The Use of the Profit Split Method in Highly Integrated Transactions

Given the increased significance of the transactional profit split method, the author provides a critical analysis of this transfer pricing method related to highly integrated transactions within multinational enterprises in light of the recently published discussion drafts on profit splits by the OECD. Particularly, this article addresses different aspects of these discussion drafts and gives a real-life example of a profit split in the construction industry in the context of highly integrated transactions.

1. Introduction

The recent number of released discussion drafts on base erosion and profit shifting (BEPS) Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation), particularly the three discussion drafts related to BEPS Action 10 concerning profit splits, shows the growing importance of the profit split method in transfer pricing. On 22 June 2017, the OECD published a second revised draft guidance on the transactional profit split method (TPSM), which replaced the first revised discussion draft released in July 2016.

One concept, among others, outlined by the two revised discussion drafts on profit splits by the OECD. Particularly, in light of the recently published discussion drafts and gives a real-life example of a profit split in the construction industry in the context of highly integrated transactions.

2. Overview and Recent Evolution of the Profit Split Method

2.1. Overview

The profit split method is one of the five transfer pricing methods and the only two-sided method defined by chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 (OECD Guidelines (2010)), as well as the most recent OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD Guidelines (2017)). This method examines the division of profits that independent companies would have expected for a transaction in comparable circumstances.

In general, there are two commonly used approaches for splitting the profits, particularly the (i) contribution analysis and (ii) the residual analysis.
Under the contribution analysis, the combined profit from the controlled transaction is divided between related companies based upon a reasonable approximation of the division of profits that independent companies would have expected to realize from engaging in comparable transactions. In case there is no comparable data available, the basis for the contribution analysis is often the relative value of the functions performed by each participating party in the controlled transaction, taking account of their assets used and risks assumed.

A residual analysis is designed to divide the combined profits from the controlled transaction into two stages. In the first stage, it assigns an arm’s length compensation for routine (typically simpler) contributions to each participant in the transaction by applying one of the traditional transaction methods or the transactional net margin method (TNMM). In the second step, it allocates any residual profit (or loss) among the participating parties in the controlled transaction based on the relative value of their contribution.

An alternative approach to applying a residual analysis could be one that seeks to replicate the outcome of bargaining between independent companies in the free market or one that takes into consideration the discounted cash flow of the parties to the controlled transaction over the anticipated life of the business.

Each type of profit split necessitates an in-depth analysis of the associated parties’ relative contributions. To translate these relative contributions into a ratio for splitting the profit, various approaches are used, e.g. external market data, internal data, bargaining theory models, discounted cash flow analysis or survey approaches.

The recent results from the BEPS initiatives regarding profit splitting can be summarized as follows:
- on 16 December 2014, the OECD issued a first discussion draft on the use of profit splits in the context of global value chains (Action 10 Discussion Draft (2014));
- on 5 October 2015, the OECD released the BEPS Action 8-10 final reports (Actions 8-10 Final Report);
- on 4 July 2016, the OECD published a revised discussion draft (Actions 8-10 Discussion Draft (2016)),

With respect to highly integrated transactions, as a commentator pointed out, the Action 10 Discussion Draft (2014) recognizes that a one-sided method may not be applicable in all situations and presents ten situations whereby the profit split method could potentially be used for highly integrated companies that share and jointly manage strategic risks. The Action 10 Discussion Draft (2014) makes only a few references to highly integrated transactions in comparison to the revised Actions 8-10 Discussion Draft of 2016 and the revised Action 10 Discussion Draft of 2017. Nevertheless, this changed most notably in the Actions 8-10 Discussion Draft.

The following sections depict the results of the evolution of the TPSM in light of the revised discussion drafts on the profit split method most recently released by the OECD, namely the Actions 8-10 Discussion Draft (2016) and the Action 10 Discussion Draft (2017).

2.2. The Actions 8-10 Discussion Draft (2016)
The revised Actions 8-10 Discussion Draft (2016) brought some new definitions and concepts, in particular with regard to highly integrated operations/transactions.

