



The Impact of Tax-Avoidance Measures by the Government on Taxable Income Differential Between Foreign- and Domestic Companies in Saudi Arabia

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Received Date : 9/2/2020

Accepted Date : 11/3/2020

DOI : <https://doi.org/10.31559/GJEB2020.8.2.11>

Abstract: The purpose of this research to identify the existence of differences in taxes paid to the government due to different practices implemented in terms of transfer pricing by foreign companies operating in Saudi Arabia. The transfer pricing policies implemented by the foreign companies can lower the taxable income of the company which results in lower taxes for the companies. This study was conducted for multiple domestic and foreign countries operating in Saudi Arabia. Alhassan and Bajaher (2016), used different regression models to understand the relationships between transfer pricing, taxable income and the taxes paid by the companies operating in Saudi Arabia for the years 2016, 2017 and 2018 . These regression models were used to identify and measure the differences in taxes paid by the domestic and foreign companies operating in the country. The results of the statistical analysis showed that foreign companies pay more taxes as compared to the domestic companies in the country. The analyses showed that there is a mean difference of nearly 1.8% in the taxes paid by the companies based on their locations.

Keywords: Corporate tax rates; shifting profits; transfer pricing.

1. Introduction

Multinational companies use transfer pricing methods to minimize the overall taxes that they have to pay on their profits. This results in loss of tax revenue for the tax authorities and the government of Saudi Arabia since the companies use transfer pricing methods to reduce their taxable income and the taxes paid by the company on this income. In case of Saudi Arabia, different companies, based on their location pay different rates of taxes on their profits to the authorities. This is made possible due to the differences in tax policies in different countries. This paper will analyze the difference in taxes paid to the Saudi Arabian government by the domestic Multinational companies in the country and the foreign Multinational companies.

The issue intrinsically revolves around the practices of the management teams of these companies and their exploitation of differences in tax regulations and policies in different countries to minimize their tax expenses. There is an increasing concern in the global community that the differences in tax policies are allowing the companies operating in more than one country to use transfer pricing methods to shift their profits to countries with lower tax rates on the profits.

The study conducted by Dharmapala (2014) identifies the magnitude of similar ministrations carried out by the managements of multinational companies for the purpose of tax avoidance and minimization by shifting the profits of the companies to low tax rate jurisdictions using transfer pricing methods like intra-company trading and intra company debt issuances. Multiple other empirical studies have come to the same conclusion that a vast majority of multinational companies have used the transfer pricing methods in the past to minimize their tax expenses and to shift their profits to the jurisdictions with low tax rates. The multinational companies benefit from transfer pricing methods by holding their intangible assets and repatriating the profits to low tax countries to avoid paying high taxes. In recent years, the practices of large US multinational companies have been brought to attention that use similar tactics to shift their profits to reduce tax expenses.

As a response to this issue, Borge and Byberg (2018) also revealed that several governments have taken certain initiatives to curtail the following problems. This has been done by introducing reforms in the tax policies after consultation with other nations to standardize the tax jurisdictions. Profit shifting and tax minimizations result in a loss to the local economy due to the shrinkage of the tax base which results in a loss in the tax revenues of the governments. The tax authorities have access to a vast array of economic and regulatory tools that can be used to eradicate this problem. In recent years, several of these tools have been brought into use. A prime example of this

fact is the reforms introduced by the member countries of the Organization for Economic Co-operation and Development (OECD).

The OECD member countries have introduced different tools to reduce losses in tax revenues due to profit shifting. This involves the implementation of Controlled Foreign Corporation (CFC) rules and Thin Capitalization Rules (TCRs). The OECD introduced an anti-profit shifting initiative that encompasses multiple member countries of the OECD, titled Base Erosion and Profit Shifting (BEPS). This initiative was introduced in 2015 and has reduced the possibility of benefits and possibility of profit shifting in the member countries. Despite the success of this initiative as well as other measures to curtail this issue, there is the potential for using transfer pricing for tax minimizations.

2. Objectives of the Study

This research paper aims to identify whether a difference still exists in the taxes paid by the domestic multinational companies and the foreign based multinational companies in Saudi Arabia in the aftermath of the anti-avoidance measure implemented by the country. This analysis will be conducted by comparing the taxes paid by the oil companies in relation to the revenues of these companies.

