



# **WESTERN INDIA REGIONAL COUNCIL OF ICAI**

## **SEMINAR ON TRANSFER PRICING 23<sup>rd</sup> September, 2017**

### **Valuation Approaches and their applicability under Transfer Pricing**

**CA Siddharth Banwat**

# WHAT IS VALUATION?



# WHAT IS VALUE?

A value in exchange *is a hypothetical price* and the hypothesis on which the value is estimated is determined by the purpose of the valuation.



A value to the owner is *an estimate of the benefits that would accrue to a particular party from ownership.*

# WHAT CREATES VALUE?

**Benefit** > **Cost**

**Revenue**

**Sales**

**Market Share**

**Royalties**

**Competitive**

**Advantage**

**Reduced costs**

**Operational costs**

**R & D costs**

**Overheads**

**Cost of development**

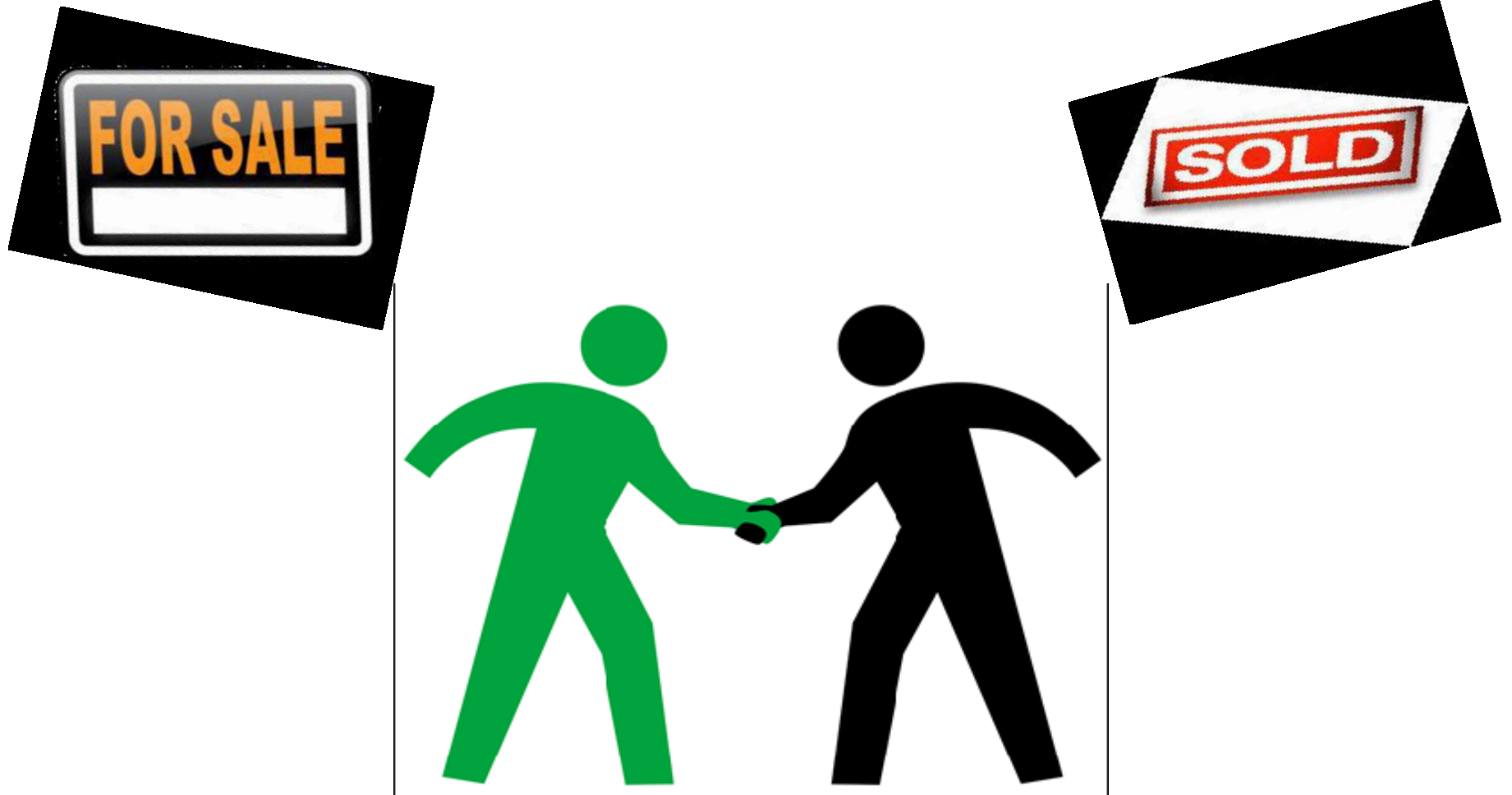
