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September 15, 2017

VIA ELECTRONIC TRANSMISSION

Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
TransferPricing@oecd.org

Re: Comments on June 22, 2017 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,

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. Executive summary of comments

The PDD deals with clarification and strengthening of guidance on the transactional profit split method ("***TPSM***") set out in the BEPS Actions 8–10 *Final Report*. In particular, it sets out proposed revised guidance on application of the TPSM, together with three questions. In this letter we comment on the proposed revised guidance, and answer some of the questions.

The SVTDG believes the most reliable indicator of whether the TPSM may be a more appropriate method than a one-sided method is whether each of the parties to a controlled transaction contributes unique or valuable intangibles, or assumes risks that aren't comparable to risks assumed by uncontrolled parties in comparable circumstances and that are a key source of actual or potential profits. The SVTDG recommends the PDD be revised to make this clear. Some of our comments on the PDD follow from this indicator.

Regarding unique and valuable contributions of intangibles to a controlled transaction, the SVTDG recommends the PDD be clarified to explain why consideration of assumption of economically significant risks ("***ESRs***") relating to such intangibles is relevant to whether those intangibles are unique and valuable. Regarding highly-integrated business operations, the SVTDG recommends certain language in the PDD dealing with holistic valuation be changed to make it less confusing (as described below).

The SVTDG has three significant concerns about the PDD's description of risk triggers signaling possible application of the TPSM.

Our first concern relates to three requirements the PDD lists which, if all met, implies likely non-application of the TPSM. One of the requirements is that one party to the transaction doesn't assume ESRs. Consistent with our view of the most reliable indicator (above), the SVTDG believes this requirement should be expanded to be that one party to the transaction doesn't assume ESRs comparable to risks assumed by uncontrolled parties in comparable circumstances. That is, one party assuming ESRs, per se, shouldn't be read to signal possible application of the TPSM as the most reliable method.

Our second concern relates to the PDD assertion that a TPSM may be found to be the most appropriate method in a situation in which each party to a controlled transaction shares the assumption of one or more of the ESRs relating to the transaction. For reasons explained below, the SVTDG recommends the PDD be revised to take into account the point—consistent with *TPG* guidance—that in a two-party controlled transaction that's silent about risk sharing, and in which one party exercises most control over the risk, no risk sharing should be asserted. If these facts obtain, the TPSM shouldn't be found to be the most appropriate method.

Our third concern relates to "closely-related risks." The SVTDG recommends the PDD be revised take into account the directive in the *TPG* that for transfer pricing purposes an associated enterprise can't assume a risk over which it has no control. Accordingly, application of the TPSM in a "closely-related" risks situation would violate this directive if, as a consequence, an associated enterprise is allocated profits or losses relating to risks over which it has no control. Furthermore, the SVTDG respectfully asks that the definition of what makes ESRs "closely related" be further refined to add precision, and that *Example 3* likewise be augmented to better explain its conclusion. The presence of "closely-related risks" in a controlled transaction is a potential red herring if the risks are comparable to risks assumed by uncontrolled parties in comparable circumstances—in this case, the TPSM shouldn't be the most appropriate method.

The SVTDG recommends the Analysis in *Example 3* be revised to clarify confusion (explained below).

Finally, the SVTDG responds to Questions 1 & 2 posed in the PDD.

II. Specific concerns with the PDD

A. Unique and valuable contributions by each of the parties to the transaction

The SVTDG agrees with the PDD that the existence of unique and value contributions by each party to a controlled transaction is an indicator that the TPSM may be appropriate.

