
# Transfer Pricing in Commodities

*An Analysis on Commodity Marketing and Trading Activities*

20 March 2020, Friday

*Facilitated by:*
Ms Adriana Calderon

Due to the depth of its trading market and its close proximity to key markets, Singapore has been the preferred location for commodity marketing and trading activities. Given the importance of the trading industry, IRAS released its first specialised e-Tax guide, covering transfer pricing (TP) for commodity traders engaged in marketing and trading activities. The e-Tax guide explains in detail the economic and commercial drivers for commodity trading in Singapore, including what Singapore has to offer as a prime destination for reasons other than tax.

Homing in on TP for commodity marketing and trading activities in Singapore, businesses should know that commodity marketing and trading activities involve a wide spectrum of activities, over and above the actual acquisition and sale of commodities. The crux of TP issues often lies with the functional analysis and characterisation of the commodity marketing and trading entity in Singapore.

"When comparing prices, bear in mind that indices indicate the price to the final customer and would be difficult to use for commodity marketing and trading entities that act as intermediary entities and do not sell to end customers," highlighted Adriana Calderon, Director, Transfer Pricing Solutions Asia, as she shared her insights at a recent Tax Excellence Decoded session by the Singapore Chartered Tax Professionals (formerly Singapore Institute of Accredited Tax Professionals).

## *Functional Analysis of Commodity Marketing and Trading Entities*

To better appreciate pertinent TP issues for commodity marketing and trading entities, it is useful to first understand their typical business models and the way they conduct their business. The functional profile of the entity is dependent on the nature of activities performed, taking into account the assets used and risks assumed, which in turn defines its contribution to value. Emphasis must be placed on the entity's decision-making capacity and capacity to exercise authority. The most common types of commodity traders in Singapore are:

1) Marketers/ Distributors responsible for selling commodities sourced from related parties to third parties;
2) Procurement entities responsible for sourcing commodities for a related party from third parties, and
3) Full-fledged traders that may operate as full risk-taking entrepreneurs.

### COMMERCIAL OBJECTIVES AND FUNCTIONS PERFORMED BY COMMODITY MARKETING AND TRADING ENTITIES

Commodity marketing and trading entities undertake a wide spectrum of activities with varying levels of intensity. Such commodity marketing and trading entities may adopt a variety of business models, whether as a service entity, an agent, a marketer, a distributor, or a full-fledged trader, depending on the type of commodities they deal with and their specific business needs.

A commodity marketing and trading entity may act as a service provider that gathers and provides market intelligence to a supplier, without assuming any risk relating to the commodity. It may also act as an agent on behalf of the supplier to develop and service a market by providing market intelligence, building up a customer base, managing customer relationships, negotiating with customers, and providing other services.

Alternatively, the commodity marketing and trading entity may take on the role of a marketer, handling freight and logistics, credit management, formulation of strategies and more, but without the obligation to buy and sell the commodity. Unlike the marketer, a commodity marketing and trading entity that acts as a distributor mainly focuses on the purchase and sale of commodities, bridging the gap between suppliers and customers. They may range from limited risk distributors (performing all sales and distribution functions and have limited risk profile) to full-fledged distributors (bearing the principal responsibility in transactions, including inventory risk and customer credit risk, and setting the price of transactions).

Finally, there are commodity marketing and trading entities that choose to act as full-fledged traders and engage in all activities – ranging from the purchase and trading of commodity, the central management for shipping, storage and risk management, to market maintenance for the commodity on its own account.

### Assets and Risks of Commodity Marketing and Trading

Besides taking into account the nature of the commodity marketing and trading activities an entity performs, it is also important to consider the assets used and risks assumed when determining the economic value created by the entity.

In considering the assets used to determine the arm's length price for Singapore TP purpose, it should be noted that the Inland Revenue Authority of Singapore (IRAS) is interested in not only tangible assets (such as warehouse and equipment) but also intangible assets (such as knowhow and customer relationships). In practice, the challenge is to price in such intangible assets due to the difficulties in finding reliable comparables.

In order to assume a risk for TP purpose, the commodity marketing and trading entity must be able to control the risk and has the financial capacity to assume the risk.

In determining the transfer price, consideration must be given to contribution made by the commodity marketing and trading entity to the overall value creation in the group supply chain. As value creation is based on the economic significance of the functions (and not simply on the number of functions performed), taking title to commodity alone is not sufficient to determine the overall function profile of the entity.

## *Transfer Pricing Methods*

Various TP methods may be used to price related party commodity transactions. The following five TP methods are set out in IRAS' e-Tax guide.

