

# Commodity trading companies

Meeting the challenge of tax  
and regulatory change

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# Contents

01

## Introduction

02

## Key findings and insights

Commercial and regulatory pressures	2
Pressures from international tax reform	2
Positioning for post-BEPS success	3

04

## Commercial and regulatory pressure change the game

Tightening regulation squeezes out banks	4
Volatility in commodities prices	5
Geopolitical risks	5

06

## BEPS – Commodity trading structures under threat?

Tax authorities gaining new powers of reconstruction	7
Aligning value creation with location of profit	7
Returns on at-risk capital	8
Pricing for cross-border commodity transactions	9
Tax transparency and country-by-country reporting	9
Redefining permanent establishment	10
Structures under threat	10

12

## Winning in a post-BEPS world

Prepare for substance-based challenges	12
Monitor impacts on trading hub locations	13
Global commodity trading hubs – Impact of BEPS on locations of choice	14
Review your transfer pricing	16
Consider APAs to manage transfer pricing risk	16
Keep informed and get involved	16
Conduct a tax health check	16

17

## Contributors





# Introduction

For companies in the energy and natural resources (ENR) industry, regionally and globally centralized commodity trading companies offer tremendous competitive advantages. But sustaining these advantages is becoming increasingly difficult in the face of increasing regulation, changing market conditions and international tax reforms.

In the 2012 report, *Commodity trading companies: Centralizing trade as a critical success factor*, ENR tax and management consulting professionals with KPMG International's network of member firms explored the growing popularity of these centralized commodities trading entities and outlined their benefits and risks, commercially and from a tax perspective.

Since then, the global landscape for the oil, gas and mining industries and commodity trading entities has changed dramatically. Regulatory changes are taking hold, the direction of international tax reforms is becoming somewhat clearer, and the long-term impact of current pricing volatility, especially for crude oil is unknown – all of which make this an opportune time to take stock of the trends and developments that are transforming the commodity trading sector. To this end, we sought the views of KPMG ENR professionals around the world to answer these questions:

- How are commercial and regulatory pressures influencing commodity trading business models?

- What aspects of the global movement to address base erosion and profit shifting are creating the biggest tax risks for international commodity trading structures?
- How can commodity trading companies manage these risks and position themselves to thrive in the years to come?

The ENR team's combined insights are distilled in the following pages. We also highlight the collective views of international ENR tax executives who took part in an informal poll conducted by KPMG International in 2014.

As the following discussions show, global companies can continue to reap substantial benefits from their centralized commodity trading operations – but their success depends on their ability to navigate and manage a dynamically changing global marketplace.



## Key findings and insights

### Commercial and regulatory pressures

- Rising regulation and commercial pressure are changing the market for ENR commodity traders, with significant effects on their commercial structures, trading strategies and profitability.
- With markets shifting for a number of commodities (e.g., coal, oil, gas and metals) to a position of oversupply and with off-take risk increasing, the role of centralized marketing and trading functions could become even more valuable.
- Major players are continuing to pursue greater vertical integration, consolidating and securing assets at all points in their supply chains.
- Changes to the regulatory environment in the United States and Europe, along with greater scrutiny from regulators, are leading some banks and market players to exit the sector. For those players remaining in the sector, their compliance programs – the processes by which an entity manages and monitors its trading activities with respect to laws, regulations, exchange rules and company policies – need to be increasingly central to their operating models.
- As some banks and other players vacate the sector, opportunities are opening for commodities traders to increase their paper trading, physical asset acquisitions and mergers and acquisitions (M&A) activity.
- Pricing volatility is generally a fact of life for commodity trading companies, but a sustained decline in commodity prices could significantly alter global markets. Some worry that an ongoing price war between OPEC nations and the United States could depress oil prices for an extended time period, impeding long-term investment in higher-cost oil production facilities.
- Due to economic sanctions arising from the current geopolitical situation, traders need to monitor and ensure that they are not dealing with sanctioned entities.

