



cutting through complexity

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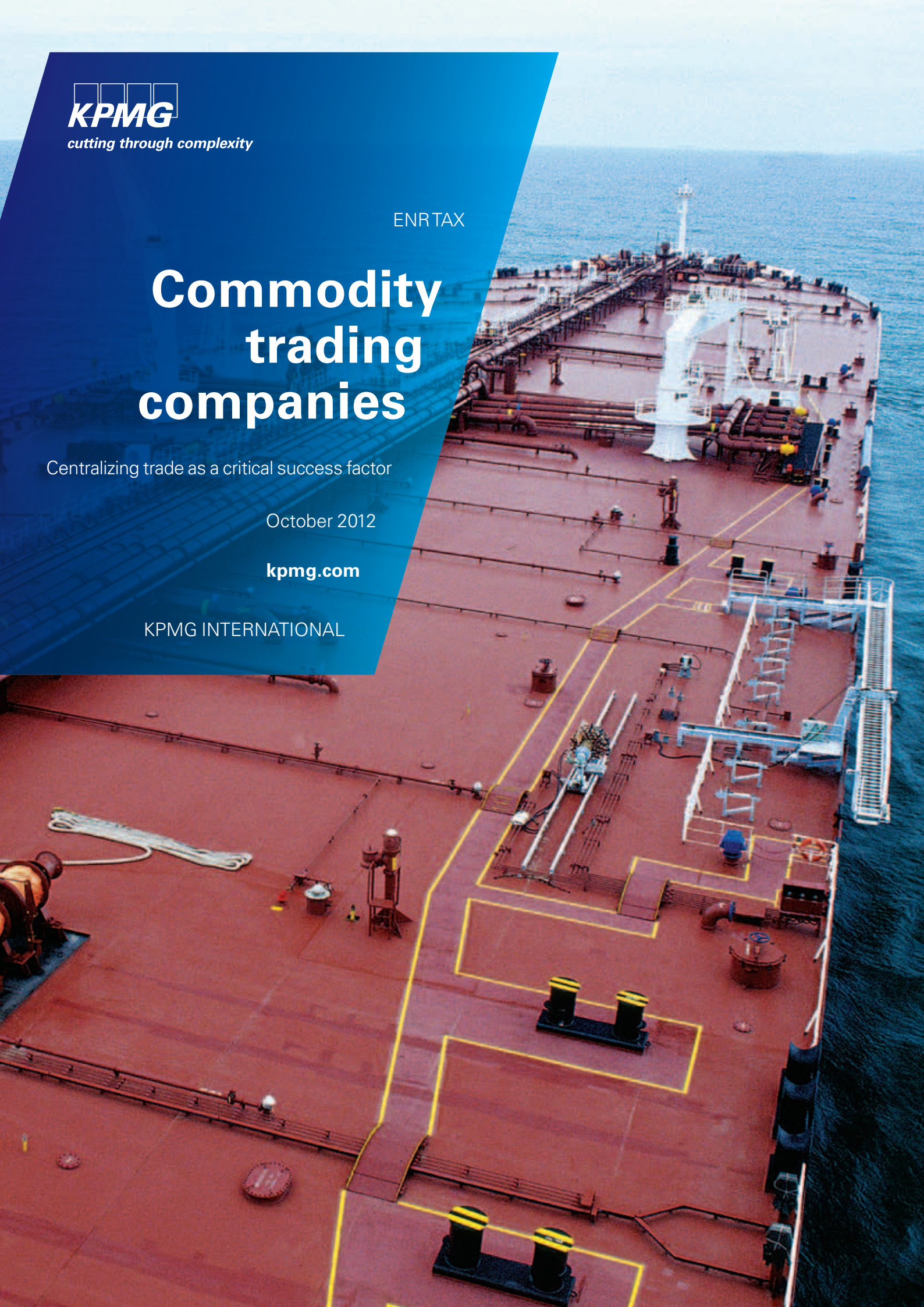
Commodity trading companies

Centralizing trade as a critical success factor

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Contents

01

Introduction

02

Key Findings

04

A Global Approach to Commodity Trading

Securing top margins while cutting costs	4
24/7 access to commodities markets and exchanges	5
Dynamic supply chain management	5
Cutting freight costs and improving logistics	6
Beyond supply chain trading	6

07

Locations Compared

Current destinations of choice	7
Other destinations	7
Potential future destinations	7

10

Managing Income Tax Issues

Substance-based challenges	11
Transfer pricing for related-party transactions	11
Transfer pricing issues on migrating functions and risks	12
Taxable presence	12
Tax implications of contractual arrangements	13
Treaty relief	13
Accounting issues	13

14

Managing Indirect Tax Issues

Rising audit activity puts pressure on VAT/GST management	14
VAT/GST differences heighten compliance risk	15
Managing VAT/GST through centralized teams	15
Customs risk and opportunities	16

18

Looking Ahead



Introduction

24-hour trading. Dynamic supply chain management. Logistical efficiency. Tax and investment incentives. The benefits of centralized commodity trading operations are clear, and many of the world's biggest oil and gas and mining majors have set up international trading structures to win competitive advantage.

With an international commodity trading company, a corporate group can manage its global trading and marketing activities within one or a few specialized entities, unifying trading operations and consolidating sources of supply. That way, they can better manage and meet customer demand while improving their profit margins at the same time.

From North America and Europe to the Middle East and Asia, a number of locations around the world have emerged as vibrant centers for this activity. By offering practical benefits and incentives, business-friendly policies, and sound financial infrastructures, many of these locations have actively sought to create the right conditions for commodity trading operations to thrive.

But wherever they are located, international trading companies face a world of risks. Given their complex supply chains and the scope of their activities, commodity trading companies must manage their way through an intricate web of cross-border income tax, value added tax (VAT) and customs issues. They also must be ready to defend their transactions and structures against growing aggression and heightened scrutiny on the part of some tax authorities.

In reviewing the potential benefits of establishing specialized commodity trading entities and in assessing existing structures, companies face a range of complex questions:

- What are the potential advantages of centralizing commodity trading operations?
- What factors are most important when deciding where to locate the operations?
- What are the tax risks involved, and what practical steps can be taken to reduce or eliminate them?
- Over the long term, how could the trend toward centralized trading affect the oil and gas and mining industries, and individual companies and markets?

To answer these questions, KPMG International sought the views of professionals from its member firms worldwide who specialize in international corporate tax, global VAT and customs, transfer pricing and tax-efficient supply chain management in the energy and natural resource industries. As their combined insights in following pages show, the trend to greater centralization of commodity trading is likely to continue, and companies that take up this model with a sound structure that addresses tax and business risk stand to reap substantial benefits.

