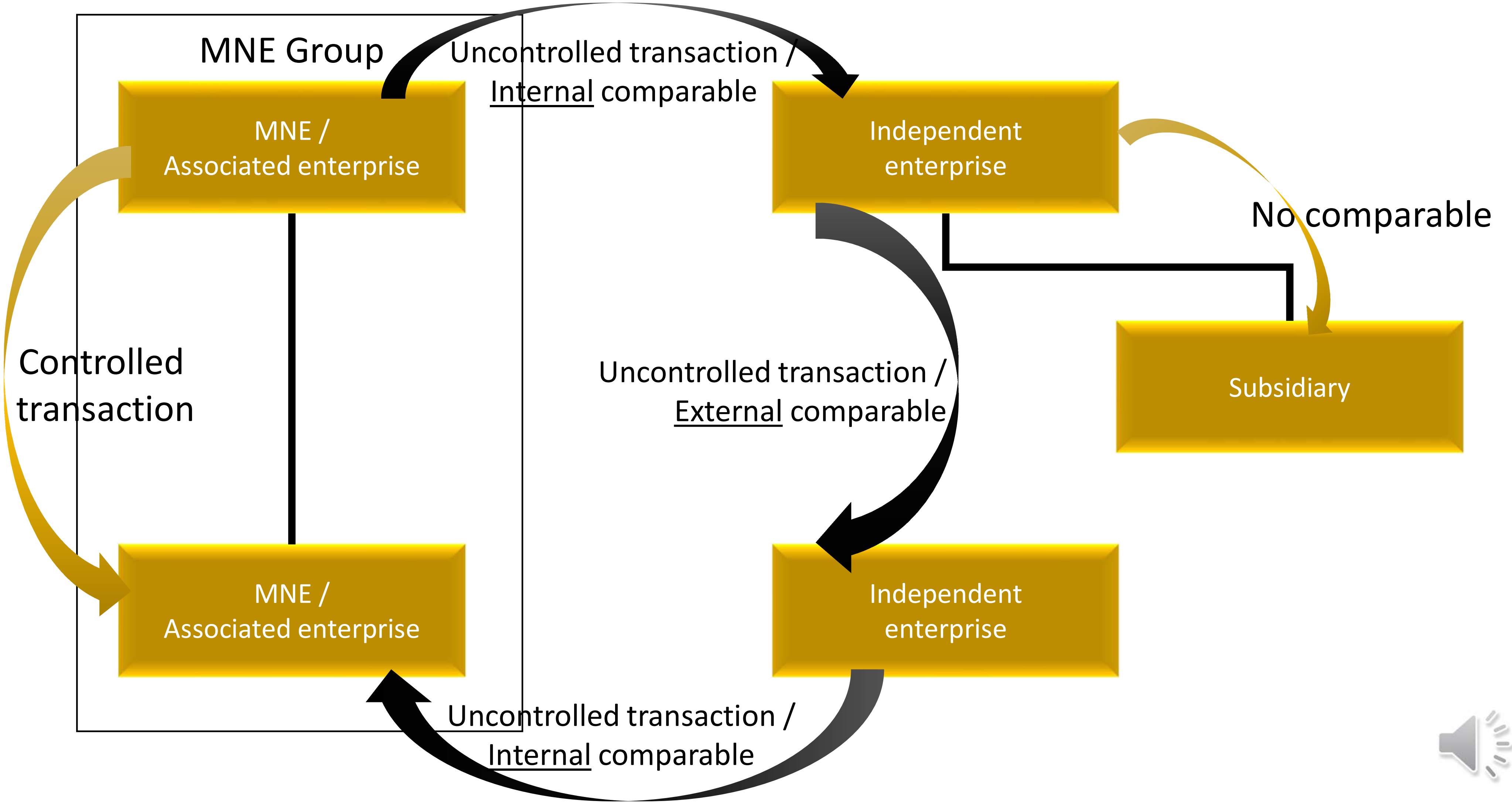
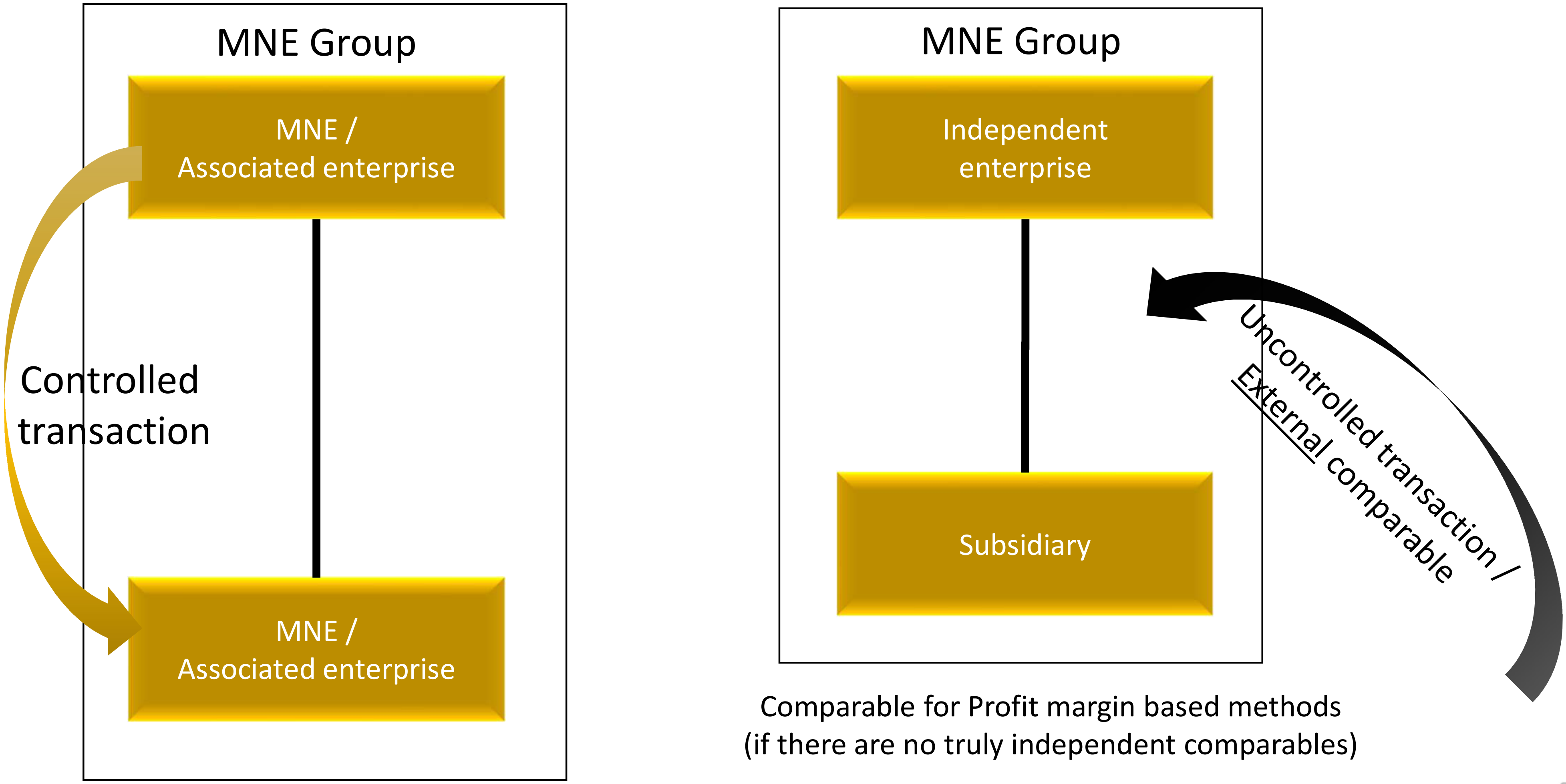
II.A - Key concepts