2.2.1. Unique and valuable contributions
When it comes to unique and valuable transactions, the Actions 8-10 Discussion Draft (2016) specifies contributions as “unique and valuable” where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) their use in business operations represents a key source of actual or potential economic benefits. The Actions 8-10 Discussion Draft (2016) sets out that the two factors are often linked and comparables for such transactions are seldom found, since they are key for economic advantage.

As an example, digital businesses are characterized by their reliance on intangibles, integrated value chains as well as unique structures for which no comparable market operations exist.

2.2.2. Highly integrated transactions
In the Actions 8-10 Discussion Draft (2016), the OECD introduced a new chapter C.3.1, outlining the concept of highly integrated operations in more detail. Although earlier papers in the context of the TPSM have mentioned
The Actions 8-10 Discussion Draft (2016) established the concept of parallel and sequential integration. Accordingly, the profit splitting of actual profits is more likely to be applied to parallel integration by the associated enterprises, where multiple parties to the transaction are involved in the same stage of the value chain, since for parallel integration, it may be the case that the accurate delineation of the actual transaction determines that each party shares economically significant risks. With respect to sequential integration, this is rather not the case, as parties perform discrete functions, and it will usually be possible to find reliable comparables for companies in each stage in the integrated value chain. However, some commentators expressed their concerns in stating that an analysis of specific facts and circumstances needs to consider other elements, and they presented examples of situations where “specific, possibly unique, facts and circumstances” exist that are not present between independent enterprises.

2.2.3. Anticipated versus actual profits

The Actions 8-10 Discussion Draft (2016) proposes two ways of splitting profits (or losses), namely combining and splitting (i) anticipated profits and (ii) actual profits. The OECD clearly sets out that the focus in the Actions 8-10 Discussion Draft (2016) lies on the application of the transactional profit splits of actual profits as the “most appropriate method.” Irrespective of splitting the anticipated or actual profits, the basis upon which those profits are to be split between related parties must be determined upfront on the basis of reasonably foreseeable or known information by the involved parties at the time the transaction was entered into. Whether this could give rise to a formulary apportionment methodology is not further outlined in this article.

2.2.3.1. Anticipated profits

The transactional profit split of the anticipated profits, as set out by the OECD, “is a type of price arrangement whereby the principles of splitting profits on an economically valid basis are applied to the anticipated profits of an enterprise resulting from its own contributions and also from those made by an associated enterprise.”

2.2.3.2. Actual profits

In contrast, the basis for a transactional profit split of actual profits is the combined profit and respective contribution of each enterprise involved in the transaction(s) derived from the commercialization of products using the intangibles. Although the split of combined profits is stipulated ex ante, it is the actual, combined profit resulting from the transaction(s) that is taken as the basis to split the profits.

The Actions 8-10 Discussion Draft (2016) makes it clear that for an application of a transactional profit split of actual profits, a high level of integration of activities is required. However, a public commentator has expressed that for MNEs that operate what is effectively called a unitary business in the sense that they operate as a set of centrally directed and managed operations, the profit split method as applied to actual profits is not only appropriate, it is usually the most appropriate method.


The latest revised Discussion Draft, released by the OECD on 22 June 2017, presents revised guidance on the application of the TPSM. One of the outstanding changes with regard to highly integrated transactions compared to the Actions 8-10 Discussion Draft (2016) is the removal of the distinction between parallel and sequential integration as well as others such as the discussion of group synergies.

3.1. Nature of the transaction(s)

The Action 10 Discussion Draft (2017) offers the following potential indicators where the TPSM may be considered as appropriate:

- the existence of a unique and valuable contribution by each party to the controlled transaction;
- a high level of integration regarding business transactions to which the transaction relates; and
- the shared assumptions of economically significant risks by the parties to the transaction.
3.1.1. Unique and valuable contributions

The definition for perhaps the most concise indicator for applying the TPSM outlined by the Action 10 Discussion Draft (2017) is in line with the definition set out in the previous Actions 8-10 Discussion Draft (2016). Nevertheless, it remains unclear what is precisely meant by “unique and valuable” and whether both conditions, “unique” as well as “valuable”, should be fulfilled (e.g. a contribution may be unique but not valuable).

