



## Newsflash

**SAP Labs India: Supreme Court holds Transfer Pricing disputes in Arm's Length Price (ALP) determination give rise to 'Substantial question of law'**



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### **SAP Labs India: Supreme Court holds Transfer Pricing disputes in Arm's Length Price (ALP) determination give rise to 'Substantial question of law'**

*For Circulation*

*25 April 2023*

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#### **1. BACKGROUND:**

- 1.1 Determination of arm's length price ('ALP') is the bedrock of Transfer Pricing ('TP') analysis. It is viewed largely as a factual and subjective exercise, consisting of broadly analysing an international transaction and identifying a 'comparable' uncontrolled transaction(s). The process of identifying a comparable uncontrolled transaction involves various aspects of selection- such as selection of the most appropriate method, comparability parameters and filters, a comparable company, comparability adjustments, etc. all of which while undertaken within the confines of the TP rules and regulations coded in the Income-Tax Act, 1961 ('Act') and Income-Tax Rules, 1962 ('Rules') also involve the inherent element of factual analysis and application.
- 1.2 This exercise of ALP determination, because of its significance in TP analysis has given rise to a substantial number of TP disputes currently pending at various levels of the Indian income-tax judicial and appellate forums. The ALP disputes originate at the Transfer Pricing Officer/ Assessing Officer level and then make their way to Income-Tax Appellate Tribunal ('Tribunal'), wherein the ITAT is usually considered as the final 'fact finding' authority on such ALP disputes.
- 1.3 Following a Tribunal ruling, the taxpayer or the Indian Revenue Authorities ('Revenue') can take recourse to filing an appeal before the Hon'ble High Court ('HC') only when the conditions stipulated in Section 260A of the Act were fulfilled, in other words the Hon'ble HC can only admit an appeal only if it is satisfied that the case involves a 'substantial question of law'. Therefore, posing a substantial question of law becomes vital.
- 1.4 The genesis of the current ALP dispute can be traced back to the case of M/s. Softbrands India P. Ltd, wherein the Karnataka HC, was asked to adjudicate whether comparability issues in TP as decided by the Tribunal give rise to any substantial question of law that can be admitted and thereafter adjudicated.
- 1.5 The Karnataka HC pronounced its ruling<sup>1</sup> in June 2018 holding the view that in a TP case the aspects related to the choice of comparable companies, filters used, correctness of application of filters, choice of method, etc. are factual exercises, the HC will not admit any question arising from these unless perversity is demonstrated. It was also held that facts established by the Tribunal cannot be disturbed by a HC unless they are ex-facie perverse and unsustainable and exhibit a total non-application of mind by the Tribunal to the relevant facts of the case and evidence before the Tribunal. Even an inconsistent view taken by the Tribunal depending on the facts of the case before it, cannot lead to a substantial question of law in a particular case.

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<sup>1</sup> I.T.A.No.536/2015 C/W I.T.A.No.537/2015 order dated June 25, 2018

- 1.6 Separately, an appeal on the similar issue has been filed by the Revenue before the Delhi HC in the case of SAP Labs India Private Limited<sup>2</sup>, wherein such appeal was dismissed by the Delhi HC placing reliance on the judgement pronounced in the case of M/s Softbrands India P. Ltd (supra).
- 1.7 The Revenue as well as a few taxpayers filed a Special Leave Petition before the Hon'ble Supreme Court ('SC') seeking clarification on whether comparability is a question of law that is admissible for adjudication by HC. The SC pronounced its judgement on April 19, 2023<sup>3</sup> which has been discussed below:

## 2. REVENUE'S CONTENTION:

The Revenue seeking that the judgement pronounced in the case of Softbrands India (P) Ltd. (supra) is required to be corrected by the SC contended that:

- 2.1. The Karnataka HC erroneously held that the Tribunal is the final fact-finding authority on determining the ALP and once the Tribunal determines the ALP, the same cannot be subject to judicial scrutiny/scrutiny in an appeal under Section 260A of the Act.
- 2.2. There cannot be any absolute proposition of law that against the decision of the Tribunal determining the ALP, there shall not be any interference by an HC in an appeal under Section 260A of the Act.
- 2.3. The ALP is to be determined taking into consideration the TP guidelines stipulated in the Act and the Rules. ALP determined by the Tribunal *de hors* the TP guidelines stipulated under the Act and the Rules, can be said to be perverse and subject to the scrutiny by the HC in an appeal under Section 260A of the Act.

## 3. TAXPAYER'S CONTENTION:

The taxpayers contended that since there is no perversity found in the order passed by the Tribunal in determining the ALP, no substantial question of law arises, and the appeal should be dismissed. The following submissions were made before the SC:

- 3.1. Once ALP is determined by the Tribunal taking into consideration the relevant TP guidelines, thereafter, challenging the same cannot be a substantial question of law to be considered in an appeal under Section 260A of the Act.
- 3.2. The Hon'ble HC may determine any issue on appeal under section 260A of the Act 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 a question of law. A substantial question of law can arise only when a question of law is fairly arguable, where there is room for difference of opinion on it.
- 3.3. A finding of fact may give rise to a substantial question of law on below mentioned points:

- (i) No evidence; and/or

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<sup>2</sup> ITA no. 188 of 2016 order dated August 01, 2018 and ITA no. 224 & 225 of 2018 order dated August 30, 2018.

<sup>3</sup> Civil Appeal No. 8463 of 2022 order dated April 19, 2023.

- (ii) 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) The evidence has been misread.

