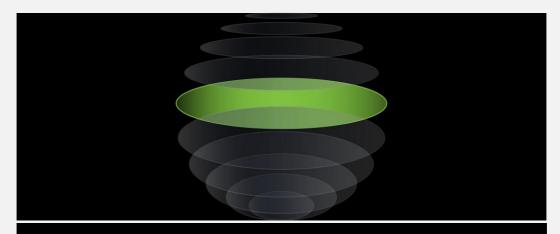
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Singapore Transfer Pricing developments— TP guidelines on commodity marketing and trading activities Confidence to think ahead

## **Background**

On 24 May 2019, the Inland Revenue Authority of Singapore (IRAS) released its transfer pricing guidelines for taxpayers engaged in commodity marketing/trading activities. This is through a new e-tax guide entitled "Transfer Pricing Guidelines: Special Topic – Commodity Marketing and Trading Activities (First Edition)", which supplements the Singapore Transfer Pricing Guidelines (Fifth Edition) issued on 23 February 2018.

This new e-tax guide analyses the economic value of taxpayers' commodity marketing and trading activities in Singapore and aims to help taxpayers comply with the arm's length principle and transfer pricing documentation requirements.

# **Key highlights**

The e-tax guide sets the scene by citing Singapore's well-established history as a trading nation and its role as a leading hub for international commodity trade today. It recaps the typical reasons of multinational enterprises (MNEs) for establishing their commodity marketing/trading entities in Singapore—mainly due to Singapore's strategic location, infrastructure, talent pool, and excellent business climate.

Transactions and activities of these commodity marketing/trading entities can take different forms (from support service providers, marketing agents, buy-sell entities, through to full risk-taking entrepreneurs) that are intended to

support the commercial objectives of their respective businesses. As such, the e-tax guide emphasises that the functional profile of a commodity marketing/trading entity is dependent on the actual nature of the commodity marketing/trading activities it performs (taking into account assets used and risks assumed), which in turn defines its contribution to value and the corresponding remuneration.

# Importance of comparability and functional analysis

The e-tax guide acknowledges that commodity marketing and trading activities involve not only buying and selling commodities, but a wide spectrum of other activities such as sourcing, gathering real time market intelligence, managing logistics, sales and marketing, storage, and managing risks and cash flows, etc. Accordingly, it is vital for the transfer pricing analysis to delineate the actual related party transaction, which necessitates understanding the dynamics of the industry and establishing the economically relevant characteristics of the particular transaction.

For such exercise, the e-tax guide provides examples on the typical functions and roles of commodity marketing/trading entities, including considerations on decision-making capabilities and required specialised expertise. It also provides examples of possible outcomes to illustrate the contribution of these entities from undertaking such activities.

The e-tax guide further provides a comprehensive list of the types of risks relevant to commodity transactions and ways to mitigate them. It then highlights that in order to assume a risk (and receive the upside benefits or incur the downside costs), the party must be able to control the risk and has the financial capacity to assume the risk.

Taking title to a commodity alone is not a sufficient differentiator to determine the overall functional profile of a commodity marketing/trading entity—an entity could create significant economic value even though it does not take title to the commodity, and an entity taking "flash title" is not indicative of limited functions and risks.

The e-tax guide also clarifies that the contribution to value creation is not based on the number of functions performed; instead, it is the economic significance of those functions in terms of frequency, nature, and value to the respective parties to the transaction that is important.

## Pricing actual related party commodity transactions

The e-tax guide is generally in line with Chapter II of the 2017 Organisation for Economic Co-operation and Development (OECD) Transfer Guidelines with regards to the transfer pricing approach for commodity transactions.

When selecting the most appropriate method to price a related party commodity transaction, besides the availability of reliable independent comparables, it is essential to consider industry practices as they provide indications of what

independent parties would have agreed under comparable circumstances.

A commodity marketing/trading entity should not always be assumed as the tested party. If the functional analysis of the actual related party commodity transaction indicates that the related party with which the commodity marketing/trading entity transacts has less complex functional profile, the related party could be the tested party.

In testing the results of the tested party, the e-tax guide provides lengthy discussion with examples on the application of each of the five methods as listed in the Singapore Transfer Pricing Guidelines (Fifth Edition). It delves into some detail on the application of comparable uncontrolled price (CUP) method and transactional net margin method (TNMM), and briefly discusses the rest of the other methods.