Key Findings

An international commodity trading company is a distinct, specialized entity established to centrally manage trading activities and related functions for specific commodities in the oil and gas and mining industries. The advantages of centralized trading are numerous, and many locations in the world have arisen as important focus points for this activity.

To help energy and natural resources companies understand the substantial benefits and risk management issues involved in these complex operations, this publication distills the views of professionals from KPMG member firms worldwide who specialize in a range of global tax and advisory disciplines. Their most important observations and insights about the trend toward centralized commodity trading are set out in brief below.

What are the advantages of commodity trading companies?

- Centralizing trading and marketing activities in one or a few locations allows companies to consolidate sources of supply so they can better manage and meet customer demand.
- By managing global trading from a central location, a trading company is positioned to sell product into whatever market will fetch the top profit margin. These companies are well positioned to match supplies from multiple extraction points with the needs of customers in multiple markets.
- Even more efficiencies can be gained by setting up multiple trading companies in various time zones across the globe, allowing the group of companies to boost its margins with non-stop trading 24 hours a day.
- The ability to mix and match supplies from multiple sources also allows for greater supply chain stability, which can translate into higher trading margins.
- By swapping freight, companies can reduce their high haulage and control costs and improve logistics.

- In addition to supply chain trading, many commodity trading companies are taking on other types of transactions, ranging from proprietary trading to asset optimization, derivative market-making, arbitrage, and dynamic hedging of asset portfolios.

What factors should drive decisions over potential locations?

- Deciding where to locate an international trading company is a tactical and marketing decision. Tax costs are just one of a host of factors that companies need to consider.
- Preferred locations have investment-friendly government policies, strategic proximity to markets, and good financial services infrastructures.
- Countries that actively seek to provide this mix can gain substantial economic spin-off benefits from the activities of these entities. By doing so, for example, Switzerland and Singapore have succeeded in becoming two of the world's most popular destinations for international commodity trading activity.
- Other countries that are home to substantial numbers of these structures include the United Kingdom (London), the United States (Houston), Canada (Calgary), the Netherlands and Hong Kong. Brazil, Barbados and Dubai could emerge as destinations of choice in the future.

What income tax issues can arise?

- Like any global business, international trading companies and their parents need to manage a host of direct and indirect tax matters.

- If these entities are located in a jurisdiction that is different than the source of production, tax authorities will often take a closer look to determine:
 - whether the trading company's activities and functions added value to the business
 - whether it is reasonable for the operations to compensate that entity.
- As a first line of attack, many tax authorities around the globe would seek to challenge international trading companies under anti-avoidance rules based on a lack of business substance.
- Tax authorities may challenge transactions with international trading companies on the basis of their transfer prices.
- Other income tax issues can involve:
 - exit charges on moving functions and risks from one jurisdiction to another
 - the possibility that the trading activities may inadvertently create a taxable presence in a country, for income or indirect taxes, or both
 - the potential that a tax authority will seek to deny treaty benefits based on its position regarding beneficial ownership of the trading company's income
 - the impact of differences in the accounting and tax treatment of certain items.
- To guard against income tax challenges, a thorough tax risk exposure analysis should be conducted to anticipate and address all possible questions and alternative arguments so you can make sure all your bases are covered.

What indirect tax issues can arise?

- International trading companies tend to focus on income taxes and neglect the potentially high but less visible costs of other taxes. Nevertheless, these companies are likely to face more scrutiny of their indirect tax compliance and more aggressive audit activity.

“Centralization and cross-pollination with members of the banking sector is allowing pure energy producers and mining companies to take part in a more diverse range of financial activities.”

“Many of the world's major oil and gas and mining companies have already established international trading structures to gain competitive advantage, and the trend toward centralized trading is expected to continue.”

- Issues often arise due to differences among various VAT/ GST systems. Differences between European VAT systems are often overlooked. In countries like China and Korea, VAT systems are relatively new and quite different from European systems, heightening the risk of compliance errors and missteps.
- The largest commodity trading companies have global VAT management strategies and large indirect tax teams to manage their global VAT obligations and ensure appropriate processes are in place.
- With their dynamic supply chains, international commodity companies are also exposed to customs risk. International trading companies can optimize their customs costs by avoiding unnecessary customs charges and by taking part in simplified customs procedures and programs.

Looking ahead

- Many of the world's major oil and gas and mining companies have already established international trading structures to gain competitive advantage, and the trend toward centralized trading is expected to continue.
- National oil companies are also centralizing their trading activities in key international trading centers.
- As the majors consolidate their supply chains, downstream service companies are under pressure but have opportunities to diversify their activities.
- Centralization and cross-pollination with members of the banking sector is allowing pure energy producers and mining companies to take part in a more diverse range of financial activities.
- The greatest uncertainty of international trading companies is the specter of more stringent tax and trading regulation.
- Commodity prices will dictate the future of international trading companies. As long as commodity prices remain high, the trend toward centralization in favorable trading locations will continue.



A Global Approach to Commodity Trading

As oil and gas and mining markets grow ever more interconnected, some of the largest companies in the energy and natural resources sector are profiting by taking a more global approach to commodity trading. Centralizing trading and marketing activities in one or a few locations allows companies to consolidate sources of supply so they can better manage and meet customer demand. Around the world, many locations have attracted a critical mass of commodity trading companies and emerged as important hubs for global commodity trading.

In the past, commodities markets were more regional. Now, products that once could only be sold in New York or London can be offered in Asia and the Middle East. International commodity trading companies are sophisticated sales and marketing arms set up by many major oil and gas and mining companies that work to sell product to the highest bidder. By managing global trading from a central location, a trading company is positioned to sell product

into whatever market will fetch the top profit margin. Centralization makes it easier to re-route product when it is in transit to a new destination and to buy product of similar quality to re-distribute to the original location.

Securing top margins while cutting costs

Consider a simple example. Say a trader based in London has contracted to deliver crude oil to a customer in Spain, and a

tanker carrying the crude is en route from the North Sea. The trader then develops an opportunity to sell more crude oil at a higher price per barrel to a company in the United Kingdom. The trader diverts the tanker from the North Sea to meet the UK customer's need, and dispatches another tanker from the company's operations in Nigeria to fill the Spanish order.

Through such traditional techniques, the trader has increased the company's profits by getting the best market price while reducing its freight costs by changing the first tanker's destination in transit. Through centralized trading operations, companies are much better positioned to match supplies from multiple extraction points with the needs of customers in multiple markets in a perpetual process that ensures product gets sold at the highest-return delivery point.

