Allotment of Securities) Rules 2014 infers requirement of a valuation report issued by a valuer both at the time of sending out notice (along with explanatory statement) to such persons and thereafter, the said rules also prescribe annexing a valuation report to the return of allotment of shares/ securities, to be filed with the Registrar of Companies in Form PAS-3.

As a result of the above, as a part of the private placement process as well, any shares (equity shares or

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preference shares) or any other security (such as debentures) to be issued to a select group of persons, whether convertible into equity shares (such as optionally or compulsorily convertible debentures) which provide for a fixed conversion ratio, would also require valuation from a 'registered valuer' to determine the fair value of such shares/ security.

- **Schemes of arrangement, etc.**

Section 232: Merger and amalgamation of companies

When an application for an arrangement made to the NCLT involves a merger or demerger, the NCLT may order a meeting of the creditors or members as the case may be. The section enlists documents to be circulated for such a meeting which include a report laying out the share exchange ratio, specifying any special valuation considerations.

Section 230: Scheme of corporate debt restructuring

Among several disclosures to be made by the applicant to the National Company Law Tribunal (NCLT), a scheme of corporate debt restructuring submitted must include a valuation report by a registered valuer in respect of the shares, and tangible and intangible property of the Company.

Section 236: Purchase of minority shareholding

This section deals with a scenario in which an acquirer becomes a registered holder of 90% or more of the issued equity share capital of the company, by virtue of an amalgamation, share exchange, conversion of securities or for any other reason. In such a case, the acquirer shall notify the company of its intention to buy the remaining shares of the company. The price offered by the acquirer to the minority shareholders for their shares shall be determined on the basis of a valuation by a registered valuer.

SEBI Regulations

In addition to the aforesaid compliances under the Companies Act, in case of listed companies, there is an additional burden of compliance with the SEBI Regulations.

- **SEBI (Issue of Capital and Disclosure Requirements) Regulations ('SEBI ICDR Regulations') pertaining to preferential allotment of shares**

There is no requirement under SEBI ICDR Regulations to obtain a valuation where the securities are issued for cash consideration.

As per Reg. 163(3), when the securities are issued on a preferential basis for consideration other than cash, the valuation of the assets for which the equity shares are issued has to be done by a valuer. SEBI ICDR Regulations define the term "valuer" to mean a person who is registered under Section 247 of the Companies Act i.e. "registered valuer" as discussed earlier.

The pricing of frequently traded shares is to be determined based on formula provided in Reg. 164 i.e. taking into consideration the volume weighted average price of the shares quoted on a stock exchange and does not require a valuation report. However, if the shares of an issuer are not frequently traded, as per Reg. 165, the price to be determined by the issuer must take into account the prescribed valuation parameters, including book value, comparable trading multiples, etc. and the issuer has to submit a certificate that has to be obtained from an independent valuer.

- **SEBI (SAST) Regulations/ Takeover Code**

The offer price, in case of frequently traded shares, is to be determined based on various parameters provided in Reg. 8(2) or Reg. 8(3), which required taking into consideration, *inter alia*, highest negotiated price, the volume-weighted average price on a stock exchange, etc. and does not require a valuation report.

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In case of direct acquisition of shares or voting rights or control in the target company, as specified in Reg. 8(2) of the SEBI Takeover Code, if the shares are infrequently traded, the offer price is to be determined taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies.

A similar approach is also prescribed (Reg. 8(4) of the SEBI Takeover Code) for cases where the offer price cannot be determined in case of indirect acquisition of shares or voting rights in, or control over the target as per the parameters specified in Reg. 8(3).

Further, as per Reg. 8(16) of the SEBI Takeover Code, SEBI may require valuation of the shares by an independent Merchant Banker (other than the manager to the open offer) or an independent Chartered Accountant in practice having a minimum experience of 10 years.

