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SAP Labs/ SoftBrands – SC Ruling

Key Takeaways

April 2023

Background

The Hon'ble Supreme Court (SC) on 19 April 2023 pronounced its order[1] in the case of SAP Labs India, overturning the landmark Karnataka High Court ruling in the case of Softbrands India. It is known that Income Tax Appellate Tribunal (ITAT) is the final fact-finding authority, for Transfer pricing cases. In the Softbrands ruling the High Court (HC) ruled that unless the order of ITAT is perverse and it is demonstrated, substantial question of law does not arise w.r.t. determination of arm's length price (ALP). In the recent ruling, SC ruled that HC ought to examine whether the arm's length price has been determined in accordance with the Chapter X of the Income Tax Act, 1961, and it cannot be said that decision of ITAT is final and further held that determination of ALP price is a substantial question of law.

HC and SC Rulings

1. HC Ruling in the case of Softbrands

The HC dealt in detail on determination of ALP, based on various SC and HC rulings, and decided that appeal before it cannot be entertained unless there is a substantial question of law i.e., when there is a perversity in order of ITAT. The HC would interfere with findings of ITAT only if:

- Material evidence is ignored / acted on no evidence or inadmissible evidence has been considered,
- Drawn wrong inferences from proved facts by applying law erroneously,
- Wrongly cast the burden of proof,

HC concluded by stating mere dissatisfaction with the findings of facts of ITAT order is not a valid ground to appeal before the HC based on Section 260A. This resulted in dismissal of multiple cases filed by both revenue and Tax payer.

2. SC Ruling

The question before SC was where ITAT determines the ALP, the same attains finality and HC is precluded from considering the determination of ALP. The SC decided that when determination of ALP is challenged

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[1] https://main.sci.gov.in/supremecourt/2018/38332/38332_2018_4_1501_43620_Judgement_19-Apr-2023.pdf

before HC, HC has to consider and examine whether ALP is determined as per the Income Tax Act and it can also examine the question of comparability of companies, selection of filters etc. Thereby SC overruled the HC decision in case of Softbrands. As a consequence, SC remanded back all the cases to the HC and also indicated that these cases needs to be resolved within a time frame of 9 months.

Key Takeaways and Considerations

The following are some of the key takeaways and points to be considered in light of the recent SC ruling:

- In the order, SC has stated that HC will have to adjudicate the cases within 9 months from the receipt of the order by the respective HC. The appellant will now have to present before HC on why ITAT has not determined ALP as prescribed under the Income Tax Act and Rules.

- Basis our experience, more than 50% of the cases at the ITAT level, are decided in favour of the tax payer and therefore given the recent SC ruling, it will likely open the floodgates of cases earlier settled at the ITAT level, resulting more uncertainty for the taxpayers. Consequently the time line for completion of appeal proceedings would get elongated significantly leading to increased interest and penalties (if adverse) on completion

- In terms of Tax demand, even in cases where the ITAT has ruled favourably for the taxpayer, one needs to see the willingness of revenue to process the refund if they take shelter under this ruling and appeal before the HC. In case of unfavourable orders for the taxpayer, they will along with the appeal to the HC also file a stay of demand to the HC (balance 80% as ITAT would have granted stay on payment of 20%) and it is the discretion of the HC to grant the stay.

- In case of appellants (who had not filed the SLP before SC) aggrieved by the order of the HC (HC not determining the ALP) in their respective cases, the appellant now has two options. One, filing of review petition before the HC – based on the order of SC. Though this action is legally possible, the extent to which this option will be favourable/successful is dependent on the respective bench. Alternatively, the aggrieved appellant can file a SLP before the SC and may get adjudication on similar lines as that of SAP Labs

- During the proceedings before ITAT, the appellant's at times do not press on certain grounds as part of their approach / strategy. Since HC now has greater responsibility to review the ITAT order in detail on determination of ALP, more onus would now fall on ITAT to adjudicate on all the grounds/aspects in line with ALP prescribed under the Income Tax Act to ensure that HC does not remand back to ITAT (does not strike down the order of ITAT) on not adjudicating on certain aspects. The ITAT orders would, therefore, need to be more comprehensive in addressing all the grounds / issues raised by the appellant. Hence, appellants will have to take more care in presenting the grounds / issues before the ITAT.

- Disclosures on contingent liabilities and provisions - Taxpayers have varied level and extent of disclosure of contingent liability in their financial statements. Especially where Fin. 48 compliance is applicable, scrutiny of contingent liability is more important. With the SC ruling, auditor will

have to evaluate disclosure of contingent liability or provision for tax liability whether there is favourable /adverse ruling depending on the company specific facts and arguments of the tax payers.

