SPOTLIGHT ON COMMODITY TRANSFER PRICING

May 2019

On 24 May 2019, Inland Revenue Authority of Singapore ("IRAS") released new transfer pricing guidance for businesses engaged in commodity marketing/ trading activities in Singapore in the form of an e-tax guide titled "Transfer Pricing Guidelines, Special Topic – Commodity Marketing and Trading Activities (First Edition)". This guidance is an extension of the Singapore Transfer Pricing Guidelines (Fifth Edition) issued on 23 February 2018.

Key features of the guidance include:

- Analyses of the commercial objectives of commodity marketing/trading entities and commercial considerations in setting up commodity marketing/ trading entities in Singapore
- Clarification of the existing guidance on how to analyse related party commodity transactions and the selection of most appropriate transfer pricing method to determine the arm's length transfer price for commodity marketing/trading activities
- Specification on the contents of a transfer pricing documentation for commodity marketing/trading entities in Singapore

In a nutshell

The guidance is generally in line with the guidance on commodity transactions issued by the Organisation for Economic Co-operation and Development ("OECD") in their discussion draft of 16 December 2014 (under Action 10 of the BEPS Project) and included thereafter within Chapter II of the 2017 OECD Transfer Pricing Guidelines.

At the onset, the guidance sets out that related party commodity transactions can take many forms and Singapore marketing/trading entities can be operating on a spectrum starting from limited service providers, to undertaking marketing functions, to simple buy-sell entities, to full-fledged traders adding entrepreneurial value. It is, therefore, fundamental to the transfer pricing analysis to delineate the actual related party transaction.

To this end, the guidance launches into a discussion on key features of the commodity industry and establishes the economically relevant characteristics of typical commodity transactions. It details functional analysis principles, including specific possible benefits and outcomes from commodity marketing/trading activities undertaken. The guidance then examines the risks specific to commodity transactions including ways to mitigate these risks, and importantly states that risks, as well as upside benefits and downside costs, need to be allocated to the entities which control those risks and have the financial capacity to assume them.

When selecting the most appropriate transfer pricing method to price a related party commodity transaction, the guidance states that both the availability of reliable, independent comparables and industry practices need to be considered. The guidance then delves into some detail on the use of the Comparable Uncontrolled Price ("CUP") method.

Use of the CUP Method

Considering the facts and circumstances of the case, where CUP method is the most appropriate transfer pricing method, the guidance states that the arm's length price can be determined, not only by reference to comparable third party transactions but also by reference to comparable third party arrangements represented by a

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quoted price. The term "quoted price" refers to the commodity price in the relevant period that is obtained from an international or domestic commodity exchange market. A quoted price also includes prices obtained from recognised and transparent price reporting, statistical agencies or from governmental price-setting agencies, where such sources are used as a reference by unrelated parties to determine prices.

For the CUP method to be reliably applied, the guidance emphasises that the economically relevant characteristics of the related party transactions and the third party transactions represented by the quoted price need to be comparable. The economically relevant characteristics that need to be considered to establish comparability include physical features and quality of the commodity and the contractual terms of the related party transaction. Specifically, when applying quoted price CUPs there must be a high degree of commodity comparability as prices of the commodity are dependent on the nature of commodity dealt in.

The guidance notes that when using quoted price to price the commodity transaction, the pricing date is a particularly relevant factor. The "pricing date" is defined as the specific time, date or time period selected by the parties to determine the price for the commodity. The taxpayer must ensure there is reliable evidence of the pricing date agreed in the related party transaction at the time the transaction is entered into and that this is consistent with the actual conduct of the parties. Reliable evidence of the pricing date is clarified to include proposals and acceptances, contracts or other documents setting out the terms of the transaction. The guidance warns that where the agreed pricing date is inconsistent with the actual conduct, tax authorities may deem a different pricing date.

Further, where comparable independent transactions produce a range of prices, the inter-quartile range can be used as the arm's length range (or in cases where all points in the range are equally reliable, the full range can be accepted as arm's length).

Notwithstanding the above, the guidance asserts that the commodity industry generally has complex inter-company structures and value chains, which can make the use of the CUP method inappropriate. Where there are adjustments made which undermine the reliability of the CUP method, it may be necessary to select another less direct method.

Transactional Net Margin Method ("TNMM")

The guidance limits the use of cost-based methods including TNMM with full cost mark-up as profit level indicator ('PLI") to cases where costs are a relevant indicator of the value of the commodity marketing/trading activities performed. It concedes that these methods may be appropriate to cases where the commodity marketing/trading activities comprise services that do not require significant specialised expertise, risks assumption or risk control functions; or where there are contract or toll manufacturing activities.

In the same vein, the guidance limits the use of TNMM with operating margin ("OM") as a PLI to cases where sales is a relevant indicator of the value of the functions performed by the commodity marketing/trading entity. It explicitly highlights that this method might be unreliable if the commodity marketing/trading entity makes valuable contributions from its commodity trading with know-how generated from specialised expertise.

Other Methods

Unlike the Singapore Transfer Pricing Guidelines (Fifth Edition) which only explores the five transfer pricing methods (i.e. CUP method, Resale Price method, Cost-Plus method, TNMM and Profit Split method), the guidance introduces the possibility of using a sixth "other methods" to establish transfer prices. This is the first time that IRAS has acknowledged that other methods may be appropriate, to the extent that the commodity marketing/trading entity can explain and maintains proper transfer pricing documentation to substantiate the use of the other method.

Documentation Requirements

IRAS articulates in the guidance its expectations of what commodity marketing/trading entities should include in their transfer pricing documentation. We note that these expectations are generally in line with the prescriptive guidance in the Singapore Transfer Pricing Guidelines (Fifth Edition), but there is a clear emphasis on the need for more robust group value chain analysis, as well as thorough functional and risk analyses analysing and evidencing the assumption, management and control of risks. Where the CUP method is applied, due diligence must be conducted to establish comparability and supporting information must supplied, particularly where comparability adjustments are made.

Key Takeaways

There has been an increased focus by tax authorities around the world on transactions involving commodities, as evident from the earlier OECD guidance published. This is also the first time that the IRAS has issued industry-specific transfer pricing guidance and in such a detailed manner.

This reflects the vital role of Singapore as a commodity marketing/trading hub, and the importance for Singapore commodity marketing/trading entities to substantiate the function performed, assets used and risks assumed by them, to ensure that the transfer pricing for related party transactions are reflective of their contribution to the value creation of the group.

Global businesses will want to evaluate their transfer pricing policy for commodities, the comprehensiveness of their related documentation, and their preparedness to respond to IRAS queries for specific information supporting the pricing of commodity transactions.

BDO Tax Advisory Pte Ltd will be hosting a seminar in July that will provide a comprehensive review of the new guidance and what it means for Singapore commodity marketing/trading entities. Watch this space.

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