



2121 41st Avenue  
Suite 301  
Capitola, CA 95010  
PHONE 831.465.8204  
FACSIMILE 831.465.9384

www.svtdg.org  
info@svtdg.org

September 5, 2016

**VIA ELECTRONIC TRANSMISSION**

Tax Treaties  
Transfer Pricing and Financial Transactions Division  
OECD/CTPA  
[TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

**Re: Comments on July 4, 2016 OECD Public Discussion Draft on BEPS Actions 8–10  
*Revised Guidance on Profit Splits***

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group (“*SVTDG*”) hereby submits these comments on the above-referenced Public Discussion Draft (“*PDD*”). *SVTDG* members are listed in the Appendix of this letter.

Sincerely,

A handwritten signature in blue ink that reads "Robert F. Johnson".

Robert F. Johnson  
Co-Chair, Silicon Valley Tax Directors Group

## I. INTRODUCTION AND SUMMARY

### A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

### B. Summary of comments

In this letter, we comment on the alternative approaches proposed by the PDD for implementing the transactional profit split method and the guidance provided by the PDD regarding the conditions under which these alternative approaches are appropriate. We believe the conditions under which the two types of profit split methods are applicable have not adequately been defined in the PDD. In particular, the choice between these methods is unclear in transactions where parties are exposed to some, but not all, risks of the transaction and where their activities are either partially integrated or focus on different steps in the value chain for end-products. Concepts critical to the choice of an appropriate method, such as “highly integrated” activities, “closely related” risks, and “parallel” versus “sequential” integration remain ill-defined, leaving considerable latitude for arbitrarily exposing taxpayers to the risk of retrospective disputes with tax authorities over the interpretation of these terms and the choice of intercompany payment terms. The “value chain” analysis proposed by the PDD as a guide to the choice of methods addresses relevant economic questions regarding the economic contributions of affiliated parties in the transaction. However, it is unclear how this value chain analysis differs from a rigorous application of the functional analysis already required by the OECD’s transfer pricing guidelines.

## II. SPECIFIC CONCERNS WITH THE PDD

### A. An overview of the proposed transactional profit split methods

The PDD proposes that the transactional profit split method (“*TPSM*”) can be applied under two alternative approaches. The first approach involves combining and splitting the actual profits arising from a transaction on the basis of certain factors determined *ex ante* at the time the transaction is entered into (“*TPSM Actual*”). The second approach involves identifying the anticipated profits associated with the transaction at the time it is entered into and splitting these

anticipated profits on the basis of factors identified at the time of the transaction (or “*TPSM Anticipated*”).<sup>1</sup>

The PDD notes that under a *TPSM Actual*, risks associated with the business activities undertaken within a transaction are shared by the participants of the transaction. Following the guidance in Section D of Chapter I of the 2016 *Transfer Pricing Guidelines*, the PDD states that such a sharing of risks requires a “high level of integration of activities” between participants in the transaction, with economically significant risks associated with the transaction being controlled, either separately or collectively, by the parties sharing the actual profits.<sup>2</sup> The PDD adds that it would be “contrary to the guidance in Section D of Chapter I” to apply a *TPSM Actual* when one party “does not exercise any degree of control” over the risks associated with the business activities undertaken in the transaction.<sup>3</sup>

The applicability of *TPSM Anticipated* appears to have been defined only by contrast to the conditions under which the alternative *TPSM Actual* is applicable. The PDD notes that “a transactional profit split of anticipated profits does not require the same level of integration or risk sharing required for a transactional profit split of actual profits.”<sup>4</sup> In a similar vein, the PDD says “a further difference between the two approaches is that there is a greater sharing of uncertain outcomes resulting from the risks associated with the transaction under a transactional profit split of actual profits, than under a transactional profit split of anticipated profits.”<sup>5</sup>

## **B. The conditions under which the two forms of *TPSM* are applicable are ill-defined**

The PDD explains how the *TPSM* should be applied in polar extreme cases of risk-bearing and integration. When one party “does not exercise any degree of control” over the risks inherent in the transaction, the *TPSM Actual* may not be applied.<sup>6</sup> At the opposite end of the spectrum, when all parties to the transaction are highly integrated and exercise control over economically substantial risks, the *TPSM Actual* is appropriate.

However, most intercompany transactions—like most third-party transactions—lie between these two extremes on the spectrum of integration and risk-taking. For such transactions, the PDD is unclear on the objective criteria by which taxpayers and tax authorities

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<sup>1</sup> PDD, Section C, ¶ 2–4.

<sup>2</sup> PDD, Section C, ¶ 6, 9.

<sup>3</sup> PDD, Section C, ¶ 10.

<sup>4</sup> PDD, Section C, ¶ 20 (emphasis added).

<sup>5</sup> PDD, Section C, ¶ 6 (emphasis added).

