

Public Discussion Draft

BEPS ACTION 10: DISCUSSION

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16 December 2014 - 6 February 2015



DISCUSSION DRAFT ON THE TRANSFER PRICING ASPECTS OF CROSS-BORDER COMMODITY TRANSACTIONS

16 December 2014

Public comments are invited on this discussion draft which deals with work in relation to Action 10 (“Assure that transfer pricing outcomes are in line with value creation” in the context of “other high-risk transactions”) of the BEPS Action Plan.

The Action Plan on Base Erosion and Profit Shifting, published in July 2013, identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement these actions.

Action 10 of the BEPS Action Plan, identifies that work needs to be undertaken to develop “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to ... (iii) provide protection against common types of base eroding payments.”

Within this mandate, Working Party No. 6 on the Taxation of Multinational Enterprises has considered transfer pricing issues in relation to commodity transactions that may lead to base erosion and profit shifting. Problems reported by some countries involve difficulties in determining adjustments made to quoted prices, verifying the pricing date, and accounting for the involvement of other parties in the supply chain. The issues may be most acute for commodity dependent developing countries, for which the commodity sector provides the major source of economic activity, contributing in a significant manner to employment, government revenues, income growth and foreign exchange earnings. In this discussion draft, the term “commodities” refers to physical products for which a quoted price is used by independent parties to set prices.

In response to these issues, some countries have adopted specific unilateral approaches for pricing commodity transactions, such as the so-called sixth method in the Latin American region. The emergence of such approaches has highlighted the need for clearer guidance on the application of transfer pricing rules to commodity transactions. To this aim the following proposals have been developed under the BEPS Project, on which comments are sought:

- A. Additional guidance in Chapter II of the Transfer Pricing Guidelines clarifying that: (i) the comparable uncontrolled price method can be an appropriate transfer pricing method for commodity transactions between associated enterprises; and, (ii) that quoted or publicly available prices (“quoted price”) can be used under the CUP method as a reference to determine the arm’s length price for the controlled commodity transaction.
- B. Additional guidance in Chapter II of the Transfer Pricing Guidelines regarding the adoption of a deemed pricing date for commodity transactions between associated enterprises in the absence of evidence of the actual pricing date agreed by the parties to the transactions.

C. Potential additional guidance on comparability adjustments.

The proposed guidance seeks to ensure that pricing reflects value creation, thereby protecting the tax base of commodity dependent countries, by ensuring that parties performing value-adding functions in relation to the commodity being transferred are remunerated with arm's length compensation.

Transfer pricing work being undertaken under BEPS Action 9 (on risk and capital), BEPS Action 10 (especially on recharacterisation and low value-adding services) and BEPS Action 13 (transfer pricing documentation and country-by-country reporting) is also relevant to commodity transactions and will help to ensure that transfer pricing outcomes in commodity transaction are in line with value creation.

The views and proposals included in this discussion draft do not represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

This discussion draft is submitted for comment by interested parties. Comments should be submitted by **6 February 2015 (no extension will be granted)** and should be sent by email to **TransferPricing@oecd.org** in Word format (in order to facilitate their distribution to government officials). They should be addressed to Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration. It is requested that comments be provided in separate text containing references to paragraph numbers of the Discussion Draft, instead of in the form of a mark-up of the text of the Discussion Draft itself.

Please note that all comments received regarding this consultation draft will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons should identify all enterprises or individuals who are members of that collective grouping or coalition, or the person(s) on whose behalf the commentator(s) are acting.

A public consultation on the discussion draft and other topics will be held on 19-20 March 2015 at the OECD Conference Centre in Paris. Registration details for the public consultation will be published on the OECD website in due time. Speakers and other participants at the public consultation will be selected from among those providing timely written comments on the discussion draft.