The PDD states that in a situation in which each party to a transaction "legally owns unique and valuable intangibles relevant to the transaction, it will also be necessary to consider whether . . . they each assume the [ESRs] relating to those intangibles . . . ."[1] This statement is potentially confusing for two reasons. First, for assets (including intangibles) the indicator depends on whether they're used in or contributed to the transaction. Intangibles being "relevant" to a transaction is a vaguer notion. The SVTDG recommends the statement be made

[1] PPD ¶ 17 (emphasis added).

more precise. Second, the relevant passage doesn't explain why consideration of assumption of ESRs relating to intangibles might relate to whether those intangibles are unique and valuable. If consideration of such intangibles risk is independent from uniqueness or the valuable nature of the intangibles, to avoid confusion we recommend this statement is perhaps better placed in § C.2.2.3, dealing with risks.

B. Highly integrated business operations

The PDD states that in a situation in which contributions by associated enterprises to a controlled transaction are highly inter-related or inter-dependent upon each other, "the evaluation of the respective contributions of the parties may be need to be done holistically."[2] The PDD explains this statement with an example:

> For instance, the contribution by each party may be unique and valuable, or may have a greater value when considered in combination with the particular contribution of the other party, even if it may not have such significant value on a purely standalone basis. See [*TPG* ¶ 6.94].

This statement is potentially confusing. The initial indicator for when a TPSM might be the most appropriate method is if each of the parties to the transaction makes unique and valuable contributions to the controlled transaction. Referenced paragraph 6.94 in the *TPG* makes the point that intangibles may have greater value in the aggregate rather than in isolation. But uniqueness of the contribution—whether or not the contribution is comparable to those made by uncontrolled parties in comparable circumstances—should be independent of whether the evaluation is holistic. If a party to a controlled transaction makes non-unique contributions, that should preclude the TPSM from being an appropriate method. The SVTDG recommends the above quoted sentence be modified to delete reference to uniqueness.

C. Risk sharing

1. The conditions for non-applicability of the TPSM should be revised

The PDD signals that a TPSM "typically would not be appropriate" if accurate delineation of the transaction determines that one party to the transaction (i) performs only simple functions; (ii) doesn't assume ESRs in relation to the transaction; and (iii) doesn't otherwise make any contribution that's unique and valuable.[3] *Example 4* concludes on its facts that the TPSM mightn't be the most appropriate method because the functional analysis determines the risks assumed by one party (Company B) aren't economically significant for the

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[2] PDD ¶ 22.

[3] PDD ¶ 14.

business operation. That is, requirement (ii) is met (in addition, presumably, to requirements (i) & (iii)).

The three requirements listed for likely non-application of the TPSM wouldn't be met—thereby potentially allowing application of the TPSM, according to the PDD—if, for example, one of the parties performs only simple functions (satisfying (i)) yet assumes ESRs in relation to the transaction, regardless of the nature of the risks assumed. For example, the risks assumed could be non-unique in the sense that they're comparable to risks assumed by uncontrolled parties in comparable circumstances. The SVTDG believes that in this case the TPSM also typically would not be appropriate because a one-sided method would likely be the most appropriate method. The TPSM shouldn't be considered as an appropriate method if there's evidence of comparable risks assumed by uncontrolled parties in comparable circumstances, regardless of the nature of the risks (whether economically significant or not), or the extent of risk sharing between the parties.

The SVTDG accordingly recommends requirements (i)–(iii) be revised to reflect this. The problem can be remedied by including the sub-requirements of uniqueness and being valuable in requirement (ii). That is, the three requirements signaling typical inappropriateness of the TPSM would be that one party to the transaction (i) performs only simple functions; (ii) doesn't assume, in a unique way, ESRs in relation to the transaction; and (iii) doesn't otherwise make any contribution that's unique and valuable.

2. The conditions indicating appropriateness of the TPSM are ill defined—shared assumption of ESRs, or separate assumption of closely-related risks

a. Shared assumption of ESRs

The PDD states that a TPSM may be found to be the most appropriate method in a situation in which each party to the controlled transaction shares the assumption of one or more of the ESRs in relation to that transaction.[4] For this assertion the PDD cites *TPG* ¶ 1.95, which provides:

> Where two or more parties to the transaction assume a specific risk (as analysed under step 4(i)), and in addition they together control the specific risk and each has the financial capacity to assume their share of the risk, then that assumption of risk should be respected. Examples may include the contractual assumption of development risk under a transaction in which the enterprises agree jointly to bear the costs of creating a new product.

