

Significance and implications of the Apex Court's Ruling on 'Substantial Question of Law' for Transfer Pricing matters

The Hon'ble Apex Court, in its order dated 19 April 2023, in the case of SAP Labs India Pvt. Ltd. quashed and set aside the ruling of the High Court (HC) and observed that the selection of comparables, the application of filters, etc. gives rise to a substantial question of law and thereby remitted back the case to the HC to decide the matter afresh. Civil Appeals were preferred by the Revenue and a few of the taxpayers arising out of the orders passed by various HCs, more particularly the HC of Karnataka, in the case of SAP Labs India Pvt. Ltd.¹

In this context, it is pivotal to understand what the substantial question of law means and its interplay with Transfer Pricing principles.

Substantial Question of Law

In legal terms, a 'substantial question of law' refers to an important and relevant issue of law that requires interpretation, determination, or clarification by a higher court. It is a question that involves a significant legal principle, which has not been clearly defined by previous decisions or statutes, and its resolution could have far-reaching implications for future cases. When a case involves a substantial question of law, it can be appealed to a higher court for review and decision.

Transfer Pricing (TP) is not an 'exact science'

TP, as everyone knows, deals with determining the Arm's Length Price (ALP). There are several factors that need to be considered for such a determination, such as the nature of activity involved, functions performed, and risks assumed by the parties involved. Moreover, TP involves a certain degree of subjectivity, which can result in differences of opinion among taxpayers and tax authorities on various issues like selection of most appropriate method, choice of comparable companies, characterization of the functional profile of the taxpayer, aggregation of international transactions, etc. This is because the ALP cannot be determined with absolute certainty, and there is always a degree of judgment involved.

While the statutory guidelines do prescribe the broad framework basis which the comparable companies are to be selected and benchmarking to be performed, it remains a dynamic and factual process that requires a degree of judgement.

1. Arising out of the Civil Appeal No. 8463 of 2022



Adjudication by the various HCs on the issue relating to determination of the Arm's Length Price (ALP)

The matters relating to the choice of comparables and determination of the ALP are often dismissed by the HCs stating that the Tribunal is the final fact finding authority on determining the ALP and therefore, once the Tribunal determines the ALP, the same cannot be subject to judicial scrutiny/scrutiny in an appeal under Section 260 of the Income-tax Act, 1961 (ITA) citing the order issued by the HC of Karnataka in the case of *Softbrands India (P) Ltd.*² It was held in the said ruling that the issues decided by the Tribunal are questions of fact and since perversity was neither pleaded nor argued nor demonstrated by placing material to that effect, no 'substantial question of law' arises for consideration under Section 260A of the ITA and the matter was dismissed by the HC of Karnataka.

Matter before the Apex Court

Civil Appeals were preferred by the Revenue and few of the taxpayers arising out of the orders passed by various HCs, more particularly the HC of Karnataka in the case of *SAP Labs India Pvt. Ltd.*, dismissing the appeal challenging the findings of the Tribunal. The issue before the Apex Court was to decide as to whether in every case where the Tribunal determines the ALP, the same shall attain finality and the HC is precluded on adjudicating the matters (in line with the powers vested as per the provisions of Section 260A of the ITA) relating to the determination of ALP already determined by the Tribunal.

Key contentions on behalf of the taxpayers

- It is a settled proposition that the jurisdiction under Section 260A of the ITA cannot be invoked unless there arises a substantial question of law which is fairly arguable or may arise where there is a difference of opinion on it.
- 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 HC³.

- Acceptance of batch of Revenue's appeals about lack of application of mind by the HC would cast an unjust burden on the HC to undertake a suo moto exploration of facts not placed before it and would upset the settled law with reference to Section 260A of the ITA.

Key contentions on behalf of the Revenue

- There cannot be any absolute proposition of law against which there would not be any interference by the HC (pursuant to provisions of Section 260A of the ITA) against the decision of the Tribunal determining the ALP.
- The ALP is required to be determined in line with the guidelines prescribed under Section 92 of the ITA in line with Rule 10 of the Income-tax Rules (IT Rules) whereby it is always open for the HC to examine as to whether the guidelines stipulated under the ITA and IT Rules is followed by the Tribunal while determining the ALP.

