Equity with Differential Rights – how does it deal with the test of inadequate consideration within the **Income-tax (rule 11UA)**

September 2020

incwert
Valuation Research

Foreword

The finance bill, 2017 introduced two critical provisions which are meant to ensure that consideration offered in a transaction is not inadequate when compared to the fair value of the asset being transferred. Legislature in its prudence considered it appropriate to benchmark such consideration against the net book value as computed under Rule 11UA of the Income-tax rules which CBDT subsequently notified in July 2017; **however, with the idea of differential rights as to dividends, voting or otherwise (hereafter referred to as 'DVRs') picking-up in India pursuant to the introduction of section 43(a)(ii) of the Companies Act, 2013, can DVRs be a stratagem to emaciate the income tax (Rule 11UA) valuation?**

In this paper, we delve into this compelling question and seek to understand if the current rule is water-tight to address the grey areas of valuing the stocks with DVRs. We attempted to analyse situations where issuance of DVRs could have the possibility of undermining section 50CA and clause (x) in sub-section (2) of section 56 of the Income-tax Act. For example, a higher priced class of equity share of a company being underplayed by being ascribed a lower value determined on a pro-rata basis under the extant rule.

DVR, a strategic and substantive control feature embedded in the equity, can it be capable of laying waste the deeming provision of the full value of consideration and that of the taxability of receipt of the sum of money or property without/inadequate consideration.

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

Meaning of DVRs

DVR simply means that a company has issued more than one class of stocks with different voting rights. Against a simple common stock issuance which has 1:1 voting right (i.e. 1 vote for 1 stock owned), such equity shares have differential voting rights. For example, a company X could issue two classes of shares – Class A with voting rights and Class B with no voting rights. In another case, a company Y could issue two classes of shares – class A with 10:1 voting rights and class B with 1:1 voting right.

Globally, DVR structures are most commonly seen in founder-led companies where founders are considered to be critical for the success of the company, have a high amount of pre-IPO funding and are averse to any change of control[1]

In India, while many of the early-stage companies issue to investors shares which have exotic structures with varied features which include inter-alia conversion rights, higher participation rights, liquidation preference, redemptions rights/ puttable features and anti-dilution features, not many founders are able to negotiate differential voting/ dividend rights for themselves. So far, shares with DVR structure have therefore been less often seen in the Indian start-up environment; but the trend is gradually catching up with Investors lapping such rights.

Price discovery challenge

Companies Act, 2013, allows a private limited company to issue equity shares with differential voting rights as part of its share capital. **The differential rights attached to such equity shares may be with respect to dividend, voting or otherwise.** A question may thus arise in the reader's mind on how much expensive such inferior/ superior share be when compared to the ordinary share.

Allocation of the value of the enterprise, which is a function of economic and control rights, can vary significantly across the various class of shares. While the divergence in the pricing of the listed companies can be empirically assessed (in India, price divergence in DVR shares of listed companies has been between 3-45%), the task for determining the value of the different class of shares of a private company is challenging, if not impossible.

[1]Source: https://www.cfainstitute.org/-/media/documents/survey/apac-dual-class-shares-survey-report.ashx

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

Potential tax avoidance

It is this challenge in segregating the value across various share class, which is potentially open to exploitation and tax avoidance. Presently Rule 11UA (1)(c)(b) or 11UA (1)(c)(c) does not explicitly provide an adjustment to address the value allocation across the various stock class. The rule states the following:

> *Rule 11UA(1)(c)(b) ".....the fair market value of unquoted equity shares =(A+B+C+D - L)× (PV)/(PE), where,*
> *..........*
> *..........*
> *PV= the paid up value of such equity shares;*
> *PE = total amount of paid up equity share capital as shown in the balance-sheet;"*

Hence, the equity value is distributed on a pro-rata basis across all the equity stock class, and there is a possibility that the value of a specific stock class thus determined is lower than the fair value adjusted for such differential voting rights.

Let's understand this based on the following example:

Fair market value of unquoted equity shares (as per Rule 11UA) of 100% equity interest: 5,000

- Class A equity share (100 shares issued, subscribed and paid-up @ 1) has 90% control over the business with mere 10% stake
- Class B equity share (900 shares issued, subscribed and paid-up @1) has only 10% control over the business with 90% stake

The entire holding in class A share is transferred for a consideration of 750.

