

# Emerging Transfer Pricing Controversy and Interplay of valuation techniques in the Transfer Pricing Realm

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Transfer pricing is a widely recognized and critical aspect of tax regulation that focuses on determining an arm's length price for transactions between two independent enterprises. This principle ensures that transactions involving the supply of goods and services between related entities are conducted under market conditions similar to those between unrelated entities.

The law of transfer pricing provides a fair allocation of profits among related entities within multinational enterprises. Valuation, on the other hand, involves determining the fair value of securities, financial assets, and both tangible and intangible property. Dealings between multinational enterprises often involve the purchase and sale of financial assets and securities, which fall under the definition of related party or international transactions under Indian Transfer Pricing regulations. Consequently, the arm's length price of such transfers of shares and securities between two enterprises must be determined according to the principles embodied in these regulations.

Recent jurisprudence suggests that transfer pricing officers are scrutinizing the transactions involving the transfer of securities and financial assets/shares between related enterprises more closely, using transfer pricing techniques. This article explores recent jurisprudence in which tribunals have examined the detailed issues concerning the interplay of transfer pricing and valuation methodologies for pricing intra-group transactions.

### **Background of the case:**

Tata Sons Private Limited sold 10 million shares of Tata Global Beverages Group Ltd. (TGBGL) to an

overseas subsidiary i.e. Tata Global Beverages Capital Ltd. (TGBCL). The valuation of these shares was carried out by an independent valuer who implemented a combination of the Comparable Companies Multiple (CCM) method and the Discounted Cash Flow (DCF) method, giving equal weightage of 50% to each method.

The Transfer Pricing Officer (TPO) rejected the hybrid approach, advocating for a pure DCF method as prescribed by the Income Tax Rules and raising objections to selection of comparables under CCM method. The TPO thus, held that value of shares should have been determined in accordance with DCF method and proposed upward TP adjustment accordingly.

### **Facts and relevant legal Framework:**

The case primarily revolves around the determination of the Arm's Length Price (ALP) in international transactions, as established in the Income Tax Act. The central issue was whether the hybrid method used by independent valuer for valuation could be considered under the 'Other Method' as per Rule 10AB of the Income Tax Rules, for justifying the transaction of issuance of shares by Tata Sons, from arm's length perspective. The ITAT noted several critical aspects as mentioned hereunder:

- At the outset, ITAT noted that as per RBI Circular (RBI Mater Circular No. 11/2011-12, where shares of an unlisted company are disinvested in a private arrangement, the share price should not be less than the value certified by a Chartered Accountant/Certified Public Accountant based on the latest Audited Financial Statement of the wholly owned subsidiary (WOS). It is an undisputed fact that TGBGL is a WOS of the assessee, the shares of TGBGL are sold to TGBCL in a private arrangement. A perusal of the valuation report dated 17/11/2011 reveals that valuation analysis of shares of TGBCL is based on Audited Financial Statement as on 31/03/2011. The report has been certified by a Chartered Accountant. Thus, all the mandatory conditions set out in RBI Circular (supra) are duly complied.
- Secondly, ITAT noted that the taxpayer transferred shares at a rate determined by the Independent Valuer and clarified that such valuation and the transaction based thereon are not to be disregarded, unless the valuation is based on patently wrong approach or assumptions or there is fundamental flaw in the valuation.

On examination of the Valuation Report, ITAT noted that the Independent Valuer in Section 5 of the report pointed certain limitations in comparable selection for the purpose of applying CCM method and based thereon, comparables chosen lack comparability or adequate information within beverages segment (with some not even involved in tea industry, and others contributing minimally to total revenue) and viewed that despite these shortcomings, Independent Valuer assigned 50% weightage to CCM method. Accordingly, ITAT held that there were flaws in valuation of shares under CCM approach and thus the valuation report to that extent was rejected.

- However, ITAT clarified that the objection of the TPO against application of hybrid method for valuation of shares is "devoid of merit" and principally accepted that as long as valuation of shares is based on accepted method(s), single or combination of methods and justifiable reasons are given for allocating weightage for each of the method adopted after factoring limitations, the valuation should be accepted.

### **Key Takeaways:**

The principal emerging from the aforementioned judgment emphasized that the valuation of shares could be assessed using a combination of multiple valuation techniques. The tribunal highlighted that the chosen techniques should be backed by reasonably accurate data concerning the relevant facts and assumptions. Furthermore, the tribunal endorsed the transfer pricing approach while rejecting the CCM-based valuation method, citing inconsistencies in the factual assumptions underlying its application.

### **Judicial Pronouncements:**

Visteon Asia Holdings Inc [TS-669-ITAT-2016(CHNY)-TP]

Emphasis is placed on the judgement of the honorable Chennai Tribunal in the case of Visteon Asia

Holdings Inc whereby the tribunal rejected the valuation techniques adopted by the assessee on the grounds that the same was not universally accepted method of valuation and places more emphasis on valuation determined using discounted cash flow analysis undertaken by the transfer pricing officer. The relevant extract of case is as hereunder:

#### Quote

“..... ITAT accepts Discounted Cash Flow (DCF) method for determining ALP of Indian Company's share sale by US Parent Company to Mauritius & Singapore Holding companies; CCI valuation [using average of Net Asset Value (NAV) and Profit Earning Capacity Value (PECV)] used by taxpayer not acceptable, in view of ITAT ruling in Ascendas; Both assessee and Revenue accepted DCF during subsequent year's DRP proceedings; Considering consistency principle, no reason to go for another method in current year.”