- **“Merchant Bankers” under SEBI**

Under SEBI (Merchant Banker) Regulations, 1992, the term “merchant banker” has been defined as any person who is engaged in the business of issue management …… or corporate advisory services in relation to such issue management. Although the Regulations do not specifically cover valuation as a service that can be provided by a Merchant Banker, it is conducted on account of several provisions (IT Act, SEBI and FEMA) impliedly granting the power to a Merchant Banker for the same.

FEMA Regulations

The entire process of issuing/ transferring shares becomes more complicated if the shares are being issued to persons resident outside India or an investment is being made outside India by an Indian entity. FEMA Regulations discussing the requirements of a valuation are summarised below.

- **Inbound investments – FEM (Non-debt Instruments) Rules, 2019**

Rule 21 of FEM (Non-debt Instruments) Rules, 2019 provides the pricing norms that need to be adhered to in case of an inbound investment.

In cases where shares of an Indian company are either (i) being issued to a person resident outside India, or (ii) being transferred by a resident to a person resident outside India, the floor price i.e. the minimum price at which the transfer or issue can be undertaken is:

a. either the price determined as per the relevant SEBI Regulations, if the company is listed, or

b. the price determined by a valuation conducted as per internationally accepted pricing methodology certified by a Chartered Accountant or a SEBI-registered Merchant Banker or a practicing Cost Accountant, in case of an unlisted company.

On the other hand, where shares of an Indian company are being transferred by a person resident outside India to a resident, the price determined as per the aforementioned parameters shall be the ceiling price i.e. the maximum price at which the transfer can executed.

- **Outbound investments – FEM (Transfer or Issue of any Foreign Security) Regulations, 2004**

Where an outbound investment is to be made by way of remittance from India into an existing company outside India, such investment should be in compliance with the valuation of shares determined by [either under Automatic Route as per Reg. 6(6) or under Approval Route under Reg. 9(2A)]:

(a) If investment is more than USD 5 million - Category I Merchant Banker registered with SEBI or Merchant Banker/ Investment Banker registered with an appropriate regulatory authority outside India;

(b) In other cases - Chartered Accountant or Certified Public Accountant.

However, if the investment in an existing company outside India is to be made for a consideration of the

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Indian company's shares, then irrespective of the value of the investment, the valuation shall be determined Category I Merchant Banker registered with SEBI or Merchant Banker/ Investment Banker registered with an appropriate regulatory authority outside India.

Any subsequent transfer of shares in a company outside India shall not be at a price less than the fair value determined by Chartered Accountant or Certified Public Accountant.

Income-tax Act provisions

Over the years, several sections in the Income-tax Act, 1961 ('IT Act') have been introduced or modified that require determination of fair value of shares and such fair value is considered as a benchmark for imputing income in the hands of the taxpayer. Some key sections and provisions have been discussed below.

- Section 56(2)(viib) - Issue of shares at a premium

Where a closely held company receives consideration for issue of shares which is in 'excess' of the fair value (to be determined as per Rule 11UA of the Income-tax Rules, 1962), such 'excess' shall be taxable in the hands of the company.

As a background to the introduction of this section is the case of Sun Direct TV Pvt Ltd. In FY 2008-09, Sun Direct TV, despite not having any substantial business operations, received share subscription money from a foreign company which included share premium of Rs. 200 crores. The issue was that Sun TV had issued shares to Mr. Kalanithi Maran and his wife at face value and hence, the tax department concluded that the share premium received from the foreign company was excess value received that should be taxable as income in the hands of Sun TV. While this matter was then reopened for assessment of such share premium under Section 68 of the IT Act, in the meantime, CBDT took a drastic step and introduced Section 56(2)(viib) of the IT Act.

- Section 50CA - Transfer of shares of unquoted shares

Where the consideration received upon transfer of unquoted shares is less than the fair value (again as per Rule 11UA), the fair value shall be imputed as the deemed consideration for such transfer. Rule 11UA does not require a valuation to be done, but to avoid confusion later, it may be advisable to get a valuation.