DISCUSSION DRAFT ON THE TRANSFER PRICING ASPECTS OF CROSS-BORDER COMMODITY TRANSACTIONS

I. Introduction

1. The commodity sector provides the major source of economic activity for many countries, especially developing countries, in which the commodity sector contributes significantly to employment, government revenues, income growth and foreign exchange earnings. Accordingly, for many of these countries, dependence on commodities has defined their economic policy (making commodity exports the primary driver of growth and investment) and development trajectory.

2. There are several problems and policy challenges in respect of commodity transactions faced by tax administrations generally and, most acutely, by tax administrations of commodity-dependent developing countries. One of these main issues is transfer pricing-oriented tax base erosion resulting from cross-border controlled transactions the object of which is the sale or purchase of commodities (“commodity transactions”). Countries have reported the following key transfer pricing issues that may lead to base erosion and profit shifting (“BEPS”) in cross-border commodity transactions:

- The use of pricing date conventions which appear to enable the adoption by the taxpayer of the most advantageous quoted price;
- Significant adjustments to the quoted price or the charging of significant fees to the taxpayer in the commodity producing country by other group companies in the supply chain (e.g. processing, transportation, distribution, marketing); and,
- The involvement in the supply chain of entities with apparently limited functionality, which may be located in tax opaque jurisdictions with nil or low taxation.

3. In response to these issues some countries have adopted specific domestic approaches for pricing commodity transactions. An example would be the so-called sixth method adopted by a number of countries in Latin America. The emergence of such approaches has highlighted the need for clearer guidance on the application of transfer pricing rules to commodity transactions. The proposals described below aim at providing a consistent set of rules within the arm’s length principle to determine the arm’s length price for commodity transactions, which not only reduces the opportunities for BEPS, but also minimizes the instances where double taxation may occur.

4. The following proposals are covered in this discussion draft:

1. Additional guidance in Chapter II of the Transfer Pricing Guidelines clarifying that: (i) the comparable uncontrolled price method can be an appropriate transfer pricing method for commodity transactions between associated enterprises; and, (ii) that quoted or publicly available prices (“quoted price”) can be used under the CUP method as a reference to determine the arm’s length price for the controlled commodity transaction.

2. Additional guidance in Chapter II of the Transfer Pricing Guidelines regarding the adoption of a deemed pricing date for commodity transactions between associated enterprises in the absence of evidence of the actual pricing date agreed by the parties to the transactions.
3. Potential additional guidance on comparability adjustments.

5. Transfer pricing work being undertaken under BEPS Action 9 (on risk and capital), BEPS Action 10 (especially on recharacterisation and low value-adding services) and BEPS Action 13 (transfer pricing documentation and country-by-country reporting) is also relevant to commodity transactions and will help to ensure that transfer pricing outcomes in commodity transaction are in line with value creation.

6. The proposals aim to create greater consistency in the way tax administrations and taxpayers determine the pricing of commodities under the arm's length principle. The proposals take into account concerns expressed by some tax administrations about the difficulty they face in obtaining information to verify the price of commodities, including pricing date conventions and comparability adjustments. The proposed guidance seeks to ensure that pricing reflects value creation, thereby protecting the tax base of commodity dependent countries by ensuring that parties performing value-adding functions in relation to the commodity being transferred are remunerated with arm's length compensation.

7. Implementation of any of these measures demands that tax administrations have knowledge of how the commodity markets operate and how commodity businesses contribute to value at various stages in the value chain. The development and implementation of transfer pricing rules which do not take into account the economic context, industry and business model in which associated enterprises operate and transact with one another may lead to arbitrary and unrealistic results and with that may lead to double taxation or double non-taxation hindering cross-border trade and investment. In their Communiqué of September 2014 G20 Finance Ministers and Central Bank Governors, under "Issues for Further Action", have asked the OECD and the World Bank Group to explore ways to support ongoing efforts to improve the availability of quality transfer pricing comparability data for developing economies. In this context, research will be undertaken as part of the Tax and Development Programme to identify common adjustments to quoted prices to account for physical and functional differences in the controlled transaction and with that supplement the BEPS work with practical tools to help developing economies make maximum use of quoted prices for commodities. The research will focus on mineral commodities when they are traded as ores or in intermediate forms, initially covering iron ore, copper and gold.