Held by the Apex Court

- Determination of ALP, choice of comparable companies, and filters shall be construed as substantial question of law before the HC under Section 260A of the ITA.
- Determination of ALP contrary to the prescribed statutory guidelines can be referred to as perverse and thereby warrant intervention by the HC giving rise to substantial question of law.
- There is a prescribed timeline of 9 months within which the HC has to determine whether the statutory guidelines prescribed have been adhered to or not.

Implications on the ongoing TP cases

On account of ambiguity that comes from inherent differences between related and unrelated transactions, disputes between multinationals and tax authorities across jurisdictions is inevitable. Comparability analysis involving issues relating to benchmarking methods, choice of comparable companies, application of filters, selection of the tested party, etc. is one of the most litigated areas of TP.

2. *PCIT vs Softbrands India (P) Ltd.*, reported in (2018) 406 ITR 513 (Karnataka)

3. *Placing reliance on Vijay Kumar Talwar vs CIT*, (2011) 1 SCC 673 and *Sir Chunilal Vs Mehta and Sons Ltd. vs Century Spinning and Manufacturing Co. Ltd* (AIR 1962 SC 1314)



Pursuant to this ruling by the Apex Court, wherein it is held that the HC can examine as to whether the determination of the ALP and the findings recorded by the Tribunal are perverse or not, a plethora of impugned judgements dismissing the appeal of the Revenue and even the appeals preferred by the taxpayers would be required to be quashed and set aside. The matters would be required to be remitted to the respective HCs to be disposed within nine months to determine as to whether principles of ALP has been followed or not. This would potentially lead to a significant surge in the ongoing litigation involving issues relating to TP, especially for the past cases adjudicated by the HC.

It would be worthwhile to see how the Hon'ble HC shall evaluate the appropriateness of the comparables selected by the taxpayer or the revenue authorities, and how this would impact the ALP of the international transactions entered into by the taxpayers.

Macro aftermath

Pendency of the outnumbered TP cases across various level was already a challenge faced by the tax administration in India. The protracted and voluminous litigation may potentially act as a hindrance to the impetus of the Indian government's mission of promoting ease of doing business in India, especially for multinational enterprises that conduct multiple international transactions within the group companies and may potentially impact foreign direct investment inflows in India for the years to come.

The multinational enterprises would constantly be required to pursue tax certainty to better manage growing geographic footprints. It would also garner the following dispute resolution mechanism tools which can be considered by the taxpayers in India that may potentially reduce the protracted litigation and provide clarity and certainty on the tax matters:

- **Advance Pricing Agreement (APA)** is an agreement between the taxpayer and tax authorities to adopt the most appropriate TP methodology for determining the ALP for the covered international transaction. APAs can be unilateral/bilateral/multilateral. With the recent conclusion of 95 APAs in financial year (FY) 2022-23, the Indian APA team has achieved a significant feat since the APA program was launched.

However, in the past decade, more than 1,500 APA applications were filed, whereas 500+ APAs have been concluded, thereby leaving 2/3rd of the APA applications to be still dealt with.

- **Mutual Agreement Procedure (MAP)** is a dispute resolution procedure which enables the taxpayer to achieve certainty and clarity on issues of economic or juridical double taxation. Over the past decade, India has moved some large pending MAP applications and has brought relief to taxpayers. If this approach is continued and quick resolutions are offered, this can be a life saver, However, where there is a Tribunal ruling already provided, the Competent Authorities may not finalize the outcome contrary to the Tribunal ruling.
- **Safe Harbor provisions** were introduced to reduce litigation wherein the taxpayer declares the transfer price as per the provisions and subject to certain conditions. While these provisions have not garnered much interest from the industry at large due to the high rates of mark-up, this still appears to be a pragmatic solution as compared to the long-drawn litigation awaiting post this ruling.

While this ruling provides guidance to the HCs on dealing with TP matters, especially in cases involving comparability issues, one will have to see how the HCs are equipped to deal with the volume of cases, especially given the huge pendency of non-tax cases before them.

Robust documentation on arm's length pricing at the time of undertaking the transactions (rather than as a post-facto analysis), using technology tools to implement and monitor the transfer prices on a real-time basis and frequent corrections in the transfer prices coupled with using the avenues available under the law (such as APAs and Safe Harbors) would ensure limited litigation and more tax certainty.



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