3.1.2. Highly integrated transactions

Following the Action 10 Discussion Draft (2017), the definition of a high degree of integration is the same as in the Actions 8-10 Discussion Draft (2016), meaning that the way in which one party to the transaction performs functions, uses assets and assumes risks is interrelated with, and cannot reliably be assessed in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks. A situation with a high degree of integration may be where the integration between the parties to the transaction takes the form of a high degree of interdependency. However, there is no threshold for highly integrated operations presented, although a threshold may be needed or it may be advisable to replace “highly integrated” with more reliable indicators. Likewise, some commentators, such as the United States Council for International Business (USCIB) expressed their concern with regard to the definition of highly integrated transactions, stating that the language referring to a particularly high degree of integration should be standardized and better defined.

As outlined before, the distinction between parallel and sequential integration has been completely removed by the OECD in the Action 10 Discussion Draft (2017).

3.1.3. Shared assumption of economically significant risks, separate assumption of closely related risks

The OECD clearly states that a TPSM may be the most appropriate method where each party to the transaction shares the assumption of one or more economically significant risks pertaining to that transaction or various economically significant risks pertaining to the transaction are separately assumed by the parties, but those risks are closely interrelated, so that the playing out of the risks of each party cannot reliably be isolated.

The detailed analysis and determination of significant risks is part of the broader functional analysis (which, in turn, is an element of the comparability analysis) and helps to determine comparability. Control of risk is the key factor for the determination of which legal entity is entitled to the risk-bearing return, either positive or negative.

The Action 10 Discussion Draft (2017) remains silent on why the split should be performed on actual profits in cases of shared assumption of economically significant risks or separate assumption of closely related risks and why on anticipated profits in the other cases.

3.2. Strengths and weaknesses of the TPSM as the most appropriate method

The OECD describes the following strengths and weaknesses in section C.2.1 of the Action 10 Discussion Draft (2017).

3.2.1. Strengths of the profit split method

The key strength of the TPSM is the possibility to offer a solution where both parties to the transaction make unique and valuable contributions to the transaction as well as for highly integrated transactions in cases for which a one-sided method would not be appropriate.

Another strength of the TPSM is that it provides flexibility by taking into consideration specific, possibly unique, facts and circumstances of the related enterprises. Additionally, it can allow for the determination of an arm’s length profit for each party to the transaction where there is a high degree of uncertainty for each of the parties in relation to the transaction.

Further, the TPSM allows a direct evaluation of both parties to the transaction.

3.2.2. Weaknesses of the profit split method

A first weakness detected by the OECD is that, for the TPSM, associated companies and tax authorities alike may have difficulty accessing information from foreign affiliates. Additionally, it may be difficult to assess the relevant revenue and costs for all the associated companies to the transactions. Another weakness may be, as one commentator explained, that transactional profit splits tend to have a higher level of complexity compared to other transfer pricing methods, which can make them more open to challenge in a tax audit and leading to higher
uncertainty for taxpayers. Furthermore, with respect to the application of operating profits, the identification of the appropriate operating expenses associated with the transaction as well as the allocation of the costs between the transaction(s) and the associated enterprises’ other activities may be difficult.

For countries like China, one should expect the tax authorities to limit the use of one-sided transfer pricing methods and favour the application of the profit split method. However, this could also cause a misuse of the TPSM by certain tax authorities in applying it instead of a one-sided methodology in cases where a one-sided method may be more appropriate.

3.3. Determining the profits to be split
As underlined by the Action 10 Discussion Draft (2017), the relevant profits to be split should only be those arising with regard to the controlled transaction or transaction under review.

3.3.1. Different measures of profits
The OECD states that, in general, the relevant profits to be split under the TPSM are operating profits. However, it also notes that, in some cases, it may be appropriate to apply a different measure for the split, such as gross profit, and then deduct the expenses incurred by or attributable to each relevant enterprise. For instance, if the accurate delineation of the transaction(s), which is key for the determination of the measure of profits to be split, reflects that the parties share assumptions of not only market risk, but also risks related to producing or otherwise acquiring goods and/or services, which affect the level of gross profits, it would be most appropriate to use gross profits as the basis for the split.