II.A - Key concepts

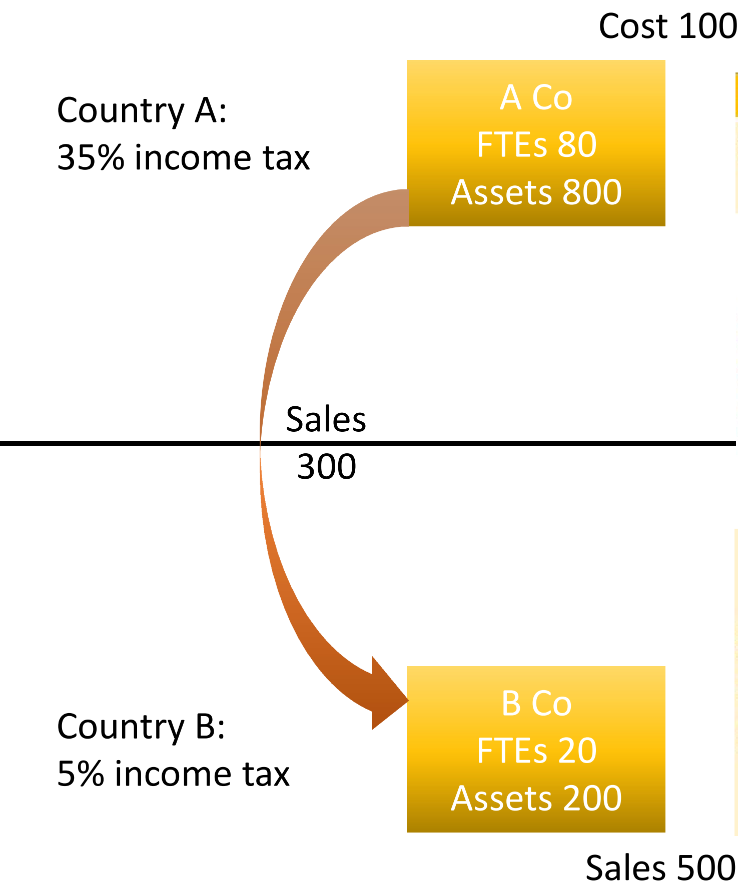


Comparable for Profit margin based methods
(if there are no truly independent comparables)

II The arm's length principle (ALP)

A	Interpretation of the arm's length principle and current dialogue	3 Points
B	Associated enterprises	3 Points
C	Global formulary apportionment	1 Point
D	Recognition of the actual transactions undertaken	2 Points
E	Losses and the effect of government policy	2 Points

