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EY Tax Alert

Supreme Court of India rules on the admissibility of transfer pricing appeals by High Courts

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Executive summary

This Tax Alert summarizes the decision of the Supreme Court of India (SC) on the admissibility of transfer pricing (TP) appeals by High Courts (HC). The SC pronounced its ruling on 19 April 2023 in a batch of appeals involving several taxpayers, with *SAP Labs India Private Ltd*[1] being the lead case.

Under the Indian Income-tax law (ITL), an appeal against an order of an Income-tax Appellate Tribunal (Tribunal), which is the second-level appellate forum in the hierarchy of appellate authorities, can be made to the jurisdictional HC. However, an HC can only admit an appeal if it is satisfied that the case involves a "substantial question of law." In the case of *Softbrands India Private Ltd*[2], the Karnataka HC ruled that the Tribunal is the final fact-finding authority and the jurisdiction to consider the factual nature of issues is with the Tribunal. As long as there is no unreasonableness in the order of the Tribunal in the findings of the fact, the same does not qualify to be a "substantial question of law." The HC also held that issues pertaining to selection of comparable data and criteria for comparability while undertaking an economic analysis in a TP study do not give rise to a "substantial question of law."

The SC has reversed the order of the HC and ruled that there cannot be an absolute proposition of law and that in all cases where the Tribunal has determined the arm's length price (ALP) the same is final and cannot be the subject matter of scrutiny by the HC in an appeal. According to the SC, in an appeal involving TP issues it is always open for a HC to examine in each case whether the provisions of the ITL dealing with TP have been followed or not and whether there is any perversity in the findings recorded by the Tribunal while determining the ALP.

While the ruling is expected to provide better clarity to taxpayers as well as tax authorities on the admissibility of TP appeals by HCs, it is also likely to result in proliferation of appeals and add to the backlog of cases. Taxpayers would accordingly need to consider their strategies for TP controversy management in India, including use of alternative channels such as Mutual Agreement Procedure (MAP) and Advanced Pricing Agreements (APAs).

[1] SAP Labs India Pvt Ltd v ITO [TS-225-SC-2023-TP]
[2] PCIT v Softbrands India Pvt Ltd [TS-475-HC-2018(Kar)-TP]

Background

- Taxpayers involved in the appeals were mostly Indian affiliates of multinational groups having international transactions with their respective associated enterprises. Taxpayers were subject to TP adjustment based on a TP audit conducted by the Tax Authority. The TP adjustment was made largely by adopting a different set of comparable data as well as by adopting different criteria for selection of comparable data by the Tax Authority as compared to what was used by the taxpayers in their TP documentation. Most of the taxpayers were successful, partially, or fully, in deleting the TP adjustments in appeals before the Tribunal, the second level appellate authority. The Tax Authority thereafter filed appeals before the jurisdictional HCs against the order of the Tribunal.

- The HC, in the case of *Softbrands India Private Ltd (Supra)*, sought to first address the threshold issue of whether the questions in appeal come up to the level of "substantial questions of law" for the HC to accept the appeal. The HC observed that the entire exercise of making TP adjustments on the basis of the comparability analysis is a matter of estimation by the taxpayer as well as the Tax Authority. Further, the Tribunal, being the final fact-finding authority, adjudicates on the TP issues based on relevant material/facts produced. The HC also noted that the Tribunal is expected to act fairly, reasonably, and rationally to avoid unsupportable decisions. Accordingly, by relying on certain judicial precedents, the HC held that the same does not qualify to be a "substantial question of law." Further, considering that the Tribunal is the final fact-finding body, the HC considered it appropriate not to entertain an appeal in the absence of involvement of a "substantial question of law." The ratio of this decision was thereafter applied by HCs in number of other taxpayers.

- The Tax Authority filed appeals in the SC against the HC rulings. It may be noted that the Appellants in the batch of appeals before the SC also included a few taxpayers as well in addition to the Tax Authority.

Taxpayer's arguments

- Challenging the ALP determined by the Tribunal taking into consideration the TP provisions of the ITL cannot be said to be a substantial question of law.