3. Significance of the Study

The importance of this study stems from the fact that multiple empirical studies have identified the usage of transfer pricing methods to minimize tax expenses while the application of transfer pricing for these purposes has not been empirically studied in Saudi Arabia. The aim of this is to provide empirical evidence on two major issues related to the transfer pricing methods. The issues involve the differences in management practices in light of the different tax policies and jurisdictions in the countries of operation for multinational companies. The research will also identify whether the multinational oil companies operating in Saudi Arabia use transfer pricing to shift their profits to low tax countries to lower their tax expenses. This study will also provide information about the efficacy of the different policies and measures implemented by the OECD member nations during the last decade. For this purpose, the results of this study will be compared with the results from the study conducted by Alhassan and Bajaher (2016). In their study, the researchers tested the same hypothesis for the data collected for years 2005 to 2007. Their study proved that the domestic multinational oil companies operating in Saudi Arabia pay lower taxes to the government of Saudi Arabia as compared to the foreign multinational oil companies operating in the country.

The introduction section will be followed by a summary of the literature review on the transfer pricing methods and different empirical analysis models that can be used to evaluate the hypotheses that will be tested in this paper. The next section will describe the methodology and models that will be used to evaluate the plausibility of the hypotheses presented in this paper. The results of the empirical and statistical models will be described in the fifth section of the paper while the last section will provide a summary of the research paper and the conclusions that can be drawn from the results of the statistical and empirical analyses.

This paper will test the following hypotheses:

Hypothesis 1: the management of companies operating in Saudi Arabia use transfer pricing methods to shift their profits to low tax jurisdictions outside of Saudi Arabia which results in lower tax costs for the domestic oil companies operating in Saudi Arabia compared to the revenues of these companies.

Hypothesis 2: the tax differentials between the tax costs of domestic multinational oil companies operating in Saudi Arabia and the foreign multinational oil companies operating in the same country have decreased due to the implementation of anti-avoidance measures in collaboration with other OECD member nations.

4. Literature Review

Gidirim (2016) further revealed that economists and empirical researchers have projected and used different methods and models in their researches to appraise the usage of transfer pricing for the purpose of shifting profits to low tax jurisdictions to minimize the tax costs. Most commonly used models in the researches have been provided by Silva (1999), Grubert and Mutti (1991), Hines and Rice (1994) and Nielsen, Raimondos-Møller, and Schelderup (2001). These models were used by the researchers to conduct empirical analyses for the companies based in the United States and Europe. There is a vast difference in the data sets available for the companies operating in developed countries and the countries operating in Saudi Arabia. Due to this, the models proposed by the above mentioned researchers could not be employed to evaluate transfer pricing use in Saudi Arabia.

Silva (1999) used the statistical data for public companies operating in the United States in the toiletry, cosmetics, drugs and perfumes industries. Silva used a simple statistical model that analyzed the usage of transfer pricing methods by the selected companies. The statistical model was based on the ratio of operating expenses and

other random factors related to the companies. This statistical model can't be applied for the purpose of this study since the variables used by Silva for his study are not available for the companies operating in Saudi Arabia.

Grubert and Mutti's (1991) concept is a transfer pricing strategy used in many industries across the country. The example provides an economic solution to the transfer pricing problem and provides quantitative analysis in three areas, including the possibility of exchanging funds between tax-affected countries whose tax results and taxes are in the approval of international business processes Access to capital and tax consequences as well as political costs. The transfer cost results can be used in the example of Grubert and Mutti (1991).

Clausing (2016) stated that it relies on known microeconomic properties of capital and infrastructure, including increased profitability, competition for capital, and research on capital flows. Therefore, Jacob (1996) revealed that this makes the search process easier to use and reproduces well with users. However, in the Saudi region, like US companies, the model found no significant changes.

Hines and Rice (1994), cited in the Grubert and Mutti report, provided a comprehensive analysis of issues related to the use of US companies as grounds for lawsuits and tax incentives, which are among the reasons for abuse. Market migration and taxes. All the way to the United States. This study provides information on the importance and reliability of model statements. The results of this study provide guidance for the assessment of transfer pricing in Puerto Rico and discuss this issue with criteria and structural equations (SEM) (Grubert & Slemrod, 1998).

However, like US companies, the model does not have the necessary variables in the Saudi market. Nielsen, Raimondos-Møller, and Schelderup (2001) proposed a transfer pricing method that can be used to obtain transfer pricing, detailed information on the oil and gas industry, and other publicly available information. The model takes advantage of transfer pricing and market conditions in oligopolistic competition, depending on the current state of the industry. However, the Saudi Arabia region has not yet achieved significant changes like American companies.