**Working Capital**

**Capital expenditures**

# ROLE OF MARKETS IN VALUATION



# WHAT IS A MARKET?



# EXAMPLES OF MARKETS



# MARKET

Markets provide evidence of the **value** of an asset:



An asset is worth what a buyer will pay to acquire it and what an owner will accept to sell it



# ARM'S LENGTH PRICE VS. FAIR MARKET VALUE



# WHAT IS A PRICE?

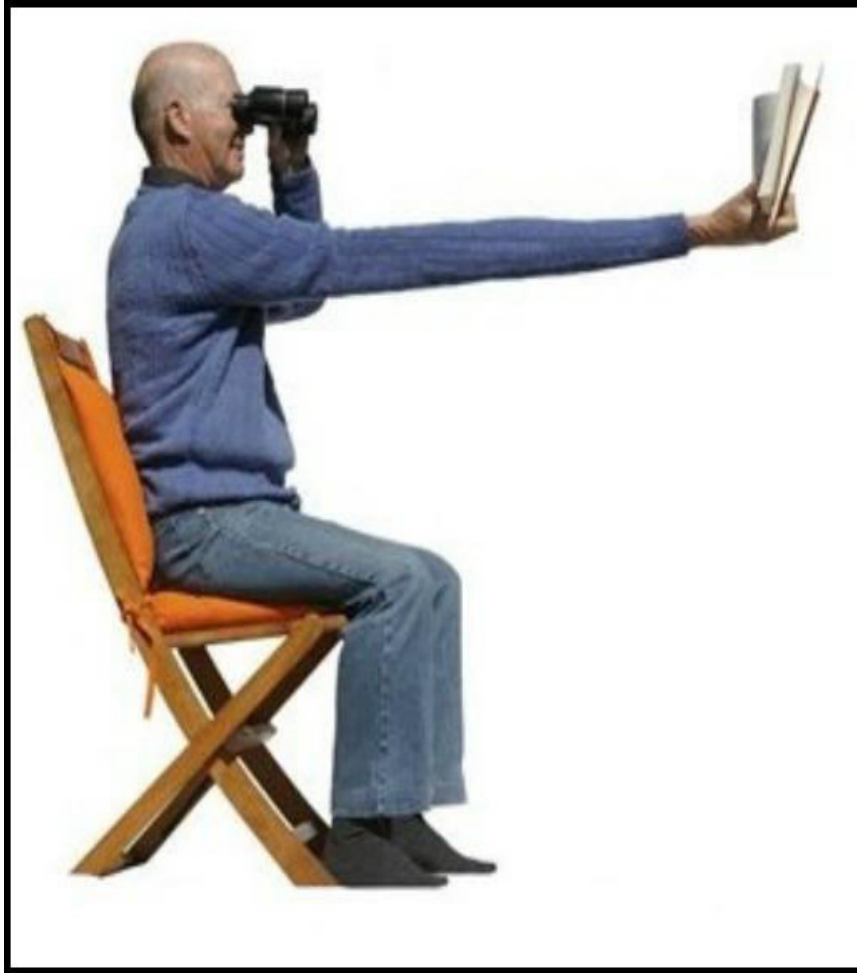
Price is the amount asked, offered or paid for an asset. Because of the financial capabilities, motivations or special interests of a given buyer or seller, the price paid may be different from the value which might be ascribed to the asset by others.

# FAIR VALUE ?

## Fair value

The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.

