

EY Tax Alert

Supreme Court rules shares under lock-in-period are not “quoted shares” and need to be valued as “unquoted shares” to determine gift tax liability

Executive summary

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

This Tax Alert summarizes a recent decision¹ of the two-judge bench of the Supreme Court (SC) in the case of DCIT vs. BPL Ltd.² (Taxpayer) on valuation of equity shares of listed company held as part of promoter’s quota that was subject to lock-in-period of three years.

During tax year 1992-93, the Taxpayer transferred such shares at less than a price quoted by stock exchange to its sister companies, which was permitted as per extant securities regulations. The tax authority characterized such transfer as effected for inadequate consideration and, hence, treated it as a “deemed gift” chargeable under the Gift-tax Act, 1958 (GTA). For this purpose, the tax authority valued such shares by treating them as “quoted shares” (i.e., by adopting stock exchange quotation price), notwithstanding the restrictions on transferability during the lock-in-period. The Taxpayer contended that the valuation should be done under a prescribed break-up value method by considering the shares as “unquoted shares”, as the shares transferred were not tradeable on stock exchange during the lock-in-period.

The SC ruled in favor of the Taxpayer and held that the equity shares of listed company forming part of the promoter’s quota under the lock-in-period are not “quoted shares” and, hence, required to be valued as “unquoted shares”. The SC, *inter alia*, held that although the shares were of listed company, in view of being under lock-in restriction, they did not meet the essential conditions of being quoted in any recognized stock exchange with regularity from time to time and presence of current transactions made in the ordinary course of business.

¹ Dated 13 October 2022

² TS-804-SC-2022

Background

- ▶ This SC ruling was rendered in the context of the GTA for the tax year 1992-93.
- ▶ Under the GTA, where a property was transferred for inadequate consideration; (a) the market value of the property on the date of transfer, as exceeding; (b) the amount of consideration, was taxed as “gift” in the hands of the transferor [Section 4(1)(a) of the GTA].
- ▶ As per the relevant provisions of the GTA, the value of property was to be computed as per the manner prescribed under the Wealth-tax Act, 1957 (WTA)³.
- ▶ For determining the value of shares and debentures⁴, the relevant provisions of WTA provided as under:
 - ▶ Different rules applied to compute value of “quoted share and debentures” and “unquoted shares and debentures”⁵.
 - ▶ “Quoted share” in case of an equity share means a share which is quoted on any recognized stock exchange (RSE) with regularity from time to time and where the quotation of such shares is based on current transactions made in the ordinary course of business.

Further, with regards to any question on whether a “share” or “debenture” is “quoted” within the above meaning, a certificate to that effect furnished by the concerned stock exchange in Form O-II⁶ shall be accepted as conclusive (certificate of quoted shares or debenture in a company).
 - ▶ “Unquoted share”, in case to an equity share, means a share which is not a quoted share.
 - ▶ The value of quoted shares was to be taken as the value quoted on the relevant date on the stock exchange [Rule 9 of Part C of Schedule III to WTA].

- ▶ The value of unquoted share was 80% of its break-up value which was computed based on the net-asset value of such shares determined as per a prescribed normative formula [Rule 11 of Part C of Schedule III to WTA].

Facts

- ▶ The Taxpayer was holding shares in two public limited companies (transferred companies), which were listed and quoted on Bangalore stock exchange. The shares held by the Taxpayer were part of promoter’s quota and were, therefore, restricted from being traded on stock exchange for a lock-in period of three years.
- ▶ On 2 March 1993, which fell within the lock-in period, the Taxpayer transferred these shares to its sister concerns, for inadequate consideration (i.e., consideration was lesser than the market quotation-based value of shares).
- ▶ The transfer was undertaken in the tax year 1992-93 when the GTA was applicable to the transferor/donor. Since the transfer was for inadequate consideration, the tax authority invoked the provisions of the GTA on the aforesaid transfer of shares and held that; (a) the value of shares, exceeding; (b) the value of consideration; was a “deemed gift” taxable in the hands of the Taxpayer.⁷
- ▶ As per the tax authority, the shares transferred were “quoted shares” as the lock-in-period of shares had not affected the transfer of shares by the Taxpayer. Accordingly, the tax authority took the value of shares of transferred companies quoted on the stock exchange on the date of impugned transfer, as the value of shares transferred by the Taxpayer to arrive at the valuation of INR 209.40m.
- ▶ Before the appellate authorities, the Taxpayer had submitted the certificates (including Form O-II) issued by the Bangalore stock exchange, which stated that;
 - (i) the impugned shares were not being transacted on the stock exchange; (ii) value as quoted on relevant dates for these shares was ‘Nil’; and (iii) the impugned shares are not tradeable on stock

³ Section (s.) 6(1) read with Schedule II of the GTA, contained the rules for determining the value of a gifted property (other than cash). As per Schedule II, the value of property transferred by way of gift is to be determined in accordance with Schedule III of WTA.

