

Softbrands ruling – Karnataka HC

July 2018

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The HC Ruling



Facts in brief

The HC Ruling

Facts in brief

- Assessee was an Indian company (subsidiary of a foreign parent) providing software services at cost + margin to AEs
- CUP method was applied by assessee; however rejected by TPO and TNMM applied
- TPO margin – 20.68% on cost; Assessee margin – 8.33% on cost
- CIT(A) ruling
 - RPT and turnover filter was applied; list of comparable companies was reduced to three
 - Both Revenue and Assessee filed appeals with ITAT
- ITAT ruling
 - RPT filter kept at 15%
 - Turnover filter decision of CIT(A) not disturbed as Revenue had not challenged it
 - Based on functional comparability of comparable companies, the list was changed (deleting CIT(A) comparables and adding some of TPO comparables)
- Revenue appeal to HC – substantial questions of law
 - Whether ITAT was right in applying 15% RPT filter?
 - Whether ITAT's act of rejecting comparable companies (four comparable companies named in the appeal memo) was right?



HC observations and precedents relied on

The HC Ruling

HC observations and precedents relied on

Para #	Key observations	Precedents relied on
14	<p>HC summarises that the dispute relates to –</p> <ul style="list-style-type: none">• Whether ITAT has rightly included/excluded comparables after analyzing each of them• Whether correct filters have been applied• Whether right method has been selected• Other connected factors in deciding the appropriate TP adjustment	-
15-17	<p>Formulates scope of appeal before HC -</p> <ul style="list-style-type: none">• Appeal can only pertain to “substantial question of law”• Unless perversity in findings of ITAT can be demonstrated based on evidence on record, there cannot be “substantial question of law”• ITAT has analysed each of the comparables in detail and these findings, prima facie, are not perverse, so as to admit the appeal	-

The HC Ruling

HC observations and precedents relied on

Para #	Key observations	Precedents relied on
18 - 27	<p>Can any question of law be decided by HC?</p> <ul style="list-style-type: none">• Argument cannot be accepted that HC can decide any question not decided by ITAT• Sec 260A(6) is <i>pari materia</i> with Sec 103 of CPC; only such issue not decided (or wrongly decided) by ITAT can be dealt with, based on the answer given by HC to the main substantial question of law (framed by and answered by HC)• Facts confirmed by ITAT cannot be disturbed, unless perversity is established	<p>Section 260A is <i>pari materia</i> with section 100 and 103 of Code of Civil Procedure (CPC)</p>
28 - 31	<p>What is "substantial question of law"?</p> <ul style="list-style-type: none">• Scope of "substantial question of law" has been clarified by a host of SC judgments• HC has to determine whether the question that arises before it in all cases, including TP cases falls within that scope	<p><i>Chunilal V Mehta Vs Century Spinning AIR 1962 SC 1314</i></p> <ul style="list-style-type: none">• A question of law would be substantial if (a) it is of general public importance OR (b) if it directly and substantially affects the rights of parties; and in either cases, it is either an open question that is not finally settled by the SC/PC/FC OR is not free from difficulty OR calls for discussion of alternate 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, then no substantial question of law arises

The HC Ruling

HC observations and precedents relied on

Para #	Key observations	Precedents relied on
28 - 31	<p>What is “substantial question of law”?</p> <ul style="list-style-type: none">• The scope of “substantial question of law” has been clarified by a host of SC judgments• HC has to determine whether the question that arises before it in all cases, including TP cases falls within that scope	<p><i>Hero Vinoth Vs Seshammal (2006) 5 SCC 545</i></p> <ul style="list-style-type: none">• A substantial question of law will also arise in a contrary situation; where the legal position is clear, but lower Court has decided the case either ignoring or acting contrary to such legal principle• General rule that HC will not interfere with concurrent findings of lower Courts is subject to some exceptions –<ul style="list-style-type: none">– Lower Courts have ignored material evidence or acted on no evidence (‘no evidence’ includes cases, where the evidence taken as a whole, is not reasonably capable of supporting the finding)– Wrong inferences drawn from proved facts by applying law erroneously– ‘burden of proof’ wrongly cast <p><i>Vijay Talwar VS CIT (2011) 1 SCC 673</i></p> <ul style="list-style-type: none">• While arriving at a finding, lower Court has not taken into consideration relevant admissible evidence OR inadmissible evidence has been taken into consideration OR legal principles have not been applied in appreciating the evidence OR when the evidence is misread
31 - 39	HC notes the scheme of the Act and Rules in relation to transfer pricing provisions	-

