

# Transfer Pricing Alert

2 May 2023



## Supreme Court rules on ‘substantial question of law’ in transfer pricing cases

In a recent ruling<sup>1</sup>, the Hon’ble Supreme Court has reversed the decision of Karnataka High Court<sup>2</sup> which held that determination of arm’s length price (‘ALP’) by the Income Tax Appellate Tribunal (‘Tribunal’) is final and cannot be subject matter of appeals before High Court. The Supreme Court has held that the High Court can examine as to whether the determination of ALP, selection of comparables, and application of filters by the Tribunal is in accordance with provisions under Chapter X of the Income-tax Act (‘the Act’).

### Background and facts of the case

- As per Section 260A of the Act, a Taxpayer and / or the Tax Department (‘Revenue’) can prefer an appeal to the High Court against an order of the Tribunal. **However, such appeal can be admitted by High Court only if it is satisfied that the case involves a ‘substantial question of law’. The Tribunal is the last forum to decide all issues of facts.**
- In 2018, the Karnataka High Court in the matter of *Softbrands India Private Ltd (supra)* held that transfer pricing issues pertaining to selection of comparables and application of filters do not give rise to a ‘substantial question of law’. This ruling has been relied upon by several High Courts in subsequent cases to dismiss appeals on the issue of comparables in transfer pricing (‘TP’) matters by holding that a substantial question of law was absent.

<sup>1</sup> *SAP Labs India Pvt. Ltd. & Others* (Civil Appeal No. 8463 of 2022) (SC), order dated 19 April 2023

<sup>2</sup> *PCIT v. Softbrands India (P) Ltd.*, reported in (2018) 406 ITR 513 (Karnataka)



- Aggrieved by these rulings, the Revenue (and in few cases, Taxpayers), filed appeals before the Supreme Court against these High Court Rulings. The Supreme Court has heard this matter as a batch of appeals with SAP Labs India Private Limited being the lead case.
- The Supreme Court rendered its decision on this fundamental issue which would have bearing on a large number of similarly placed matters.

### Revenue's contentions

- The view taken by Karnataka High Court is too broadly stated that a question of law cannot arise out of the TP matters which involve selection of comparable and application of filters, which have been decided by the Tribunal on factual findings.
- There cannot be any absolute proposition of law that against the decision of Tribunal determining the ALP, there shall not be any interference by the High Court in an appeal under Section 260A of the Act.
- The ALP is to be determined taking into consideration the guidelines stipulated under the provisions of the Act and the Rules<sup>3</sup>.
- It is always open for the High Court to examine, whether the guidelines stipulated under the Act and the Rules, while determining the ALP have been followed by the Tribunal or not.
- If determination of the ALP by the Tribunal is not as per the guidelines stipulated under the Act and the Rules, the determination can be said to be perverse which is always subject to the scrutiny by the High Court in an appeal under Section 260A of the Act.

### Taxpayer's contentions

- It cannot be said that there exists a substantial question of law, to be considered in an appeal under Section 260A of the Act, if ALP is determined by the Tribunal taking into consideration the relevant provisions of the Act and the Rules.
- As per the Act, the High Court may determine any issue which (a) has not been determined by the Tribunal; or (b) has been wrongly determined by the Tribunal, by reason of a decision on such question of law as is referred to in relevant provision of the Act.
- A substantial question of law can arise in a case only when a question of law is fairly arguable, where there is room for difference of opinion on it.
- A fact finding may give rise to a substantial question of law, inter alia, if the findings are based on (i) no evidence; and/or (ii) while arriving at the said finding, relevant admissible evidence has not been taken into consideration or inadmissible evidence has been taken into consideration; or (iii) legal principles have not been applied in appreciating the evidence; or (iv) when the evidence has been misread.
- The Supreme Court and High Courts have consistently held that the Tribunal is a final fact-finding authority and in the absence of demonstrated perversity in its finding, interference by High Court is not warranted.
- A substantial question of law can arise in TP matter in cases where the issue relates to whether a transaction falls within the definition of 'international transaction', or if two enterprises are 'associated enterprises' as per the definition under the Act.

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<sup>3</sup> Income Tax Rules, 1962



- Admission of such appeals before High Court would cast an unjust burden on the High Court to undertake suo moto exploration of facts not placed before it and which have been considered by the Tribunal.
- TP provisions are essentially a valuation exercise involving determination of a statistical sample of comparables and the Supreme Court in the case of *G.L. Sutania*<sup>4</sup> had unequivocally held that valuation is a question of fact.

### Supreme Court ruling

- The Supreme Court has quashed the High Court orders which had held that the Tribunal's determination of arm's length price is final, and in absence of any demonstrated perversity, a substantial question of law does not arise for admission of appeal before High Court.
- The Supreme Court held that the ALP determination de hors the relevant provisions of the Act and Rules can be considered as perverse, and it may be considered as a substantial question of law as perversity itself can be said to be a substantial question of law.
- There cannot be any absolute proposition of law that in all cases where the Tribunal has determined the ALP the same is final and cannot be the subject matter of scrutiny by the High Court in an appeal under section 260A of the Act.
- High Court can also examine the question of comparability of two companies or selection of filters and examine whether the same is done judiciously and on the basis of the relevant material/evidence on record.
- Where determination of ALP is challenged before the High Court, it is always open for the

High Court to examine in each case whether while determining the ALP, the guidelines laid down under the Act and the Rules are followed or not and whether the determination of the arm's length price and the findings recorded by the Tribunal while determining the ALP are perverse or not.

- The High Courts have been directed to dispose the appeals afresh, preferably within a period of 9 months, after examining whether statutory provisions of the Act and the Rules for the determination of the ALP have been followed or not.

### Dhruva Comments

While it is true that the Supreme Court has held that there cannot be an absolute proposition of law that in all cases Tribunal's determination of ALP is final, however, the Supreme Court ruling cannot be interpreted in a manner that all the cases involving ALP determination by the Tribunal can be challenged before the High Court. Only those Tribunal rulings wherein there is perversity i.e. the relevant TP provisions are not followed while determining the ALP or selection of comparable or filters, the order can be challenged before the High Court.

The Supreme Court has not dealt with the aspect whether the impugned Tribunal orders suffered perversity or not. The Supreme Court remitted the case to the High Court to examine whether in each case while determining the ALP the guidelines laid down under the Act and the Rules, are followed or not and whether the findings recorded by the Tribunal while determining the arm's length price are perverse or not.

Before the High Court, the respondent can prove no perversity in the order as the ALP determination in their case by the Tribunal was not de hors the relevant TP provisions. If the High Court is convinced that there exists no perversity in the Tribunal order, no question of law shall arise to be adjudged by the High Court.

<sup>4</sup> *G.L. Sutania and Anr v SEBI and Ors.* 2007 (5) SCC 133



This ruling should be viewed as a reminder for the taxpayers to have a robust and contemporaneous documentation in place with objective and well-defined comparability parameters. Once the comparability parameters are backed by substantive research and work, then it would be extremely difficult to allege the results to be dehors the relevant TP provisions.

A transfer pricing analysis of selection of comparables, filters, is a very detailed exercise and if the High Court starts reviewing these in detail, it is likely to result in significant additional time to achieve a finality on TP disputes under the domestic litigation process.

Given the above, the taxpayers would need to evaluate whether they should follow the domestic litigation route or alternative dispute resolution options such as Advance Pricing Agreement ('APA'), Mutual Agreement Procedure ('MAP') or Safe Harbour Rules.

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