### Pressures from international tax reform

- The current wave of international tax reform is creating uncertainty over the tax position of existing business structures. In particular, the G20-OECD Action Plan on Base Erosion and Profit Shifting (BEPS) will create significant uncertainty in tax outcomes, which could lead to more tax disputes and threaten the effectiveness of existing commodity trading operating models.
- For commodity trading companies, the OECD's anti-BEPS initiative will have the biggest impact on transfer pricing. Among other things, it seems likely that the changes in OECD rules (and local tax amendments) will give tax authorities more powers to recharacterize transactions and reconstruct transfer prices based on their views of appropriate arms' length terms.
- The BEPS Action Plan targets situations where risks, and the resulting rewards, are not aligned with value-creating substance, that is, significant people functions. Rewards that previously would have flowed to value drivers such as physical or financial assets, which can be contractually owned by or allocated to certain group entities, may flow to key people functions post-BEPS. One potential result of this is that highly valuable contributions for commodity traders (i.e., access to physical assets and at-risk capital) may be overlooked when rewards are allocated.
- In a December 2014 discussion paper, the OECD proposed to amend its transfer pricing guidelines to address cross-border commodity transactions. The paper singles out commodity transactions as an area where BEPS occurs and proposes different (potentially non-arm's length) treatment for certain commodity transactions.
- For commodity trading companies, detailed country-by-country tax reporting could reveal unexpected profit flows and draw attention to those jurisdictions that receive large payments and have transactions with 'high-risk' (i.e., low-tax) jurisdictions.
- Changes to the OECD's definition of permanent establishment currently under debate are quite broad but lacking in detail, raising fears that changes to the way taxable presence is defined could have significant unintended consequences for commodity traders.

The Action Plan creates a risk that tax authorities may challenge returns allocated to intragroup financial capital or guarantees. Financial and counterparty guarantees are commonly used by trading businesses in arm's length situations, and their use should not be denied in an intragroup context.

### Positioning for post-BEPS success

- As we move into the new post-BEPS world, tax executives of ENR commodity trading companies should:
  - prepare to defend against substance-based challenges
  - monitor the impact of international tax changes on commodity trading operations in both OECD and non-OECD jurisdictions, particularly in Singapore, Switzerland and other popular trading hubs
  - review their approach to transfer pricing
  - consider advance pricing arrangements to reduce transfer pricing risk
  - keep informed about the OECD's ongoing work and raise concerns about any negative implications for businesses
  - conduct a comprehensive tax health check.
- In the final analysis, as long as the commodity trading company's business substance is real and well documented, its related-party pricing practices are sound and comprehensive tax compliance processes are followed, the company likely would continue to enjoy the financial benefits of their centralized trading operations in the post-BEPS era.





# Commercial and regulatory pressure change the game

Over the past two years, rising regulation and commercial pressure have continued to shape the market for ENR commodity traders, with significant effects on their commercial structures, trading strategies and profitability.

Our 2012 report identified a clear trend in the oil and gas and mining industries toward the greater centralization of commodity trading activity within international commodity trading companies to win competitive advantage. Through centralization, 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. This allows commodity trading companies to better manage and meet customer demand while improving their profit margins at the same time.

In the current market, the drive to centralize trading activities in order to better manage key issues relating to price and supply risk continues. With markets shifting for a number of commodities (e.g., coal, oil, gas and metals) to a position of oversupply and with off-take risk increasing, the role of centralized marketing and trading functions could become even more valuable.

Major players are continuing to pursue greater vertical integration, consolidating and securing assets at all points in their supply chains, from mines to smelters, pipelines and refineries, to warehouses and port facilities. Supply chain security is increasingly important in production sites that may be more vulnerable to political and financial instability, such as those in North Africa and Eastern Europe.

## **Tightening regulation squeezes out banks**

As many larger ENR companies continue to centralize and consolidate trading and other activities, changes to the regulatory environment in the United States and Europe, along with greater scrutiny from regulators<sup>1</sup>, are leading some banks and market players to exit the sector. For example:

- Under Basel III, banks are tightening access to financing in order to lower their trade-finance exposure, resulting in higher costs for trade-finance products and making it difficult

<sup>1</sup> See, for example, the US Senate report, Wall Street Bank Involvement with Physical Commodities, published in November 2014, which reports on hearings conducted as part of an ongoing investigation in this area by the US Permanent Subcommittee on Investigations.

for companies, especially high-risk producers, to raise investment through letters of credit and syndicated loans.