[4] PDD ¶ 25

As *TPG* ¶ 1.95 makes clear, a pre-requisite for shared assumption of an ESR relating to a transaction is an explicit agreement between the two parties to that effect. The SVTDG recommends the PDD clarify this point. Clarification is necessary lest the TPSM be asserted as the most appropriate method indiscriminately by a tax administration, for example in a situation in which one of the parties simply performs minor control functions relating to a risk, with no explicit intention of sharing the risk. The *TPG* are clear that in a situation in which several parties both exercise control over a risk and have financial capacity to assume the risk, "the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control."[5] In a two party controlled transaction that's silent about risk sharing, and in which one party exercises most control over the risk, no risk sharing should be asserted, and accordingly these facts shouldn't present a situation in which the TPSM is likely appropriate. The SVTDG respectfully requests that the PDD be clarified on that point.[6]

b. Separate assumption of closely inter-related risks

The *TPG* provide that an associated enterprise can't—for transfer pricing purposes—assume a risk over which it exercises no control.[7] Application of the TPSM in a situation in which associated enterprises separately share "closely-related" risks is contrary to this principle if, as a result of application of a TPSM, an associated enterprise is allocated profits or losses relating to risks over which it has no control. The SVTDG recommends the PDD be clarified to make this point.

The PDD states that a TPSM may be found to be the most appropriate method in a situation in which "the various [ESRs] in relation to the transaction are separately assumed by the parties, but those risks are closely inter-related such that the playing out of the risks of each party cannot reliably be isolated."[8] Defining "closely inter-related" risks to be those "such that the playing out of the risks of each party cannot reliably be isolated" is vague and provides little

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5 *TPG* ¶ 1.98.

6 The PDD tangentially addresses this point in § C.2.2.2—dealing with highly integrated business operations—in ¶ 24, which provides that "[w]here a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction, this may, in some cases, demonstrate that it is appropriate for the first party to share in the potential upside and downside associated with that risk, commensurate with its contribution to control . . . . [See *TPG* ¶ 1.105]. However, the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the [TPSM] is the most appropriate method in the case." (Emphasis added).

7 *TPG* ¶ 1.95 provides that "[i]f it is established . . . that [an] associated enterprise does not exercise control over the risk . . . then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk."

8 PDD ¶¶ 13 & 23—in sections not nominally dealing with risk—refer to "closely related" risks.

helpful guidance to taxpayers. The SVTDG respectfully asks that the definition of what makes ESRs "closely inter-related" be further refined to add precision. *Example 3* concludes on the facts that the relevant risks "are closely inter-related and interdependent upon each other" but doesn't explain how this conclusion is reached—in particular, it doesn't explain why "the playing out of the risks of each party cannot reliably be isolated."[9] The SVTDG also recommends *Example 3* be clarified to explain the conclusion.

It's possible that a company performing routine functions for an associated enterprise also bears certain risks under this transaction, consistent with allocations of risk observed at arm's length. For example, a company performing distribution services may also bear a part of the downside resulting from 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. But the language of the current PDD may leave room for a tax administration to assert a TPSM as the most appropriate method for pricing payments to the distributor, on the grounds that product warranty risks are "closely inter-related" to product quality, which in turn is related to the development and marketing activities of the associated enterprise. That is, the tax administration might assert the playing out of risks of the principal and the distributor can't reliably be isolated. This example shows how imprecision in the definition of "closely inter-related" risks can work to taxpayers' detriment. This example also shows that—regardless of how "closely inter-related" ESRs are defined—the TPSM shouldn't be considered an appropriate method if such risks are comparable to risks assumed by uncontrolled parties in comparable circumstances. The SVTDG recommends that the PDD be revised to clarify this.