Borvornboonrutai (2001) uses a multivariate analysis method to better understand the factors related to tariffs and tax rates paid between domestic and foreign companies operating in Thailand. A secretary can use the following types of information to identify financial transactions, equity, interest rates, and other financial indicators to identify potential sources. In addition, the authors performed other empirical tests to see if there is a significant difference in tax-related income between companies in Thailand and foreign companies operating in Thailand.

The study conducted by Alhassan and Bajaher (2016) used a simple statistical model based on the publicly available data for 21 companies operating in Saudi Arabia. The analysis was conducted for the data of 13 domestic multinational oil companies and 8 foreign multinational oil companies operating in Saudi Arabia. For the purpose of their study, data for the time period between 2005 and 2007 was analyzed.

5. Methodology and Model

To test the hypotheses mentioned in the introduction section of this study, the model used by Alhassan and Bajaher in their study was replicated to understand the usage of transfer pricing for minimizing the tax expenses. This model has been selected due to its simplistic mathematical nature and the availability of the data for the variables used in the analysis. Furthermore, using the same model as used by Alhassan and Bajaher (2016) in their study will allow the testing of the second hypothesis mentioned in the introduction section by comparing the results for the same companies chosen by Alhassan and Bajaher for the last three years of available data. The analyses will test the validity of the two hypotheses mentioned in the introduction section. The following table shows the companies that will be used to test the hypotheses in this research. These are the same companies as used by the researchers in their study in 2016.

Table (1): List of companies operating in Saudi Arabia used for hypothesis testing

Saudi Arabia Companies	Foreign Companies
Advanced Polypropylene Company	ExxonMobil
Alujain Corporation	Royal Dutch Shell
Nama Chemicals Company	BP
National Industrialization Company	Chevron
Rabigh Refining and Petrochemical	ConocoPhillips
Sahara Petrochemical Company	Marathon Oil Corporation
Saudi Arabia Fertilizers Company	Sunoco
Saudi Basic Industries Corporation	Vaalco
Saudi Industrial Investment Group	
Saudi International Petrochemical	
Saudi Kayan Petrochemical Company	
Yanbu National Petrochemical Company	
Saudi Electricity Company	

The analysis will be conducted using the following model for linear regression analysis:

$$Tax = a + c + e + ta + dp + dl + n$$

Based on the model, the tax costs are evaluated as a function of seven different variables. The variables used in the model are:

'a' represents the age of the company in number of years. The data for this variable will be collected in the form of whole numbers by rounding off any values in fractions.

'c' represents the current ratio of the company which is measured by dividing the current assets of the company by its current liabilities. The ratio is an indicator of the company's ability to meet its short term obligations using its assets. The current ratio data will be collected in the form of fractions.

'e' represents the ratio of equity used by the company for financing the assets of the company. The data was collected in the form of fractions.

'ta' represents the total assets of the company that includes the tangible, fixed assets of the company as well as the intangible assets and current assets of the company.

'dp' represents the dividend payout ratio of the company. This ratio was calculated by dividing the dividends paid by the company by the total revenue of the company.

'dl' is a measure of the degree of leverage of the company and was calculated by dividing the total revenue of the company by the total debt used by the company to finance its assets.

'n' shows the location of the company and has only two possible values. '1' for the Saudi companies and '0' for the foreign companies operating in Saudi Arabia. This variable was included in the regression model to calculate the impact of location on the other variables and the resultant impact on the taxes paid by the company.

6. Results/ Analysis

Table (2): Descriptive Statistics for Domestic Companies

	Tax	Age	Current Ratio	Equity	Total Assets	Dividend	Leverage
Mean	0.0307	22.30	2.0066	0.4739	13.6858	0.1107	0.6394
Standard Error	0.004	2.00	0.3167	0.0446	3.7147	0.0399	0.0833
Standard Deviation	0.027	12.50	1.9781	0.2788	23.1986	0.2493	0.5205
Minimum	-0.025	9	0.2170	0.1441	1.5633	0	0.0093
Maximum	0.0848	53	12.2201	0.9841	125.9773	1.3915	1.8669

Table 2 shows the descriptive statistics of the variables for the companies that are domestically controlled in Saudi Arabia. The analysis was conducted using a dataset of 13 domestically controlled oil companies in Saudi Arabia for the years 2016, 2017 and 2018. The analysis shows that the domestic companies operating in Saudi Arabia in the oil and chemicals industry are paying nearly 3.07% of their total revenues in taxes to the national government. The average age of the domestic oil and chemicals companies operating in Saudi Arabia is nearly 22 years. The publicly traded oil companies in Saudi Arabia are comparatively young if compared to other similar companies on the global level. The mean value for current ratio, at 2, is a testament to the financial health of these companies. Similarly, the ratio of total revenue generated by the company in a year to the total assets employed by the company is at a healthy 13.68 which shows efficient and effective usage of resources. At least 47% of the assets of the companies are funded by the equity of the company at average which shows that these companies have a low degree of leverage at average. The equity holders of these companies benefit from a healthy dividend payout system with dividends amounting to nearly 11% of the total revenues of the companies for the last three years.