- US swap dealers have seen increasing cost pressures on their trading operating models as a result of the ongoing implementation of the Dodd-Frank Act.<sup>2</sup>
- To meet requirements under the European Market Infrastructure Regulations (EMIR) in effect from 2013, derivative traders have needed to upgrade their systems and processes and increase their working capital due to changes affecting clearing fees, margins and collateral.
- As the European Union's Markets in Financial Instruments Directive (MiFID) is phased in (starting in 2014) and as MiFID II is finalized, derivatives traders need to make and prepare for even more compliance upgrades to enable, for example, tracking of trading thresholds and position limits.
- The European Market Abuse Directive (MAD) and the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) both increase data tracking and reporting requirements. In particular, REMIT governs insider trading, or using inside information to acquire or dispose (or try to acquire or dispose) of wholesale energy products, within European gas and power markets, in which many commodity traders are active due to the volatility and liquidity of these markets.

In light of these requirements, many larger banks are divesting of commodity trading units, shedding physical assets and limiting their activities to transacting in derivatives with customers (whether hedging related or otherwise) rather than taking physical positions. As some banks exit the sector, opportunities are opening for non-bank commodity traders to increase their range of activities, along with their paper trading, physical asset acquisitions and mergers and acquisitions (M&A) activity.

### Volatility in commodities prices

Pricing volatility is generally a fact of life for commodity trading companies. Increased volatility may create more opportunities for the speculative traders. Producers and companies with significant physical positions generally prefer more stable prices that allow for the long-term planning that is often critical to developing new projects.

However, a sustained decline in commodity prices could significantly alter global markets – as shown by the recent plunge in oil prices. During the second half of 2014, Brent crude oil prices exited the safe harbors in the range of the 90-125 US dollars (USD) per barrel, where prices had stood for the past 4 years, tumbling to below USD50 per barrel in early 2015. The sudden price fall has put enormous strain on oil revenues and

capital expenditure budgets for oil and gas companies, causing the share prices of global oil majors and upstream companies to fall significantly.

The recent price fall will add further pressure to exploration budgets, as upstream players seek to reduce their exposure to high-risk prospects. The ability of some companies to service their debt in this market may also be affected by lower cash flows. Oil producers face a tricky dilemma in deciding whether to hedge at the current market rate or delay and potentially face the fallout from further declines.

However, investment opportunities remain for those with significant cash and debt capacity. For example, depending on their hedging strategies, oil-intensive users, such as airlines, can capitalize on the low price environment and secure long-term price protection.

Looking further ahead, some worry that an ongoing price war between the Organization of Petroleum Exporting Countries (OPEC) nations and the United States could depress oil prices even more. Many view OPEC's decision to maintain its production quota of 30 million barrels a day as an attempt to protect market share; a cut to production at a time when both the US and Russia are pumping at record levels, would in effect, relinquish market share to the US, therefore reducing OPEC's ability to influence prices in the future. OPEC has taken a gamble that low oil prices and high production costs will combine to curtail investment in oil production outside the Gulf region.

Since the beginning of 2015, the weak demand and supply fundamentals seen in the oil market has contributed to a steepening contango<sup>3</sup> along the forward curve of the West Texas Intermediate (WTI) and Brent contracts. In a contango market, traders are able to inject crude oil into storage and sell at an almost risk-free profit at a later date. In the past (e.g., 2009), trading companies have participated in 'storage' plays using a combination of onshore and offshore (vessel) storage to capitalize on this market phenomenon, something we expect to see in 2015.

### Geopolitical risks

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. Trade restrictions may be directed against nuclear proliferation, the oil and gas sector, and the financial sector. They may target certain persons or specific countries or their governments (e.g., Iran, Sudan, Russia, and North Korea). The measures prevent businesses from facilitating trade with these entities; violation of economic sanctions is a serious crime. A system of effective internal controls can help ensure successful trade compliance.