⁴ The provisions for determining the value of property being shares and debentures in a company, was contained in Part C of Schedule III to WTA.

⁵ Rule 9 and Rule 11 of Part C of Schedule III to WTA, dealt with the valuation of quoted shares and debentures, and that of unquoted shares and debentures.

⁶ Prescribed under Rule 13 of Wealth-tax Rules.

⁷ Up to Karnataka High Court (HC), the Taxpayer had also challenged the characterization of impugned transfer of shares as “deemed gift” on the ground that transfer by holding company to subsidiary company cannot be regarded as “gift”. However, the Karnataka HC dismissed this ground in the Taxpayer’s case by concurring with the findings of the tax authority that the Taxpayer intentionally and deliberately tried to make the transferee sister-companies as its subsidiaries to evade gift-tax. This ground was not challenged by the Taxpayer before the SC and the limited issue before SC was on valuation of impugned shares. Accordingly, this tax alert is restricted on the issue of valuation of shares as dealt by the SC.

exchange during the lock-in-period and price quoted on stock exchange is applicable only to shares freely tradeable on the stock exchange.

- ▶ The first appellate authority held that since such shares were prevented from being traded on stock exchange during the lock-in-period, they could not be treated as “quoted shares”. The first appellate authority upheld the valuation done by considering the shares as “unquoted”, at INR 50.60m.
- ▶ On further appeal, the Bangalore Tribunal emphasized that even within the lock-in-period, the Taxpayer had transferred the shares and the restriction did not prevent such transfer. It ruled that merely because there is a bar on trading did not mean that shares were itself “unquoted shares”. The Tribunal set aside the findings of the first appellate authority and valued the shares as quoted, at INR 167.60m.
- ▶ The Karnataka HC, in the same case, held that mere quoting of shares in the market would not by itself give any valuation, at the most, it may only indicate ownership. Value quoted in stock exchange would be available only if the shares are traded. The certificates are not disputed, and Form O-II is conclusive, which makes it clear that the impugned shares are not tradeable. Basis this, the HC upheld the valuation as “unquoted shares” at INR 50.60m.

SC ruling

- ▶ Confirming the decision of Karnataka HC, the SC ruled in favor of the Taxpayer and held that the equity shares under the lock-in-period and forming part of the promoter’s quota, were not “quoted shares” for the following brief reasons:
 - ▶ **Not meeting the conditions of “quoted shares”**
 - ▶ Since the impugned equity shares under the lock-in period could not be traded, it did not meet the two conditions in the definition of “quoted shares”, viz. (a) shares were not quoted in any RSE with regularity from time to time and (b) there were no current transactions made in the ordinary course of business. Accordingly, these shares remained unquoted in any RSE.
 - ▶ **Position as per the SEBI guidelines/ circular**
 - ▶ As per Securities and Exchange Board of India (SEBI) guidelines, there is a complete bar on transfer of impugned shares during the lock-in-period and this is enforced by

inscribing the words “not transferable” in share certificate.

- ▶ Although, as per a general circular issued by SEBI, the shares under the lock-in period can be transferred *inter se* the promoters, such restricted transfer to promoters by private transfer/sale, does not satisfy the above two conditions of “quoted share”.
- ▶ **Prescribed valuation rules**

- ▶ The valuation of unquoted shares as per the prescribed normative formula is mandatory and no other method is permitted⁸.
- ▶ The valuation of quoted shares must be based on market quotations which reflects the market value of shares that are transferable in a stock exchange. Hence, such marked price would not reflect the true and correct market price of shares which are subject to restrictions on their transferability.
- ▶ The value/price of shares is normally impacted by important considerations of easy and unrestricted marketability. However, restrictions on transferability have an effect on such value/price of share. Such value may have to be depreciated to arrive at the value for shares which are subject to such restrictions.
- ▶ However, applying a hybrid method to make *ad hoc* depreciation to the value of quoted price is not permitted as per the valuation rules governing the quoted shares⁹. The valuation of unquoted shares (which for this purpose are defined as the shares other than quoted shares) must be done on a standalone basis as per the prescribed normative formula¹⁰.
- ▶ The above would be in accordance with s.6(1) of the GTA, which requires the valuation of gifted property to be carried out in the prescribed mechanism which, in turn, refers the valuation rules under WTA.