Commercial analysis of value of Class A equity share: since the class A controls 90% of the business, fair value of 100% interest in Class A equity would necessarily be far more than value derived on a pro rata basis i.e. 500 using Rule 11UA. Say, if the value were to be allocated on the basis of proportion of control exercised on the business, the value of Class A equity share would be 4,500 (90% of 5,000)

Value under rule 11 UA: The tax rules do not have any provision for adjustment for differential voting rights and hence, the value per share would be 5 and the aggregate value of Class A share would be 500

Taxability under sec. 56(2)(x) – since the payment of 750 is more than the 11 UA value of 500, there is no tax implication u/s 56(2)(x) for the recipient of shares

Taxability under sec. 50 CA – consideration of 750 received for transfer of shares is more than 11UA value of 500. Hence, deemed consideration will not be applicable.

Potential tax incidence (if the basis of computation of value under Rule 11UA(1)(c) were amended to take DVR into account):

- Say, the fair market value allocable to Class A share, if control aspect is considered, is 90%. The value per 11UA would be 4,500. Accordingly, u/s 56(2)(x), the recipient will be liable for tax on 4,500 less 750 i.e. 3,750 as other income
- U/s 50CA, deemed consideration would be 4,500 and capital gain tax shall be computed accordingly

Note: *The analysis carried out in the above example is merely for illustrative purposes. In real-life situations, valuing a stock with varied economic and control features involves the use of complex equity valuation allocation methods including the adoption of the Merton model, Black-Scholes model, Option pricing methods and Monte-Carlo simulations.*

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

Potential tax avoidance (contd.)

Similarly, there could be structures which offer **significantly higher dividends** to a specific class of equity share. While, by utilising a dividend discount model (assuming a simplistic scenario), it would be possible to determine the value of different classes, the extant rule 11UA may not uncover the veil on value allocation. The rule could thus be exposed to transactions which bypass test of inadequate consideration.

Furthermore, there are companies which offer a higher dividend to compensate for the loss of control to the shareholders. The net effect is that the allocation of value among share classes will widen the schism in the meaning of fair value under rule-based valuations and commercial transactions unless the tax rules are updated to reflect the changing investment landscape.

The downside

While the gap in the methodology may work to the advantage of some share class, a reverse situation could be where a share class controls only 10% but represents 90% of the paid-up value, which can lead to a distraught scenario for the shareholder holding this class of share.

Thought process underpinning the rule

Rule 11UA utilises cost approach as part of the building blocks of the rule-based method. What this means is that in the ordinary course of valuing enterprises **under a going concern presumption**, the shareholder is unlikely to find this rule a stumbling block. The value derived based on cost approaches typically fall in the lowest strata of the value pyramid compared to the market and income approaches. The Legislature in its prudence possibly thought of subverting the inadequate consideration transactions by testing the transaction value against the book net asset value. However, what is perhaps missed out was addressing the change in corporate law which had an allowance for flexible capital structure.

Does the gap in the rule have a material impact on the transactions in the start-ups in India?

Speaking of start-ups, where shares with different economic and control rights are frequently occasioned, the rule-based valuation in the extant state may continue to hold good. The reason we believe this is because, despite the issuance of varied classes of shares with different control and economic rights, balance sheets of start-ups are thin as the cash raised by the start-ups is typically expensed and the rate of capitalisation is low. Therefore, the secondary sale price tends to be higher than the value derived based on the cost approach and therefore the question about inadequate consideration is unlikely to be triggered.

Conclusion

Change in the rule will be of great import for the companies that are asset-heavy and have equity shares with differential rights. Albeit we cannot undermine other situations for example where transaction value of 100% equity is close to the book value determined as per the rule and the company has equity shares with differential rights.

Accordingly, we reckon the CBDT should look into the matter and possibly amend or come out with a consultation paper for fair valuing unquoted shares with DVRs and other substantive rights.