# Comparable uncontrolled price (CUP) method

Where the CUP method is the most appropriate method based on the facts and circumstances of the case, the arm's length price for a related party commodity transaction may be determined by reference to comparable independent party transactions or comparable independent party arrangements represented by the "quoted price". The term "quoted price" refers to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market, or from recognised and transparent price reporting or statistical agencies, independent brokers or from governmental price-setting agencies, where such indexes are used as a reference by independent parties to determine prices.

A high degree of comparability is required between the economically relevant characteristics of the related party commodity transaction and the independent party transactions or the quoted price CUPs. These would include physical features and quality of the commodity, and the contractual terms of the related party commodity transaction. In addition, a particularly relevant factor when using the quoted price is the pricing date (i.e., the specific time, date or time period selected by the related parties to determine the price for the commodity) and the availability of reliable evidence to support the pricing date.

In the absence of reliable evidence of the agreed pricing date or the agreed pricing date is inconsistent with actual conduct of the parties, there could be a risk of double taxation arising from tax administrations deeming the pricing date for the related party commodity transaction on the basis of the evidence available to the respective tax administrations.

Where the comparable independent party transactions produce a range of prices, the inter-quartile range (or the full range when all the points in the range are equally reliable) established from the comparable transactions could be used as the arm's length price range. The e-tax guide highlighted that it may be difficult to find transactions between independent parties that are similar enough to the related party commodity transaction as they are usually highly confidential and are not publicly available. The commodity industry also generally involves complex intercompany structures and value chains that can make the use of the CUP method inappropriate. In such situations or when reliable adjustments to the CUPs cannot be made without affecting their reliability, it may be necessary to select another less direct method.

# TNMM using various profit level indicators (PLIs)

The e-tax guide acknowledges that cost-based transfer pricing methods including TNMM with full cost mark-up as PLI (and the Cost Plus method) are appropriate, where the commodity marketing/trading activities are services related, which do not require significant specialised expertise, risks assumption, or risk control functions relating to the commodity.

Along the same line, the e-tax guide identifies that the TNMM with Operating Margin (OM) as PLI may be appropriate where sales is a relevant indicator of the value of the functions performed by the commodity marketing/trading entity. However, this is unlikely to be an appropriate method to price valuable contributions and risk-taking entrepreneurial activities in relation to commodity trading. That said, the e-tax guide suggests that the TNMM with OM as PLI may provide a practical solution to otherwise difficult pricing problems when used sensibly with appropriate adjustments to comparable independent party transactions to account for differences.

The TNMM with Berry ratio or value-added cost mark-up as PLI relies on the presumption that the value of the functions performed is proportional to the operating expenses and not to sales, such as those under back-to-back trading arrangements where the entity is merely taking "flash title" and does not bear any risk or perform any value-added functions. In such a case, operating expenses may be a relevant indicator of the value of the commodity marketing/trading entity's functions performed.

Lastly, the e-tax guide mentions that return on asset can be an appropriate PLI in cases where assets (rather than costs or sales) are a better indicator of the value of the commodity marketing/trading activities carried out in a related party commodity transaction.

## Resale price and transactional profit split methods

Limited guidance is provided on the use of resale price and transactional profit split methods.

Resale price method is likely to be useful where the related party commodity transaction involves marketing operations and where independent parties performing comparable operations are remunerated by reference to sales values and earn a percentage discount (or resale price margin, or gross margin) from a sale price. For this purpose, the commission

rates available in comparable independent party contracts (i.e., CUPs) or internal comparables, or from external comparables obtained from commercial databases, may be considered as a reference for determining the appropriate percentage discount.

Transactional profit split methods may be appropriate for global trading of commodities. An example is where the commodity marketing/trading entity based in Singapore and its related commodity trading entities based overseas trade on commodities and arbitrage their positions through an integrated, single, global trading book where they work closely to optimise the global profitability, and share the assumption of economically significant risks. In this instance, traders' remuneration of both companies may be considered an appropriate profit splitting factor if it is directly linked to the profits (or losses) generated from commodity trading.