<sup>6</sup> PDD, Section C, ¶ 10 (emphasis added).

can gauge the degree of integration and risk-taking that would be considered sufficient to support the application of a TPSM Actual. Consider the example of Company A that owns certain technology and bears the expense of continuing research and development (“*R&D*”) on this technology. The failure of products incorporating these intangibles would place Company A’s investments in R&D at risk. Suppose Company A licenses its technology to an affiliated Company B, which manufactures the product and markets it in a certain territory. Company A bears the risk its technology will prove commercially unviable and its R&D expenditures wasted if the product fails in the market. However, Company A does not participate in, or control, the manufacturing and marketing activities that bring the product to market. Will Company A’s risk-bearing on R&D activity be considered sufficiently significant in the aggregate risks of this business activity that a TPSM Actual can be used to determine the Company’s arm’s length profits from this transaction? If the answer depends upon the facts of the transaction, by what objective criteria can taxpayers or tax authorities evaluate whether the facts of a particular transaction merit the application of a TPSM Actual? It is important for the OECD to articulate these criteria to eliminate regulatory and compliance uncertainties in the structuring of intercompany transactions.

The PDD allows a TPSM Actual to be applied in cases where parties do not share the same economically significant risks, provided they share “closely related” risks associated with the business opportunity.<sup>7</sup> At the same time, however, the PDD states that applications of the TPSM Actual should be governed by the principle articulated in Section D of Chapter I that parties cannot be assigned the impact of risks they do not control.<sup>8</sup> In a transaction where Company A contributes technology and an affiliated Company B contributes marketing intangibles towards a common product, each company bears risk that the other will fall short in its area of activity. Each company is exposed to risks it does not control; therefore, under the principles of Section D in Chapter I, this transaction may be deemed inappropriate for a TPSM Actual. Yet, the risks borne by each may be “closely related” since their intangibles are being commercialized through the same product and the quality of each intangible affects the value of the other. Therefore, the same transaction might be deemed appropriate for a TPSM Actual under the “closely related risks” criterion. Without further guidance on what constitutes “closely related” risks, taxpayers face the risk that conflicting guidance could cause their transactions to be challenged or re-characterized.

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<sup>7</sup> PDD, Section C, ¶ 16.

<sup>8</sup> PDD, Section C, ¶ 10 (“It would be contrary to the guidance in Section D of Chapter 1 to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control.” (Emphasis added)).

Ambiguities regarding the definition of “close” risks can also affect the choice between a TPSM Actual and methods other than a TPSM. When a company performs routine functions for an affiliated enterprise, it is customary for the terms of the transaction to be determined with reference to the profit margins earned by unaffiliated companies performing similar functions at arm’s length. However, it is possible that the company performing routine functions also bears certain risks under this transaction, in keeping with allocations of risk observed at arm’s length. For example, the company performing distribution services may also bear a part of the cost created by product failure through losses on inventories of the product or by bearing product warranty risks for the product. To the extent similar risks are borne at arm’s length by unaffiliated distributors, a transactional benchmarking analysis may be used to establish the arm’s length profit margin of the company. However, the language of the current PDD may leave room for a tax authority to require that the distributing entity enter into a profit split with the affiliated enterprise whose product it distributes, on the grounds that product warranty risks are “closely related” to product quality, which in turn is related to the development and marketing activities of the affiliated enterprise.

The PDD could be improved by including a more focused and balanced discussion of the circumstances under which the TPSM is the most appropriate method. The PDD’s statement of the strengths and weaknesses of the TPSM is over-weighted towards strengths and fails to mention a number of important weaknesses (e.g., the subjectivity involved in attempting to hypothesize transactional or segmented profit from consolidated profit statements, the need for a tax system and administration to have achieved a certain level of sophistication before applying a TPSM, the reluctance of some administrations to apply the method to both profit and loss situations, etc.). The PDD is overly focused on integration of activities (which occurs to varying extents within all multinational groups) as an indication of sharing of risks and as a potential trigger for the TPSM, when a better indicator of whether the TPSM is a more appropriate method than a one-sided method is whether each of the parties to the transaction contributes unique or valuable intangibles or assumes risks that are not comparable to risks assumed by uncontrolled parties in comparable circumstances and are a key source of actual or potential profits. The PDD should be revised to ensure that the TPSM does not, in effect, become a default method whenever comparables are scarce or integration exceeds some subjectively determined “high” threshold.

