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Tax alert: High Court judgement on principles for comparability analysis

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We are pleased to enclose our alert on a recent ruling of the Hon'ble Karnataka High Court (the Court) in the consolidated appeal by SAP Labs India Private Limited[1] and other taxpayers, dealing with the extent of Court's intervention on issues relating to comparability analysis and on the different aspects of comparability analysis while determining the arm's length price.

In a nutshell

In the case of Softbrands India Pvt. Ltd. (Softbrands), the Karnataka High Court adopted a restrictive approach with respect to the scope/ powers of the High Court dealing with transfer pricing matters and held that comparability analysis is predominantly a fact-finding exercise and the ITAT is the final fact finding authority. It was held that merely disagreeing with the ITAT's selection of comparables, filters, margins, etc. does not automatically give rise to a substantial question of law before the High Court, unless the Revenue/assessee demonstrates perversity or ex-facie unreasonable finding by the ITAT.

This created an important practical barrier for taking TP disputes relating to comparability analysis for the High Courts and consequently, the matter reached the Supreme Court of India in case of SAP Labs India (P) Ltd, being the lead case, along with connected appeals. The Supreme Court overturned the previous Softbrand's doctrine pronounced by the High Court and held that the absolute proposition in the Softbrands case cannot be accepted. It cannot be concluded that the determination of ALP by the ITAT is automatic/ final and cannot be challenged before the High Court.

The Hon'ble Supreme Court remanded the entire batch of appeals to the respective High Courts. In the second batch of proceedings, the Karnataka High Court laid down various principles on comparability analysis to determine the arm's length price.

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[1] SAP Labs India Pvt. Ltd. v. Income Tax Officer, Circle 6, Bangalore – ITA No. 10/2011 c/w 23, 24 of 2011, 44, 128, 469 of 2015, 492, 514 of 2016, 884, 955, 956 of 2017 and Cross objection 1/2018

Background

- The litigation relating to the extent of interference of the High Court on specific transfer pricing matters surrounding ALP determination such as selection of comparables, application of filters, grant of specific economic adjustments like working capital, tolerance benefit of +/-5%, among other issues, started in 2018 when the Karnataka High Court in the case of ***Softbrands India Private Limited***[2] held that the aforesaid issues constitute a specific fact-finding exercise while determining the ALP and hence, the ITAT is the final fact-finding authority.
- The High Court stated that unless perversity is demonstrated in the ITAT's directions with respect to determination of ALP, no substantial question of law emerges and hence, the appeals cannot be admitted at the judicial level.
- Based on this decision, the High Court dismissed similar appeals in other cases and upheld the directions of the ITAT. Against this, the Revenue filed an appeal before the Supreme Court in the lead case of SAP Labs (supra) challenging the directions of the High Court. In 2022, the Supreme Court pronounced its judgement and held that determination of ALP at the ITAT level may not be automatically held to be final and is capable of scrutiny by the High Court. The Supreme Court clarified that the High Court must examine, within the parameters of Section 260A of the Income Tax Act, 1961 (the Act) whether:
  - The statutory provisions of the Act relating to transfer pricing were followed;
  - The Rules relating to determination of ALP were correctly applied; and
  - The findings of the ITAT are perverse
- In addition to the above, the Supreme Court also provided a conclusive finding that evaluation of whether a substantial question of law exists, would itself constitute a substantial question of law. The High Court ought to have evaluated these matters rather than dismissing them, prima facie.
- On this premise, the Supreme Court remitted the entire batch of cases back to the High Court for fresh consideration.
- In the second round of proceedings before the Hon'ble High Court of Karnataka, the Revenue presented arguments on various transfer pricing comparability related issues on a batch-hearing basis wherein select cases which represented a particular category of issues (like selection of companies, use of filters, most appropriate method, etc.) were taken up for deciding the principles and thereafter, the other cases which fell under the relevant category, were decided in view of the laid down principles.

  The key findings emerging from the Court's order are summarized below.

Core Legal Principles and Statutory Interpretation

The Court established several fundamental principles regarding the genesis of the dispute and the legislative scheme.

I. The Burden of Proof

The Court clarified the shifting nature of the burden of proof in determining arm's length price for transfer pricing purposes:

- **Initial Burden:** The taxpayer is responsible for the maintenance of transfer pricing study report,

[2] PCIT v. Softbrands India Pvt. Ltd. - **ITA Nos.:** 536/2015 & 537/2015

detailed Functions, Assets, and Risks (FAR) analysis, and other documentation as specified under Section 92D of the Act read with Rule 10D of the Income-tax Rules, 1962 (the Rules).

- **Shifting Burden:** If the TPO rejects the taxpayer's TP study report and substitutes it with an independent analysis, the burden shifts to the Revenue to justify the new set of comparables, and its compliance with the ALP.
- **Appellate Challenge:** The burden remains with the party seeking to include or exclude a specific comparable before the Tribunal.

II. Fidelity to the Statutory Conditions

The TPO cannot reject a taxpayer's ALP determination arbitrarily. Under Section 92C(3), the TPO must satisfy at least one of four conditions:

1. Price not determined as per section 92C(1) and (2) of the Act; (i.e. selection of any of the method as most appropriate method)
2. Prescribed information/documents not maintained by the Assessee;
3. Information/data used is unreliable or incorrect; and
4. Failure to furnish required information

   The Court had grouped various transfer pricing matters into certain categories and pronounced its ruling on each such category. The broad nature of the categories/ issues dealt with by the Court are:

   - Appropriateness in selection of comparable companies
   - Application of Turnover filter
   - Related party transaction filter threshold
   - Treatment of foreign exchange gain or loss
   - Burden of proof
   - Inclusion or exclusion of comparables at the Appellate stage
   - +/-5% tolerance benefit
   - Working capital adjustment
   - Correctness of the Tribunal in following earlier discussions

III. The Selection and Filtering of Comparables

A significant portion of the judgment addresses the criteria for identifying *"comparable uncontrolled transactions."*

1. Turnover Filter

The Revenue argued that turnover is irrelevant as long as profit margins are compared. The Court rejected this position, holding that the size of a company is a critical comparability factor:

- **Advantages of Scale:** Large companies enjoy brand value, greater bargaining power, ownership of Intellectual Property Rights (IPRs), and economies of scale.
- **Rationality of the Limit:** The Tribunal's adoption of an upper turnover filter of INR 200 crore was upheld as a rational and logical basis for software and ITeS segments.