24/7 access to commodities markets and exchanges

Companies can gain even more efficiencies by setting up multiple trading companies in various time zones across the globe. This way, companies can have one company assume the trading and supply management activities after another company's close of business as the world's commodities exchanges open and close, allowing the group of companies to boost its margins with non-stop trading 24 hours a day.

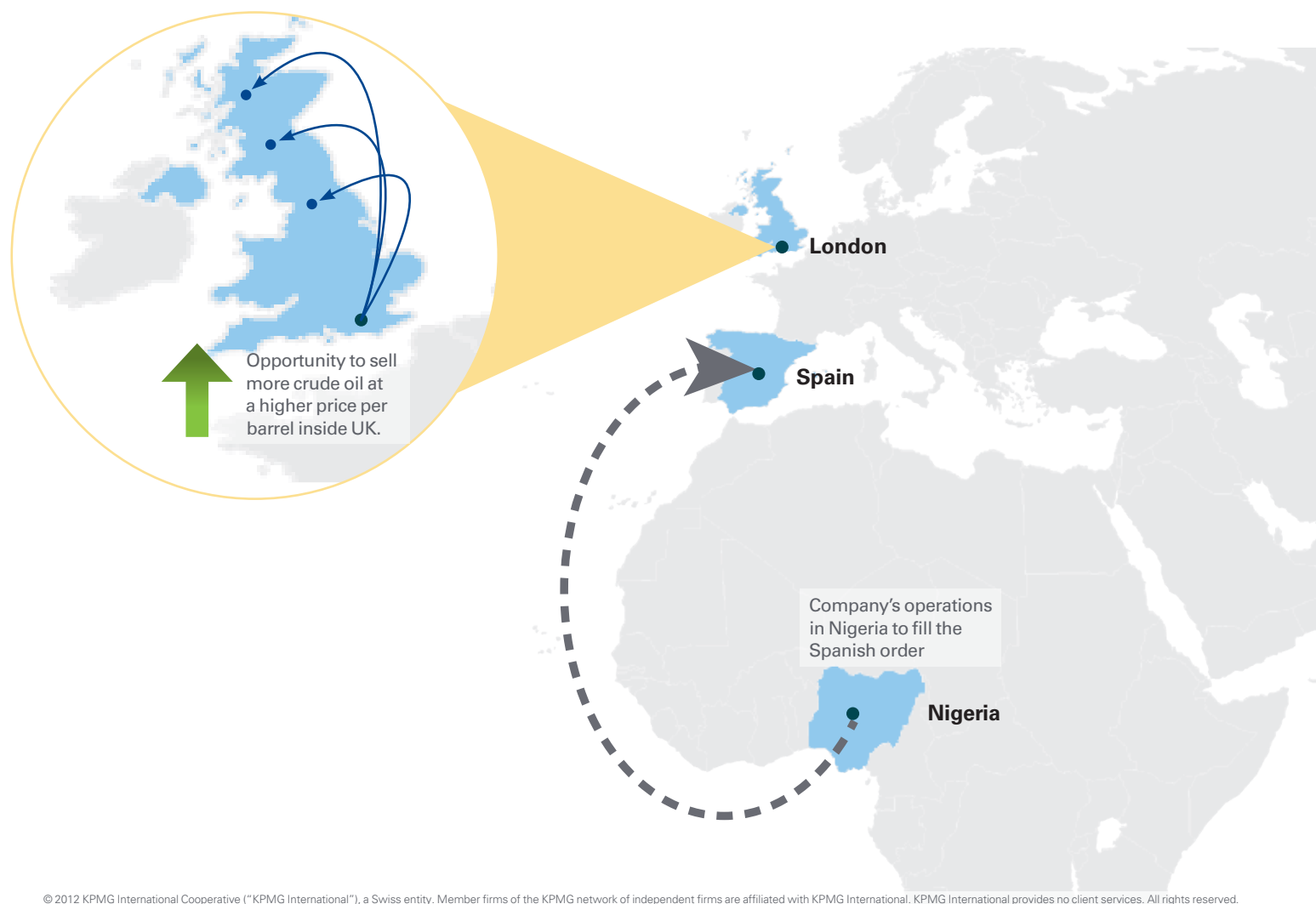
Some commodity trading structures have associated satellite offices. For example, a central company in Singapore could employ traders working out of locations in Dubai, Japan and

the United States. This strategy allows companies to benefit from centralization while retaining the competitive advantage that stems from the traders' local market knowledge.