<sup>2</sup> Note, however, that in late 2014, the US Congress repealed a provision of the Dodd Frank Act (known as the 'Lincoln' amendment or 'swap push-out' rule), which was scheduled to take effect on 1 January 2015. The impact of the repeal of this rule on commodity trading activities of banks and financial institutions subject to the Dodd Frank Act remains uncertain at this time.

<sup>3</sup> A 'contango' occurs when a commodity's future spot price is higher than its current price, opening opportunities for traders to potentially profit from buy-and-hold strategies.



# BEPS – Commodity trading structures under threat?

Just as the regulatory environment is disrupting traditional commodity trading models, the current wave of international tax reform is creating uncertainty over the ongoing effectiveness of tax outcomes under existing business structures. Traditionally, commodity trading structures have faced high levels of scrutiny from tax authorities because trading functions are often based in low-tax jurisdictions. As the G20-OECD Action Plan on Base Erosion and Profit Shifting (BEPS) unfolds, commodity trading structures could come under even more threat.



***Three-quarters of ENR tax executives surveyed do not think the BEPS Action Plan initiative will successfully tackle tax avoidance in the ENR sector.***

Source: KPMG International 2014.

The G20-OECD project on BEPS is an ambitious action plan encompassing fifteen areas that are perceived to have the greatest potential for abuse by international companies. The goals of the plan are to identify concrete strategies for addressing tax base erosion and taxpayer profit shifting. The OECD aims to provide governments with coordinated domestic and international instruments to prevent international companies from paying too little or no taxes.

Work on the Action Plan's 15 items is well underway, and guidance on each area is expected to be complete by December 2015. A number of documents have already been published, including guidance on transfer pricing for commodity transactions and allocations of risk and capital.

For commodity trading companies, the BEPS Action Plan initiative will have the biggest impact on transfer pricing. Transfer pricing drives the allocation of profit between group companies, and thus where and how much tax gets paid. The 'arm's length principle' drives transfer pricing, which decrees that intragroup prices should be market based, but the way this principle is interpreted by tax authorities is already changing as a result of BEPS.

**Tax authorities gaining new powers of reconstruction**

The BEPS Action Plan puts more focus on providing tax authorities with the power to recharacterize transactions and reconstruct transfer prices based on their views of appropriate arm's length terms. The OECD project's draft guidance in this area suggests a significant broadening of situations where this reconstruction may be possible.

Local tax legislation is also changing in this regard as tax authorities take unilateral action to protect their tax bases. For example, new transfer pricing legislation already in place in Australia gives the Australian Taxation Office (ATO) the power to hypothesize and reconstruct the terms and conditions of the transactions and make adjustments. In the context of related-party commodity trades, the ATO could take the view that an arm's length commodity trading party would not have been exposed to a particular price risk or supply risk in

the commodity trading jurisdiction and allocate that risk (and related profit margin) to the extraction operation.

Given the significance of such new powers, it is more important than ever to review the terms and conditions of all commodity trading transactions to ensure they are well supported as being arm's length.

**Aligning value creation with location of profit**

The BEPS Action Plan seeks to address scenarios where multinational groups can unfairly reallocate profit between different tax jurisdictions. In particular, BEPS targets situations where risks, and the resulting rewards, are not aligned with value-creating substance – by which the OECD means significant people functions. It also requires a review of overall value chain profitability in determining entity-based profitability. Of particular focus going forward will be aligning the value creation process – and specifically the location of key employees – with the location of profit.

Rewards that previously would have flowed contractually to risk-bearing locations (i.e., for providing access to at-risk capital) may flow to key people functions post-BEPS. The same is true for rewards flowing to assets. The OECD's near-final guidance on transfer pricing for intangible assets downplays the value attributed to legal ownership of intangible property (e.g., trademarks, patents) and ensures value is attributed to the individuals managing particular assets.