# MEANING OF ARM'S LENGTH PRICE

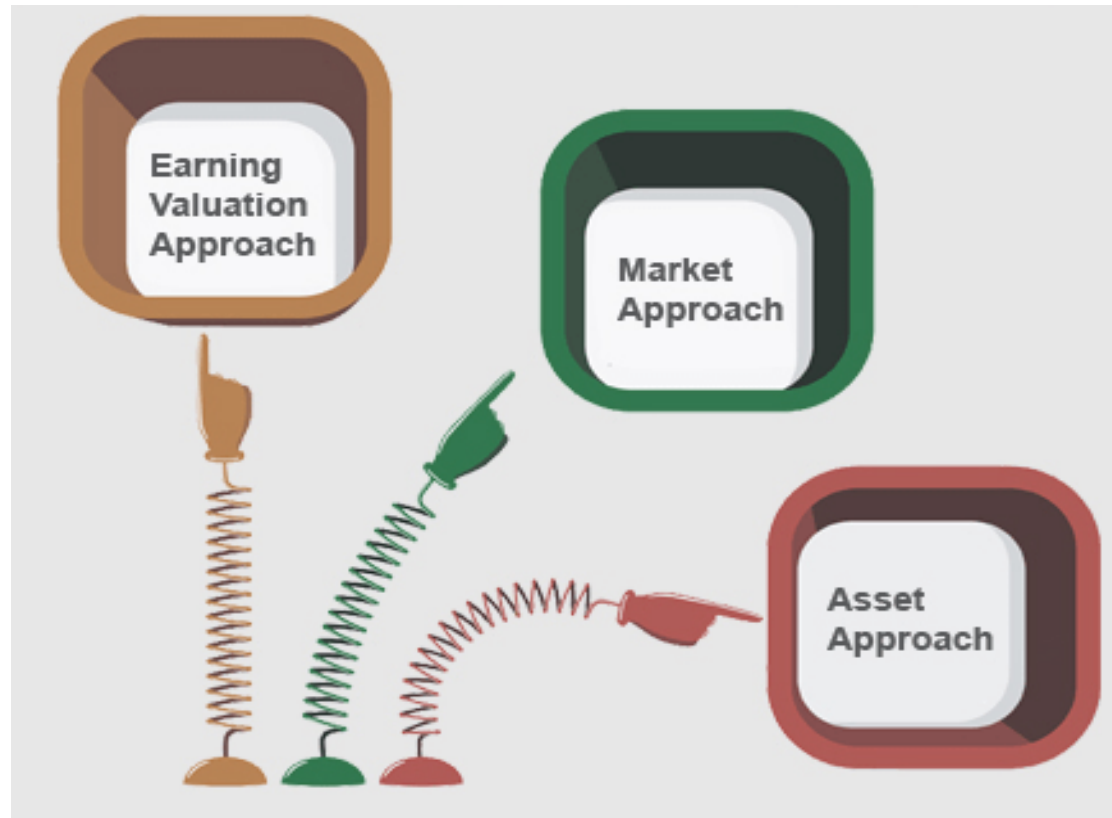


- (1) Arm's Length Price ('ALP') means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. (Section 92F(ii) of ITA)
- (2) Computation of ALP is subjective and involves making lots of adjustments before arriving at a final price.
- (3) ALP is determined by selecting the most appropriate method out of the prescribed transfer pricing methods (discussed later...)

# CORRELATION BETWEEN PRICE, COST AND VALUE

- ❑ Cost is the amount required to acquire or create the asset.
- ❑ When that asset has been acquired or created, its cost is a fact.
- ❑ Price is related to cost because the price paid for an asset becomes its cost to the buyer.

