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Tax on share deals below 'fair' price

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The 2010-11 budget proposes to tax the sale of shares at a price below the fair market value, a practice seen in purchases by private equity (PE) funds in private placements and rights issues. The tax proposal has got investors worried.

The proposal is to tax the difference between the market value of the shares and lower price paid. The tax will be on the buying company. Present pricing guidelines do not apply to investments a venture capital firm makes and shares bought in private placements.

There is no mandatory requirement for the transaction to be at the fair market value. Normally, these deals are made at a mutually decided price.

"In such cases, the new provision will be triggered, subjecting the transaction to tax on the difference between the fair market value and the purchase price paid by the investor," said Nishit Desai Associates, a Mumbai-based global legal and tax consulting firm, in a note.

The budget says, "To prevent the practice of transferring unlisted shares at prices much below their fair market value, it is proposed to amend section 56 (of the Income-Tax Act) to also include within its ambit transactions undertaken in shares of a company (not being a company in which the public is substantially interested) either for inadequate consideration or without consideration where the recipient is a firm or a company (not being a company in which the public is substantially interested).

According to Nishit Desai Associates, no rules have been prescribed for the valuation of shares so transferred. This has caused uncertainty about how the provision will be applied.

What the proposed amendment does is introduce the concept of a 'deemed fair market value' of the transferred property, which permits the revenue authorities to question the price paid.

"This may effectively result in any transaction being questioned by the tax authorities. It will lead to extensive litigation," the consulting firm said.

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