This change is significant. For commodity trading companies, much of the substance that creates value lies in its people – its traders and the staff who set overall trading strategies, negotiate long-term supply or customer contracts, manage risk, and determine asset investments.

Looking ahead, traditional commodity trading structures may no longer be appropriate. For example, a centralized trading model – with a single central trading entity that provides trading support and financial capital, holds intangibles and earns the majority of group profits, and a network of trading service providers in key locations earning relatively low returns – may no longer be straightforward under BEPS, especially where there are deemed to be key decision makers in the trading operations.

***About one-third of ENR tax executives expect to restructure their business as a result of anti-BEPS measures.***

Source: KPMG International 2014.

As many commodity traders rely on derivative and physical traders who often operate on a global basis across such locations as Switzerland, London, New York, Houston and Singapore, it is critical to review significant people functions against the creation of value across the entire group value chain. For many traders, comparison of the tax outcomes for existing business models in a pre- and post-BEPS world may lead to very different results.

### Returns on at-risk capital

The BEPS Action Plan creates a risk that tax authorities may challenge returns allocated to intragroup financial capital or guarantees, which are commonly used by trading businesses. Difficult audits and double taxation could result.

Historically, tax authorities have raised issues over returns on risk and capital, based on their view that the location of risk

and capital is easy to manipulate. Actions emerging from the BEPS Action Plan are likely to go even further by seeking to ensure that inappropriate returns will not accrue to an entity for providing capital or contractually assuming risk.

Essentially, the reward flowing to capital providers and risk bearers will (in most cases) still be recognized. However, there will be more scrutiny and rewards will have to be more closely aligned with substance and/or third-party examples of risk allocation contracts. Commodity trading companies and their parents may have difficulty in determining the nature and level of substance required across locations, in supporting an appropriate return to capital provided to support trading operations, and in justifying and explaining this to the various tax authorities.

For commodity traders this is particularly important, as financial capital is a key driver of group value. Insufficient



group capital can mean an inability to trade with key counterparties, so traders often operate a global structure with one central provider of capital (i.e., the parent company). Such entities have strong balance sheets and credit ratings, and often use a system of guarantees or capital flows to enable their subsidiaries to take trading positions. Other structures, for example, in which each of the group's trading entities is capitalized to the same level as the parent, are not commercially desirable.

The BEPS Action Plan creates a risk that tax authorities will challenge or disallow rewards to foreign providers of capital, even where this group company has no other choice and where that capital faces material speculative trading risks. Looking ahead, trading groups should revisit their transfer pricing, and possibly their business model, to ensure that group substance is aligned with rewards and that tax authority challenges to foreign capital rewards can be well defended.

### Pricing for cross-border commodity transactions

In December 2014, the OECD released a discussion paper<sup>4</sup> focused on the transfer pricing aspects of cross-border commodity transactions. The paper says that some countries have reported difficulties in pricing cross-border commodity transactions – especially in determining adjustments to quoted prices, verifying the pricing date, and accounting for the involvement of other parties in the supply chain.

These difficulties have led some countries to adopt specific unilateral approaches for pricing commodity transactions, such as the so-called "sixth method." The OECD states that the emergence of such approaches has highlighted the need for clearer guidance on the application of transfer pricing rules to commodity transactions.

The paper also proposes changes to the OECD Transfer Pricing Guidelines. Among other things, the amended guidelines would specify that the comparable uncontrolled price (CUP) method as generally the most appropriate method to use for commodity transactions. The proposed guidelines say that quoted or public pricing from commodities markets (e.g., the London Metals Exchange) is appropriate evidence of arm's length pricing.

However, as pointed out in a submission to the OECD from KPMG's Global Transfer Pricing Services, there are some situations where use of this CUP data would not be appropriate, or indeed arm's length. The commodity sector involves various complex inter-company structures and value chains. Companies that trade commodities have many and various business models depending on their chosen strategy

and their market segment (i.e., energy, power, metals). For some markets and trading strategies, third parties do not set pricing based on current quoted exchange prices in the spot market for a product – and this requirement should not be imposed on taxpayers in an intragroup context.