3.3.2. Anticipated versus actual profits
The OECD emphasizes in the Action 10 Discussion Draft (2017) that the splitting of actual profits would only be appropriate where "the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity." For highly integrated business operations and/or for business operations where each party makes unique and valuable contributions, these kinds of risk assumptions may occur.

In contrast, if one of the parties does not share in the assumption of the economically significant risks, a split of anticipated profits is more appropriate. It is likely that two independent parties transacting based on splitting the anticipated profits would assess the results periodically to review the commercial viability of continuing the transaction on the basis of splitting anticipated profits. If the outcomes vary significantly from the anticipated outcome, independent parties would most likely seek to renegotiate or exit from the arrangement.

3.4. Profit splitting factor(s)
The Action 10 Discussion Draft (2017) discusses mainly asset/capital and cost-based factors, but also refers to other profit splitting factors such as incremental sales or employee compensation. In each case, the determination of the appropriate profit splitting factor(s) should reflect the key contributions to value in relation to the transaction.

3.4.1. Asset-based factor(s)
The profit splitting factor(s) based on assets or capital can be appropriate where it is possible to identify a strong correlation between tangible assets or intangibles, or capital employed and the creation of value in line with the controlled transaction.

3.4.2. Cost-based factor(s)
The cost-based profit splitting factor(s) may be appropriate where there is a strong correlation between relative expenses incurred and relative value contributed. When identifying and applying appropriate cost-based profit splitting factors, a number of issues may need to be taken into consideration. These issues could be:

- differences between the parties in the timing of expenditure;
- the relevant costs may be part of a larger cost pool that needs to be analysed and allocated to the contributions made to the profit split transaction(s);
- where location savings retained by member(s) of the MNE are a significant contributor to profits and such costs are included in the profits to be split;
- cost-based profit splitting factors can be very sensitive to deviations and changes in accounting classification of costs; or
- the determination of the relevant period of time from which the elements of determination of the profit splitting factors(s) should be taken into consideration.
As the Asociación Argentina de Estudios Fiscales (AAEF) commented, if the profit splitting factors are based on costs, relative spending and/or investment in key areas such as research and development (R&D), engineering or marketing is often used where it captures the relative contributions of the parties to the profits being split.\(^{75}\) NERA makes the point that the most appropriate profit splitting factor in one set of circumstances may not be appropriate under different circumstances, depending upon the underlying profit drivers and the relative contributions and risk capacities of the parties.\(^{76}\)

### 4. Example: Identification of Highly Integrated Transactions and Their Practical Application

The identification and application of the profit split method can be described and illustrated with the following concrete example from the construction crane industry.

**4.1. Overview of the construction crane industry and facts of the business case example**

The MNE in question is the world leader in the mobile crane business, not only because of its innovative cranes and technology, but also because of the quality, functionality and safety of its broad range of cranes. These are also the key value drivers and critical success factors for the MNE within the construction crane industry.

The MNE has two different main divisions, which consist of mobile construction cranes and tower cranes. Company A is the original equipment manufacturer (OEM) of mobile construction cranes and resident in Germany. Company B is the OEM of tower cranes and resident in Austria. Both OEMs are members of the same MNE group. The two OEMs develop and produce hybrid cranes, meaning that some parts and inputs for specific product functionalities of the end product stem from Company A and others from Company B. The profits realized with the sale of these hybrid construction cranes are directly linked to the innovative technological intellectual property (IP) of both OEMs.

Both OEMs purchase their relevant raw material and components for producing the hybrid cranes either from unrelated third-party suppliers and/or related-party suppliers by remunerating them with an appropriate arm’s length transfer price based on the cost-plus method. Company A firstly assembles all the necessary components for the hybrid cranes and transports the semi-finished goods exclusively to related Company B, which installs its core components. The still semi-finished cranes in turn need to be transported from Company B exclusively to associated Company A, which finalizes the hybrid crane with certain key parts so that the end product can be sold to either associated distributors, which distribute the hybrid cranes to unrelated customers (assuming that the transfer price between the associated distributors and Company A is consistent with the arm’s length principle and based on the resale price method), to third-party distributors or directly to end consumers.