It has been consistently held that the Tribunal being a final fact-finding authority, in the absence of demonstrated perversity in its finding, interference by the Hon'ble HC is not warranted<sup>4</sup>.

#### 3.4. Substantial question of law in TP matters can arise:

- i) whether the transaction falls within the definition of 'international transaction', or
- ii) whether the enterprises are 'associated enterprises' as per the definition provided under the Act.

The question of comparability of two companies (controlled and uncontrolled) or selection of filters are usually question of fact, primarily dependent on the functions performed, assets employed and risks assumed by the tested party as well as comparable transactions. Unless perversity in the findings of the Tribunal is pleaded and demonstrated, by placing material on record, no substantial question of law can arise and, therefore, there can be no interference by the HC.

- 3.5. In all the appeals filed by the Revenue, the primary issues raised pertained to inclusion and exclusion of a few comparables and selection of filters, which are essentially questions of fact and there is a consensus *ad idem* to this extent between the parties. In none of the appeals has the Revenue pleaded, argued, or placed any material to demonstrate perversity in the order of the Tribunal. Therefore, the Hon'ble HCs after noting the questions raised, findings rendered by the Tribunal and noting that perversity is neither pleaded/argued nor demonstrated by placing any material, dismissed the appeals, by relying on principles laid down in *Softbrands India (P) Ltd. (supra)*. Therefore, no error can be attributed to the orders passed dismissing the appeals, in such circumstances.
- 3.6. The submission of the Revenue that in each case the Hon'ble HC should examine whether the guidelines laid down in the Act and the Rules are followed to determine the ALP is not correct and farfetched as the Hon'ble HC can only decide substantial questions of law raised and arising before it.
- 3.7. Revenue's submission that the judgment in *Softbrands India (P) Ltd. (supra)* indicates that there will be no interference even where inconsistent views are taken by the Tribunal is misconceived, because, it is possible that in view of the particular set of facts in one case, one Bench excludes a company and in another case includes the same in view of different set of facts, or similarly applies a filter in one and not in another. In almost all cases, it is the Revenue which uses the same set of comparables for determining an ALP, thus, painting all assesseees with the same brush. These are questions of facts, which would require determination on a case-by-case basis.
- 3.8. TP is a valuation exercise involving determination of a statistical exercise using database of companies in public domain. Reliance was placed on the Hon'ble SC ruling in *G.L. Sutania and Anr v SEBI and Ors. reported in 2007 (5) SCC 133* wherein it was unequivocally stated that valuation is a question of fact.

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<sup>4</sup> Reliance was placed upon the decisions of this Court in the cases of *Vijay Kumar Talwar v. CIT, (2011) 1 SCC 673* and *Sir Chunilal V. Mehta and Sons Ltd. v. Century Spinning and Manufacturing Co. Ltd., reported in AIR 1962 SC 1314*.

#### 4. JUDGEMENT OF THE SC:

4.1. The SC hearing the submissions made by the Assessee and Revenue, framed the following issue for consideration:

*“.....whether in every case where the Tribunal determines the ALP, the same shall attain finality and the High Court is precluded from considering the determination of the ALP determined by the Tribunal, in exercise of powers under Section 260A of the Act?”*

- 4.2. Rejecting the view of the Karnataka HC in the case of Softbrands India (P) Ltd. (supra) and without entering into the merits of each case, the SC held that any determination of the ALP under Chapter X of the Act *de hors* the relevant TP provisions in the Act and the Rules<sup>5</sup>, 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.
- 4.3. 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 HC in an appeal under Section 260A of the Act.
- 4.4. When the determination of the ALP is challenged before the HC, it is always open for the HC to consider and examine whether the ALP has been determined while taking into consideration the relevant guidelines under the Act and the Rules.
- 4.5. The Hon'ble HC can 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, whether the comparable transactions have been taken into consideration properly or not, i.e., to the extent non-comparable transactions are considered as comparable transactions or not.
- 4.6. In each case, the HC should examine whether the TP guidelines laid down in the Act and the Rules are followed while determining the ALP and therefore, the view in case of Softbrands India (P) Ltd. that in the TP matters, the determination of the ALP by the Tribunal is final and cannot be subject matter of scrutiny under Section 260A of the Act cannot be accepted.
- 4.7. The SC quashed and set aside the impugned judgments and orders passed by the respective HCs, remitting the same back to the respective HCs to decide and dispose of the appeals afresh and 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 ALP are perverse or not, within nine months from the date of receipt of the present order by the respective HCs.

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<sup>5</sup> Sections 92, 92A to 92CA, 92D, 92E and 92F of the Act and Rules 10A to 10E of the Rules.

## 5. IMPLICATIONS OF THE SC RULING:

The immediate impact of the SC ruling will be felt in the increasing number of TP ALP disputes that would now be brought before the HC for adjudication. The bulk of TP litigation pertains to issues around comparable company selection, appropriateness of filters, selection of benchmarking methods, etc. which in most cases till date attained finality at the Tribunal level. Such issues now can be appealed before the HC which will effectively result in adding another layer in the appellate process, thereby increasing the backlog of pending TP disputes.

Taxpayers with a history of TP litigation should evaluate the feasibility of alternative options for dispute resolution/ prevention, such as safe harbours, Mutual Agreement Procedure (MAP) and Advanced Pricing Agreements (APAs) to avoid the long-drawn litigation process.

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This Newsflash summarizes on the Supreme Court ruling in the case of SAP Labs India which held that Transfer Pricing disputes in Arm's Length Price (ALP) determination give rise to 'Substantial question of law'. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said judgement and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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26 April 2023

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