Hence, determining an upper turnover limit of INR 200 crore is a factual exercise and entails logic/ rationale. Therefore, when the Act or Rules do not provide any specific threshold of upper turnover to be adopted, the action of the Tribunal in applying this filter cannot be said to be perverse and hence, warrants no further interference.

2. **Related Party Transaction (RPT) Filter**

   The RPT filter eliminates companies influenced by controlled transactions.

   - **15% Threshold:** Generally preferred as it ensures narrower tolerance and reduces the influence of related party transactions on profitability.
   - **25% Upper Limit:** May be used only if the TPO or taxpayer demonstrates that an adequate number of comparables is unavailable at the 15% level. This requires a specific finding of fact.

   The Court held that principally, 15% RPT filter threshold can be applied unless the taxpayer/ Revenue is unable to demonstrate that sufficient number of companies satisfying this filter is not available. In such cases, a higher RPT filter threshold of 20% or 25% can be applied.

3. **Functional Dissimilarity**

   The Court emphasized that "standard sets" of comparables used by the Department are often legally unsustainable. Selection must be based on a specific FAR analysis for the tested party. The Court also held that no perversity was demonstrated by the Revenue in the present case and hence, the issue of selection of comparable companies does not constitute substantial question of law, thereby not warranting any further interference.

4. **Burden of Proof**

   With respect to comparable selection, the Court held the burden of proof to furnish the information/ documentation necessary to support such determination would lie with the taxpayer or the Revenue, on a case-to-case basis. The Court held that such determination of comparable is a fact based exercise.

IV. Economic and Financial Adjustments

1. **Foreign Exchange (Forex) Gain or Loss**

   The Court addressed whether forex fluctuations constitute operating income/cost.

   - **Nexus Requirement:** Forex gains or losses are to be treated as operating only if they are inextricably linked to the international transactions;
   - **Attributable vs. Derived:** If the gain/loss arises purely from the date of realization and is external to the transaction value, it is merely attributable to the business and should be excluded for computing operating margin.

2. **Working Capital Adjustment (WCA)**

   - **Purpose:** To neutralize financing cost differences arising from levels of receivables, payables, and inventory.
   - **Nature:** WCA is a comparability adjustment, not a selection filter. Its application is a data-driven exercise and a finding of fact.
   - **Fact-Based Determination:** The grant or denial of working capital adjustment invariably involves an appreciation of facts. Unless it is demonstrated that the determination suffers from a violation

of the provisions of the Act or the Rules, or that the findings recorded by the Tribunal are perverse, the conclusions reached by the Tribunal on WCA remain findings of fact and, by themselves, do not give rise to any substantial question of law.

V. Specific Interpretations of Section 92C

The Court corrected a common misinterpretation of the proviso to Section 92C(2) in relation to variation rule

- **Variation is not a Deduction:** The 5% (Currently 3%) range is a tolerance range or getaway clause, intended to avoid transfer pricing disputes arising due to minor pricing differences. It is not a standard deduction to be subtracted from the total adjustment.
- **Application:** If the variation between the ALP and the actual price exceeds the tolerance percentage, then full adjustment must be made.

VI. Retrospective Amendments

The Court held that Section 92C(2A), inserted by the Finance Act, 2012, operates retrospectively from 1st April 2002 and is applicable to all pending cases. Section 92C(2A) is essentially a transitional provision introduced to deal with the change in the tolerance range computation mechanism.

This disentitles taxpayers from claiming the 5% (Currently 3%) variation option for any assessment year starting from 2002-03 if the variation exceeds the tolerance limit.

VII. Inclusion and exclusion of comparables at the Appellate stage

Selection of comparables constitutes the foundational step in determining the ALP. During the assessment proceedings or appellate proceedings, more comprehensive and reliable data may become available, revealing better comparables than those originally selected.

The taxpayer cannot be precluded from seeking inclusion or exclusion of comparables on the basis of such subsequently available data. Hence, the Court held that exercise is entirely fact driven and does not constitute any substantial question of law.

VIII. Tribunal's role in comparable selection and reliance of Tribunal on earlier decisions

Tribunal is the principal fact-finding authority. Its findings should not ordinarily be disturbed unless contrary to law or demonstrably perverse. Tribunal can rely on its own decision and there is no need for a repetitive exercise. If the functional profile and other relevant facts remain unchanged, the Tribunal does not have to undertake the entire comparable analysis again merely because it is deciding a different assessment year.

The Court specifically clarified that merely relying on an earlier Tribunal decision does not mean that the Tribunal has failed to apply Section 92C of the Act and Rule 10B of the Rules.

Our Comments

This is a first detailed ruling by the High Court providing directional guidance on the various aspects of comparability analysis and determination of arm's length price by the taxpayer and tax authorities. The ruling will pave the way for more consistent approach by taxpayers and tax authorities in determining arm's length price on the aspects of applicable filters, comparable selection, economic adjustments etc. which would help in reducing litigation.