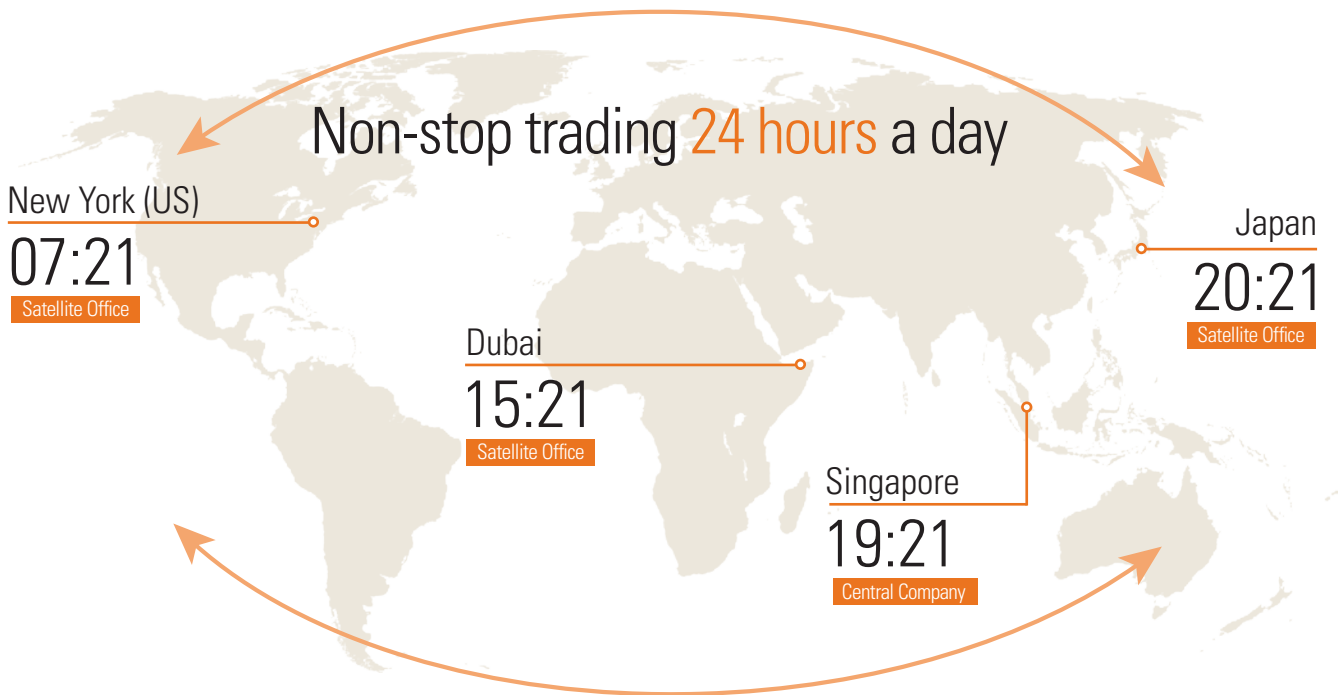
Dynamic supply chain management

The ability to mix and match supplies from multiple sources allows for greater supply chain stability, which can translate into higher trading margins. Most customers contract to receive commodities within a specific window of time as missed or late deliveries can disrupt their own production schedules. But it is difficult for a supplier to guarantee deliveries of commodities from one source. For example, mining operations are unpredictable and rarely hit their production targets. Extraction can halt unexpectedly due to cave-ins or closures for maintenance, losses can occur during transport due to the nature of certain products, and extreme weather can delay shipments en route.

If the supplier has only one product source and that source is not available to meet commitments to customers on time, then suppliers are forced to fill shortfalls by paying higher spot prices to secure product from alternative sources. Because international trading companies can supply customers with product from multiple supply points, they are able to anticipate and cover any product shortfalls more cost-effectively and offer more stable supplies.



Centralization in trading



Local Market Knowledge

Cutting freight costs and improving logistics

The ability to swap shipments of similar quality to recover the same price produces savings on transport costs. Because freight costs for commodities are so high, their rationalization through centralized trading is a significant benefit. This is especially true for generic products such as aluminum, iron ore and uranium. From a freight cost-management

perspective, the more generic the product, the bigger the pool and the greater the opportunity to improve margins.

By swapping freight, companies can reduce not only haulage and control costs, they can avoid demurrage costs by rerouting ships away from ports where loading or unloading may be delayed. They can also avoid stack-out losses on commodities that have a limited storage life.

Beyond supply chain trading

International trading companies in the oil and gas and mining industries generally conduct two types of trading:

- supply chain trading, in which traders work to meet customers needs with available supplies
- proprietary trading, in which traders play the commodities markets using their first-hand knowledge of supply and demand.

Other common trading techniques include asset optimization, derivative market-making, arbitrage and dynamic hedging of asset portfolios.

While supply chain trading is often a primary purpose of these structures, major players are increasing their proprietary trading activities. Their traders are uniquely positioned to understand the market and spot opportunities that might not be apparent from other vantage points.

“Through such traditional techniques, the trader has increased the company’s profits by getting the best market price while reducing its freight costs by changing the first tanker’s destination in transit.”



Locations Compared

Deciding where to locate an international trading company is a tactical and marketing decision. While there is a common misperception that tax planning considerations are the driving factor, tax costs are just one of a host of factors that companies need to consider in determining where to base their international trading activities.

Preferred locations have investment-friendly government policies, strategic proximity to markets, and good financial services infrastructures. Countries that get the mix right stand to gain substantial economic spin-off benefits from the activities of these entities.

Current destinations of choice

Switzerland and Singapore have succeeded in becoming the world's most popular destinations for international commodity trading activity. Both countries have actively courted this activity by setting fiscal policies and incentives that complement their existing positive attributes. It is expected that the number of international trading companies setting up shop in these countries will continue to rise.

Other destinations

Other countries that are home to substantial numbers of these structures include the United Kingdom (London), the United States (Houston), Canada (Calgary), the Netherlands and Hong Kong. These locations are historical destinations of

choice due to of their proximity to European, North American or Asian markets or production sources. The United Kingdom and Canada are also attractive due to their critical mass of local expertise in these sectors and opportunities to raise capital.

Each of these locations has a lot of momentum behind them, and currently established trading companies may have no compelling business reason to migrate elsewhere. However, unless these countries become more proactive in creating a more attractive environment, they may not attract substantial new trading operations going forward as other countries take specific action to attract these businesses.

Potential future destinations

Another set of countries could emerge as international trading hubs in the future – but only if they can improve in key areas, such as political stability, physical and financial infrastructure, and business-friendly tax and commercial policies. Dubai, Barbados and Brazil are among these countries.

What conditions are important for an international trading location? Factors to assess include:

- Business-friendly policies
- Proximity to multiple markets
- Attractive location and amenities for executives and personnel
- Skilled local workforce with understanding of the industry and ability to manage transactions
- Financial facilities for hedging and treasury functions
- Favorable, stable tax rules and administrative procedures, including a binding rulings process
- Networks of investment protection agreements and tax treaties that follow the OECD model and allow for withholding tax reductions
- Open trade policies and participation in free trade agreements
- Political stability
- Well developed legal and judicial system (e.g., for enforcing contracts)

International trading hubs

Calgary

- Center for capital-raising activities for investment in mining activities outside Canada
- Foreign affiliate taxation system allows for tax-free repatriation of foreign active business income, with opportunities to reduce or eliminate tax on income from trading activities in Canada
- Highly skilled talent pool and strong capital market
- Extensive networks of tax treaties and investment protection agreements, and an expanding network of free trade agreements
- Established commercial hub for this activity

Houston

- Access to North American markets and proximity to oil fields in Texas and Gulf of Mexico
- Sustainable track record as an international commodity trading location
- Sophisticated financial infrastructure and skilled workforce
- No personal taxes at the state and local levels
- Potential 40 percent effective tax rate and potential subpart F tax issues

Barbados

- Business-friendly environment and policies designed to attract foreign investment
- Actively seeking to attract international commodity activities
- Expanding treaty network includes new agreements with a number of Central and South American and West African countries
- Barbados International Business Corporations (IBC) are not recognized in many of its treaties, and so Barbados might soon allow oil and gas and mining operations to operate in the country through regular Barbados companies (paying more tax than IBCs but less than in many other countries)

Brazil

- Leading financial center for Latin America
- Commodity-rich country with a rapidly growing economy
- Highly skilled talent pool
- Inwardly focused government policies and complex tax system create challenges



Current destinations



Historical destinations



Future destinations

United Kingdom

- Proximity to European markets and North Sea oil fields
- Leading financial center with a highly skilled workforce
- Attractive location for international employees
- Location of two domestic oil majors
- Tax rate is relatively high but it is possible that the rate could drop to 20 percent in future
- Very wide tax treaty network
- English language

