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**Ref: OECD DISCUSSION DRAFT: TRANSFER PRICING ASPECTS OF CROSS-BORDER
COMMODITY TRANSACTIONS**

Dear Andrew,

BIAC thanks the OECD for the opportunity to provide comments on its three Discussion Drafts covering elements of Actions 8, 9 and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan issued on 16 & 18 December 2014 (the Discussion Drafts). We acknowledge and thank you for the huge amount of effort that you and others have put into these drafts.

There is no doubt that transfer pricing issues, along with deductible payments, lie at the heart of the BEPS project. Governments have expressed concerns about aggressive structures in certain contexts, lack of clear (or any) guidance in others, and the perceived inability of the fact-driven arm's length standard to deal with new situations in still others. BIAC agrees that all of these areas should be examined, and that the legitimate concerns of governments fully and swiftly addressed. However, BIAC also believes that the arm's length standard, properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to "real-world" economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, however, then we will see a further acceleration in a worrying trend already apparent in the transfer pricing audit practices of several countries, where a broad interpretation of "BEPS principles" is used to justify new unilateral theories, and the automatic application of non-arm's length approaches in routine situations.

So, elements of the proposed guidance in currently unclear areas such as risk or commodity transactions are greatly to be welcomed – but such guidance should build upon established concepts rather than upon new ones (such as, for example, "moral hazard"). Likewise, profit splits may well be appropriate in certain difficult cases – but the default position, nevertheless, should be application of the arm's length standard, with profit splits only being applied where the default position cannot be. Recharacterisation, or "special measures", which recast a contract or other legal arrangements from the form agreed by the parties into a new and different form, may be justified in egregious cases – but only when other alternatives, most particularly, the proper application of intercompany pricing principles, have been tried and failed. While it may sometimes be more time-consuming to run through a full functional analysis, than to move swiftly to a recharacterisation, such a functional analysis (the elements

of which are broadly agreed and widely understood) not only provides more commercial certainty for taxpayers, but also benefits governments because there will be fewer instances of double taxation as different countries seek to apply different rules with no commonly-agreed standards.

Finally, and as noted in my comments on Action 14, particularly if dispute resolution is not improved, then business may return to a more adversarial relationship with tax authorities and, especially in the complex area of Transfer Pricing, seek new ways to mitigate double taxation in the face of risk from ad hoc recharacterisations, and non-arm's length practices. A return to this type of cat and mouse game would be to neither the advantage of governments nor the vast majority of responsible, unaggressive taxpayers.

In each of our three sets of comments, we give much more detail on where we think the new proposals will eliminate BEPS-related issues, and/or provide new and helpful guidance. Likewise, in our comments we also present what we hope are constructive alternatives, where we disagree with proposals made in the three Discussion Drafts. To reiterate, however, while we acknowledge weaknesses and gaps in the current rules, and are supportive of moves to rectify both, we also strongly advocate that the arm's length standard, and the legal form adopted by taxpayers, remain the starting point – if not always the ending point – for dealing with the matters raised in Actions 8-10.

We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next several months.

Sincerely,



Will Morris
Chair
BIAC Tax Committee

BIAC Comments

1. BIAC supports the OECD's work on transfer pricing aspects of cross-border commodity transactions as a crucial issue that many MNEs face in their day-to-day business. Clarifications and guidelines in this regard are welcomed as a way to improve the understanding of commodity businesses and create a consistent framework and a methodical approach for analyzing commodity transactions. The approach should, however, not be overly simplistic to avoid solutions that are inconsistent with the arm's length principle. As we understand the Discussion Draft does not represent a consensus view, we encourage Member States to reach agreement to reduce double taxation on the topics described. Similarly, we encourage the OECD to engage with non-OECD members to obtain further commitment to a common approach.
2. Commodity markets are very complex and involve the participation of different key players in the supply chain until the product is delivered to the final consumer (e.g. producers, brokers, traders, marketers, distributors, etc.), with the traders performing a critical role based on the necessary assumption of a wide range of risks and functions inherent to international commodity trading transactions. Therefore, tax administrations' understanding of this critical role forms a core part of the transfer pricing discussion on commodities.
3. In relation to the OECD's broader work on Action 10, BIAC does not believe that services provided by a trader in relation to the supply chain should be considered "low value-adding" in nature, as per the definition and examples set out in the discussion draft entitled "*Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines relating to Low Value-Adding Intra-group Services*".
4. We believe that, if supported by a broad international consensus, further OECD guidance in this area under the arm's length principle, could and should replace local and fragmented approaches to analyzing cross-border transactions affecting commodities (e.g. the so-called 'sixth method', implemented with particularities in each jurisdiction where it has been adopted). Applying an internationally agreed pricing framework to such transactions should facilitate taxation according to value creation in addition to the avoidance of potential double taxation and mitigation of base erosion practices.
5. For industrialized markets, the pricing of commodity transactions is of a great importance, given their significance to the value chains of many MNEs and given the importance of the taxation of natural resources to certain countries. The proper valuation of transactions affecting commodities should result in appropriate taxation across the different jurisdictions. We note that such industries, countries and commodities can have very different characteristics, increasing the difficulty of applying specific rules or principles to all situations.
6. The CUP method would generally be the most appropriate transfer pricing method for commodity transactions to the extent the conditions for the comparability analysis are duly met, and assuming that reasonably accurate adjustments are admitted to ensure that the economically relevant characteristics of the transactions are sufficiently similar. It is therefore critical that tax administrations prove that those conditions are respected if they intend to impose the CUP method.