- ITL provides that HC 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 the relevant provision of the ITL deal with appeals to HC.

- 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.

- Fact finding may give rise to a substantial question of law, inter alia, in the event the findings are based on (a) no evidence; and/or (b) while arriving at the said finding, relevant admissible evidence has not been taken into consideration or inadmissible evidence has been taken into consideration; or (c) legal principles have not been applied in appreciating the evidence; or (d) when the evidence has been misread.

- HC as well as SC have consistently held that Tribunal being a final fact-finding authority, in the absence of demonstrated perversity in its finding, interference by HC is not warranted - reliance was placed on various judicial precedents of the SC[3].

- Specific instances where a substantial question of law could arise in TP matters is (a) where the issue relates to whether at all a transaction falls within the definition of 'international transaction'; or (b) if two enterprises are 'associated enterprises' as per the definition under the IT Act.

- Tax Authority has not pleaded, argued, or placed any material to demonstrate perversity in the order of the Tribunal and hence, interference therewith by the HC is not warranted.

- TP provisions are essentially valuation exercise involving determination of a statistical sample of comparables - reliance was placed on the ruling of Supreme Court in case of G.L. Sutania and Anr v SEBI and Ors. wherein it has been unequivocally held that valuation is a question of fact.

Tax Authority's arguments

- No absolute proposition of law that against the decision of Tribunal determining the ALP, there shall not be any interference by the HC in an appeal under the provisions of the ITL.

- Determination of ALP *de hors* the TP provisions of the ITL can be perverse and subject to scrutiny by HC under ITL.

[3] Vijay Kumar Talwar v. CIT, (2011) 1 SCC 673; Sir Chunilal V. Mehta and Sons Ltd v. Century Spinning and Manufacturing Co. Ltd reported in AIR 1962 SC 1314

Supreme Court's ruling

The SC rejected the view taken by the Karnataka HC that in TP matters the determination of ALP by the Tribunal is final and cannot be subject matter of scrutiny by the HC. While reversing the decision of the HC, the SC held as follows:

- While determining the ALP, the Tribunal has to follow the TP provisions that are contained in the ITL. Any determination of the ALP de hors the relevant TP provisions of the ITL 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.
- Therefore, there cannot be any absolute proposition of law that in all cases where the Tribunal has determined the arm's length price the same is final and cannot be the subject matter of scrutiny by the HC in an appeal.
- 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 TP provisions of the ITL.
- The HC can also examine the question of comparability of companies or selection of filters and examine whether the same is done judiciously and on the basis of the relevant material/ evidence on record. The HC can also examine 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.

The SC held that the orders passed by the HC dismissing the appeals filed by Appellants are quashed and set aside and remitted back to the concerned HCs to decide and dispose of the respective appeals afresh preferably within a period of nine months.

Before concluding, the SC clarified that the merits of the appeals have not been ventured into and concerned HCs would take fresh decisions on the determination of the ALP in respective Taxpayer's cases.

Implications

One of the key TP challenges faced by taxpayers in India relates to the time-consuming nature of the appeal process because of the number of tiers of appellate authorities and the inventory of cases at each level. HCs in the past have generally shown a fair degree of flexibility in admitting appeals involving TP matters, including those involving comparability issues. The Karnataka HC ruling in the *Softbrands case (supra)* resulted in the HC applying more scrutiny while admitting appeals involving TP matters. With the SC reversing the HC decision and holding that TP issues, including those relating to comparability, could involve "substantial question of law", taxpayers as well as tax authorities would now have better clarity on the appeal process involved in TP litigation. This would also imply that there could be a proliferation of appeals involving TP matters at the HC level, adding to the significant backlog of cases.

The ruling is relevant for taxpayers while deciding their strategies for TP controversy management in India. Taxpayers who are subject to a TP adjustment should consider strengthening their defense on factual matters before the Tribunal. In addition, taxpayers would need to evaluate alternative options for dispute resolution/ prevention, such as use of MAP and APAs to avoid a protracted litigation process.

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