# WITH DUE RESPECT – NO CONTEMPT

## SAP Labs India Pvt. Ltd. v. ITO (SC) [Determination of Arm's length Price & Substantial Question of Law]

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### 1.0 Introduction

The authoritative statement of Arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention 2022, which reads as under:

*[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*

Analysis of the controlled and uncontrolled transactions, which is referred to as 'comparability analysis' is at the heart of the application of the arm's length principle (ALP). In order to demonstrate that international transactions with associated enterprises are at arm's length, the taxpayer is under an obligation to select and apply the most appropriate method having regard to the nature of transactions or class of transactions or class of associated enterprises or functions performed by such persons. The methods prescribed under Sec 92C of the Income Tax Act, 1961 are

a) Comparable Uncontrolled Price method (CUP);

b) Resale price method (RPM);

c) Cost plus method (CPM)

d) Profit split method (PSM)

e) Transactional net margin method (TNMM);

f) Such other method as may prescribed by the Board

Most appropriate method would be selected and applied to compute the arm's length price. It is often contested before the Hon'ble Income Tax Appellate Tribunal (ITAT) by taxpayers and the Revenue in respect of issues relating to selection of comparables, selection of filters etc. ITAT being the final fact-finding body rendered plethora of judgments in respect of comparability issues. OECD Transfer Pricing guidelines, 2017 and currently updated version 2022, provide that the following factors are relevant in choice and application of particular pricing methods:

a) The contractual terms of the transaction

b) Functional analysis

c) Characteristics of property or services

d) Economic circumstances

e) Business strategies

All these factors are basically driven by factual analysis. Critical analysis of facts behind the taxpayer's international transactions and the corresponding facts behind comparable uncontrolled transactions is basically an exercise of facts which results in functions, assets and risk analysis (FAR). Accordingly, the comparability analysis with respect to selection of comparables etc. is a question of fact as held

by the Hon'ble Karnataka High Court in *PCIT v. Softbrands India Pvt Ltd [406 ITR 513] [2018].* Several appeals were filed before the Hon'ble Supreme Court both by the taxpayers and the revenue in cases where Softbrands (supra) ratio was followed and the appeals were dismissed by the High Courts. All such cases have been heard together in a batch of appeals with the lead case being *SAP Labs India Pvt Ltd v. ITO [TS-225-SC-2023-TP].* The Hon'ble Apex Court pronounced the decision on 19th April 2023.

## 2.0 Ratio of the SAP Labs Judgement

It was argued by counsels on behalf of the respective assessees that once the arm's length price is determined by the Tribunal taking into consideration the relevant guidelines the same cannot be contested before the High Court under Sec 260A of the IT Act as a substantial question of law. It was further argued that an appeal shall lie to the High Court from every order of the Tribunal only if the High Court is satisfied that the case involves a substantial question of law. It is submitted that finding of fact may give rise to a substantial question of law, inter alia, in the event the findings are based on

(i) No evidence; and /or

(ii) While arriving at the said decision the 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.

It has been consistently held by the High Courts as well as by the Hon'ble Apex court that the Tribunal being the final fact-finding authority, in the absence of demonstrated perversity, interference there with its order by the High Court is not warranted. In this context the Counsels relied on *Vijay Kumar Talwar v. CIT [2011] [1 SCC 673] and Sir Chunilal V. Mehta and Sons Limited v. Century Spinning and Manufacturing Co. Ltd reported in AIR 1962 SC 1314*. It is further submitted that perversity should not only be specifically alleged in appeal before the High Court but the same ought to have been demonstrated. In the present appeals the revenue neither pleaded nor argued or placed any material to demonstrate perversity in the orders of the Tribunal. Hence it was argued that the principles laid down in *Softbrands case* (supra) cannot be found fault with. It is further argued that ratio in the *Softbrands* India's case cannot be misconceived as providing that there will be no interference even when the inconsistent views are taken by the Tribunal. In *Softbrands case* it was held that in view of particular set of facts in one case one Bench excludes a company and, in another case, it includes the same as a comparable company in view of different set of facts. It was further submitted that transfer pricing provisions are essentially a valuation exercise involving determination of a statistical samples of comparables. Transfer pricing is not a science but an art. Counsels have relied on Apex Court decision in *G.L. Sutania and another v. SEBI and others [2007] (5) SCC 133* wherein it was held that valuation is a question of fact.