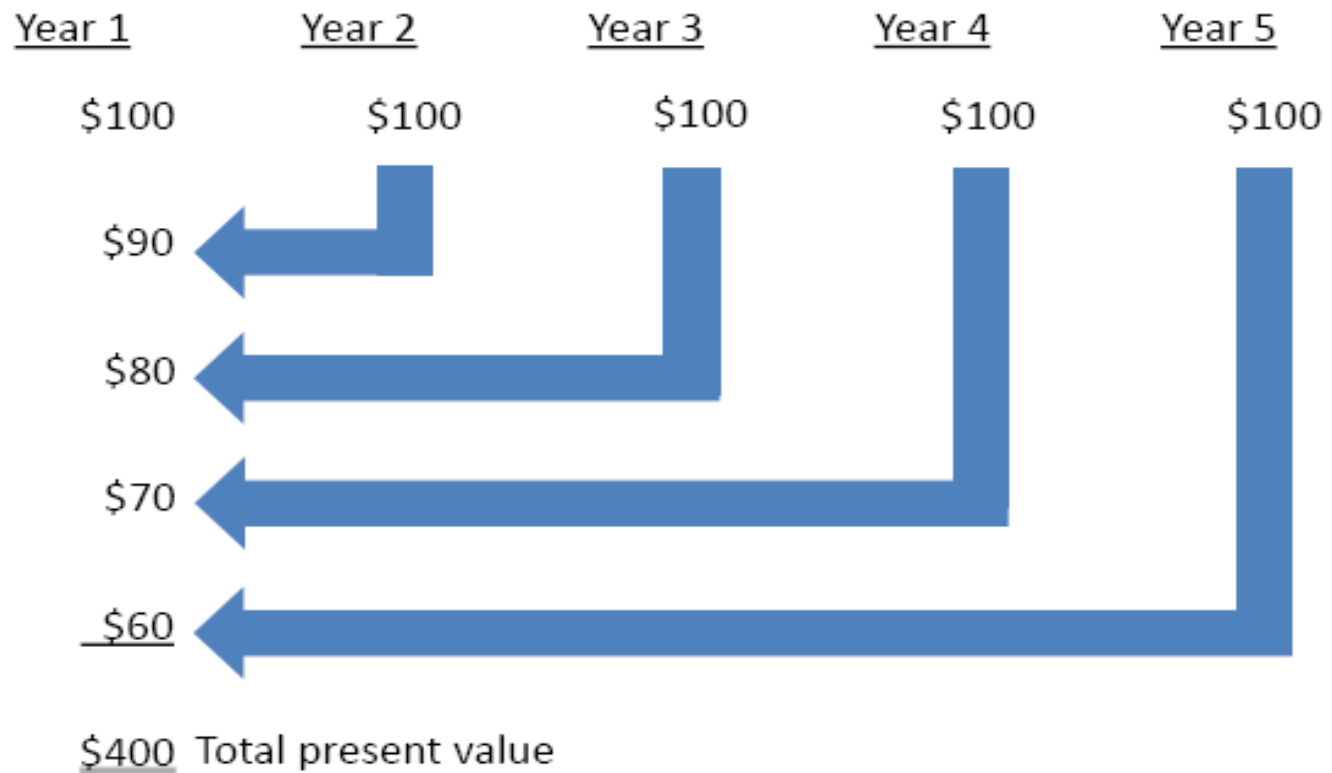
# COMMON APPROACHES TO VALUATION



# INCOME APPROACH

- ❑ The *Income approach* method determines the value of a business based on its ability to generate desired economic benefit for the owners.
- ❑ The key objective of the income based methods is to determine the business value as a function of the economic benefit.
- ❑ The value is based on the **net present value (NPV)** of expected future income streams from the ownership of the asset.

# A DOLLAR RECEIVED IN THE FUTURE IS WORTH LESS THAN A DOLLAR RECEIVED TODAY





# INCOME APPROACH

<b>STRENGTHS</b>	<b>WEAKNESSES</b>
Revenue and cost estimates can be determined for the specific business in question.	Poor assumptions used in the net present value calculation will lead to meaningless results (i.e., garbage-in, garbage-out)

