Fair market value formula not that fair: Experts

Tax consultants and experts are seeing various irritants in the draft rules on calculation of fair market value (FMV) for indirect share transfers. Although the draft adds some certainty to taxation of Vodafone- like transactions, these flaws could lead to anomalies, they say. One of the issues is the definition of the term ‘book value of liabilities’.

The draft prescribes the manner in which FMV of the foreign target company (FTC) shares and the underlying India company (IC) shares can be determined for the purpose of indirect transfer taxation. Any transaction where the value of Indian assets exceeds 50 per cent of the FTC would attract taxes in India.

Explanation 6(b) requires such FMV to be determined without reduction of the company’s book value of liabilities.

The term “book value of the liabilities” has been defined to mean the value of liabilities as shown in the balance- sheet, excluding the paid- up capital in respect of equity shares/ members’ interest. Since the exclusion has been given only to “equity share capital,” the same could dilute the effectiveness of FMV determination and could have adverse impact both from the perspective of the tax department and the taxpayer, consultants said.

“The manner of FMV determination under the draft rules has the risk of either gobbling those transactions, which effectively should have remained outside the fold of indirect transfer taxation or vindicating those transactions, which otherwise should have been taxed in India,” said Ravi Mehta, senior partner at Grant Thornton LLP. For example, foreign investors and Indian promoters often use instruments such as convertible preference shares for investments in Indian firms. Since these investments would be added to the liabilities, the FMV would be inflated to that extent. Depending on whom these instruments are issued to, the tax treatment would be affected. “There has always been a differing school of thought as to whether it was appropriate on the part of the legislators while introducing Explanation 6 (b) to S9(1)(i) to not allow reduction of liabilities while determining the FMV of the relevant assets. The rules now proposing addition of every liability, except Equity, for the purpose of determining FMV would further aggravate the effectiveness of FMV determination,” Mehta of Grant Thornton added. While the valuation report of a reputed valuer would be largely based on business factors, it is quite likely that a transaction price in an unrelated party transaction many a times get staked up because of non- business factors such as competitive conditions, control premium, regulatory factors and labour issues. In such a situation, anon- resident seller having Indian and non- Indian assets may fall in a situation wherein it would need to cough out Indian tax under indirect transfer provision determined based on valuation report, even if its actual transaction price should not have triggered such taxation. The draft rules propose that if transfer or failing to provide necessary information for application of prescribed formulae, whole income from transfer of shares shall be deemed to be attributable to assets located in India. Jiger Saiya, partner (direct tax) at BDO India, said, “Again a debatable question — can the rules define or alter the taxability of income arising from indirect transfer of shares (in the absence of back- up documentation)?” Documentation could also be a big headache as requirements are exhaustive and rigorous.

The critical areas of documentation include information relating to decision or implementation process of overall arrangement of transfer; information relating to business operation, personnel, finance and properties, internal and external audit or valuation report forming basis of consideration in respect of share/ interest of foreign entity being transferred and its subsidiaries that directly or indirectly hold assets in India.

“Maintenance and production of such minute details is going to be painstaking for Indian arm of the MNC, more so in the case of multi- layered structures of holding/ subsidiary companies,” said Saiya of BDO India.

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