- Section 56(2)(x) - Receipt of shares for inadequate consideration

The same comment regarding non requirement of valuation report applies as what is mentioned in relation to Section 50CA.

Consequential to Section 50CA, the difference between the fair value of the shares and the actual consideration shall be considered as income taxable in the hands of the recipient of the shares.

Rule 11UA prescribes a specific formula (but does not require a valuation report) for determining the fair value of unquoted equity shares for the purposes of Sections 50CA and 56(2)(x) i.e. adjusted net book value. In case of shares other than equity shares, however, the value shall be determined as per the valuation undertaken by a Merchant Banker or an "accountant". While the definition of the term "accountant" has been omitted from Rule 11U, the definition in Explanation to Section 288(2) of the IT Act can be referred to; in the said Explanation, an "accountant" is defined to mean a chartered accountant as defined in Section 2(1)(b) of the Chartered Accountants Act, 1949 who holds a valid certificate of practice under Section 6(1) of that Act.

For the purposes of Section 56(2)(viib) i.e. issue of shares at a premium, Rule 11UA requires the fair value to either be adjusted net book value (as per the formula provided) or a value determined by a Merchant Banker using the Discounted Cash Flow method.

Serious impact on ease of doing business by introduction of these sections

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In terms of Section 56(2)(viib), conceptually, an amount infused in company by way of share capital/ premium cannot take the character of income. Unfortunately, some outlier cases have created an extreme situation which is a major dampener and militates a situation of a legislation which needs to be for the "greater good of greater numbers" and has legislated for such outlier situations causing tremendous hardship to the remaining genuine cases, thereby, seriously impacting EODB in India. Legislating for some stary cases does not help since, in any case, there already exist several Special Anti-Avoidance Provisions (for instance, Section 68) and opportunities under General Anti-Avoidance Rules to deal with a handful of malafide cases.

Even in terms of transfer of unquoted shares, the intent of introduction of these sections was to counter evasion and laundering of unaccounted income under the garb of gifts, particularly after abolition of the Gift Tax Act. However, due to the approach towards drafting of the tax laws, the provisions that were intended to only apply certain tax avoidance practices are now applicable to the entire horde of genuine transactions which are driven by purely commercial considerations. For instance, some investor may be seeking an exit from an unlisted holding company is contemplating transfer of the said shares to an institutional investor or one of the other majority shareholders, albeit at a value lower than the "fair value" as per Rule 11UA; this can happen because the negotiated price may be lower than the Rule 11UA value for a variety of reasons. The basic reason is commercial negotiations; say, the buyer may say that the reckoner value of the properties may not be relevant, because there may be no intent to sell and same could be the case with market value of listed shares. Clearly, there is no intention of tax avoidance or "gifting" the shares and the decision of selling the shares at a negotiated value is purely commercially driven. Yet, Section 50CA would apply to such a transfer and impute the Rule 11UA value as deemed consideration in the hands of the transferor, despite him not getting any benefit out of the transfer.

Not only does this result in unnecessary and irrational requirement of obtaining valuation reports and determining "fair value" for commercial transactions, it also leads to a huge waste of effort and resources in protracted litigations. A classic example is the litigation in the case of Shell India, where it had issued shares to its Shell Gas BV, its holding company, at face value and the tax department made a transfer pricing adjustment to the income of the company on the basis that the share value was much higher. The case was finally ruled in favour of Shell India by the Bombay High Court[1].

Different valuers prescribed for obtaining valuation reports

As would have been observed from the provisions summarised above, the issue does not stop at the unnecessary and sometimes, impractical need of determining valuation of shares under a host of different laws and regulations. Most of these regulations are not aligned (presumably drafted without consultation with either the regulatory bodies or the public/ stakeholders) and prescribe different valuers, even if the valuation is to be obtained for the very same transaction.