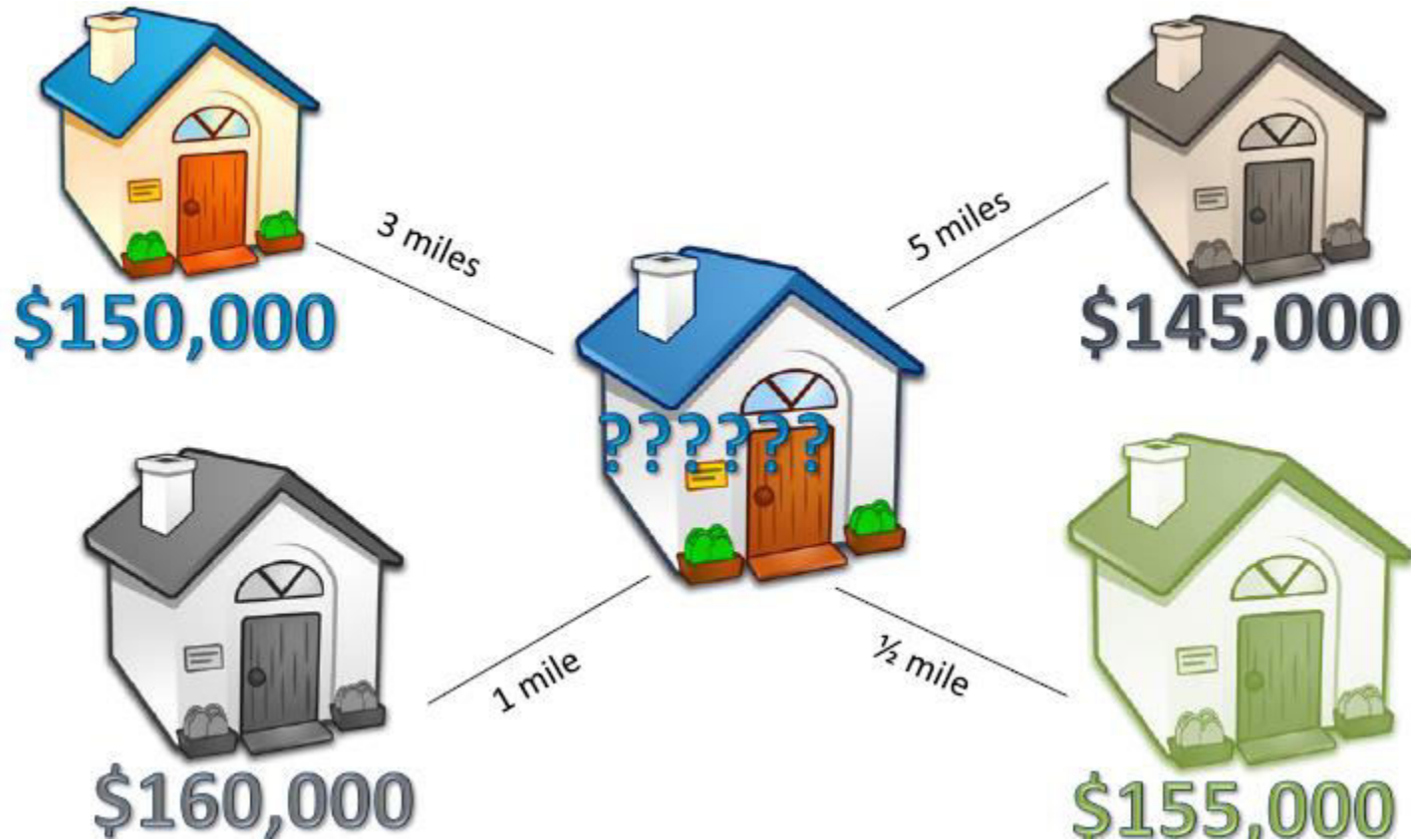
# INCOME APPROACH – FACTORS TO CONSIDER WHILE DEVELOPING PROJECTIONS

- Economic conditions and trends
- Industry conditions and trends
- Competition
- Company specific information
- Assumptions should be reasonable and have a basis

# MARKET APPROACH

- ❑ The *market approach* provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.
- ❑ It is based on arms-length transactions of comparable assets.
- ❑ An asset is worth what other, similar assets are worth.

# MARKET APPROACH



# MARKET APPROACH

## STRENGTHS

As it is based on actual transactions for similar companies, transactions are “real world” data points of the value.

## WEAKNESSES

There is very little information available in public domain to draw direct comparability.