II. Proposed additions to Chapter II of the Transfer Pricing Guidelines

A) *The use of the CUP method for pricing commodity transactions and the use of quoted prices in applying the CUP method*

8. The first proposal involves clarifying the guidance in the existing Transfer Pricing Guidelines stating that the CUP method would generally be the most appropriate transfer pricing method for commodity transactions and that, under the CUP method, the arm's length price for the controlled commodity transaction can be determined, not only by reference to comparable uncontrolled transactions, but also by reference to a quoted price.

9. This proposal is grounded on the fact that for transactions involving the sale or purchase of commodities with a quoted price, such quoted price will generally provide evidence (taking into account any comparability adjustments needed) of whether or not the price agreed in the controlled transaction is arm's length. Quoted prices are not set by a single individual or entity (except in the case of governmental price control), as they are the result of the interaction of supply and demand in the market for a certain quantity of a type of product at a specific point in time. Quoted prices for

commodities can be obtained from the transparent markets trading in commodities (e.g. London Metal Exchange, Chicago Board of Trade, Tokyo Grain Exchange) or from price reporting agencies¹ (e.g. Platts, Argus or Bloomberg). In addition, there is considerable evidence that quoted prices are used as benchmarks or markers to price commodities in transactions between unrelated parties.

10. Where a quoted price is available for a commodity, and the terms and conditions of that comparable uncontrolled transaction are comparable to those of the controlled transaction, the quoted price may provide a reliable CUP. Where there are differences that have a material effect between the terms and conditions of the controlled transaction and the uncontrolled transaction represented by the quoted price, adjustments should be made to improve the reliability of the analysis. For this purpose, taxpayers and tax administrations could take as a reference the standard specifications, on which the price of the commodity is based, used in commodity markets and by price setting agencies.

11. The current Transfer Pricing Guidelines already indicate that the CUP method is an appropriate transfer pricing method to determine the price for commodity transactions. Indeed, paragraph 1.9 of the Transfer Pricing Guidelines acknowledges that the arm's length principle has been found to work effectively in many cases involving the purchase and sale of commodities where an arm's length price may readily be found in a comparable transaction undertaken by independent enterprises under comparable circumstances. Furthermore, the guidance in Chapter II on the CUP method is illustrated by an example where the CUP method is applied to determine the price for the sale of coffee beans (see paragraph 2.18), where the controlled and uncontrolled transactions are comparable (e.g. product features, trading and delivery terms) and occur in comparable circumstances (e.g. same stage in the production/distribution chain).

12. The following guidance is proposed to be inserted after existing paragraph 2.16 in Section B in Chapter II of the Transfer Pricing Guidelines:

1. The CUP method can be an appropriate transfer pricing method for establishing the arm's length price for the transfer between associated enterprises of commodities for which a quoted or public price is available ("quoted price"), subject to the conditions of the controlled transaction and the conditions of the quoted prices being comparable. The reference to "commodities" shall be understood to encompass physical products for which a quoted price is used by independent parties in the industry to set prices in uncontrolled transactions.
2. Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognized and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used by unrelated parties to determine prices in transactions between them. Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type and amount of commodity, traded under specific conditions at a certain point in time. A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction.

¹ These agencies assess prices for physical commodities. Usually, they do not participate, directly or indirectly, in the traditional financial markets. They generate their own proprietary price assessment by using transactional data and publicly available data such as future settlements in conformance with their published methodologies.

Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated enterprises.