#### Unquote”

#### **Strides Arcolab Ltd** [\[TS-304-ITAT-2023\(Mum\)-TP\]](#)

Incidentally in the case of Strides Arcolab Ltd, the Mumbai Tribunal observed that while the assessee has used the Net Asset Value (NAV) method for valuation of shares. The said method cannot be outrightly rejected unless a transfer pricing officer is able to provide sound reasoning and rationale basis for rejection of such method and adoption of DCF method. Although the tribunal did not specifically lay down the most appropriate valuation method, it reiterated the case to file with the Transfer Pricing officer for examining the issue.

The relevant extracts are reproduced below:

#### Quote

“... the valuation method adopted by the assessee cannot be rejected without scrutinizing the valuation done by the assessee though the DRP is well within its rights to examine the methodology adopted by the assessee and/or underlying assumptions and if not satisfied, it can challenge the same and suggest necessary modifications/alterations provided the same are based on sound reasoning and rationale basis. However, on perusal of records we notice that no such specific findings is given by the DRP. In view of these discussions, we deem it fit to remit the issue back to the AO/TPO with a direction to examine the NAV method of valuation as adopted by the assessee afresh excluding the revaluation reserve for the year ended 31st December 2009 and decide in accordance with law”

#### Unquote”

In view of the above rulings, traditionally, the DCF method has been the go-to methodology for valuing shares. However, in the instant ruling ITAT clearly emphasized that as long as the valuation of shares is grounded on an accepted method or a combination thereof, and reasons for the allocation of weightage among the methods are well-justified, such valuation should be recognized. This case illustrates the importance of employing flexible and case-specific valuation approaches in determining the arm's length pricing of international transactions. It also clarifies that while the DCF method is valuable, it is not the only recognized method, and the choice of method should ultimately aim to reflect the true value of transactions based on comparables.

#### **The interplay of Section 50CA read with Rule 11UA:**

In the realm of income tax law, Section 50CA of the Income Tax Act stands as a critical guidepost for the valuation of shares transferred between unlisted entities. According to this provision, the valuation must be aligned with Rule 11UA, which typically employs the Net Asset Value (NAV) method—a book value approach to determining share worth.

Section 50CA, a deeming provision, prescribes mandatory income tax valuation methodologies for share transfers, irrespective of whether these transactions occur between residents and non-residents or among residents. The essence of a deeming provision is its strict application without deviation, posing

intriguing questions about its broader implications.

The Core Question: Does Section 50CA, by virtue of its specific valuation mandate, define the most appropriate method for determining the arm's length price under transfer pricing regulations, as stipulated in Section 92E of the Income Tax Act?

### **Two Schools of Thought:**

1. **The Purist Perspective:** Proponents argue that since the Act clearly outlines the valuation method, the valuation determined under Section 50CA should be deemed the most appropriate for establishing the arm's length price. This view hinges on the statutory endorsement of the method, suggesting a straightforward application.
2. **The Contextual Perspective:** Others posit that Section 50CA merely establishes a baseline for share valuation, indicating that the price must not fall below the determined value. From this viewpoint, Section 50CA provides a minimum benchmark, necessitating the application of additional valuation techniques and transfer pricing principles for any higher valuation.

To bolster this latter interpretation, one can look to Section 92(3) of the Income Tax Act, 1961. This section asserts that transfer pricing provisions should not lead to a reduction in the chargeable income tax. Hence, if a particular valuation method results in a value lower than that established under Section 50CA, the provisions of Section 50CA take precedence, nullifying the application of transfer pricing rules. Conversely, if the valuation methods yield a higher value than that prescribed by Section 50CA, transfer pricing provisions come into play.

In conclusion, while Section 50CA sets a foundational standard for share valuation, its interaction with transfer pricing regulations invites a nuanced approach. This ensures a balanced framework where statutory benchmarks are respected, and the integrity of transfer pricing principles is maintained.

### **Concluding Remarks:**

#### **The Arm's Length Principle: The Bedrock of Intervention**

At the heart of TP lies the arm's length principle. This principle dictates that transactions between related parties (entities under common control) should be priced at arm's length, which is the price that would be charged between unrelated parties in an open market transaction for the same or similar goods, services, or intangibles.

In the context of transfer pricing valuations, a comprehensive understanding of the various valuation methods beyond the Discounted Cash Flow (DCF) approach is essential. Asset-based, market-based, and income-based valuation techniques each offer unique insights and considerations that can inform the determination of appropriate transfer prices. By combining multiple valuation methods, businesses can develop a more robust and well-rounded understanding of the fair market value of their assets, goods, or services being transferred between related entities.