7. Under the CUP method, the arm's length price (or arm's length range since the same commodity may be quoted in the different commodity exchange markets with slightly different prices and/or the price of a commodity may change in a very short period of time in the same commodity exchange market) for the controlled commodity transaction can be determined, not only by reference to comparable uncontrolled transactions, but also by reference to a quoted price with its subsequent corresponding adjustments, if applicable. Accordingly, alternative methods should not be necessary given the specific characteristics of commodities (such as pricing methodologies) in transparent and standardized markets and where information is available and allow for a reasonable and fair analysis. Nevertheless, it is worth mentioning that the underlying principle should remain to apply "the most appropriate method" which will often be a CUP. However, in practice, in markets which are not highly liquid or where products are not standardized, it is often not feasible to reach an acceptable degree of comparability (e.g.: gas, LNG cargoes delivered in a closed area, power in poorly connected regions, etc.). In addition, for vertically integrated businesses, it is not uncommon to have a specific allocation of risks that makes the application of a CUP method difficult. In such cases transactional methods are often applied.
8. The use of quoted or publicly available prices, with appropriate adjustments, as a particular application of the CUP method, has been used for many years by industrial MNEs in order to determine the arm's length price of their related party commodity transactions. BIAC welcomes any initiative that facilitates agreement and standardization of the sources of information that should be used for the application of this approach. In this regard, we noted that the use of quoted prices is, in many cases, the most appropriate starting point for a transfer pricing analysis supplemented with discounts, premiums and other appropriate adjustments (e.g. remuneration for traders, distributor, marketers, transportation, etc.) to allow for comparability adjustments where required. It should also be noted that there can be different quotations for the same commodity in different commodity exchange markets. The number and the difficulties to realize those adjustments should however not be underestimated.
9. For many standardized commodities, it is common that prices agreed between independent parties are made up of a market reference plus or minus a premium or discount due to different factors such as quality, volumes, availability, etc. In these situations, the alignment of the related party transaction with the arm's length principle will rest not only on the market reference itself, but also on the additional elements. The market reference component usually represents by far the largest element of the actual price agreed.
10. Transactions involving commodities within a MNE can be established through (long-term) contracts where pricing formulas are applied for all transactions performed under the agreement. In such cases, for documentation purposes, once the pricing formula used is tested, all transactions conducted following that formula should be considered to be arm's length. However, for certain commodities, market practice would suggest that prices are agreed on a transactional basis, taking into account the spot market or forward market. That would mean no general formulas or policies would or should be applied to such transactions on a related party basis – instead, the transaction price will be established on a case by case basis looking at the market at the moment in time when the deal is closed (using quoted prices, similar transactions, etc. and building up

the final price as a market reference (for a given pricing period) plus a premium or discount to account for comparability adjustments). Industrial companies dealing with commodities perform several thousands of spot or forward transactions every year. Documenting compliance with the arm's length principle for each of these transactions is a substantial administrative burden. We believe that tax administrations and taxpayers should work to develop a more pragmatic approach to reduce the burden: for example, agreeing on the principle of using quoted prices supplemented with comparability adjustments, using sampling or selection methods to identify the most relevant transactions, etc.

11. In connection with the deemed pricing date for commodity transactions, no unequivocal answer can be provided to identify the best date to which the quoted price should be referenced; market practices vary depending on the commodities traded, geographic market, interests of the parties, circumstances of the transaction, etc. For example, for forward prices the relevant date is not the date of delivery (i.e. date where the commodity is put at the disposal of the buyer) but the trading date (i.e. date where the transaction is concluded).
12. BIAC requests the OECD to further clarify what constitutes "reliable evidence" and proposes that terms adopted by related parties should be the basis for the agreed pricing date. However, where no reliable evidence is available of the terms adopted or where the date is inconsistent with other facts of the case, tax administrations should have the burden of proof and should seek to gather the relevant facts of the commodity, the producer, its customers and the characteristics of the market in which the commodity is sold, in order to establish the pricing date that would be most appropriate from an arm's length perspective given market practices. The deemed pricing date should only be used as a method of last resort (i.e. an anti-abuse measure) in cases where the tax payer has failed to provide any reliable evidence.
13. Therefore, BIAC proposes that the terms adopted by related parties should be the basis for the agreed pricing date. The contractual arrangements between the parties involved should generally be sufficient to reliably evidence the agreed pricing date. Therefore, flexibility should be allowed in connection with the deemed pricing date proving that such date is aligned with their industry practice.
14. With regards to the selection of the index or exchange price to be used, it should be noted that there could be a number of indices for the same commodity observed in third party transactions, and thus, flexibility should be allowed by tax administrations as long as sufficient comparability is granted. This may include the different grade/quality of a particular index and a customer's preference for that grade/quality. For example, in the mining industry, Richards Bay Coal indices are for a lower grade coal that is attractive to a certain market, compared to Newcastle coal indices which has higher calorific values and lower ash and sulphur content which typically achieves a premium.
15. In conclusion, we support the direction of the OECD's work and we are willing to accept the OECD's invitation to provide further information on how commodity markets operate, the important role centralized marketing organizations play in the value chain and specifically how comparability adjustments are set. BIAC also believes that the

proposals described in the Discussion Draft (quoted price, date of shipment) should not be presented as presumptions that the taxpayer must rebut. This would shift the burden of proof to the taxpayers, and would reflect different principles to those used in the pricing of transactions between unrelated parties. A greater emphasis should be made on building tax authorities' knowledge and capacity in commodity industry practices to ensure the arm's length principle is consistently applied, rather than developing a rigid or restrictive set of conditions and guidance on applying quoted prices and pricing/sources of differentials as well as selection of pricing dates.