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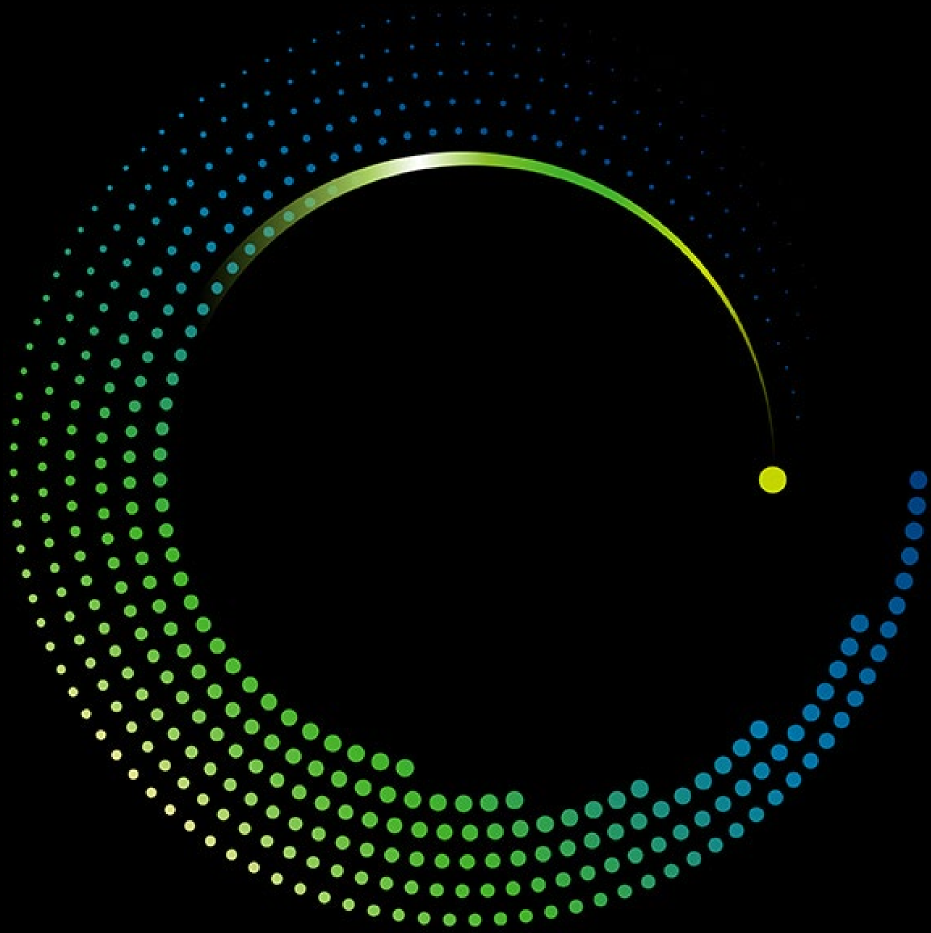
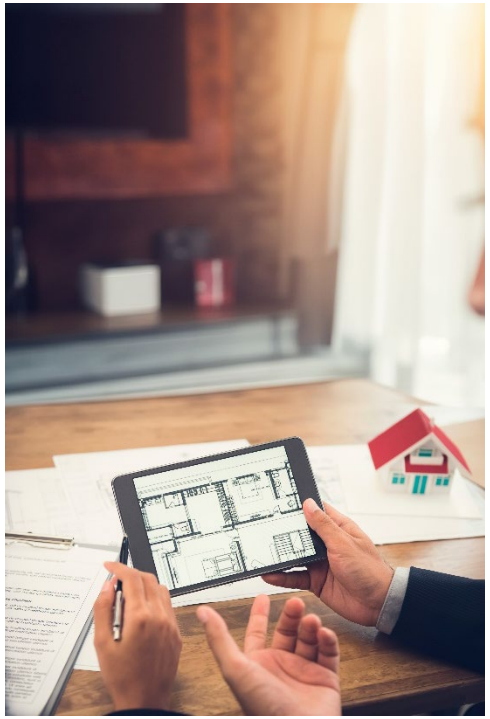
Tax Newsletter | El Salvador
March 2024



Tax Newsletter

Timely news and information on national tax issues

Alternative method for the analysis of leasing of property in Transfer Pricing



In Transfer Pricing practice, it is common that the first option for analyzing intercompany transactions for the leasing of property is through the application of the Comparable Price Method ("CPM") and the search for external comparables (prices per m^2).

Very often, the result of this search for comparables does not meet solid comparability criteria. Therefore, a market range can be presented that has a high risk of questioning by the tax authorities.

The International Valuation Standard entitled *Valuation Approaches and Methods* recognizes income capitalization as a valuation technique under the income (or revenue) approach, which could be a more appropriate approach for comparability for Transfer Pricing purposes.

In this respect, it is important to mention that within the real estate industry it is known that the price of the property is not the decisive factor when investing, but rather that any investor will be more interested in the cash flow generated by the property than its price.

Technically, there are two types of income capitalization. The first one estimates the value based on a single income and is called direct capitalization; and the one that estimates the value based on determining the present value of a series of income that is expected to be received in the future is called cash flow capitalization.

For purposes of this document, we are only considering direct capitalization.

Mathematically, the income capitalization rate (also known as "Cap Rate") of a property is the financial ratio between the net operating income ("NOI") or annual rent and property value. Therefore, the income capitalization rate constitutes the current return on the property, as detailed below:

$$Cap\ Rate = \frac{Annual\ Rent}{Property\ Value}$$

From this equation, we derive the estimated market income:

$$Property\ Value\ x\ Cap\ Rate = Market\ Income$$

To determine the Cap Rate, the following is suggested:

- Consider the Cap Rate of the appraisal report,
- Identify Cap Rate of comparables (public sources),
- Perform a return-on-investment analysis.

For the application of this methodology, it is necessary to (i) have a recent appraisal report for the property or a report that can be reasonably updated considering the increase in value and inflation; and (ii) determine the Cap Rate range for the tested party using any of the options previously indicated. In this case, the tested party is the entity that owns the property that is acting as the lessor; in other words, the investor that grants the use or benefit of the property to the lessee and expects a return.

Finally, if the price of a lease of the tested party is within the reference market range (determined based on the Cap Rates), it would be possible to conclude whether it complies or not with the arm's length principle.

The methodology for analyzing property leasing transactions through *Cap Rates* could be useful when the traditional analysis through square meter pricing information does not produce reasonable results or this type of information is not available.

This type of income capitalization analysis is based on generally accepted valuation techniques.

More information:

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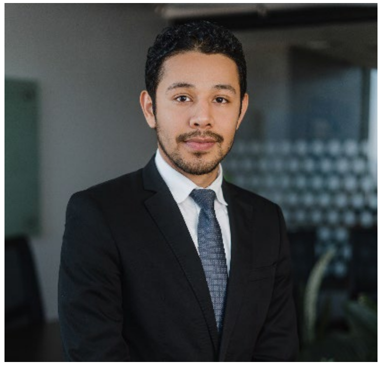

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Tax Calendar

Use our 2024 Tax Calendar to keep informed about:

- Tax Obligations before the Tax Office (Ministerio de Hacienda)
- Municipal Tax Obligations
- Payroll Management Obligations

March 2024

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

To learn more about **March's** obligations:

Download the 2024 Tax Calendar

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