III. RECOMMENDATIONS FOR CHANGES TO *EXAMPLE 3*

In section II.2.b, above, we explained how the analysis in *Example 3* was conclusory and unhelpful in explaining why the relevant risks were "closely inter-related." *Example 3* is also troublesome because of confusing language:

> The performance of each of the parties and the outcomes of each of their respective risks have a very significant influence on the other <u>and the contributions of Company A and Company B are unique and valuable</u>. Under these circumstances, the [TPSM] is likely to be the most appropriate method for determining the profits of Company A and

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9 *Example 3* introduces, without definition, the concept of "inter-dependent" risks—presumably as distinct from "inter-related" risks. This introduces some confusion. The relevance of this new term is unclear from the *Example*.

> Company B from the sales of the products as both parties to the transaction assume closely related risks that are economically significant for their business operations.[10]

We also pointed out in section II.2.b, above, that shared assumption by both parties of ESRs, or separate assumption of closely-related ESRs, shouldn't be an indicator of whether the TPSM is an appropriate method if those ESRs are comparable to risks assumed by uncontrolled parties in comparable circumstances. Under those circumstances a one-side method is more likely to be the most appropriate. The statement in the passage above that "the contributions of Company A and Company B are unique" could be taken to mean that the risks assumed by Company A and Company B are unique—i.e., there are no comparable risks assumed by uncontrolled parties in comparable circumstances. If that's what was meant, then the conclusion holds, but only because of a necessary further reason: not only are the risks "closely related" and economically significant, but there are also no comparable risks assumed by uncontrolled parties in comparable circumstances. The SVTDG recommends *Example 3* be revised to make this clear.

IV. Answers to Specific Questions Posed

> **Question 1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.**

SVTDG response: With the assumption that the TPSM is the most appropriate method, the SVTDG believes in general it's preferable that a split of actual profits should be used. The PDD notes, for example, if—with this assumption—each party shares assumption of ESRs, "it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits will reflect the playing out of the risks of each party. That is, the transfer pricing outcome—a sharing of actual profits—should align with the accurate delineation of the transaction."[11]

In transactions between independent parties involving intangibles, for example, it's common to observe contingent payment forms—e.g., royalties contingent on sales, or units sold.[12] A contingent payment shifts certain risks to the transferor, but the transferee also bears

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[10] PDD ¶ 82 (emphasis added).

[11] PDD ¶ 27.

[12] *TPG* ¶ 6.179.

risks if the transferred intangibles fail.[13] Risks are thus split. The parties each exercise control over risks they bear.[14] The SVTDG believes that the relevant risks are generally economically significant. The SVTDG also believes this mirrors the situation in many controlled transaction situations in which a contingent payment form is chosen. The SVTDG accordingly believes a contingent payment form chosen for a controlled transaction generally accords with a split of actual profits. If a TPSM is thus chosen as the most appropriate method, and the associated enterprises chose a contingent payment form or otherwise share assumption of ESRs, a split of actual profits is warranted. The SVTDG recommends the PDD be revised to make this clear.

Question 2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

a. **Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.**

b. **Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?**

c. **Given the existing guidance in Chapters I and IX of the TPG, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?**

d. **What other profit splitting factors should be included in the guidance, and in what circumstances?**

SVTDG responses: The SVTDG agrees with the PDD that, assuming the TPSM is the most appropriate method, arm's length parties generally split profits on the basis of their relative contributions to the creation of those profits.[15]

Regarding capital or capital employed, the current TPG explain:

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[13] The transferor risks getting paid less than it would if lump-sum or installment payment forms were chosen; the transferee retains risks that its efforts in exploiting the intangibles won't be successful.

[14] The transferor, for example, may take steps to make the license agreement terminable after a certain period of time, or if the license is non-exclusive, the transferor may license another party. The transferee/licensee controls risks associated with its exploitation of the licensed intangibles.

[15] PDD ¶ 54.