### Other methods

The e-tax guide introduces the possibility of using a sixth method, i.e., "other methods". If circumstances render another method, other than the above listed methods, to be more appropriate to establish the transfer price, the commodity marketing/trading entity may apply that method provided that the outcome satisfies the arm's length principle and that proper transfer pricing documentation is prepared. However, the IRAS clarifies that it may use any of the five methods or other reasonable basis to evaluate the appropriateness of the method applied by the commodity marketing/trading entity.

# Arm's length results and transfer pricing documentation

The e-tax guide confirms that the IRAS would not disregard a related party commodity transaction or replace it with an alternative transaction, unless the transaction is commercially irrational. It also reiterates some of the prescriptive requirements in the Singapore Transfer Pricing Guidelines (Fifth Edition) with emphasis on the IRAS' expectation for taxpayers to include certain information, including the value contribution of the commodity marketing/trading entity relative to the group value chain and reliable evidence supporting the management and control of risks. Where the CUP method is applied, sufficient information should be provided to establish comparability of independent party transactions or quoted price CUPs, and support any comparability adjustments made.

In the event that transfer pricing adjustments are made by the IRAS, such adjustments are subject to a surcharge of five percent regardless of whether there is tax payable on the adjustments. Failure to comply with the documentation requirements could result in a fine not exceeding S\$10,000.

## Avoiding and resolving transfer pricing dispute

The e-tax guide reminds taxpayers that when they suffer double taxation from adjustments made by the IRAS or a foreign tax authority on the transfer prices of related party commodity transactions, they can choose to resolve the issue through taking legal remedies in the jurisdiction in which the transfer pricing adjustments are made and/or requesting the IRAS to resolve the double taxation through the Mutual Agreement Procedure (MAP). Taxpayers may also choose to avoid transfer pricing disputes by applying for an Advance Pricing Arrangement (APA) for related party commodity transactions for future years.

# **Deloitte Singapore's views**

This e-tax guide is the first "special topic" to supplement the Singapore Transfer Pricing Guidelines, and likely signals more industry-focused or theme-based issuances by the IRAS on topics of interest to Singapore in future.

Selecting commodity trading as the first such "special topic" reflects the importance of this industry to Singapore's economy as a global trading hub, providing taxpayers operating in this industry with invaluable insights into the IRAS' views, technical positions, and requirements in examining commodity transactions and the associated activities.

It is of note that the e-tax guide reinforces a "substance" based approach to transfer pricing, which examines the "economic value" of the actual activities, as well as the need to demonstrate and provide evidence on the assumption and management of risks. It underscores the IRAS' position that it subscribes to the overarching principle that profits should be taxed where the real economic activities generating the profits are performed and where value is created, as articulated in the Singapore Transfer Pricing Guidelines (Fifth Edition). Though not explicit stated, the e-tax guide also somewhat demonstrates the confidence that most trading operations located in Singapore do have "substance", in terms of activities and the seniority of personnel with decision-making authorities.

The e-tax guide recognises that trading entities could be organised at varying depths of sophistication and their operations could be undertaken through different business models. However, given the complexity of the trading business, one potential unintended consequence of this e-tax guide may be the possibility of a rigid application by the IRAS, during the course of a transfer pricing audit, of the concepts in the illustrative examples provided in the e-tax guide. Certain "bespoke" cases would necessitate transfer pricing approaches that may differ from those provided in the illustrations.

Therefore, it would be paramount for a trading business to articulate its operations and the actual activities carried out in Singapore clearly in its transfer pricing documentation. In addition, with the substantial recent re-writes to the Singapore

Transfer Pricing Guidelines, the IRAS is moving towards a formal transfer pricing regime (as supposed to a practice based approach) where it seeks to enforce compliance by providing technical guidelines and impose penalties for non-compliance (i.e., surcharge and fine) and these are reiterated in this e-tax guide.

Overall, the issuance of this e-tax guide is a welcomed move, as additional insights and guidelines are provided to taxpayers to assist them to comply with the arm's length principle and Singapore's transfer pricing regime as well as documentation requirements. Accordingly, it is an opportune time for global businesses with commodity marketing/trading activities to evaluate their actual footprint in Singapore, revisit their transfer pricing approaches for their related party commodity transactions if necessary, and prepare robust transfer pricing documentation in the light of this new e-tax guide.

### **Contacts**

For more information on the above or any other matters, please contact either the listed contacts below, or any member of the <u>Singapore Tax & Legal team</u>.

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