The HC Ruling

HC observations and precedents relied on

Para #	Key observations	Precedents relied on
41 - 48	<ul style="list-style-type: none">• HC notes that the arguments of parties in the subject appeals largely relates to either wrong filters applied or filters have been wrongly applied, particularly turnover filter• Contention raised is that since there are differing views of ITAT on above issues, the appeals need to be admitted to enable the HC to lay down general principles of guidance about filters, most appropriate method, etc• Above parameters do not satisfy requirement of "substantial question of law"• Perversity in ITAT order has not been pointed out by parties• HC cannot undertake factual analysis of comparables; HC does not have sufficient data or technical expertise to undertake fact finding exercise• Facts established by ITAT cannot be disturbed by HC unless they are ex-facie perverse and unsustainable and exhibit a total non-application of mind by the ITAT to the relevant facts of the case and evidence before the ITAT• Even inconsistent view taken by ITAT, depending on the facts of the case before it, cannot lead to a 'substantial question of law' in a particular case	-

The HC Ruling

HC observations and precedents relied on

Para #	Key observations	Precedents relied on
48 – 49	<p><i>"...For instance, while dealing with comparables or filters, if unequals like software giant Infosys or Wipro are compared to a newly established small size company in software service, it would obviously be wrong and perverse. The very word "comparable" means that that the group of entities should be in a homogenous group. They should not be wildly dissimilar or unlike or poles apart. Such wild comparisons may result in the best judgment assessment going haywire and directionless wild, which may land up the findings of the Tribunal in the realm of perversity attracting interference under section 260A of the Act.."</i></p> <ul style="list-style-type: none">• Above observations of HC in obiter could have persuasive value	-
50 - 53	<p>Key excerpts relied on by the HC from other HC judgments</p> <ul style="list-style-type: none">• Madras HC refusing to admit Revenue appeal against inclusion of <i>HMT Ltd</i> as a comparable by the ITAT (ITAT's basis - said company was similar in function and had turnover of 2x that of assessee company; ITAT notes that excluding companies with turnover of 3x – 5x is an accepted norm)• HC refused Revenue appeal against exclusion of three comparable companies by ITAT, based on analysis of facts of those comparables	<ul style="list-style-type: none">• CIT Vs Same Deutz-fahr India (2018) 253 taxman 32 (Mad)• PCIT Vs WSP Consultants (2017) 253 taxman 58 (Del)• CIT Vs PTC Software (2017) 395 ITR 176 (Bom)

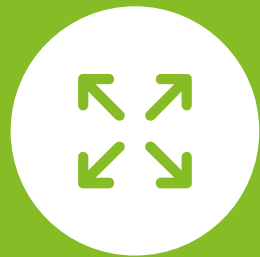


HC conclusions

The HC Ruling

HC conclusions

Para #	Key observations	Precedents relied on
54	<ul style="list-style-type: none"> • HC notes that TP cases are long drawn litigations and there is considerable delay, by the time it reaches ITAT and ITAT decides • Much time and money is lost by the time these appeals are decided, besides giving an adverse picture of the sluggish dispute resolution process through these channels 	-
55	<p><i>"...If appeals were to be lightly entertained by the HC against the findings of the ITAT, without putting it to strict scrutiny of the existence of the substantial questions of law, it is likely to open the floodgates for this litigation to spill over on the dockets of the High Courts and up to the Supreme Court, where such delay may further cause serious damage to the demand of expeditious judicial dispensation of such cases.."</i></p>	-
56	<p><i>"...Had it been a case of substantial question of interpretation of provisions of DTAA, interpretation of provisions of the Act or overriding effect of the Treaties over the domestic legislations or the questions like treaty shopping, BEPS, transfer of shares in tax havens (like in the case of Vodafone, etc), if based on relevant facts, such substantial questions of law could be raised before the HC under section 260A, the Courts could have embarked upon such exercise of framing and answering such substantial questions of law. On the other hand, the appeals of the present tenor as to whether the comparables have been rightly picked up or not, filters for arriving at the correct list of comparables have been rightly applied or not, do not, in our considered opinion, give rise to substantial questions of law..."</i></p>	-