> . . . [C]apital-based allocation keys can be used where there is a strong correlation between . . . capital employed and creation of value in the context of the controlled transaction.[16]
>
> One possible approach . . . is to split the combined profits so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction. This method assumes that each participant's capital investment in the transaction is subject to a similar level of risk, so that one might expect the participants to earn similar rates of return if they were operating in the open market. However, this assumption may not be realistic.

The SVTDG agrees the assumptions underlying the use of capital, or capital employed, are questionable, and are unlikely to be met in most controlled transactions. The SVTDG accordingly believes explicit mention of capital or capital employed needn't be retained. As the *TPG* presumably won't be revised to provide an exhaustive set of allocation factors, dropping explicit mention of this factor doesn't preclude its application under rare but appropriate facts and circumstances.

The SVTDG believes use of (just) headcount of similarly skilled and competent employees potentially ignores characteristics of employees that are directly relevant to determining employee contributions to creation of profits. For example, in a controlled transaction involving intangibles, a tax administration might argue for fungibility of R&D engineers employed by transferor and transferee on the grounds of having roughly comparable nominal education and levels of work experience. This can ignore critical characteristics relevant to determining the value-add provided by the engineers, such as decision-making responsibility and the qualitative nature of the sorts of tasks performed (e.g., higher-level design and product architecture, compared with less complex implementation or bug-fixing). For this reason, the SVTDG believes (raw) headcount of similarly skilled and competent employees as a profit-splitting factor is potentially subject to mis-use. The SVTDG notes that, in controlled transactions involving intangibles, the actual costs—which in an MNE can be expected to reflect holistic management decisions on value drivers—is likely to be a more accurate profit-splitting factor if the TPSM is the most appropriate method.

The SVTDG also notes that in controlled transactions involving intangibles, factors other than those relevant to intangible profit creation (e.g., other than R&D costs) may also be relevant. For example, a transferee of intangibles may—in addition to adding value through R&D contributions—also contribute resources or capabilities in its exploitation of products or services using the intangibles. In this case it would be necessary to measure the transferee's such

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[16] *TPG* ¶ 2.142.

contribution, in addition to its R&D contribution, when splitting profits. A combination of factors would likely be applicable in this situation.

> **Question 3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.**

SVTDG response: the SVTDG has no further comment on this issue.

Appendix—SVTDG Membership

Accenture
Activision Blizzard
Acxiom
Adobe
Agilent
Amazon
Apple
Applied Materials
Atlassian
Autodesk
Bio-Rad Laboratories
BMC Software
Broadcom Limited
Brocade
Cadence
Chegg, Inc.
Cisco Systems Inc.
Dell Inc.
Delphi
Dolby Laboratories, Inc.
Dropbox Inc.
eBay
Electronic Arts
Expedia, Inc.
Facebook
Fitbit, Inc.
Flex
Fortinet
GE Digital
Genentech
Genesys
Genomic Health
Gigamon
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic
Google Inc.
GoPro
Hewlett-Packard Enterprise
HP Inc.
Indeed.com
Informatica
Ingram Micro, Inc.
Integrated Device Technology
Intel
Intuit Inc.
Intuitive Surgical
Keysight Technologies
KLA-Tencor Corporation
Lam Research
Marvell
Maxim Integrated
MaxLinear
Mentor Graphics
Microsemi
Microsoft
NetApp, Inc.
Netflix
NVIDIA
Oracle Corporation
Palo Alto Networks
PayPal
Pivotal Software, Inc.
Plantronics
Pure Storage
Qualcomm
Qualys, Inc.
salesforce.com
Sanmina-SCI Corporation
Seagate Technology
ServiceNow
ShoreTel
Snapchat, Inc.
SurveyMonkey
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Theravance Biopharma
TiVo Corporation
Trimble, Inc.
Twitter
Uber Technologies
Veeva Systems
Veritas
Visa
VMware
Western Digital
Xilinx, Inc.
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