2.1 Counsels arguing on behalf of revenue pleaded before the Apex Court that the scheme of Transfer Pricing, the arm's length price is to be determined taking into consideration the guidelines stipulated under the aforesaid provisions of the IT Act. It is submitted that therefore it is always open for High Court to consider and /or examine, whether the guidelines stipulated under the Act and Rules while determining the arm's length price have been followed by the Tribunal or not.

2.2 The Hon'ble Apex Court after considering the rival submissions held that

*"7. Any determination of the arm's length price under Chapter X de hors the relevant provisions of the guidelines, referred to herein above, can be*

*considered as perverse and it can be considered as 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 High Court in an appeal under Sec 260A of the IT Act. When the determination of arm's length price is challenged before the High Court, it is always open for the High Court to consider and examine whether the arm's length price has been determined while taking into consideration the relevant guidelines under the Act and the Rules. Even the 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. The High Court 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. Therefore, the view taken by the Karnataka High Court in the case of Softbrands India (P) Ltd. that in the transfer pricing matters, the determination of the arm's length price by the Tribunal is final and cannot be subject matter of scrutiny under Section 260A of the IT Act cannot be accepted.*

*8. Thus, in each case, the High Court should examine whether the guidelines laid down in the Act and the Rules are followed while determining the arm's length price. Therefore, we are of the opinion that the absolute proposition of law laid down by the Karnataka High Court in the case of Softbrands India (P) ltd. (supra) that in the matter of transfer pricing, determination of the arm's length price by the Tribunal shall be final and cannot be subject matter of scrutiny and the High Court is precluded from examining the correctness of the determination of the arm's length price by the Tribunal in an appeal under Section 260A of the IT Act on the ground that it cannot be said to be raising a substantial question of law cannot be accepted. As observed hereinabove, within the parameters of Section 260A of the IT Act in an appeal challenging the determination of the arm's length price, it is always open for the High Court to examine in each case whether while determining the arm's length price, the guidelines laid down under the Act and the Rules, referred to hereinabove, are followed or not and whether the determination of the arm's length price and the findings recorded by the Tribunal while determining the arm's length price are perverse or not"*

## 3.0 Critical Takeaways

On a careful analysis of the judgement, the High Courts have been directed to examine whether the guidelines laid down in the Act and the Rules were followed in determining the arm's length price. This observation is with the reference to the batch of appeals that were disposed of in the said order. It was further observed by the Apex court that 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 Rules have been followed or not. It is obvious that in an appeal before the High Court challenging the determination of ALP in a transfer pricing case the High Court is under an obligation to verify whether the extant guidelines under the Act and the Rules have been followed or not. Only in a case if guidelines under the Act and Rules are not followed there would be perversity in the Tribunal order, otherwise not. In other words, if the Tribunal order has followed the guidelines under the Act and the Rules there would be no perversity in the order. Is it to be understood whether existence of perversity in each case is to be examined by the High Court which inference would be casting a great burden on the High Courts. Alternatively, is it to be understood that perversity must be demonstrated by the appellant at admission stage. The second eventuality seems to be practical and legally tenable as in the first eventuality if the High Court has to examine whether there exists a perversity in the order of the Tribunal

the appeal should have been admitted and proceeded further. After admission, if it is found that there is no perversity in the order of the Tribunal the very admission and the proceedings may be against the provisions of Sec 260A of the Act as there is no perversity in the order of the Tribunal and in turn there exists no substantial question of law.