Observations and impact analysis

The HC Ruling

Observations

KHC holds that in a TP case, aspects related to choice of comparable companies, choice of filters used, correctness of application of filters, choice of method, etc are factual exercises; the HC will not admit any question arising from these, unless perversity is demonstrated based on the parameters laid out in the judicial precedents referred to -

(a) it is of general public importance OR

(b) if it directly and substantially affects the rights of parties;

and in either case (a) or (b), it is either an open question that is not finally settled by the SC/PC/FC OR is not free from difficulty OR calls for discussion of alternate views

(c) where the legal position is clear, but lower Court has decided the case either ignoring or acting contrary to such legal principle

(d) HC could interfere with concurrent findings of lower Courts if –

- (i) Lower Courts have ignored material evidence or acted on no evidence ('no evidence' includes cases, where the evidence taken as a whole, is not reasonably capable of supporting the finding)
- (ii) While arriving at a finding, lower Court has not taken into consideration relevant admissible evidence OR inadmissible evidence has been taken into consideration OR legal principles have not been applied in appreciating the evidence OR when the evidence is misread
- (iii) Wrong inferences drawn from proved facts by applying law erroneously
- (iv) 'burden of proof' wrongly cast

The HC Ruling

Impact analysis

- HC's observations on admission of appeals under section 260A are based on established judicial precedents on what constitutes a "substantial question of law"
- After the Softbrands ruling was given, KHC has been dismissing TP appeals (largely those of the Revenue), if it relates to comparables, methods, filters, etc, unless perversity is pointed out in the facts of that case
- The KHC has been applying this test to all appeals (Revenue/assessee) whether TP or otherwise
- KHC is likely to follow this ruling for already previously admitted cases, when it comes for 'final hearing', on the basis that absence of 'substantial question of law' can be decided by the HC even during the final hearing stage

The HC Ruling

Impact analysis

Illustrative analysis of whether an appeal relates to “substantial question of law” from ITAT orders in TP cases is given below:

SI No	Issue	“Substantial question of law”?
1	Selection of comparables for a particular case	<p>No, unless it can be clearly demonstrated that the case falls in one of the parameters given at point (d) in Slide 15.</p> <p><i>Other HCs have also been dismissing appeals wrt comparables, after examining perversity aspect in ITAT orders (whether view taken by ITAT is a plausible view or no).</i></p> <p><i>Del HC in Avenue Asia Advisors Vs CIT (2017) 85 taxmann.com 311 held (assessee appeal) that ITAT erred in understanding assessee’s services and comparing with incorrect comparables, also that ITAT erred in remanding comparable to TPO if it comes to a conclusion that comparables’ profile is different from assessee. HCs have admitted some appeals, based on facts</i></p>
2	Choice of method in a particular case	<p>No, unless it can be clearly demonstrated that the case falls in one of the parameters given at point (d) in Slide 15.</p> <p><i>Del HC in CIT Vs Matrix Cellular (2018) 90 taxmann.com 54 held (assessee appeal) that ITAT could choose a different method (RPM) than that adopted by assessee/TPO/DRP (TNMM). Del HC in Headstrong Vs CIT admitted assessee appeal on rejection of CUP method by ITAT. Del HC in Rayban Vs CIT (2017) 84 taxmann.com 24 held (assessee appeal) that ITAT decided the case based on erroneous assumption of fact</i></p>
3	Non-following of ITAT orders by ITAT (judicial discipline), for eg, application of turnover filter, inclusion or exclusion of a particular item of income/expense in TNMM (for eg, forex loss/gain), etc	<p>Yes, ITAT case could amount to being “perverse”, however, similarity of facts (in the impugned case before the ITAT and in the ITAT case that was cited before the ITAT) to be demonstrated clearly (see slide 10 where KHC has held that inconsistent views of ITAT, depending on facts before it, is not appealable)</p> <p><i>Del HC in CIT Vs ST Microelectronics (2017) 87 taxmann.com 262 held that ITAT cannot blindly follow precedents w/o a factual analysis of the applicability of the precedent to the case on hand. Bom HC as well, in Lloyds TSB Global case</i></p>