For example, issue of shares on a preferential basis under Section 62(c) of the Companies Act requires a valuation report from a "registered valuer" i.e. a valuer registered with the Insolvency and Bankruptcy Board of India as per Companies (Registered Valuers and Valuation) Rules, 2017. However, since the said issue of shares also needs to be in compliance with Section 56(2)(viib) of the IT Act (shares not to be issued at a premium in excess of fair value), valuation will have to be performed by a Merchant Banker. It is rare for a Merchant Banker to also be registered as a valuer under the Insolvency Code. Thus, two different valuers will have to be appointed for determining the value at which the shares can be issued, adding on to the already enormous burden of compliances.

As such, while valuation under the Companies Act will require a valuer to be registered with IBBI, valuations required under other laws (IT Act or FEMA Regulations, for instance) do not have to be undertaken by a registered valuer and can be obtained from, say, a Chartered Accountant or a Merchant Banker who is not registered with IBBI.

Some more examples have been tabulated below:

Transaction	Companies Act	SEBI Regulations	FEMA Regulations	Income-tax Act
Issue of shares	Registered valuer (valuer registered with IBBI)	Independent valuer, if issued for consideration other	Chartered Accountant or SEBI Registered Merchant	Merchant Banker (if issued at a price above face value)

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Transaction	Companies Act	SEBI Regulations	FEMA Regulations	Income-tax Act
		than cash (refers to Companies Act i.e. valuer registered with IBBI)	Banker or practicing Cost Accountant	
Transfer of shares	No valuation required	Merchant Banker or Chartered Accountant with 10 years of experience	If shares of Indian company (inbound): Chartered Accountant or SEBI Registered Merchant Banker or practicing Cost Accountant If shares of foreign company (outbound): SEBI registered Merchant Banker or Chartered Accountant or their foreign counterparts	In case of shares other than equity shares, Merchant Banker or "accountant" (i.e. a Chartered Accountant having a certificate of practice)

Valuation Standards

In addition to the above, valuers required to be registered with IBBI (for conducting valuation under Companies Act and the Insolvency Code) by following an elaborate process which includes becoming a member of a Registered Valuer Organisation, appearing for a valuation examination, etc.; they are also required to conduct valuations in compliance with the Valuation Standards prescribed.

These Valuation Standards apply to valuation reports under the Companies Act on a mandatory basis and to valuation under other laws on a recommendatory basis. Further, IBBI has also introduced Guidelines to regulated the Caveats, Limitations and Disclaimers that the registered valuers can use in their valuation reports. Therefore, obtaining a valuation report, by itself is also not a straightforward matter. When the layers of a wide variety of provisions and regulations requiring valuations for different transactions, different valuers, taking cognisance of commercial considerations etc. are added to it, it becomes a substantially serious and complicated task.

Summing up

At some point, it is only prudent for the law- and policy-makers to take a hiatus from merely introducing additional laws and regulations and review the already existing statutes and requirements and evaluate their need in view of the constantly evolving commercial landscape. Also, there is a strong need to resist the temptation of legislating for exceptions. Experience has shown that despite such "legislation for exception" being formulated, the so-called outliers anyway tend to find divergent ways to side-track such provisions while it causes tremendous hardship to the remaining genuine cases. That seems the only way to make it easier for people to do business in the true sense.

In the above context, the following issues need to be addressed:

- Several requirements for valuation need to be reviewed; as a glaring example, the requirement under Section 56 of the IT Act needs to be done away with.
- There should be an attempt to align as to which valuer has to do the valuation; there should not be requirement for different valuers to do a valuation for the same matter as is the case under Section 62 of the Companies Act and Section 56(2)(viib) of the IT Act in relation to preferential allotment where the first requires a registered valuer, and the second refers to a merchant banker.

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[1] Shell India Markets Pvt. Ltd. v. ACIT LTU (Writ Petition No. 1205 of 2013 – Bombay High Court)

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