### Comparable Uncontrolled Price (CUP) Method

Under the CUP method, the arm's length price for commodities may be made in reference to either the comparable independent party transactions or the quoted price (which is the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market).

Care must be taken to ensure that the economically relevant characteristics of the transactions are comparable. For commodities, the economically relevant characteristics include physical features and quality of the commodity, and the contractual terms of the related party commodity transaction (such as volumes traded and the period of the arrangements).

When using a quoted price, talking to traders and operations personnel would be best in identifying the most relevant index to use. It should be noted that indices indicate the price to the final customer and as such, they are difficult to use when setting the price for commodity marketing and trading entities that act as intermediary entities and may not sell to end customers.

## RESALE PRICE METHOD

This method is appropriate where parties are remunerated by reference to sales values and earn a percentage discount (or resale price margin, or gross margin) from a sale price. Commodity marketing and trading entities that are involved in marketing operations, such as marketers or agents, may prefer to use this method. The resale price method may be applied by comparing gross margin of the commodity marketing and trading entity with internal or external comparables. Alternatively, the comparable independent commission rates can be used as a reference to determine the appropriate percentage discount.

## COST-PLUS METHOD

The cost-plus method is appropriate where costs are a relevant indicator of the value of the activities performed by the entity, such as in contract or toll manufacturing; its reliability is reduced considerably where the entity performs activities which contribute significant value. In the case of commodity marketing and trading entities, the use of the cost-plus method is mostly restricted to services which do not require significant specialised expertise, risks assumption, or risk control functions relating to the commodity. An example is market research services.

## PROFIT SPLIT METHOD

This method is generally appropriate where the commodity marketing and trading entity's interaction with its related parties and their contributions to the related party commodity transaction are highly interrelated and integrated. This method may be appropriate for global trading of commodities.

## TRANSACTIONAL NET MARGIN METHOD (TNMM)

TNMM compares the net profit earned by a taxpayer from a related party transaction with the net profit earned by independent parties in a comparable transaction. It requires the selection of a profit level indicator, and is the most commonly used TP method for entities involved in commodity marketing and trading.

The comparisons at the net profit level can be made on a single transaction, an aggregation of transactions or at the whole of entity level. When applying this method, there are various profit level indicators that can be used; care must be taken to select the appropriate indicator to ensure the appropriate profitability measure. Examples of profit level indicators are the operating margin, net cost-plus, Berry ratio and return on assets.

While selecting the appropriate TP method is key in pricing related party transactions, the biggest challenge is often in ensuring access to reliable data to support the appropriate TP method.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, brought participants through the intricacies of TP for commodity marketing and trading entities in Singapore.

## Final Tips

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared her tips on transfer pricing methods and their application.

Commodity trading and marketing entities may tend to focus on the gross profit (rather than the net profit) as industry practice. From a TP perspective, it would be advisable to monitor the net profit of the trader, as it would be hard to justify consistent losses arising from a low gross profit allocated to the commodity trader. Commodities trading and marketing entities should bear in mind whether gross profit allocation makes commercial sense from a net profit perspective. If compared with a third-party arrangement, it is unlikely that a third-party trader would be willing to accept a commission or gross profit that does not allow it to earn a net profit.

Please click here to rate this article.

Facilitator


**Ms Adriana Calderon**
Director
Transfer Pricing Solutions Asia
E: adriana@transferpricingsolutions.asia
T: +65 3158 5806


Felix Wong is Head of Tax, and Angelina Tan is Technical Specialist, Singapore Chartered Tax Professionals (formerly Singapore Institute of Accredited Tax Professionals). This article is based on SCTP's Tax Excellence Decoded session facilitated by Adriana Calderon, Director, Transfer Pricing Solutions Asia.

For more tax insights, please visit www.siatp.org.sg

This article is intended for general guidance only. It does not constitute professional advice and may not represent the views of Transfer Pricing Solutions Asia, the facilitator or the SCTP. While every effort has been made to ensure the information in this article is correct at time of publication, no responsibility for loss to any person acting or refraining from action as a result of reading this article or using any information in it can be accepted by Transfer Pricing Solutions Asia, the facilitator or the SCTP.

SCTP reserves the right to amend or replace this article at any time and undertake no obligation to update any of the information contained in this article or to correct any inaccuracies that may become apparent. Material in this document may be reproduced on the condition that it is reproduced accurately and not used in a misleading context or for the principal purpose of advertising or promoting a particular product or service or in any way that could imply that it is endorsed by Transfer Pricing Solutions Asia, the facilitator or the SCTP; and the copyright of SCTP is acknowledged.