The simplified diagram in Figure 1 illustrates the major transactions of the MNE’s supply chain for hybrid cranes (only transactional product flows are depicted).

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The functional analysis relating to the production of hybrid cranes and their controlled transactions (transactions between the two associated OEMs) identifies that both manufacturers (as the parties to the controlled transactions) perform their respective R&D functions as well as most of the functions related to logistics and production. The OEMs take their own important strategic decisions with regard to R&D as well as their use of intangibles, contribute their assets (both OEMs invest heavily in R&D) and assume the risks (including investment risk) for these activities. Both OEMs carry out economically significant key activities, contribute significant value to the transactions, take responsibility for the activities undertaken and assume the risks thereof. In terms of development, enhancement, maintenance, protection and exploitation (the so-called DEMPE functions) relating to the technology of hybrid cranes, the OEMs respectively develop, enhance and maintain intangibles. They also own unique assets and valuable intangibles, perform significant value driving functions and assume major risks. OEMs protect their IP (mostly technology-related IP) via the registering of respective patents. In addition, an executive committee has been set up, in which leaders of both OEMs are represented and take decisions for the MNE group with regard to the hybrid crane construction market as a whole.

Taking into consideration all the facts and circumstances, both OEMs can be characterized as fully fledged manufacturers in relation to the production of the hybrid cranes and effectively have the economic substance with regard to the controlled transactions. As both OEMs perform functions, use assets and assume risks related to the DEMPE functions, both enterprises should be remunerated on an arm’s length basis for their contributions. 78

4.2. Identification of highly integrated transactions

Each OEM develops and owns unique and valuable intangibles in their respective production processes, but, as the accurate delineation of the transactions clearly highlights, their operations are highly integrated in the sense that the outcome of each OEM depends on the capacity of the other. Additionally, the joint executive committee, in which leaders of both OEMs are represented and which takes decisions for the MNE group hybrid crane construction market as a whole, should be taken into consideration. On the basis of the facts and circumstances, the interactions between the two OEMs can be characterized as highly interdependent.

4.3. Application of the profit split method for highly integrated transactions in the construction industry

Given the fact that the controlled transactions are closely interrelated, both OEMs to the transactions bear the production risks and both make unique and valuable intangibles, which make it difficult to find appropriate comparable data. Therefore, the TPSM is likely to be the most appropriate method for determining the profits for each OEM from the sale of hybrid construction cranes. However, as stated by the Action 10 Discussion Draft (2017) as well as the World Bank toolkit for addressing difficulties in accessing comparable data for transfer pricing analysis, one should take into consideration that a lack of comparable data alone is not sufficient to apply the TPSM and risks leading to a significant departure from the arm’s length result.

The selection and application of the profit split method is, to a certain degree, a subjective one, for example in determining the combined profits, or in the selection and application of the allocation keys, etc. Nevertheless, especially for the concrete case at hand where neither comparable uncontrolled transactions nor concrete proceedings showing how independent parties would have split the profit in comparable circumstances are available, the profit split method might be the most appropriate.

In order to account for the relative contribution of both OEMs’ creation of valuable intangibles, a residual profit split analysis may be appropriate, based on the specific facts and circumstances that might indicate how the residual profit would have been allocated at arm’s length. As both OEMs invest heavily in R&D and the value of the contribution attributable to Company A and Company B, respectively, is proportional to their R&D costs, the R&D expenditures are considered to be an appropriate allocation key for the residual profits (cost-based approach). This is also in line with the Action 10 Discussion Draft (2017), which states that R&D expenses may be suitable for manufacturers in the case that they relate to the development of unique and valuable intangibles, such as patents.

83. Major upfront investments, such as R&D investments, in this technology-driven mobile crane industry are characterized by a rather long-term horizon, meaning that the OEMs are able to realize returns on investments from these intangibles only after a relatively long period of time.
85. Id.