3.1 If the ratio of the judgement is to be understood as covering the eventuality two, wherein the appellant has to demonstrate the existence of perversity in the Tribunal order at the admission stage, such legal position is always intact in the present scenario as well. In other words, eventuality two which seems to be a practical inference and legally tenable proposition, would only endorse the present legal position wherein the appellant has to demonstrate the existence of perversity in the Tribunal order before the High Court at the admission stage. Transfer pricing being an exercise compared with valuation can always throw different opinions in respect of ALP determination by the taxpayer and revenue respectively. It is often said transfer pricing is not an exact science but an art.

3.2 The Hon'ble Apex Court in the case *Vijay Kumar Talwar v. CIT [2011] [1 SCC 673]* observed as under:

*The expression "substantial question of law" is not defined in the Act. Nevertheless, it has acquired a definite connotation through various judicial pronouncements. In Sir Chunilal V. Mehta & Sons Ltd. v. Century Spg. & Mfg. Co. Ltd. AIR 1962 SC 1314, a Constitution Bench of this Court, while explaining the import of the said expression, observed that:*

*"The proper test for determining whether a question of law raised in the case is substantial would, in our opinion, be whether it is of general public importance or whether it directly and substantially affects the rights of the parties and if so whether it is either an open question in the sense that it is not finally settled by this Court or by the Privy Council or by the Federal Court or is not free from difficulty or calls for discussion of alternative views. If the question is settled by the highest Court or the general principles to be applied in determining the question are well settled and there is a mere question of applying those principles or that the plea raised is palpably absurd the question would not be a substantial question of law."*

*19. Similarly, in Santosh Hazari v. Purushottam Tiwari [2001] 3 SCC 179, a three judge Bench of this Court observed that:*

*"A point of law which admits of no two opinions may be a proposition of law but cannot be a substantial question of law. To be "substantial" a question of law must be debatable, not previously settled by law of the land or a binding precedent, and must have a material bearing on the decision of the case, if answered either way, insofar as the rights of the parties before it are concerned. To be a question of law "involving in the case" there must be first a foundation for it laid in the pleadings and the question should emerge from the sustainable findings of fact arrived at by court of facts and it must be necessary to decide that question of law for a just and proper decision of the case. An entirely new point raised for the first time before the High Court is not a question involved in the case unless it goes to the root of the matter. It will, therefore, depend on the facts and circumstance of each case whether a question of law is a substantial one and involved in the case, or not; the paramount overall consideration being the need for striking a judicious balance between the indispensable obligation to do justice at all stages and impelling necessity of avoiding prolongation in the life of any lis."*

*20. In Hero Vinoth (Minor) v. Seshammal [2006] 5 SCC 545, this Court has observed that:*

*"The general rule is that High Court will not interfere with the concurrent findings of the courts below. But it is not an absolute rule. Some of the well-recognized exceptions are where (i) the courts below have ignored material evidence or acted on no evidence; (ii) the courts have drawn wrong inferences from proved facts by applying the law*

*erroneously; or (iii) the courts have wrongly cast the burden of proof. When we refer to "decision based on no evidence", it not only refers to cases where there is a total dearth of evidence, but also refers to any case, where the evidence, taken as a whole, is not reasonably capable of supporting the finding."*

We are of the opinion that on a conspectus of the factual scenario, noted above, the conclusion of the Tribunal to the effect that the assessee has failed to prove the source of the cash credits cannot be said to be perverse, giving rise to a substantial question of law. The Tribunal being a final fact-finding authority, in the absence of demonstrated perversity in its finding, interference therewith by this Court is not warranted.

