COURT OF APPEAL ALLOWS TRANSFER PRICING APPEAL AND RULES THAT THE REVENUE LACKED AUTHORITY TO REVIEW PRICING METHODOLOGY

by Tan Jia Hua & S. Saravana Kumar

Recently, the Court of Appeal in EOS v Ketua Pengarah Hasil Dalam Negeri held that the Revenue has no legal authority to review and replace the taxpayer's chosen transfer pricing method (TP method). The Court of Appeal also held that the Revenue has no basis in law to apply median adjustments in relation to the taxpayer's transfer pricing treatment in the years of assessment (YA) 2014 to 2016. The court highlighted that such authority was only vested with the Revenue under the Income Tax (Transfer Pricing) Rules 2023 (TP Rules 2023), which only come into effect from the YA 2023.

The taxpayer in this appeal was successfully represented by the firm's Tax, SST & Customs Partner, S. Saravana Kumar together with associate, Tan Jia Hua.

Background Facts

The taxpayer's principal activity involved the chartering of offshore support vessels. In the YA 2014 to 2016, the taxpayer made payments to a related party for charter hire of vessels and crew management services, which were priced using the cost-plus method (CPM) with a mark-up of 35%.

The Revenue rejected the taxpayer's CPM method and substituted it with the transactional net margin method (TNMM). The Revenue further adjusted the charter hire and crew management service fees by applying the median of five comparable companies that the Revenue had identified.

Dissatisfied with the transfer pricing adjustment, the taxpayer commenced judicial review proceedings at the High Court. Although leave for judicial review was granted, the substantive application was subsequently dismissed on the basis that the dispute between the parties in relation to the appropriate transfer pricing method was essentially a question of fact. The High Court held that the matter was best referred to the Special Commissioners of Income Tax (SCIT).

Aggrieved by the High Court's decision, the taxpayer appealed to the Court of Appeal.

The Taxpayer's Appeal

At the outset, the taxpayer submitted that the present dispute raised a question of law rather than a mere question of fact, as it concerned the Revenue's authority to review and replace the TP method selected by the taxpayer under Section 140A of the ITA and the applicable TP Rules.

During the YAs in dispute, the choice of TP methods was governed by Rule 5(1) of the TP Rules 2012:

> *"A person shall apply the traditional transactional method to determine the arm's length price of a controlled transaction."*

The traditional transactional method, as defined by Rule 5(4) of the TP Rules 2012 includes CPM, which was the method used by the taxpayer in this case.

On the other hand, Rule 5(2) of the TP Rules 2012 specifies that the transactional profit method should only be applied when the traditional transactional method cannot be reliably used or is entirely inapplicable:

> *"Where the traditional transactional method cannot be reliably applied or cannot be applied at all, the person shall then apply the transactional profit method."*

The traditional profit method was defined by Rule 5(4) of the same TP Rules to include TNMM, which is the method used by the Revenue in this case.

However, neither Rule 5(1) nor Rule 5(2) empowers the Revenue to review or replace the TP method selected by a taxpayer. Instead, the TP Rules make clear that the discretion to apply the exception under Rule 5(2) rests with the taxpayer, not the Revenue.

Meanwhile, Rule 5(3) of the TP Rules 2012 merely empowers the Revenue to permit the use of an alternative method, it does not confer the authority to unilaterally review, dictate, or replace the method selected by the taxpayer.

This legal position is further reinforced by the introduction of Rule 6(3) of the TP Rules 2023, which expressly grants the Revenue the power to review and replace a taxpayer's chosen method.

In this regard, the High Court failed to appreciate that neither Section 140A of the ITA nor the TP Rules 2012 authorise the Revenue to apply the median range in making adjustments. Such an authority only arose with the introduction of Rule 13(3) and Rule 13(5) of the TP Rules 2023.

It was submitted that Parliament does not legislate in vain and as such, the very reason Parliament amended the Transfer Pricing Rules in 2023 was to expressly broaden the scope of the Revenue to review and substitute transfer pricing methods and to impose median adjustments.

However, the Minister in making the TP Rules 2023, did not intend for the Rules to operate retrospectively. This is evident from Rule 1(2), which provides that the TP Rules 2023 were to apply prospectively from the YA 2023 onwards.

Accordingly, it was argued that the Revenue acted ultra vires in reviewing and replacing the transfer pricing method used by the taxpayer for the YAs 2014 to 2016, and in selecting comparables and imposing a median adjustment in determining the arm's length prices for those years.

The taxpayer distinguished the present appeal from *Ketua Pengarah Hasil Dalam Negeri* v *Ensco Gerudi (M) Sdn Bhd* [2023] 5 MLJ 159, which was relied upon by the Revenue, for two principal reasons. First, the dispute in *Ensco Gerudi* centred on the factual issue of pricing, which concerned the computation of pricing, the accounting methods adopted by the taxpayer and the adequacy of the transfer pricing documentation. Second, in *Ensco Gerudi*, there was also the issue of time barred assessment, which inevitably raises the factual question of negligence, wilful default or fraud, all of which are factual disputes, which was absent in the present matter.

The Revenue's Response

First, the Revenue argued that tax matter in relation to transfer pricing is a question of fact and ought to be determined by the judges of facts- SCIT. This position has been confirmed in the case of *Ensco Gerudi*.

Second, the Revenue was originally empowered under Section 140A of the ITA to review and replace the transfer pricing method adopted by the taxpayer. The amendments introduced in the Transfer Pricing Rules 2023 were not to confer a new power but rather to keep pace with evolving tax developments and to provide greater breadth and clarity to the existing framework.

Finally, the Revenue submitted that since the taxpayer had already commenced its appeal before the SCIT, it would be most appropriate to allow the SCIT to continue with the determination of the dispute pursuant to Section 99(1) of the ITA. In the Revenue's view, this approach is consistent with the statutory scheme and respects the proper role of the SCIT as the fact-finding body for tax disputes.

The Court of Appeal's Ruling

The Court of Appeal unanimously reversed the decision of the High Court and in its oral judgment made several important findings.

First, the court held that the dispute was not a mere question of fact, as contended by the Revenue but one of jurisdiction. The central issue concerned whether the Revenue had acted within the scope of its statutory powers, which was a question of law suitable for judicial determination via judicial review.

Second, the court found that Section 140A of the ITA and the TP Rules 2012, which was applicable in the YAs 2014 to 2016, did not empower the Revenue to review and

replace the transfer pricing method chosen by the taxpayer. Neither did Section 140A nor the TP Rules 2012 permit the making of a median adjustment. Such powers were only vested with the Revenue through the TP Rules 2023, which was only effective from 1.1.2023.

On the basis of these findings, the Court of Appeal allowed the taxpayer's application, granted an order of certiorari and set aside the impugned tax assessments for the YAs 2014 to 2016.

Conclusion

This case is significant as it marks the first transfer pricing matter successfully allowed by way of judicial review at the Court of Appeal. While transfer pricing disputes are often fact-intensive and courts have traditionally deferred to the SCIT as the judges of fact, this decision makes clear that not all transfer pricing issues are purely factual.

The availability of judicial review in tax matters must be assessed on a case-by-case basis, particularly where the dispute concerns the jurisdiction or legal authority of the Revenue. In such circumstances, judicial review remains an appropriate remedy.

In light of the Court of Appeal's ruling that Section 140A of the ITA and the TP Rules 2012 did not empower the Revenue to review and replace the transfer pricing method chosen by the taxpayer and also to impose median adjustment, it remains to be seen if taxpayers will challenge such transfer pricing adjustments made by the Revenue prior to the YA 2023.

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