77. This is also stated in the respective intercompany agreements as well as in the current transfer pricing policy of the group.
78. See, especially, OECD, Actions 8-10 Final Report, supra n. 2, at 73-87, paras. 6.32-6.80.
79. As depicted by S.K. Bilaney, Supply Chain Management Using Alternative Manufacturing Models, 21 Intl. Transfer Pricing J. 2 (2014), at 89, Journals IBFD, a fully fledged manufacturer compared to a contract manufacturer or toll manufacturer bears additionally inventory risk of finished goods and has a high level of R&D risk as well as a higher level of general business risk.
The basis for the profits to be split are actual profits, since the transactions are highly interrelated and the accurate delineation of the transactions by using the full functional analysis reflects that the OEMs separately assume closely related, economically significant risks associated with the business opportunity.

The accurate delineation of the controlled transaction(s) shows that the OEMs, in addition to market and production risks, separately assume a further range of risks that affects the level of operating expenses (OPEX), e.g. additional investments in IP, etc. Therefore, taking into consideration all the other facts and circumstances, it is most appropriate to use the respective operating profits earnings before interests and taxes (EBIT) as the basis of the profit split.

The following description and figures show the residual profit split analysis in more detail and is in line with the example outlined in annex II to chapter II of the Action 10 Discussion Draft (2014).86

4.3.1. Profit and loss statement

The MNE has the product line income statement as shown in Table 1 based on actual figures, which have been retrieved from the respective cost accounts of the MNE’s income statements as the starting point for determining the profits to be split between Company A and Company B.87

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<th>Table 1 – Profit and loss statement of Company A and Company B</th>
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4.3.2. Determination of routine profit on production

The set of comparables shows that third-party comparable producers without such innovative IP technology earn an arm’s length return on production costs (excluding purchases) between 8 and 12% (arm’s length range, ratio of net profit over production costs),88 with a median89 of 10%. Company A’s production costs are 60, and thus the return on production costs would attribute A a routine production profit of 6.

For Company B, the production costs are 30, and hence the return on production costs would attribute B a routine production profit of 3.

The combined routine profit is therefore 9.

4.3.3. Determination and allocation of residual profit on R&D

The residual profit is 21, which results from deducting the routine profit of 9 from the total EBIT of 30. This residual profit can be split between the two OEMs based on their share of total R&D expenses.90

Each OEM’s R&D costs are 30, which gives a total of 60. The residual of 21 can now be allocated according to A and B’s share of total R&D expenses (50% respectively):

A’s share is 21 × 30 ÷ 60 = 10.5.
B’s share is 21 × 30 ÷ 60 = 10.5.

4.3.4. Revised profit and loss statement

A’s revised operating profit is thus 6 + 10.5 = 16.5.
B’s revised operating profit is thus 3 + 10.5 = 13.5.

See Table 2.

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86. The approach described in the following subsections is in accordance with the example outlined in annex II to chapter II of the OECD Action 10 Discussion Draft (2014), supra n. 18, at 24-26. Descriptions and figures are adapted to the specific business case outlined in the paper at hand.
87. See also OECD, Action 10 Discussion Draft (2017), supra n. 3, at 11, para. 41.
88. See annex II to chapter II of the OECD 2014 Discussion Draft, supra n. 18, at 25.
89. As the OECD clearly states in the Guidelines (2017), at 165, para. 3.62, it may be appropriate to use measures of central tendency to determine the point in the arm’s length range (for instance, the median, the mean or weighted averages, etc., depending on the specific characteristics of the data set), in order to minimize the risk of error due to unknown or unquantifiable remaining comparability defects.
90. This is in line with a cost-based approach.
5. Conclusion

The definition of highly integrated transactions is relatively broad and openly formulated with no clear threshold, and the concept outlined in the different discussion drafts on profit splits released by the OECD includes many changes, e.g. the discontinuation of the concept of parallel and sequential integration. Hence, the definition of what exactly highly integrated transactions are and their selection as well as the application of the concept is to a certain degree a subjective one. Nevertheless, in the author’s view, the TPSM will most probably be used or should at least be taken into consideration as the most reliable transfer pricing method whenever highly integrated operations in combination with unique and valuable intangibles exist, even more if related companies of an MNE operate in two different tax jurisdictions and at least one of the tax authorities is rather aggressive with regard to the taxation of profits from MNEs. In conclusion, the TPSM for highly integrated transactions should only be applied if the outcome is consistent with the arm’s length principle.