3.3 Another important decision was ruled by the Hon'ble Apex court on the same day 19th April, 2023 in the case of *Director of Income-tax v. Travel Port Inc [TS-218-SC-2023]* with respect to attribution of profits to a Permanent Establishment of a foreign entity in India. Assessee, Travel port Inc. is a foreign entity involved in the business of providing electronic global distribution services to airlines through 'Computerized Reservation System'(CRS). The assessee company maintains and operates a Master computer system consisting of several mainframe computers and servers located in other countries, including the USA/ Europe which is connected to the airlines' servers for continuous transmission of data on flight schedule, seat availability etc. Assessee company had appointed Indian entities and entered into distribution agreements with them for marketing and distribution of CRS services and paid commission ranging from 33% to 60% of their total earning in India which is at USD/EUR 3 per booking. During the assessment proceedings, the assessing officer concluded that entire income earned out of India by the assessees is taxable in India which was further upheld by CIT(A). On appeal, ITAT held that the assessee constituted fixed placed PE as well as Dependent Agency PE (DAPE) and since the 'lion's share of activity' is processed in host computers in countries like USA and Europe, only 15% of the revenue earned in India could be attributed to such PEs in India on the basis of FAR analysis. As the commission earned and offered for taxation by the Indian agents was much more than the attribution of 15% of the revenue as decided by the ITAT, no further commission income was taxable. The Hon'ble ITAT referred to Explanation 1 (a) to Sec 9(1)(i) which provides that only income reasonably attributable to operations carried out in India can be taken as income deemed to accrue or arise in India. The Hon'ble Apex court observed that attribution of profits to a PE is basically a question of fact and held that no interference was called for in the impugned orders of the High Court and that of ITAT. The operative portion of the judgement reads as under:

*15. It is seen from the orders of the Tribunal that the Tribunal arrived at the quantum of revenue accruing to the respondent in respect of bookings in India which can be attributed to activities carried out in India, on the basis of FAR analysis (Functions performed, assets used and risks undertaken). The Commission paid to the distribution agents by the respondents was more than twice the amount of attribution and this has already been taxed. Therefore, the Tribunal rightly concluded that the same extinguished the assessment.*

*16. The question as to what proportion of profits arose or accrued in India is essentially one of facts. Therefore, we do not think that the concurrent orders of the Tribunal and the High Court call for any interference.*

*18. Under Explanation 1(a), what is reasonably attributable to the operations carried out in India alone can be taken to be the income of the business deemed to arise or accrue in India. What portion of the income can be reasonably attributed*

*to the operations carried out in India is obviously a question of fact. On this question of fact, the Tribunal has taken into account relevant factors*

3.3.1 Attribution of profits to a PE is based on transfer pricing principles comprising of FAR analysis etc. PE of a foreign entity located in India is under an obligation to demonstrate through a transfer study report that the attribution of profits to such PE in India has been done in an appropriate manner on the basis of functions carried out, assets employed and risks assumed (FAR) by such PE in India. It is pertinent to note that the Hon'ble Apex court held that the issue of profit attribution based on transfer pricing analysis to a PE in India is basically a question of fact.

3.4 In the light of these two judgments it is very critical to understand where the arena of question of fact ends and where the arena of question of law would start in the context of determination of arm's length price under the transfer pricing analysis. The provisions of transfer pricing regulations under Chapter X and Rules need to be adhered to by the taxpayer, by the TPO and the appellate authorities up to the level of ITAT. Finally order of the ITAT should not suffer from any perversity on account of non-adherence to these provisions of the Act and the Rules under the transfer pricing regulations, failing which the same would warrant interference by the High Court as there arises a substantial question of law.

## 4.0 Conclusion

Transfer pricing analysis is driven by FAR analysis in respect of international transactions carried out by taxpayer and in comparison, with that of comparable companies selected from the public data bases such as prowess and capitaline in India. In India we have experienced a high volume of TP Litigation in the last two decades. Different views are possible and tenable in terms of selection of most appropriate method and application of filters depending on facts and circumstances. Different views would emanate on the basis of different facts and circumstances in respect of international transactions of the taxpayer and uncontrolled transactions of comparable companies. If a dispute in respect of such transfer pricing analysis is to be entertained by the High court the ratio laid down by the Apex court in this present case needs to be reconciled with the ratio of the judgments delivered by the Apex court in the past so as to obtain a harmonious essence of this judgment with respect to "a substantial question of law" in transfer pricing analysis.

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