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BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions

The OECD on 16 December 2014, released BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions. The document outlines Working Party Number 6’s considerations of transfer pricing issues that may arise from cross-border commodity transactions that may lead to base erosion and profit shifting.

The review is part of the Base Erosion and Profit Shifting (BEPS) Action Plan #10, which states 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.’”

In the discussion draft, Working Party Number 6 has proposed:

i. Insertion of additional guidance in Chapter II of the OECD’s transfer pricing guidelines related to the appropriateness and application of the comparable uncontrolled price (CUP) method to analyze related-party commodity transactions; and

ii. Research to be undertaken by the Tax and Development Program to identify common adjustments to quoted commodity prices to improve the reliability of quoted prices for use with the CUP method. The research will initially cover iron ore, copper, and gold.

The deadline for submitting comments on the discussion draft is 6 February 2015, and a public consultation regarding the discussion draft (and other topics) will be held 19-20 March. The deadline for completion of Action Item #10 is September 2015.

CUP Method

The OECD initiated its review of the transfer pricing issues related to related-party commodity (defined in the discussion draft as a “physical product for which a quoted price is used by independent parties to set prices”) transactions because countries have expressed concerns about base erosion and profit shifting from the following factors:

- The use of pricing date conventions that appear to enable 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.

In response to the above, the OECD has proposed clarifications and additional guidance to be included in the transfer pricing guidelines. Specifically, the discussion draft proposes that additional guidance be added to the existing language in Chapter II to the effect that:

- The CUP method can be an appropriate transfer pricing method for commodity transactions between associated enterprises for which a quoted or public price is available;

- Quoted or publicly available prices can be used under the CUP method as a reference to determine the arm's length price for the controlled commodity transaction; and

- 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 transacting parties.

The discussion draft notes various sources of "quoted prices." These include quotations from commodity exchanges, and from transparent price reporting or statistical agencies, or governmental price-setting agencies. Prices or indexes from reporting or statistical agencies may serve as a reference for an arm's length price if they are used by unrelated parties. Use of indexes as a reference for arm's length prices will likely require taxpayers to evaluate how indexes may be used, including how actual prices vary from the reference index in negotiating commodity transaction prices with unrelated parties. In addition, the use of indexes as arm's length benchmarks may broaden the pool of tangible goods that meet the definition of "commodity."

The discussion draft also provides various examples of adjustments that may be applied when applying the CUP method to related-party commodity transactions. Examples of such differences include: physical features and quality, volumes traded, timing and terms of delivery, different processing functions performed or required, transportation costs, insurance, and foreign currency terms. For emerging markets such as China, taxpayers may also need to consider adjustments for other factors such as import/export restrictions, limitation on currency and capital flow, and cross-border hedging, etc. If the CUP method becomes the default transfer pricing method to test related-party commodity transactions, taxpayers that support related-party commodity transactions with methods other than the CUP method may need to consider how results from their primary analysis may be reconciled with the results from the CUP method.

The discussion draft also proposes specific additions to the transfer pricing guidelines to address how dating of a transaction affects the selection of the comparable arm's length benchmark. Taxpayers that do not have clear policies or documentation of when prices are set should consider documenting (and implementing in practice) when a related-party transaction is priced to avoid the use of shipment date as the deemed date for pricing the transaction.

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