As a result, the submission calls on the OECD to soften the paper's language and remove any guidance that would:

- recharacterize an intragroup commodity transaction structure that is also used at arm's length into something for which an exchange quoted CUP can be applied
- shortcut a full transfer pricing analysis and thorough assessment of the most appropriate method.

KPMG's submission also observes that the paper does not address the fact that, in some countries, certain specific commodities (especially important local products) are priced by law. Thus, multinational enterprises could face certain issues where the OECD's guidance leads to a price that is not consistent with the price mandated by local law.

In another change, the guidelines would allow a deemed pricing date to be used in situations where the date used by taxpayers is inconsistent with the facts of the case or in the absence of reliable evidence of the transaction date. While KPMG's submission states that this guidance is reasonable, it does not address long-term pricing for commodity transactions where use of the spot rate would not be correct. The submission calls on the OECD to amend the guidance such that related parties that enter into arm's length long-term pricing arrangements are not forced to use the price on the deemed pricing date for such arrangements.

### Tax transparency and country-by-country reporting

In light of perceptions that international companies are able to abuse the current system, in part due to the lack of information shared between tax authorities on a taxpayer's global presence and profitability, the OECD and domestic governments are expected to insist on country-by-country reporting in the near future in order to facilitate this sharing of information between tax authorities.

Under these proposals, international companies would have to disclose information such as revenue, profit, location of employees and assets, cash tax payable and flows of royalty, interest and other payments between jurisdictions. This will draw focus to those jurisdictions that receive large payments and have transactions with 'high-risk' (i.e., low tax) jurisdictions.

<sup>4</sup> OECD, *BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions*, 16 December 2014.



Complying with these detailed reporting rules will be a substantial compliance burden. The rules will also likely lead to more questions and challenges from tax authorities as they seek to understand how the local share of the overall group reward was determined.

*About **two-thirds** of ENR tax executives expect to hire 1 – 5 full-time employees to tackle BEPS and country-by-country reporting challenges.*

Source: KPMG International 2014.

### Redefining permanent establishment

The G20-OECD Action Plan's aim to address non-taxation of digital economy transactions could also affect the taxability of commodity trading operations. The OECD has determined that it is not feasible to ring-fence the digital economy because it is so integrated with the economy itself, and so the OECD is seeking to rewrite the definition of permanent establishment. Changes to the definition currently under debate are quite broad but lacking in detail, raising fears that changes to the way taxable presence is defined could have significant unintended consequences. Commodity traders should monitor the evolution of this debate carefully, given the increasing ease with which transactions can be entered into from remote locations via electronic exchanges.

The next section sets out some concrete steps to consider in order to mitigate the impact of potential BEPS changes on commodity trading structures.

## Structures under threat

In summary, due to potential changes in international tax principles, ENR companies should monitor the possible impact on their commodity trading structures, for example, where:

- traders in a high-tax country are transacting on behalf of or back-to-back with a principal in a low-tax country
- large charges for risk and/or capital are paid to headquarters with low levels of substance, especially if akin to total return swaps
- deeply discounted offtake arrangements are involved
- large margins are allocated to marketing functions of extraction companies
- headquarters functions and senior decision makers earn only a cost-plus return.







# Winning in a post-BEPS world

Tax authorities are often suspicious when companies migrate functions and risks to central locations, especially when that location imposes highly favorable tax rates. Commodity trading companies that were previously subject to heightened tax risk are now under even more threat from the new focus on tax transparency and BEPS and uncertainty over how international tax reform will be implemented.

In a recent poll, ENR tax executives said their top concerns about recent anti-BEPS tax changes and developments are (in rank order):

1. increased tax authority enquiries and audits
2. country-by-country reporting
3. evolving attitudes toward intragroup capital provision

Source: KPMG International 2014.

**T**o position their businesses for ongoing success, the following are key recommendations for tax executives of ENR commodity trading companies to consider as we move into the new post-BEPS world.