Netherlands

- Proximity to European markets and North Sea oil fields
- 5–15 percent effective tax rate
- Sophisticated financial infrastructure and a skilled workforce
- Historical position and culture as a major trading nation

Switzerland

- Strategic location in Europe, well situated between American and Asian time zones
- Specialized financial service providers offer highly sophisticated financing and arbitrage products tailored to the specific needs of the commodity industry
- Effective statutory corporate income tax rates for commodity trading companies as low as 8 percent, with further reductions possible
- Financing activities might be taxed at an effective rate as low as 1 percent
- Binding advance tax rulings available, which are not time-limited
- Dividend income and capital gains on disposals of qualifying investments are tax-free
- Extensive network of tax treaties (close to 90) and investment protection agreements (over 100)
- VAT rate of 8 percent is by far the lowest in Europe
- Competitive personal income tax system
- Unrestricted access for citizens of the European Union to work in Switzerland
- Multilingual
- New trained and specialized workforce coming on the market each year through a Master in International Trading, Commodity Finance and Shipping program
- Building momentum as a hub for this activity

Dubai

- Strategic Middle East location and proximity to the Gulf oil fields
- Skilled workforce and fairly well developed financial sector
- Less attractive to some foreign workers than other international trading hubs
- Political stability in the region is uncertain

Singapore

- Strategic location in Asia
- Strong physical infrastructure for serving oil and gas businesses, with oil storage facilities, ports and shipping and government-run facilities for chemical and oil and gas processing
- Sophisticated financial infrastructure
- Simple, business-friendly tax system
- "Farm-to-table" approach to incentives, with incentives targeting all points in the supply chain
- "Global Trader Program" offers reduced tax rates of 5 or 10 percent to companies carrying on international trade in commodities, futures and derivatives
- Low personal tax rates – 20 percent top rate, reduced for individuals who do significant foreign business travel
- Open immigration policy that facilitates relocation of foreign talent to Singapore
- Extensive network of over 60 tax treaties
- Member of ASEAN free trade network; currently involved in free trade negotiations with European Union and five or six other countries

Hong Kong

- Strong financial services sector
- 0 percent tax rate on international trading that occurs entirely outside Hong Kong (raising issues in other jurisdictions, for example, with controlled foreign company regimes)
- Working to expand its treaty network
- No free trade agreements



Current destinations



Historical destinations



Future destinations



Managing Income Tax Issues

Like any global business, international trading companies and their parents need to manage a host of direct and indirect tax matters. If these entities are located in a jurisdiction that is different than the source of production, tax authorities will often take a closer look to determine whether the trading company's activities and functions added value to the business and whether it is reasonable for the operations to compensate that entity. As a result, those activities and functions should be supported by commercial reality and be properly documented. The tax considerations can be complex, and robust upfront planning is needed to ensure the structure's benefits can be sustained following a tax authority's review.

Substance-based challenges

Despite the many business benefits that international trading companies have to offer, tax authorities are often suspicious when companies move functions and risks to a central location, especially when that location imposes highly favorable tax rates. Tax authorities in many jurisdictions recognize the importance of centralizing certain functions for global multinationals. Other jurisdictions are suspicious of movements of profits associated with national resources. Because some tax authorities may view the transaction as somehow artificial or abusive, it is critical for international trading companies to be ready to defend against such challenges.

As a first line of attack, many tax authorities around the globe would seek to challenge international trading companies under anti-avoidance rules based on a lack of business substance. The number of employees providing value-adding services, the IT and accounting systems, physical facilities and level of commercial activity involved in most of these operations support the company's valid business purpose and substance. In Singapore, companies setting up trading entities are required to guarantee they will employ a certain number of workers or undertake a certain level of activities in order to access tax incentives. In many cases, these operations can be quite large, both in volume and number of employees.

To guard against substance-based challenges, documentation is crucial. International trading companies can reduce the potential for negative determinations by ensuring that planning documents are well organized and thorough and clearly identify the business rationale underlying the centralized structure. The structure should also be monitored continually to ensure that it is properly maintained and to ensure changes in legislation or the business environment do not affect the structure's ongoing viability.

Transfer pricing for related-party transactions

Tax authorities may challenge transactions with international trading companies on the basis of their transfer prices. In most countries, transfer pricing rules only apply to related party transactions but other countries' rules may apply more broadly. The entire business relationship must be considered in any event. Generally, under the Organisation for Economic

Cooperation and Development's (OECD) guidelines, which most countries follow, companies must be able to show that their intercompany prices approximate the prices that would be agreed on by unrelated parties. This entails detailed documentation to support the company's transfer pricing methods and practices.

Transfer pricing disputes are often about the allocation of profit, based on the amount of value added at each step along the supply chain – including financing, development, production, marketing and sales, transportation and delivery. Transfer prices should reflect the risks at each stage and be flexible enough (e.g., through gross-up clauses) to respond to changing circumstances, such as civil unrest, commodity price fluctuations or extreme weather events, which could change the allocation of risk among the parties involved.

In addition to arm's length terms, most tax authorities will consider the spot price for commodities in determining the price at which those commodities are sold to the trading company. The trading company's functions and risks must support whatever methodology is applied to the profits earned there, whether through a cost-plus approach or support for a price that varies from spot.

Given the complexity of this determination, many Latin American countries are introducing their own specific rules to protect the price at which their national resources leave the country. Brazil, for example, recently introduced rules that apply deemed profit margins for determining inter-company prices rather than the OECD's arm's length principle. The Brazilian legislation is moving toward a change that would consider the spot prices parameter based on international commodities exchanges or even on international independent index institutions. Other countries are aware of such practices, and some may follow suit, especially in Latin America.

Commodity trading companies can reduce their risk of a transfer pricing challenge by entering into advance pricing agreements (APA) with tax authorities. In the jurisdictions that offer them, APAs offer security that the tax authorities will accept the selected transfer pricing methodology to be used for related-party transactions over a fixed period of time. As a

Top ways to manage transfer pricing risk

- Develop a strong transfer pricing framework that meets the compliance needs of all relevant jurisdictions and to make sure it is properly implemented, documented and followed.
- Fully document your transfer pricing policies, including your choice of transfer pricing method and the inapplicability of other methods.
- Identify, quantify and document the value added and risks assumed at each stage of the supply chain.
- Be prepared to engage in tax disputes with local authorities, and develop your strategy for driving audits and disputes in advance.
- Gain more certainty that your transfer prices will be accepted by entering into an APA with the relevant tax authorities.

result, APAs can help give you more certainty that your supply chain operates as intended. While companies' experiences with tax authorities vary in terms of their flexibility in negotiating APAs, the situation in countries like Singapore is improving as tax authorities gain more experience and comfort with the process. Ultimately, it is most important to establish an APA in the jurisdiction from which the commodity is sold because that is the jurisdiction most likely to challenge the transfer price.