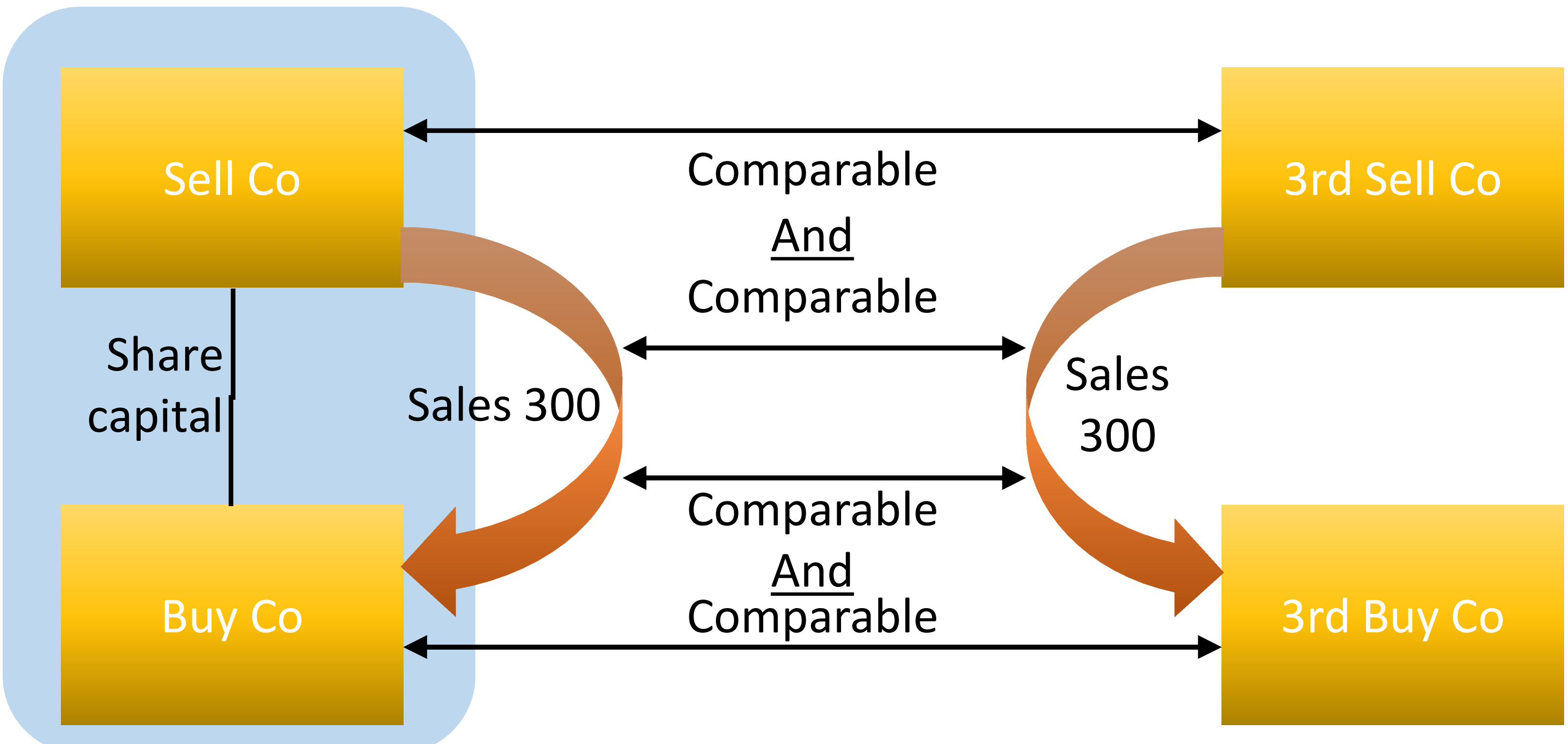
II.C – Global formulary apportionment



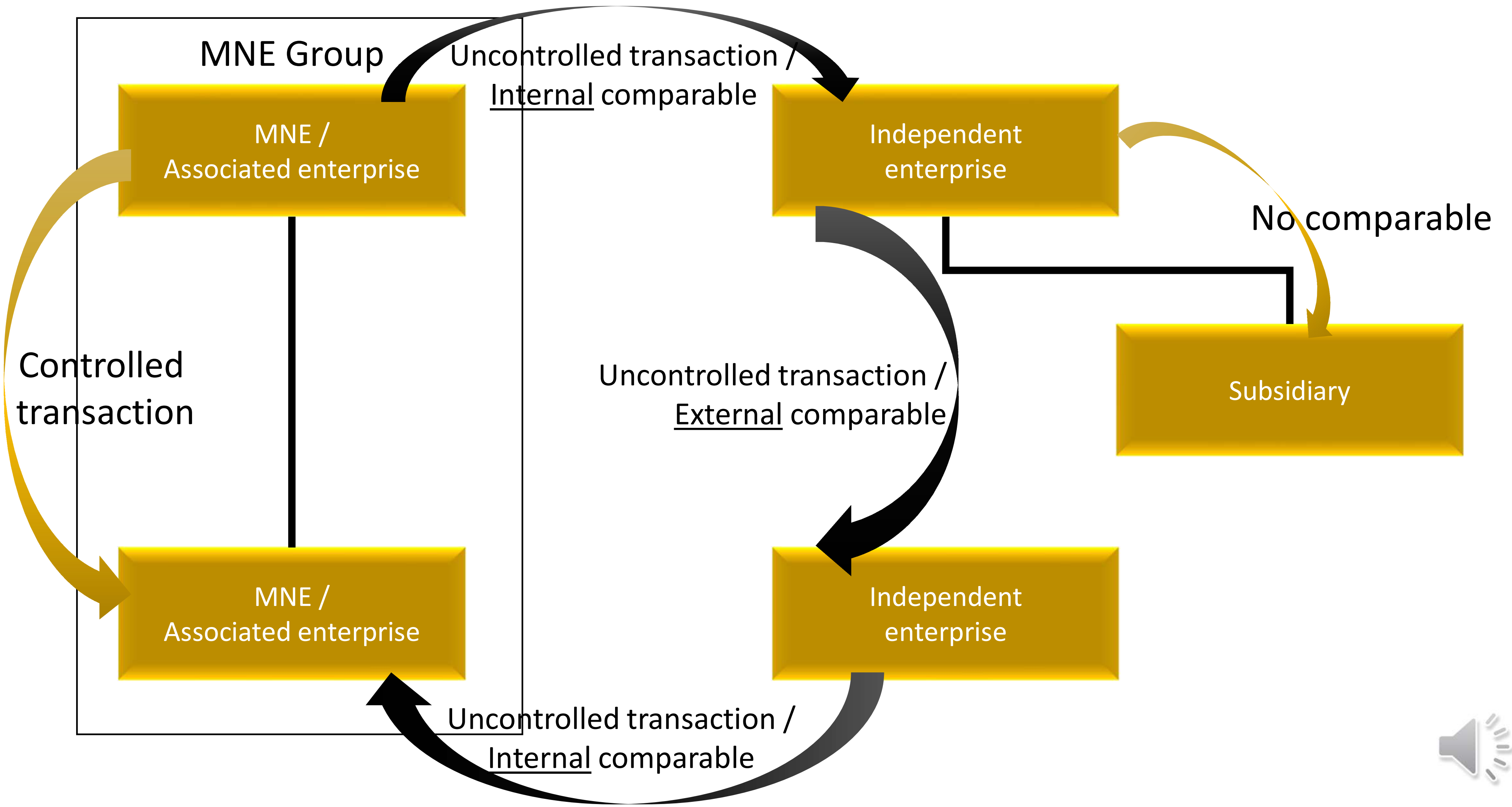
Profit allocation method	Profit A Co	Profit B Co
Arm's length principle	300 - 100 = 200	500 - 300 = 200
Formulary apportionment 33% Sales, 33% FTE, 33% Assets	500 - 100 = 400 (400x0/500))x33% ...+(400x80/100)x33% ...+(400x800/1000)x33% (0+107+107=) 214	500 - 100 = 400 (400x100%)x33% ...+(400x20%)x33% ...+(400x20%)x33% (133+28+28=) 186
Formulary apportionment 50% Sales, 25% FTE, 25% Assets	500 - 100 = 400 (400x0/500)x50% ...+(400x80/100)x25% ...+(400x800/1000)x25% (0+80+80=) 160	501 - 100 = 400 (400x100%)x50% ...+(400x20%)x25% ...+(400x20%)x25% (200+20+20=) 240