Options / Alternative available

Following the ruling of the SC, some of the options available to the taxpayers for dispute resolution and aspects to be borne in mind is provided below:

- **Advance Pricing Agreement ("APA"):** APA has been touted as the lighthouse of dispute resolution for Transfer Pricing. However, currently there is a significant inventory of APA applications filed with the Indian tax authorities that are yet to be concluded. With this SC ruling, likely that taxpayers are galvanised to opt for APA programme to hedge tax uncertainty and there is a higher inflow of APA applications. Taxpayers have a deadline of close to a year to file APA application for the upcoming financial year and need to weigh the time, efforts, other resources as well as the current outcomes of APA concluded while filing APA application.

- **Safe Harbour Rules ("SHR"):** SHR was introduced to facilitate dispute resolution at a cost-efficient manner for small taxpayers. Due to lack flexibility of SHR and seemingly high arm's length considerations for the eligible international transactions, taxpayers were wooed out from SHR. However, of late, the difference between the outcomes under other dispute resolution mechanisms and SHR are narrowing. Considering other aspects such as time, efforts, other resources required and other terms and conditions under the SHR, it might even be beneficial for taxpayers to opt under SHR. Hence eligible taxpayers, especially in case of IT and ITeS where the value of international transactions is less than INR 200 crores, SHR can be considered a worthwhile option.

- **Mutual Agreement Procedure ("MAP"):** MAP can be invoked when a notice is issued to the tax payer giving rise to demand and taxpayers wants to eliminate double tax taxation due to such transfer pricing adjustments. The time limit for initiating MAP proceedings is 3 years from when the tax liability is crystalised.

Expectations from Government

Following are some of the aspects of current dispute resolution that can be improved to address the dispute resolution requirements by taxpayers:

a) Introducing highly litigated transactions in SHR with amicable arm's length consideration and increasing the threshold limits for opting under SHR can significantly de-clutter the new applications for APA programme, which can be reserved for resolution of complex transactions.

b) In certain instances, it might not be appropriate to set one arms' length price for a particular transaction, since there would other aspects / factors that decide the arm's length price, generally in the industry. In such cases formulaic approach can be used arrived at the arm's length price, which are pegged to key parameters. This approach is currently used in SHR for

determining the arm's length price for Knowledge Process Outsourcing (KPO) services. The formulaic approach can be extended to other eligible transactions, where applicable, and align with commercial realities of the industry, thereby increase adoption of SHR programme. Through the above, SHR can aim to bridge the gap with other dispute resolution mechanisms such as APA.

Alternatively, a new hybrid programme can be developed to resolve disputes for cases / taxpayers where the complexity is more than that of SHR and lower than that of a very complex issue that requires the extensive involvement of APA for dispute resolution. Considering the current crunch in staffing of the APA programme by the revenue, viability of introduction of such a programme may be remote.

c) International Compliance Assurance Programme ("ICAP") was introduced by the OECD in 2019 on a pilot mode in 2018/2019. This is multilateral program was started to provide tax certainty for MNEs for both TP and international tax issues. The process starts with MNE Group filing the three-tier documentation and related information on the intra-group transactions. No exhaustive information is sought. MNE Group can also state the jurisdictions for which it wants to opt under the program. In the next step, risk assessment is performed on the information provided. In the last stage, outcomes are communicated to the MNE Group. There is no cost to the taxpayer and the program is time bound – 6- 12 months' time. Though it does not provide legal certainty as compared to APA, it is a more effective dispute resolution programme. Currently 22 countries are participants of this programme including US, UK, France, Australia, Japan, Netherlands, Denmark, Singapore. If India joins this international tax programme, it will provide taxpayers with a new avenue for dispute resolution.

Conclusion

The SC ruling has a huge ramification on taxpayers and applicable taxpayers will have to evaluate and frame an appropriate strategy for their transfer pricing litigation. Taxpayers will also have to revisit their approach to dispute resolution – to now opt for a dispute resolution or change the dispute resolution mechanism currently opted.

About us

VSTN Consultancy Private Ltd is a boutique Transfer pricing firm with extensive expertise in the field of international taxation and transfer pricing.

Our offering spans the end-to-end Transfer Pricing value chain, including design of intercompany policy and drafting of Interco agreement, ensuring effective implementation of the Transfer Pricing policy, year-end documentation and certification, Global Documentation, BEPS related compliances (including advisory, Masterfile, Country by Country report), safe harbour filing, audit defense before all forums and dispute prevention mechanisms such as Advance Pricing agreement.

We are structured as an inverse pyramid where leadership get involved in all client matters, enabling clients to receive the highest quality of service.

Being a specialized firm, we offer advice that is independent of an audit practice, and deliver it with an uncompromising integrity.

Our expert team bring in cumulative experience of over four decades in the transfer pricing space with Big4s spanning clients, industries and have cutting edge knowledge and capabilities in handling complex TP engagements.

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