- ▶ **Clarificatory provision on restrictive terms does not impact the characterization as “unquoted shares”:**
 - ▶ A specific rule¹¹ under WTA, provides that the restrictive terms shall be ignored while determining the price of property that it

⁸ Refer SC decisions in the cases of S.N. Wadiyar (Dead) through Legal Representative v. Commissioner of Wealth Tax, Karnataka, (2015) 15 SCC 38; and Commissioner of Wealth Tax, Meerut v. Sharvan Kumar Swarup & Sons, (1994) 6 SCC 623.

⁹ Rule 9 of Part C of Schedule III of WTA.

¹⁰ Rule 11 of Part C of Schedule III of WTA.

¹¹ Rule 21 of Part H of Schedule III of WTA.

would fetch ***“if sold in the open market”*** on the valuation date. The tax authority seems to have relied on this Rule to ignore the transferability restrictions on impugned shares so as to support the characterization as “quoted shares”.

- ▶ However, it appears that the SC has rejected such reliance placed by the tax authority on the ground that this Rule does not postulate a change in the nature or character of property, but it only permits the taxpayer and the tax authority to assume/ hypothesize a sale in the open market, despite restrictions on transferability, for determining the fair value of any property under WTA. Further, such restrictive covenant on free transferability would need to be considered in determining the fair valuation of such property.

▶ **On certificates issued by stock exchange**

- ▶ The provision requiring the certificate in Form O-II from concerned stock exchange is to only state whether share or debenture meets the condition in the definition of “quoted shares”. This provision does not prohibit the authority or the court to examine whether share or debenture is “quoted” or “unquoted” in terms of Rule 9 and 11 of WTA. This right conferred on the authorities under WTA and the GTA are not delegated to stock exchange.

Comments

The SC provides clarity that shares under lock-in-period/subject to restrictions of transferability, would qualify as “unquoted shares”. Further, the normative valuation method prescribed for “unquoted shares” is to be strictly followed and there is no room for applying any other method.

The SC reaffirms that a specific provision in valuation rules requiring valuation to be done by hypothesizing sale in the open market, despite restrictions on free transferability, is clarificatory. The restrictive covenant on free transferability would need to be considered in determining the fair valuation of such property. Further, as per the SC, such clarificatory provision will not impact the characterization of locked-in/non-transferrable shares, as being “unquoted”.

The present SC ruling, though rendered in the context of erstwhile GTA and WTA provisions, can have relevance in the context of the Indian Income-tax Act, 1961 (ITA). While the GTA was abolished from 1 October 1998 and WTA was abolished w.e.f. 1 April 2016, the expressions “quoted shares/security” and “unquoted shares/security” are used in anti-abuse provisions in the ITA, for determination of; (i) gift-tax^[12] in the hands of recipient under section 56(2)(x) of the ITA; (ii) capital gains tax for transferor covered under section 50CA of the ITA; or (iii) capital gain on business transfer by way of slump sale under section 50B of the ITA, etc.

The definition of “quoted shares” and “unquoted shares” in the context of GTA and WTA, is largely same as the definition thereof provided in the ITA^[13]. Moreover, the above ITA provisions adopt similar valuation norms and provide for differential mechanism/method to value “quoted shares” and “unquoted shares”.

Accordingly, the SC ruling may impact the valuation of locked in shares of listed company in the context of the above referred anti-abuse ITA provisions.

¹² While the gift-tax was abolished, similar provisions to levy income-tax on such gift transactions in the hands of recipient/transferee, were introduced in the ITA and are currently present in section 56(2)(x) of the ITA.

¹³ The definitions of these terms under the ITA, are provided in the Explanation to section 50CA of the ITA and Rule 11U of the Income-tax Rules, 1962.

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