The HC Ruling

Impact analysis

Illustrative analysis of whether an appeal relates to “substantial question of law” from ITAT orders in TP cases is given below:

SI No	Issue	“Substantial question of law”?
4	Capacity adjustment and other economic adjustments in arriving at the PLI (profit level indicator) of the assessee	<p>Probably Yes, if it can be clearly demonstrated that the case falls in one of the parameters given at point (d) in Slide 15 (for eg, ITAT not taking into consideration relevant evidence before it in the context of a capacity adjustment)</p> <p><i>In one of the assessee appeals that was heard by the KHC after the Softbrands case, KHC dismissed Revenue appeal in relation to appropriateness of Gross Profit being taken (prior to depreciation). Bom HC in CIT Vs Petro Araldite (2018) 93 taxmann.com 438 has allowed capacity utilization adjustment claim of the assessee (Mad HC has also admitted assessee appeal)</i></p>
5	AMP adjustment in the context of whether it is an “international transaction”	<p>Yes. <i>In one of the assessee appeals that was heard by the KHC, KHC has adjourned the case for six weeks on the basis of the submission from the company that a similar question was pending before the Supreme Court</i></p>
6	<ul style="list-style-type: none"> Whether ITAT was right in deciding on certain comparables when no grounds were raised before it? Whether ITAT was right in deciding on TNMM related aspects when it remanded the case to the AO for applying CUP? 	<p>Probably Yes. However, in these type of cases (assessee appeals), KHC has disposed of the cases with directions to the assessee to file Miscellaneous Petitions (MP) before the ITAT pointing out to these mistakes</p> <p><i>Del HC in Corning Sas-branch office Vs CIT (2017) 86 taxmann.com 144 held that ITAT cannot do an open remand to the TPO to do a fresh benchmarking analysis when the question before it was choice of three specific comparables and all evidence was on record. Similar judgment in Bechtel Vs CIT (2017) 84 taxmann.com 151 (Del)</i></p>
7	Whether ITAT was right in applying 0.1x - 10x turnover filter, despite contrary rulings of ITAT	<p>Probably Yes. <i>However, Kar HC in Swiss Re Global Solutions (TS-498-HC-2018) (subsequent to Softbrands ruling) has dismissed Revenue appeal in relation to ITAT’s rejection of comparables based on application of 10x turnover filter</i></p>

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Impact analysis

Illustrative analysis of whether an appeal relates to “substantial question of law” from ITAT orders in TP cases is given below:

SI No	Issue	“Substantial question of law”?
8	Whether working capital adjustment has to be granted or no? (<i>In certain cases, the TPO either does not grant working capital adjustment or restricts the working capital adjustment, on the basis that the Indian subsidiary receives advance monies and it has no working capital challenges</i>) – <i>ITAT generally reverses TPO’s order and directs granting working capital adjustment based on accepted methodology</i>	No , unless it can be clearly demonstrated that the case falls in one of the parameters given at point (d) in Slide 15
9	Whether ‘risk adjustment’ can be granted to a captive service provider?	Probably Yes , if it can be clearly demonstrated that the case falls in one of the parameters given at point (d) in Slide 15 (for eg, ITAT not taking into consideration relevant evidence before it in the context of a risk adjustment. For eg, if risk adjustment workings are provided to the ITAT and ITAT rejects risk adjustment request w/o considering the workings provided). <i>Del HC in Haldor Topsoe case admitted Revenue appeal on whether ITAT was right in granting risk adjustment w/o any findings/evidence</i>
10	Whether MAP agreed margin of one year could be applied (a) to other years (b) or to other country AEs in the same year?	Yes , since it can be demonstrated that the case falls in one of the parameters given at point (b) or (d) in Slide 15 – <i>there are SC judgments on binding nature of MAP settlements</i>

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Impact analysis

Illustrative TP cases, in which Special Leave Petition (SLP) is admitted (and pending) at Supreme Court:

SI No	Case	Status at SC
1	<p>Rampgreen Solutions – Del HC (60 taxmann.com 355)</p> <ul style="list-style-type: none"> • ITES – KPO Vs BPO • In TNMM method, whether <p>(i) FAR analysis of tested party and comparables has to be factored</p> <p>(ii) (ii) whether comparables with different service/product offered compared to tested party can be a criterion for inclusion/exclusion</p>	<ul style="list-style-type: none"> • Revenue appeal is admitted, final hearing is pending • SC has been tagging similar appeals of Revenue and admitting appeals (where it concerns matters which are similar to the Rampgreen case) <p><i>The Rampgreen case concerns the core issue of functional comparability of comparables, especially in a TNMM case. It covers interpretation of Rule 10B in so far as it pertains to TNMM</i></p>
2	<p>PTC Software – Bom HC (395 ITR 176)</p> <ul style="list-style-type: none"> • this was relied on by Kar HC in the Softbrands case • Revenue appeal pertained to two aspects – (i) whether HC was correct in saying that date of same FY ending has to be used (ii) KPO Vs BPO 	<ul style="list-style-type: none"> • Revenue appeal was admitted by SC on both questions • Revenue however subsequently withdrew the appeal
3	<p>Marketing intangibles issue (AMP) – pending in many cases arising from Del HC rulings</p>	<p>Appeal is admitted. Final hearing is pending</p>

The HC Ruling

Impact analysis

Illustrative TP cases, in which Special Leave Petition (SLP) is admitted (and pending) at Supreme Court:

SI No	Case	Status at SC
4	Bestseller United India(TS-623-SC-2017-TP) <ul style="list-style-type: none">• Whether HC was right in confirming ITAT order that assessee's sourcing services provided to AE was at arm's length• ITAT had given elaborate reasons as to why the transactions were at arm's length	<ul style="list-style-type: none">• Revenue appeal is admitted and final hearing is pending• SC directed tagging of this appeal with <i>Li & Fung</i> case (TS-223-SC-2017-TP), where for a similar sourcing activity, there was a dispute on the PLI to be used
5	Cushman and Wakefield (I) Pvt Ltd (TS-766-SC-2017-TP) <ul style="list-style-type: none">• Whether HC was right in reversing ITAT order that reimbursements paid by assessee to its overseas AEs was to be allowed	<ul style="list-style-type: none">• Assessee appeal is admitted and final hearing is pending



Key takeaways

The HC Ruling

Key takeaways

- KHC is likely to follow the Softbrands ruling in the context of TP appeals; tolerance level of the KHC for accepting TP related appeals is low, hence it is important strategise arguments before the HC
- Some specific action steps for companies in TP litigation –

In the case of **Revenue appeals at HCs**, ITAT order could be defended on the basis that there is no 'substantial question of law' that arises, in light of the Softbrands ruling

In the case of **Assessee appeals at HCs**, following steps to be taken:

- Review all pending appeals filed at HC and do an impact-analysis with reference to the Softbrands ruling; focus on aspects of perversity in ITAT order
- If issue involves questions on which there are other HC judgments in favour or where SC has admitted appeals, same to be used to impress upon the HC to admit the case

In **ITAT hearings**,

- Wrt exclusion/inclusion of comparables, plan the arguments appropriately and file all evidence in relation to the arguments
- If ITAT comes to a conclusion w/o due consideration of relevant evidence filed, non consideration of the same could lead to perversity in the order so as to become a 'substantial question of law'

Give due weightage to alternate dispute resolution mechanisms like APA/MAP, etc in relation to choosing between the regular appeal route and the alternate options

Abbreviations

Abbreviation	Full Expansion in English
Act	The Income-tax Act, 1961
AE	Associated Enterprise
AMP	Advertisement, Marketing and Promotion
BPO	Business Process Outsourcing
CIT(A)	Commissioner of Income-tax (Appeals)
CPC	Code of Civil Procedure
CUP	Comparable Uncontrolled Price
FAR	Functions, Assets and Risk
FY	Financial Year
HC	High Court
ITAT	Income Tax Appellate Tribunal
KHC	Karnataka High Court
KPO	Knowledge Process Outsourcing
MAP	Mutual Agreement Procedure
RPT	Related Party Transaction
Rules	The Income-tax Rules, 1962
SC	Supreme Court
TNMM	Transaction Net Margin Method
TPO	Transfer Pricing Officer

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