**C. The concepts of “parallel” and “sequential” integration are not sufficient to identify transactions with highly integrated business activities**

In an attempt to give greater clarity to the concept of “highly integrated” business activity between the participants of an intercompany transaction, the PDD draws a distinction between “parallel” and “sequential” integration. A “parallel” integration is said to occur when multiple parties to the transaction are involved in each step of the value chain, sharing exposures to the risks inherent in that step. By contrast, a “sequential” integration is said to occur when each

party performs a discrete function in an integrated value chain, as would occur, for example, when one party is responsible for technology development, another for manufacturing, and a third for marketing, all of the same product. The PDD claims that the commonality of functions and risks that mark highly integrated activity between the affiliated parties is more likely to occur with parallel integration than with sequential integration.

It is important to note that in the rapidly evolving markets faced by technology firms, a close integration between different steps in the value chain is essential for a firm to produce commercially valuable innovation. Therefore, the activities of affiliated enterprises may be highly integrated even though each focuses on a separate step of the value chain such as R&D, manufacturing, or marketing. For example, effective new product development is driven not only by the technological considerations provided by R&D teams but by intelligence from marketing teams regarding the attributes most valuable to customers. In turn, once new products are developed, engineers help marketing teams sell the product by conveying the technical attributes of the innovation more effectively to consumers. For firms that manufacture their products internally, the R&D function has to coordinate closely with manufacturing operations to develop design processes that incorporate considerations of reliable manufacturability into the design of the product itself. Given the interdependence of activity across these steps of the value chain, affiliated enterprises focusing on particular steps in the chain may nonetheless be significantly integrated with enterprises focusing on other steps.

Therefore, the mere fact that affiliated enterprises focus on different steps of the value chain does not necessarily indicate that they are less likely to be highly integrated.

**D. The PDD is unclear about the conditions under which intermediate forms of risk-bearing such as contingent royalties are appropriate**

The PDD describes the TPSM Anticipated as a pricing arrangement based on splitting the anticipated profits from a transaction between its participants. Given that the profits anticipated at the time of the transaction do not, by definition, change subsequently, one form of payment that can arise from a TPSM Anticipated is a lump-sum payment computed to ensure each participant realizes a specified percentage of the known and fixed anticipated profit. This lump-sum can be converted into a series of equivalent installment payments without changing their fundamental character as payments independent of actual outcomes.

Thus, under a straightforward construction, a TPSM Anticipated can produce outcome-independent payments that contrast with the outcome-dependent payments generated by a TPSM Actual. However, the PDD recognizes that one variant of the TPSM Anticipated can produce payments with outcome-dependence. Specifically, the PDD describes a royalty contingent on sales as a specific example of a TPSM Anticipated, in which the royalty rate is determined on the

basis of anticipated future profits but is applied to actual sales to determine annual royalty payments.<sup>9</sup>

On the central issue of when a TPSM Anticipated (including variants with contingent royalties) is appropriate, the PDD notes merely that a TPSM Anticipated does not require “the same level of integration or risk sharing” as a TPSM Actual.<sup>10</sup> This guidance is insufficient for determining when a TPSM Anticipated would be appropriate relative to a TPSM Actual, and when an intermediate form of the TPSM Anticipated would be preferable to a purely non-contingent form such as lump-sum payments. A royalty contingent on sales exposes the payor of the royalty to risks associated with the business’s sales, but not to risks associated with fluctuations in costs. Would a TPSM Anticipated with contingent royalty be considered appropriate if the payor of the royalty had some measure of control over the risks of sales, even if the recipient had no control over cost fluctuations? Is such control necessary or would this contingent royalty method be applicable even if the payor controlled only “related risks”? As before, articulating the concepts of “related risks” and the degree of integration in business activity remain important for taxpayers and tax authorities to have clear guidance on the choice of transfer pricing method.

**E. It is unclear whether a “delineation of the transaction” involving affiliated enterprises includes the payment terms associated with the transaction**

The PDD states that when evaluating the applicability of a TPSM Actual, taxpayers should perform an “accurate delineation of the transaction” and evaluate whether this delineation shows the relevant affiliated enterprises undertaking activities that involve the sharing of economically significant risks.<sup>11</sup> To the extent that an “accurate delineation of the transaction” involves a detailed analysis of the functions performed and assets contributed by each entity, we agree that such an analysis is helpful in evaluating alternative methods for determining intercompany payments.

However, it is unclear whether an “accurate delineation of the transaction” can be independent of the payment form under which the affiliated enterprises are being compensated under the intercompany transaction. As an economic matter, whether or not a party bears economically significant risks under a transaction depends on how the party is compensated. If the chosen form of intercompany payment is a royalty contingent on sales or a TPSM Actual, both the payor and the payee are exposed to the risks of actual outcomes. Conversely, regardless

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<sup>9</sup> PDD, Section C, ¶ 6 (emphasis added).

<sup>10</sup> PDD, Section C, ¶ 20 (emphasis added).