3. For the CUP method to be reliably applied to commodity transactions, the commodity being transferred in the controlled transaction and the commodity in the uncontrolled transactions or in the comparable uncontrolled arrangements represented by the quoted price need to be similar, in terms of the physical features and quality of the commodity. In addition, the contractual terms of the controlled transaction should also be considered, such as volumes traded and the timing and terms of delivery. If the quoted price is used as a reference for determining the arm's length price, the standardised contracts which stipulate specifications on the basis of which commodities are traded in the market and which result in a quoted price for the commodity may be relevant. Where there are differences between the conditions of the controlled transaction and the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are sufficiently similar. Such differences can be related, for instance, to different specificities of the commodity (e.g. premiums for quality or availability of the commodity), different processing functions performed or required, or additional costs incurred for transportation, insurance or foreign currency terms. Consideration should also be paid to how unrelated parties use the quoted price as a reference price and make adjustments to reflect the position in the supply chain of the parties to the transaction.
4. In order to assist tax authorities in conducting an informed examination of the taxpayer's transfer pricing practices, associated enterprises should document in writing, and include as part of their transfer pricing documentation, the price-setting policy for commodity transactions as well as any other relevant information related to the pricing of the commodity (e.g. pricing formulas used)."

B) *Deemed pricing date for commodity transactions*

13. Many transactions involving commodities involve physical delivery at a future date, although there can be circumstances when commodities are sold for immediate delivery (and may attract a premium over the quoted price). As a result there can be a significant period of time between entering into the contract and taking delivery of the goods. In that time, the quoted price of the commodity can fluctuate. There is considerable evidence that commodity transactions generally tend to be priced by reference to the quoted price within a quotation time period close to the time of shipment. However, options for fixing the price at different periods can be built into the contract (and priced at the outset), depending on the circumstances and risk appetite of the parties.

14. One of the challenges faced by tax administrations is the ability to verify the pricing date. To this aim, the following guidance proposes to introduce a "deemed pricing date" for commodity transactions in the absence of reliable evidence of the pricing date actually agreed by the associated enterprises in the controlled commodity transaction. The term "pricing date" refers to the specific date or time period selected (e.g. a specified range of dates over which an average price is determined) by the parties to determine the price for the commodity transactions. The proposed guidance deems the pricing date to be the quoted price, incorporating any comparability adjustments, on the shipment date as evidenced by the bill of lading or equivalent documents.

15. The following guidance is proposed to be inserted in Section B in Chapter II of the Transfer Pricing Guidelines, following the suggested text in paragraph 12 of this Discussion Draft:

5. “A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for the commodity transactions. Where the taxpayer can provide reliable evidence of the actual pricing date agreed by the associated enterprises in the controlled commodity transaction, tax administrations should take the actual pricing date as a reference to determine the price for the commodity transaction. If the pricing date actually agreed by the associated enterprises is inconsistent with other facts of the case, the tax administrations may impute an actual pricing date consistent with the evidence provided by those other facts of the case (taking into consideration industry practices). In the absence of reliable evidence of the actual pricing date agreed by the associated enterprises, tax administrations may deem the pricing date for the commodity transaction to be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport. This would mean that the price for the commodities being transacted would be determined by reference to the quoted price on the shipment date, subject to any appropriate comparability adjustments. Furthermore, it is essential to permit resolution of cases of double taxation arising from application of the deemed pricing date through the mutual agreement process.”

C) *Potential additional guidance on comparability adjustments to the quoted price*

16. Where pricing of commodities is based on adjustments or differentials from a quoted price, it is understood that those adjustments or differentials may take into account physical differences in the product, different specifications required, freight, any further processing costs, and other features of the particular transaction. In some cases these adjustments or differentials are themselves based on information and costings which are transparent or standard in the industry.

17. Where pricing formulas rely on transparent or industry standard information, it would be helpful for tax administrations to be aware of such information when considering comparability adjustments. Respondents are, therefore, invited to provide information about the common adjustments or differentials applied to the quoted price and the sources of information used to determine such adjustments or differentials, and to indicate their interest in further consultation on issues related to this proposal.