## **Prepare for substance-based challenges**

Wherever they are located, international trading companies should be ready to defend against challenges from other tax authorities. As a first line of attack, many tax authorities would seek to challenge international trading companies under anti-avoidance and anti-abuse rules based on a lack of business



substance. The number of personnel, systems, physical facilities and level of commercial activity involved in most of these operations should help to make a sustainable case for the company's valid business purpose and substance.

In Singapore, for example, companies are required to guarantee they will employ a certain number of traders or undertake a certain level of local spending or value-adding activities in order to access tax concessions. Further, new UK anti-avoidance rules impose a 25 percent tax on 'diverted profits' within low-tax structures (effective April 2015) and target 'transfers of corporate profits' through instruments such as total return swaps.

To guard against substance-based challenges, documentation is crucial. International trading companies can reduce the potential for negative determinations by ensuring that pre-project 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 that changes in legislation or the business environment do not affect the structure's ongoing viability.

KPMG has developed solutions for clients that address substance issues, assessing and documenting the roles and responsibilities of involved employees in different business processes and each employee's location. In addition, the

relative importance (weight) of a business process in the overall enterprise is assessed and documented. These assessments can help in choosing the most appropriate transfer pricing method (e.g. a profit-split approach or other transfer pricing method).

### Monitor impacts on trading hub locations

Switzerland and Singapore remain popular destinations for international commodity trading activity. Both countries have actively courted this activity by setting fiscal policies and concessions that complement their existing positive attributes. However, as the illustration on page 14-15 shows, both jurisdictions are taking the global drive to curtail BEPS and address harmful tax competition seriously.

*About half of the ENR tax executives surveyed say they would consider moving talent (e.g., traders) to manage their group tax position.*

Source: KPMG International 2014.

There is a common misperception that tax planning considerations are the driving factor in decisions about where to locate commodity trading operations. In response to KPMG's poll, ENR tax directors say the biggest non-tax benefits that led to their current choice of location for commodity trading are:

- availability of services (e.g., for hedging and treasury functions)
- access to regional markets and skilled local workforce
- financial stability
- access to capital markets
- proximity to source of production
- attractive location for executives and industry talent
- critical mass of commodity trading companies
- business-friendly regulatory, legal and governance policies
- convenient access to transportation and multiple time zones.

# Global commodity trading hubs –

## Impact of BEPS on locations of choice

### London, the Netherlands, Houston, Calgary and Hong Kong SAR

These locations are home to substantial numbers of commodity trading businesses, and they continue to be destinations of choice due to their proximity to European, North American or Asian markets and to oil-producing facilities in the North Sea, Texas or China. These locations have a lot of trading infrastructure to support them, and BEPS-related international tax changes are unlikely to compel their commodity trading businesses to migrate elsewhere.

It is possible that aggressive anti-avoidance measures, especially regarding permanent establishments and transfer pricing, could lead companies to consider moving activity and employment away from these locations and to bolster their substance in low-tax countries. However, traders' reluctance to relocate, loss of efficiency and other practical constraints may prevent such moves.

### Switzerland

Independently of the OECD BEPS project, the Swiss government has undertaken substantial tax reforms, largely in response to changing public sentiment over tax planning and EU opposition to certain Swiss tax structures. Proposed reforms that are in line with the OECD BEPS project would abolish special tax regimes, including those for holding companies and finance branches. However, other proposed reforms may benefit Swiss commodity trading operations, including a lower overall tax rate, elimination of stamp duty on bond and share issuances, and introduction of the ability to step up the basis of assets for tax purposes.

The final Swiss tax reform proposals are expected to be delivered in 2015 and to be approved by the Swiss parliament within 2–3 years. Companies with Swiss commodity trading operations might want to consider postponing any decision to migrate operations. At the same time, they should closely monitor developments as these proposals evolve and prepare strategies for establishing new structures in the future if necessary.