# COST APPROACH

- ❑ The cost approach method seeks to determine business value on the value of its assets.
- ❑ It is calculated using:
  - Fair market value of assets
  - Less** : Liabilities
- ❑ It is based on cost to replace or re-create the asset.

**FOR EXAMPLE, A HOUSE MAY BE WORTH  
WHAT IT WOULD COST TO RE-BUILD IT**



CA Siddharth Banwat

# COST APPROACH

<b>STRENGTHS</b>	<b>WEAKNESSES</b>
Costs may be easier to estimate than future revenue and expenses	Fails to reflect earning potential of the business



# VALUATION IN TRANSFER PRICING



# INTERNATIONAL TRANSACTIONS

A Transaction [Section 92F(v)]

Between Associated enterprises [Section 92A] either or both of whom are non-residents

**In the nature of**

- a) **purchase, sale or lease of tangible or intangible property;** or
- b) **provision of services;** or
- c) **lending or borrowing money;** or
- d) any other transaction having a bearing on the profits, income, losses; or assets of such enterprises;
- e) **cost sharing arrangement** and shall include a mutual agreement or an arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to any cost or expense incurred or to be incurred in connection with the benefit, service or facility provided or to be provided to any one or more of such enterprises

## DETERMINATION OF ALP – PRESCRIBED METHODS

<b>Comparable Uncontrolled Price ('CUP')</b>	The CUP method compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances.
<b>Resale Price Method ('RPM')</b>	The RPM evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions.
<b>Cost Plus Method ('CPM')</b>	The CPL method evaluates a controlled transaction by reference to the markup earned in comparable uncontrolled transactions.
<b>Profit Split Method ('PSM')</b>	The PSM allocates operating profits or losses from controlled transactions in proportion to the relative contributions made by each party in creating the combined profits or losses or in proportion to allocation of profits in arm's length transactions.
<b>Transactional Net Margin Method ('TNMM')</b>	The TNMM compares the net profit margin of the assessee arising from a non-arm's length transaction with the net profit margins realized by arm's length parties from similar transactions.
<b>Other Specified Method</b>	Any method that takes in to account the price which has been charged or paid or would have been charged or paid for same or similar uncontrolled transaction with or between non – associated enterprises

# MOST APPROPRIATE METHOD

- ❑ As per Rule 10C of the Income Tax Rules, 1962 the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction and which provides the most reliable measure of arms length price in relation to the international transaction

# WHAT ARE INTANGIBLE ASSETS??

- Intangible assets (intangibles) are long lived assets used in the production of goods and services. They lack physical properties and represent legal rights or competitive advantages (a bundle of rights) developed or acquired by an owner.

# FORMS OF INTANGIBLE ASSETS

□ ***Intangible assets*** as “**non- physical assets** such as

- franchises,
- trademarks,
- patents,
- copyrights,
- goodwill,
- equities, mineral rights, securities and contracts

**that grant rights and privileges, and have value for the owner.”**

# USE OF INTANGIBLES

- ❑ To have value, intangible assets should generate some measurable amount of economic benefit to the owner, such as incremental turnover or earnings (pricing, volume and better delivery, amongst others), cost savings (process economies and marketing cost savings) and increased market share or visibility.
- ❑ Owners exploit intangibles either in their own business (direct use) or through a license fee or royalty (indirect use).

# Intangible Valuation Approach Summary

Asset	Primary	Secondary	Tertiary
Patents	Income	Market	Cost
Technology	Income	Market	Cost
Copyrights	Income	Market	Cost
Assembled Workforce	Cost	Income	Market
Internally developed software	Cost	Market	Income
Brand names	Income	Market	Cost
Customer relations	Income	Cost	Market



# BEPS – PRINCIPLE OF VALUE CREATION

Substantial activity requirement to get tax preferential regime

Align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created.