II.A Interpretation of the arm's length principle

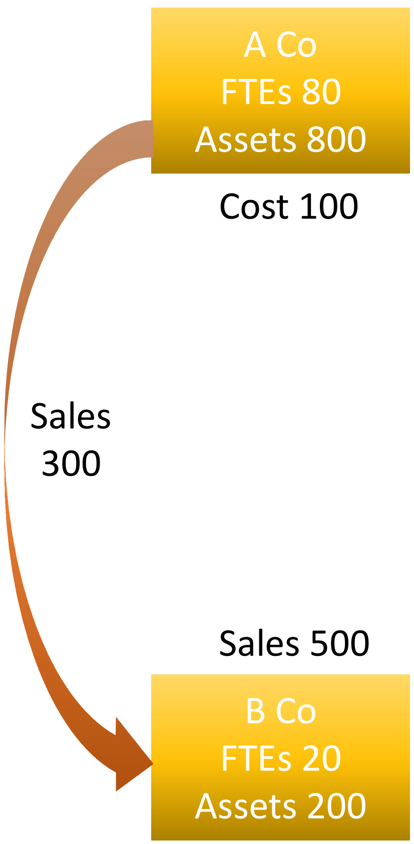
- TPG 1.6: Because of the ALP's separate entity approach, the comparability analysis with third parties is at the heart of the ALP.



I.A - Key concepts



II.A The arm's length principle: formulary apportionment vs profit split



Profit allocation method	Profit A Co	Profit B Co
Formulary apportionment Sales 33%, FTEs 33%, Assets 33%	500-100 = 400 (0+107+107=) 214	500-100 = 400 (133+28+28=) 186
ALP residual profit split Routine functions (cost +; resale -)	E.g. Like contract manufacturing Cost plus 5%. Cost = 40, plus = 2	E.g. Like routine sales Resale price - 4%. 500 x 4% = 20
ALP residual profit split Value adding functions	Unique production know how + large capital investments, justifying 65% of residual profit (400-2-20=378)*65% = 246	Large loyal customer base + strong branding performance, justifying 35% of residual profit (400-2-20=378)*35% = 132
ALP Total profit	2 + 246 = 248	20 + 132 = 152

Formulary apportionment vs the ALP profit split method

In the ALP PS compensation for 1) routine functions and 2) value adding functions are unique to every case. They are determined per case by the facts and circumstances, not a predetermined formula.

II.A Interpretation of the arm’s length principle

1. Reasons for choosing the ALP:
    1. It does not distort competition between MNE’s and independents, promoting economic growth (TPG 1.8);
    2. It is effective in the vast majority of cases (TPG 1.9).
        1. In really difficult cases the profit split method could provide a solution.
2. MNE can perform internal transactions not seen between unrelated parties (TPG. 1.11).
    1. This does not mean that the transaction or the pricing is not at arm’s length.
3. The objective of transfer pricing is to find reasonable estimates (§ 1.13).
    1. Transfer pricing is not an exact science.
    2. AND NOWHERE DO THE GUIDELINES SAY IT IS AN ART!
4. Global formulary apportionment is not acceptable in theory, implementation or practice (§ 1.15).

II.A Interpretation of the arm's length principle (The UN practical manual)

1. A large growing number of international transactions are not governed entirely by market forces, but the common interests of MNEs (UN § B.1.1.5).
2. Developing countries have tightened their TP regimes to protect their tax bases against developed countries tightening up theirs (§B.1.3.7).
3. The arm's length principle is geographically neutral as to how it treats profits from investments in different places (§B.1.4.6).
4. The UN acknowledges a sixth method (commodity rule) (§B.1.5.10).
5. Specific issues related to transfer pricing include: documentation burden and the definition of contemporaneous; intangibles and DEMPE functions; business restructurings; and secret comparables (§B.1.6).
6. Documentation requirements should as far as possible be common to reduce compliance burdens (§B.1.8.12).
7. Future TP issues include: lack of comparables (§B.1.10.6); lack of skills; complexity; the digital economy and location savings.