<sup>11</sup> PDD, Section C, ¶ 11.

of the activities performed by a party, it can be immunized from risk simply by selecting a form of payment under which the party receives a fixed (or more generally, an outcome-independent) payment, such as a TPSM Anticipated under which the payee receives a lump-sum payment. Thus, the proposed guidance that taxpayers should consider the sharing of economically substantive risks when selecting the a method for evaluating intercompany payments is potentially circular; the sharing of risks is itself a function of the form of payment

The circularity embedded in a “delineation of risks” is evident in certain statements in the PDD. The PDD states that “a key indicator for the appropriateness of a profit split of actual profits is that the parties continue to share in the outcome of the business activities and the risks associated with those subsequent outcomes.”<sup>12</sup> Yet, a TPSM Actual, if chosen, would ensure that parties “share in the outcome of the business activities.” Thus, the condition that is taken to indicate the appropriateness of a TPSM Actual is ensured by the implementation of the TPSM Actual itself—a circularity.

It is important for guidelines on profit splits to recognize that affiliated parties, acting at arm’s length, may choose between alternative forms of payment for a given transaction. As the PDD notes, an enterprise acting in a market-mediated transaction can choose to offer its assets or services either for a fee that is independent of market outcomes or for a share of the income realized by the other party.<sup>13</sup> Well-accepted economic principles can be used to compute the payment terms associated with each form of payment, given the degree of risk the enterprise will bear under the chosen payment form. The chosen payment form will affect the risks to which the enterprise is exposed at arm’s length under this transaction.

To provide clear guidance to taxpayers and tax authorities on how to evaluate the appropriateness of profit split methods, it would be helpful for the OECD to articulate the precise considerations that should enter an “accurate delineation of a transaction” and, to the extent these considerations include the terms of the intercompany payment for the transaction at issue, clarify how such an analysis can be used to choose the method for determining these payments.

**F. It is unclear how the value chain analysis described by the PDD is different from a careful functional analysis, or what role it is supposed to play**

The PDD indicates that a “value chain analysis” (or “VCA”), undertaken as part of an overall analysis of a taxpayer’s economic activities, may help to identify circumstances where a TPSM (either in Actual or Anticipated form) is appropriate. This VCA is described as including a review of the economically significant functions, assets, and risks associated with each

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<sup>12</sup> PDD, Section C, ¶ 10.

<sup>13</sup> PDD, Section C, ¶ 10.

affiliated entity and the economic circumstances under which these functions are performed, assets deployed, and risks borne. The VCA would also have to consider whether these economic circumstances allow opportunities for profits in excess of the levels typically associated with the activity because of factors such as first-mover advantages or unique intangibles.<sup>14</sup>

We agree that an analysis of the economic activities of affiliated enterprises is useful in determining arm's length terms for intercompany transactions. However, it is not clear how such a VCA is different from a careful implementation of a functional analysis, as described by the OECD's *Transfer Pricing Guidelines*. A functional analysis also examines the functions performed, risks borne and assets deployed by affiliated parties in connection with intercompany transactions.<sup>15</sup> A functional analysis should also consider factors affecting the economic values of these contributions, such as the uniqueness of an asset, the profit margins on products generated through these contributions and factors that may sustain these profit margins over time, which would include considerations such as the uniqueness of the asset or the sustainability of competitive advantage.

In light of the considerations that already fall within the ambit of a rigorous functional analysis, it would be helpful for the OECD to clarify if the VCA proposed in this discussion draft is different in scope or detail from such a functional analysis, and if so, in what respects. The PDD provides no definition of a VCA nor any guidance on best practices for how a VCA should be carried out or how it should be used or interpreted. The PDD likewise provides no guidance on whether its inclusion of the discussion of the VCA is intended to suggest that this will be a new and potentially onerous and poorly formulated compliance burden on taxpayers or merely that it may be an optional analysis some taxpayers may wish to prepare. Unless and until the PDD can clearly describe the added value (if any) of a VCA, articulate the elements and process of conducting and interpreting such an analysis, and address the significance of including a reference to the VCA in the *Transfer Pricing Guidelines*, we strongly recommend eliminating it from the final guidance.

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<sup>14</sup> PDD, Section C, ¶ 26.

<sup>15</sup> 2016 *Transfer Pricing Guidelines*, ¶¶ 1.51–1.106.

## Appendix—SVTDG Membership

Accenture  
Activision Blizzard  
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Microsemi Corporation  
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NetApp, Inc.  
Netflix, Inc.  
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PayPal Holdings, Inc.  
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Pure Storage, Inc.  
Qualcomm, Inc.  
Rovi Corporation  
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SanDisk Corporation  
Sanmina-SCI Corporation  
SAP  
Seagate Technology  
ServiceNow, Inc.  
Snapchat, Inc.  
Symantec Corporation  
Synopsys, Inc.  
Tesla Motors, Inc.  
The Cooper Companies  
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