Transfer pricing issues on migrating functions and risks

Exit charges can be an issue when moving functions and risks from one jurisdiction to another. Most countries insist on compensation when goodwill or intangible value is moved out of the country. Establishing an international trading company often involves moving a part of the business that has value – which is, in effect, a sale of the business to a foreign party. Determining a reasonable value to assign to that business can be difficult, especially on an arm's length basis.

In 2010, the OECD formally incorporated business restructuring issues in its model transfer pricing guidelines. These guidelines effectively treat a wide range of non-tax business decisions as transfer pricing issues and would apply to most reorganizations involving the establishment of an international trading company.

Under the guidelines, business restructuring is defined to include, "the cross border re-deployment by a multinational enterprise of functions, assets and/or risks." In essence, a business restructuring can involve almost any substantive change in a business relationship, including:

- a change in the nature or scope of transactions among controlled entities
- a shift in the allocation of risks
- a change in the ownership of assets, including intangibles
- a change in responsibility for specific functions
- termination of the relationship.

"Global commodity traders need to manage the location where title passes careful to avoid creating unintended tax obligations as goods move from point to point along the supply chain."

Importantly, the OECD guidelines state that the arm's length principle should not apply differently in the case of restructuring than in other transfer pricing contexts.

The guidelines stress the importance of clearly defining the structure of the transaction in terms of functions, assets and risks both before and after restructuring, with appropriate arm's length comparables where available. Written agreements that specify these terms and conditions are recommended. Regarding financing arrangements, documentation should include an analysis showing that the interest payments are commercially realistic.

Taxable presence

International trading companies need to be alert to the possibility that their transactions may inadvertently create a taxable presence in a country, for income or indirect taxes, or both. The tax authorities in Greece, for example, are aggressively seeking to tax their share of global commodity activities, among other things, by targeting ex-ship transactions in which products are delivered aboard a ship in a specified country. In some countries, such as Peru, a foreign company can create a taxable presence merely by taking title to goods in the country. The level of business activity that creates a connection to a country varies substantially.

Global commodity traders need to manage the location where title passes careful to avoid creating unintended tax obligations as goods move from point to point along the supply chain.

Top ways to manage transfer pricing risk on restructuring

Organizations thinking about migrating their international commodity trading and other functions should consider – and document – how the arm's length standard applies in terms of:

- their initial structure
- their new structure
- the payments (if any) that would be expected at arm's length on converting from one structure to the other
- the implications (if any) of the prior structure and the nature of the restructuring for prices under the new structure.

Documentation – The front line of defense

Should tax authorities decide to challenge an international trading company's arrangements based on substance, ownership of the income, transfer prices or some other basis, appropriate strategies for response and compliance are critical. When dealing with tax authorities, you need to be well prepared, well organized and in complete control of your facts and issues. This means:

- understanding why transactions or tax positions were taken

- being able to explain the technical basis of your understanding
- being ready to back up your assertions through clear, comprehensive documentation.

When preparing documentation, consider your arguments from a tax auditors' standpoint. Undertake a thorough tax risk exposure analysis to anticipate and address all possible questions and alternative arguments so you can make sure all your bases

are covered. The analysis should also assess whether transactions and strategies are in line with the company's business goals and appetite for tax risk. Given increased cooperation among tax authorities, your analysis should address potential issues and responses in all countries in which you do business.

Tax implications of contractual arrangements

On establishing an international trading structure, the legal terms and conditions that govern the dealings between the parties in the supply chain should be arranged, taking into account the tax implications. Contracts differ significantly, and can produce a range of different tax issues, depending on how they are structured.

- If the arrangement is structured as a financing contract, then issues related to limitations on interest deductibility and withholding tax obligations can arise in the source country.
- If the arrangement involves royalty payments, payments can attract withholding taxes.
- If the contract is characterized as a purchase and sale, then VAT and/or customs issues may arise.

Most of these issues can be managed through proper planning, provided they are identified at the arrangement's outset.

Treaty relief

The character of payments made to the international trading company must be determined in the jurisdiction from which it is sourced. The determination is important for assessing not only whether the income results in business activity in that jurisdiction but also whether that income could be considered a royalty or interest. Cross-border royalties and interest are often subject to tax withholdings at its source, with possible relief under a treaty.

For both income and royalties, the owner of the income must be determined. For interest, concerns often arise as to whether the recipient of the income is the "owner" of

the income. In the case of royalties, concerns also arise over how the term "beneficial owner" is interpreted in the source jurisdiction. In many cases, ownership of income hinges on which party has use and enjoyment of the income – whether an intermediary (such as an international trading company) or the ultimate parent.

The term "beneficial owner," as used in the OECD model tax treaty, has given rise to different interpretations by courts and tax administrations. Tax authorities are increasingly using "beneficial owner" concepts to look through structures such as international trading companies and deny treaty benefits on dividends or to treat these entities as conduits for other sources of income where the intermediary essentially acts as an agent for the parent.

Because of risks of double taxation and non-taxation arising from these different interpretations, the Organisation for Economic Cooperation and Development (OECD) has issued a discussion draft proposing changes to its model tax treaty commentary. This is usually left to the source country to interpret, which can lead to additional uncertainty on assessing whether treaty relief is available.

Accounting issues

In addition to tax issues discussed earlier regarding the migration of a business, accounting issues can also arise. If a transaction is undertaken to move value out of the operating jurisdiction this may result in triggering a gain for tax but not for accounting. The implications to the vendor and the purchaser must be considered for both accounting and tax. Often with tax structuring, accounting is considered late in the process and may lead to surprises on the financial statements.



Managing Indirect Tax Issues

Indirect tax issues are often overlooked by international trading companies. In establishing operations, they tend to focus on income taxes and neglect the potentially high but less visible costs of other taxes. Value-added taxes and goods and services taxes (VAT/GST) are perceived as a cash flow problem, rather than as bottom-line costs. Traders tend to concentrate on making deals and managing indirect tax problems afterward.

Countries in Europe are seeking to increase their VAT revenues to help improve their finances, while countries in emerging markets are imposing lower income taxes to attract investors and making up the reduced revenues through higher indirect taxes. Around the world, corporate tax rates have been steadily falling for a decade, while VAT/GST systems have proliferated across the globe, rising to higher rates and applying to more items as indirect tax systems mature.