### Singapore

While some may misperceive the tax concessions offered by Singapore as aggressive in the context of BEPS, these concessions strictly depend on the implementation of commercial arrangements with sufficient business substance. In fact, Singapore's Global Trader Program and other business concessions extend across the whole supply chain. In addition to its sophisticated banking and financial infrastructure, Singapore's ports, advanced refinery operations, logistics infrastructure and strategic geographic location as gateway to and from Asia Pacific have been the main drivers of Singapore's success in attracting regional headquarters for commodities companies. Singapore's critical mass of commodity traders is an offshoot of significant growth in both supply and demand in the Asia Pacific, creating a hub that largely complements trading hubs in other parts of the world, including Houston and London.

Singapore's government realizes the importance of the BEPS project for many countries and is closely monitoring how the OECD Action Plan is unfolding. While the Singapore government has yet to introduce unilateral measures to counter BEPS, the Singapore tax authority has actively engaged with the OECD during the development of the BEPS Action Plan items to ensure that Singapore is fully connected on the implementation of the BEPS measures. Singapore's tax authority has been focusing on enforcing the arms' length principle and other anti-avoidance rules, and newly released guidance is expected to tighten transfer pricing policies in line with new international developments.

Nevertheless, tax authorities in Australia and other countries are very focused on ensuring that the commercial justification of profit flows to Singapore-based companies. These issues should be addressed comprehensively and well documented when conducting commodity trading and other centralized activities in Singapore.

### Dubai

In the past few years, Dubai has developed a critical mass of commodity trading operations due to its improving physical and financial infrastructure, business-friendly policies, proximity to sources of production in the Middle East and South Africa, and favorable location between the Europe and Asia Pacific time zones.

The impact of the OECD BEPS project on traders in Dubai is unknown. While governments in the Middle East may appear less

involved in the OECD's work, they are watching developments closely and may bring some of their tax policies in line. Additionally, tax authorities in the Gulf are historically attuned to BEPS issues, as their historically high tax rates (now generally reduced) gave ample incentive to foreign investors in the oil and gas and other industries to optimize the tax they paid in the region.



### Review your transfer pricing

The immediate lesson that can be taken from the BEPS action plan is that businesses need to change their approach to transfer pricing. While the exact form in which BEPS will happen is not yet clear, the direction of travel is well signposted. Tax authorities are already applying BEPS principles in discussions and audit negotiations with taxpayers, so there is no time to delay before planning your response.

Consider looking at your current transfer pricing policies through the BEPS lens. While the forthcoming changes are not clear, there will be much more focus on the location of people rather than contractual allocations of physical and financial assets. How employees are treated and referred to will become a significant pointer to transfer pricing value.

For commodity traders, this could lead to risks of double taxation where group profit flows to offshore capital/risk takers that do not have an appropriate level of substance.

### Consider APAs to manage transfer pricing risk

Commodity trading companies can reduce their transfer pricing risk 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 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 approach in countries like Singapore and Switzerland is improving as tax authorities gain more experience and comfort with the process.

*The majority of ENR tax executives think the transfer pricing rules will be somewhat or very clear (48 percent) in the future once the OECD BEPS project is complete.*

Source: KPMG International 2014.

*Less than 5 percent of ENR tax executives have lobbied the OECD directly regarding the BEPS agenda.*

Source: KPMG International 2014.

### Keep informed and get involved

The best advice is to keep on top of developments as they occur locally and internationally and evaluate how these developments could affect your tax positions and planning.

Also bear in mind that the OECD's project offers an extraordinary chance to contribute to international tax policy development, although it appears few tax executives of ENR companies are making the most of this opportunity. Be sure to engage in BEPS-related consultations to ensure your practical business issues are raised and considered. Effective, widely accepted solutions can only be forged through broad consultation with tax professionals in business, government and public practice.

### Conduct a tax health check

In addition to the above steps, you should review all of your trading operation's existing tax transactions and structures immediately to identify potential weaknesses, and take measures to rectify these areas. With adequate preparations, multinational corporations will be able to adapt to the new tax landscape created by BEPS without causing unwarranted disruptions in business operation or incurring excessive amounts of tax costs during the transition.

In the final analysis, as long as the commodity trading company's business substance is real and well documented, its related-party pricing practices are sound and comprehensive tax compliance processes are followed, many companies should continue to enjoy the financial benefits of their centralized trading operations in the post-BEPS era.



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