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

Reference | Incwert Publications

Reference Material:

- Company filings and other publicly available information
- SEBI
- Incwert analysis

Photo credit:

- Unsplash.com
- https://www.freepik.com/vectors/background

Incwert Valuation Chronicles (click the image to download the file)

Equity risk premium in India
- Jan 2019

Valuation challenges in AIF (Pg. 69-80)
- Feb 2019

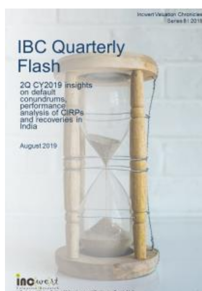
Perspective on valuation of DVRs
- Mar 2019

Junk bond valuation
- Apr 2019

IBC Quarterly Flash
- May 2019

Rule 11UA valuation
- Jun 2019

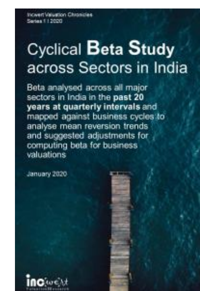
IBC Quarterly Flash
- Aug 2019



AMC listing & valuation
- Sep 2019

India Control Premium, 2019
- Oct 2019

India Beta Study
- Jan 2020



Risk free rate in a negative yield economy
- Feb 2020

Holdco Discount
- Mar 2020

Equity Risk Premium
- June 2020

Purchase price allocation study (BFSI)
- July 2020

India Control Premium, 2020
- August 2020

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

Management | Advisory Board

Sunit Khandelwal
Director

Sunit has worked across a range of sectors such as Infrastructure, real estate, FMCG, retail, engineering, clean energy, healthcare, IT/ ITeS, and other manufacturing industries.

Qualifications:
Chartered Accountant (ICAI)
B.Com (Hon.) – St. Xavier's College
Registered Valuer with IBBI

Sunit has an overall experience of over 14 years in valuation advisory, transaction advisory and M&A advisory.

As a valuation professional, Sunit has undertaken valuation of businesses for transactions, fund raising, strategic decision making, and corporate restructuring. He has also undertaken valuation of intangible assets, option valuation, litigation support, private equity portfolio valuation and valuation for reporting purposes such as purchase price allocation and impairment test under IFRS and Indian GAAP.

In past he has worked with KPMG India (as Associate Director), BDO, Grant Thornton, KPMG UK, and DBDBS a boutique M&A advisory firm.

Sunit is also an active speaker on valuation at National Institute of Finance Management (NIFM).

Punit Khandelwal
Director

Punit has worked across leveraged loans, distressed debt, insolvency/ bankruptcy situations and high-yield asset classes.

Qualifications:
Chartered Accountant (ICAI)
Chartered Financial Analyst (ICFAI)
CFA Level 2 (US)
MS in Finance (ICFAI)
B.Com (Hons.) – St Xavier's College
Registered Valuer with IBBI

Punit brings with him 15 years of experience in sell-side and buy-side advisory across equity and fixed income. He has worked on several bespoke valuations and lent research support to dozens of asset managers/investment bankers/brokers/consulting firms across the globe.

In the fixed income segment, he worked as a fundamental analyst across the capital structure: leveraged loans, distressed debt, insolvency/bankruptcy situations and high-yield asset classes. He has also helped sell-side & consulting firms increase their market presence by coming up with thematic and white label papers.

He started his career as an analyst with Zacks Investment Research & then was a part of a UK based CLO manager's research team. Then he moved on to set up research practices for couple of startups before moving onto become Global Head of Research at one of the largest BPO/KPO in the world and then finally co-founded Incwert.

He won 40 under 40 Alternative Professionals Awards 2020 by AIWMI

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

Contact us

Incwert India contacts

Delhi NCR:
Sunit Khandelwal
Mobile : +91 95606 80444
Board no: +91 124-4696689
Email: sunitk@incwert.com

Mumbai:
Punit Khandelwal
Mobile: +91 98201 38274
Email: punitk@incwert.com

Website: http://www.incwert.com

Our Offices

Gurugram

Platinum Towers,
507A, 5th floor
Sohna Road
Gurugram 122 018
India

Registered office:
F-1502,
GPL Eden Heights,
Sector 70,
Gurugram 122101

Mumbai

Casa Marina
1401, Hiranandani
Estate,
Thane (W) 400 607
India

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.

This publication has been carefully prepared only for general information and education purpose and is not a research report or any kind of investment advice. Neither authors of this publication nor Incwert Advisory Private Limited have any kind of conflict of interest with any company/firm/entity which has been cited and have been used for the sole purpose of illustration. It has been written in general terms and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. It should be seen as broad guidance only and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice after a thorough examination of the particular situation. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this proposal, and, to the extent permitted by law, Incwert Advisory Private Limited ("Incwert"), its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

incwert
Valuation | Research

© 2020 Incwert Advisory Private Limited, an Indian Private limited company having CIN U74999HR2018PTC075916 All rights reserved. Incwert and the Incwert logo are registered trademarks of Incwert Advisory Private Limited.