Rising audit activity puts pressure on VAT/GST management

International trading companies are likely to face more scrutiny of their indirect tax compliance and more aggressive audit activity. Given the high volumes of far-flung transactions undertaken by international trading companies, they are likely to encounter more pressure on their resources and cash flow as the focus on VAT/GST increases. Changing commercial circumstances and developing markets require

skillful management of indirect tax requirements. In contrast, an ineffective assessment of tax regulations in trade-related businesses can lead to ineffective supply chains and an increase of costs, eroding global competitiveness.

In the event of overpayments, the amount of time it can take to obtain refunds can be lengthy, causing tremendous cash flow problems. For example, Italy is notoriously slow at issuing VAT refunds, sometimes taking up to 3 years.

VAT/GST differences heighten compliance risk

For international trading companies, issues often arise due to differences among various VAT/GST systems. European VAT systems are relatively mature and European companies are mostly well acquainted with their obligations. Nevertheless, differences between European systems that are overlooked can lead to costly non-compliance. Beyond Europe, in countries like China and Korea, VAT systems are relatively new and quite different from European systems, heightening the risk of compliance errors and missteps.

Consider this example. In the trading sector, it is common to have chain of supplies involving companies registered for VAT in more than one country. On trading within the European Union, many companies assume that they are able to avoid multiple registrations by following the simplification measure for triangulation. However, other requirements

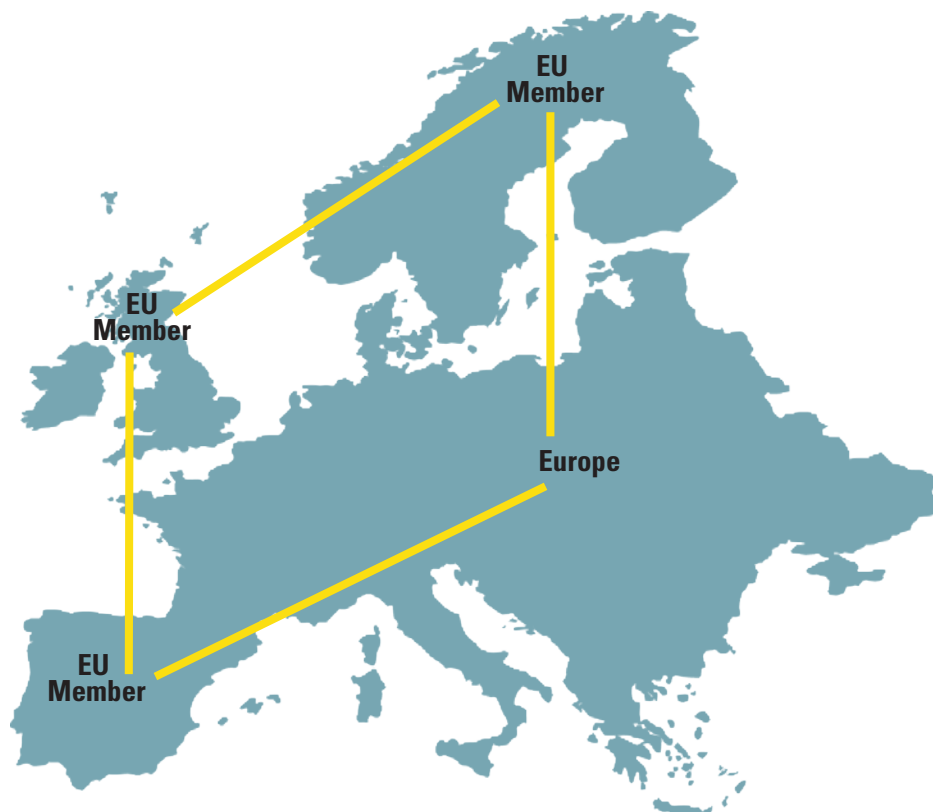
(e.g., administrative practices, special requirement based on national law) may make the transaction taxable for VAT purposes. For example, some EU member states refuse the application of the simplification measure for triangulations where the “middleman company” is also registered for VAT purposes in the EU member state of the selling company or of the buying company.

Managing VAT/GST through centralized teams

For international trading companies, it is important to have in place a global strategy for managing the company's worldwide VAT/GST risks and sufficient resources to implement that strategy. The biggest commodity trading companies have large indirect tax teams, employing 10–15 people to manage their global VAT obligations and ensure appropriate processes are in place. This team should have access to local professional advice in all relevant jurisdictions to identify and resolve VAT/GST compliance issues anywhere taxable transactions may occur.

It is also important to ensure open lines of communication between traders and VAT specialists to ensure traders can get quick answers on the VAT implications of proposed transactions. The activities of VAT and trading teams should be integrated to ensure that the company's VAT team has the opportunity to vet transactions before they take place.

VAT/GST triangulation in Europe



Top ways to manage VAT/GST obligations

- Ensure the trading and VAT/GST teams are well integrated and that processes are in place to ensure consideration of VAT/GST implications of commodity trading and related transactions.
- Seek local professional advice regarding the VAT/GST base and any available exemptions to ensure compliance and avoid added costs.
- Consider the level of symmetry among the VAT/GST systems in the countries covered by the international trading structure.
- Think about taking advantage of VAT/GST and/or customs compliance programs offered by the tax authorities.
- Look into outsourcing some or all of your regional or worldwide VAT/GST compliance to a single service provider to access economies of scale, specialized local knowledge and industry best practices.

Given the huge volumes of transactions that must be handled, a global, technology-based VAT/GST management platform can help the company's tax function reduce errors and increase tax savings. Through automation and standardization, the company also stands to gain better control over VAT issues arising in billing procedures, which create VAT obligations, and procurement processes, which create VAT recoveries.

Customs risk and opportunities

While more major international commodity companies are putting in place systems to gain more control over their VAT/GST compliance, they have yet to recognize how exposed their activities are to customs risk and bring the same level of resources to bear on customs issues. With greater focus on customs risks and opportunities, international trading companies can help ensure they are optimizing their customs costs by avoiding unnecessary customs charges and by making the most of simplified customs procedures and programs.

Value for customs

For example, when importing commodities into the European Union (EU) from foreign (non-EU) jurisdictions, commodities are cleared on the basis of "ad valorem." So, based on the EU customs code and General Agreement on Tariffs and Trade (GATT) provisions, the value for customs clearance purposes is the "transaction value," which is the price actually paid or payable for the commodities between vendor and buyer. When assessing the costs included in the customs value, however, certain non-dutiable elements may be carved out from the valuation criteria, for example, when commissions, warranty payments, or inland haulage are paid by the importer of record, resulting in an optimized cost basis.