- Modified Nexus approach - a link between IP income and qualifying R&D spend.
- Proportional approach: preferential rate for IP-related income to the extent it was generated by qualifying expenditures

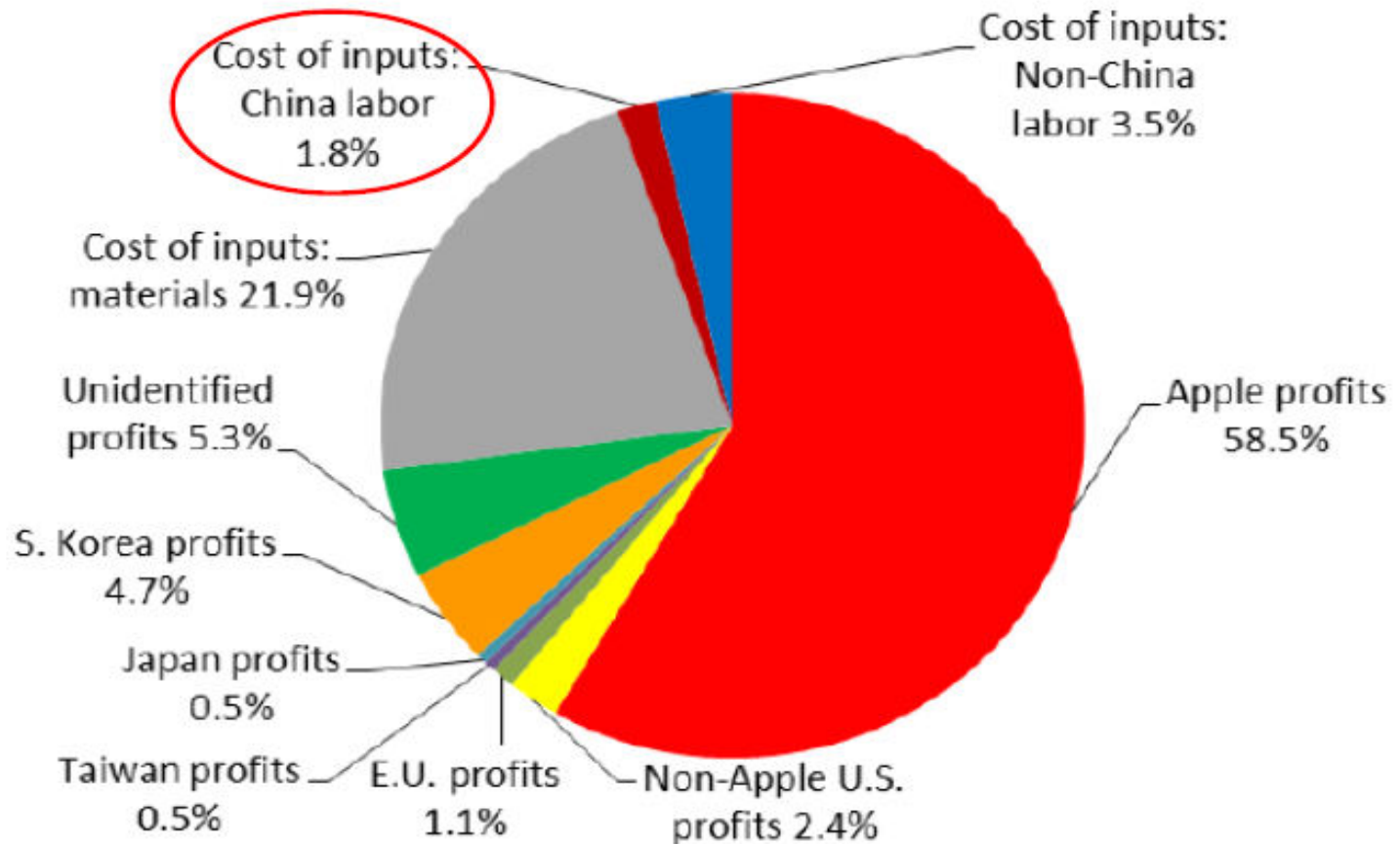
# VALUE CREATION

When an intangible is completely designed and perfected in one country but is solely exploited in a second country, where is value created in the first or the second?

**If in both countries – how to split the value creation between the two jurisdiction?**



# WHERE IS THE VALUE CREATED?



School of Information Studies, Syracuse University  
Personal Computing Industry Center, UC Irvine and Syracuse University

# THANK YOU!

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