Customs compliance programs

Within Europe and in other countries, a variety of customs programs are available that can significantly reduce supply chain costs and improve trading margins. Optimizing the benefits of these opportunities requires centralized planning combined with local knowledge of various customs compliance procedures and programs. As with VAT/GST,

companies can reduce risk and improve their bottom lines by putting in place central policies and processes for dealing with their customs issues.

The Authorized Economic Operator (AEO) program, available in the EU, the United States, Canada, Australia and other countries, is one of the most recent and important trade facilitation and control arrangements. The AEO system basically involves economic operators who can obtain different types of certification from the customs authorities according to their economic activities: certification for security issues, certification for simplification of customs procedure or a combined security/simplification certification. Benefits for successful applicants include easier admittance to customs simplifications, fewer physical and document-based controls and priority treatment if selected for customs inspection.

Additionally, EU's new Single Authorization for Simplified Procedures (SASP) opens the opportunity of utilizing local clearance procedures to perform customs formalities in the member state where businesses are established with movement of cargo in another member state, regardless of where imports and exports actually occur within the EU. Applicants who obtain AEO status may also apply for the SASP without carrying out any assessment of their business processes. SASP can allow companies to increase their trading flexibility and defer or suspend duty payment by entering commodities on an uncleared basis prior to final sales and import. SASP can offer significant operational advantages for businesses that are considering reorganizing their current supply chain, for example, by centralizing inventory locations and functions or altering product flows.

Customs warehousing schemes

Under an international convention, the EU, Switzerland and 76 other countries have agreed to adopt standard rules for customs procedures under which imported goods can be stored under customs control in a designated place (a private or public customs warehouse) without payment of import duties and taxes. Traders should be aware of some special rules that could affect VAT or other exemptions in warehouse procedures.

For example, the EU regulates two different warehousing schemes: the customs warehouse and the tax warehouse. The supply of goods to be placed under customs warehouse may be VAT-exempt, and the importation and supply of goods to be placed under tax warehouses enjoy suspension of excise duties while the goods are produced, processed, held, received or dispatched. Similarly, Switzerland has two separate schemes for customs and duty-free warehouses.

Considering that the oil products might be subject to VAT, excise duties and customs duties, traders of oil products should be aware of the different types of warehouse schemes. Commodities traders should also note that VAT is not normally levied on sales of foreign goods placed under customs warehouse since such transactions often occur before the goods are released for free circulation or cleared for import.

Excise and energy taxes on oil and gas products

Commodity traders should take special note of any excise or energy taxes that may apply to their products, along with related tax saving opportunities. Within the EU, the levels of taxation on energy products and electricity are regulated by the Energy Taxation Directive, but member states can directly provide exemptions or reductions through differentiated rates or refund mechanisms.

Traders of energy products, particularly oil and gas, should be aware of how their products are characterized under excise tax rules to ensure they are applying the correct excise duty rate. They should also reflect the cost of these taxes in their price to consumers and make the most of any possible tax exemptions or reductions.





Looking Ahead

Strategically, commercially and logistically, the benefits of international trading structures for global commodity trading are clear. Many of the world's major commodities producers already have well established centralized trading operations, and have gained significant competitive advantage.

As commodities trading continues to globalize, operations that focus on only one geographic region or that rely on point-to-point supply chains will have greater difficulty meeting customer demands. The higher margins that international trading companies can generate could force some smaller players out of the market.

Some national oil companies of smaller, resource-rich countries (e.g., Finland, Azerbaijan) that are seeking to expand are setting up international trading companies as entry points to international commodities markets. Oil producers from Gulf Cooperation Council states and former Soviet Union

members, which traditionally sold commodities through long-term contracts, are centralizing their sales and marketing arms to increase margins.

Meanwhile, centralization is allowing pure energy producers and mining companies to evolve from supply chain trading toward a more diverse range of financial activities, from hedging and proprietary trading to treasury functions. In Switzerland, banks and energy companies are developing highly sophisticated hedging products to protect their market positions, encouraging more divergence of banks into the commodity markets. Cross-pollination is encouraging a

“Although more companies are expected to establish new centralized trading operations, further centralization among existing structures may not be practical.”

mutually beneficial blending of the two industries as financial executives travel between the two industries.

As the majors move into more sophisticated trading activities and integrate downstream processes into their supply chains, downstream service companies, such as smelters and refineries, are feeling the squeeze. But as the large majors shift their focus upstream, there are opportunities for downstream companies to move in. For example, some companies in the smelting business are strengthening their position by buying mines and engaging in primary production.

Although more companies are expected to establish new centralized trading operations, further centralization among existing structures may not be practical. Beyond a certain point, centralization can cause a loss of geographic advantage in terms of time zones and proximity to commodities markets. As noted, a multiple trading company structure that allows 24-hour trading across time zones is emerging as a common practice among the largest commodities companies.

The greatest uncertainty for international trading structures is the specter of more stringent regulation. For example, the US Dodd-Frank Act represents a sea change for the way commodities are tracked, for the legal and capital structure of market participants, and potentially for the types of activities that traditional players are willing to continue doing in the future. At the same time, the world's tax authorities could

target international trading activities by imposing stronger legislative action to curb the use of these structures and gain a greater allocation of taxable profits, for example, through more prescriptive transfer pricing rules.

Additional risks arise for global commodity traders from the need to comply with economic sanctions. Economic sanctions are published at the international and national levels due to foreign policy and national security concerns. Targeted trade restrictions may be directed against nuclear proliferation, the oil and gas sector, and the financial sector. They may target certain persons and also specific countries or their governments (e.g., Iran, Sudan, North Korea). The measures prevent businesses from facilitating trade with these countries; violation of economic sanctions is a serious crime. A system of effective internal controls can help ensure successful trade compliance. Setting up a global trade management program that includes an economic sanctions chapter is essential for global commodity trading.

In the final analysis, commodity prices will dictate the future of international trading companies. As long as commodity prices remain high, the trend toward centralization in favorable trading locations will continue. But if the world's commodity prices experience a sustained decline, this business model may falter as companies with losses decide to keep more of their trading activities in higher tax locations.

Key trends

- Many of the world's major oil and gas and mining companies have established international trading structures to gain competitive advantage.
- National oil companies are increasingly centralizing their trading activities in key international trading centers.
- As the majors consolidate their supply chains, downstream service companies are under pressure but have opportunities to diversify their activities.
- Centralization and cross-pollination with members of the banking sector is allowing pure energy producers and mining companies to take part in a more diverse range of financial activities.
- Further centralization among existing trading structures may not be practical due to the loss of geographic advantage.
- The greatest uncertainty for international trading companies is the specter of more stringent tax and trading regulation.
- Commodity prices will dictate the future of international trading companies. As long as commodity prices remain high, the trend toward centralization in favorable trading locations will continue.

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