Table (3): Correlation Analysis for Domestically-Controlled Companies in Saudi Arabia

	Tax	Age	Current Ratio	Equity	Total Assets	Dividend	Leverage
Tax	1						
Age	-0.0412	1					
Current Ratio	0.3965	-0.1639	1				
Equity	0.3358	0.1821	0.5822	1			
Total Assets	-0.0080	-0.1180	-0.0881	-0.0707	1		
Dividends	0.3013	-0.1151	0.4065	0.2781	-0.0977	1	
Leverage	-0.1878	0.0383	0.3792	0.6794	-0.2408	-0.0024	1

Table 3 shows the results of the correlation analysis for the variables, from the companies that are domestically controlled in Saudi Arabia. The results of the correlation analysis showed a moderate correlation between equity

and current ratio and leverage and equity. The results also showed a low correlation between taxes and current ratio, equity and taxes, dividends and taxes, current ratio and dividends, current ratio and leverage. **Very weak** relationship was found among the rest of the variables.

Table (4): Linear Regression Results for Tax Ratio

	Coefficients	Standard Error	t Stat	P-value
Intercept	0.0256	0.0094	2.7310	0.0102
Age	-0.0003	0.0003	-1.0509	0.3012
Current Ratio	0.0032	0.0023	1.3966	0.1722
Equity	0.0802	0.0211	3.7959	0.0006
Total Assets	-0.0002	0.0002	-1.2199	0.2314
Dividends	-0.0061	0.0157	-0.3884	0.7003
Leverage	-0.0454	0.0098	-4.6472	0.0001
Adjusted R Square	0.4307			

$$Tax = 0.0256 - 0.003a + 0.0032c + 0.0802e - 0.0002ta - 0.0061dp - 0.0454dl$$

Table 4 shows that the linear regression analysis also indicates that the adjusted R-squared value for this model is 43%. This indicates that, 43% of the variance in the tax ratio for these companies is explained by the variables in the model. This is a relatively moderate percentage, considering the number of variables and what they represent. The adjusted R-squared percentage shows that the linear regression model based on the selected variables accounts for more than 43% of the change in tax ratio of the companies in the analysis. The level of significance based on the p-value of the regression test is high for equity and leverage which shows that these two variables have a high impact on the tax ratio of the companies. Furthermore, regression analysis showed that age, total assets, dividends and leverage have a negative impact on the tax ratio. An increase in the value of either of these variables will result in a decrease in the taxes paid by these companies as a percentage of the total revenues of the company. On the other hand, current ratio and equity variables have a positive impact on the tax ratio which means that an increase in either of the two variables will result in an increase in the tax ratio.

Table (5): Descriptive Statistics for Foreign-Owned Companies

	Tax	Age	Current Ratio	Equity	Total Assets	Dividend	Leverage
Mean	0.0641	66.125	1.2884	0.6925	1.7046	0.0361	1.3722
Standard Error	0.0190	2.0219	0.1228	0.1832	0.3378	0.0038	0.1652
Standard Dev.	0.0934	9.9052	0.6019	0.8977	1.6549	0.0189	0.8097
Minimum	0.0003	52	0.6925	-0.0044	0.2871	0	0.2974
Maximum	0.41217	89	3.7430	4.0624	7.7137	0.0728	4.1499

Table 5 shows the descriptive statistics of the variables for the companies that operate in Saudi Arabia and are controlled from outside the country. The analysis was conducted using a dataset of 8 foreign controlled oil companies in Saudi Arabia for the years 2016, 2017 and 2018. The analysis shows that the foreign companies operating in Saudi Arabia in the oil and chemicals industry are paying nearly 6.41% of their total revenues in taxes to the national government. The average age of the foreign oil and chemicals companies operating in Saudi Arabia is nearly 66 years. The foreign oil companies operating in Saudi Arabia are comparatively mature if compared to the domestically controlled oil companies in Saudi Arabia. The mean value for current ratio, at 1.28, is a testament to the financial health of these companies. The closeness of this ratio to 1 shows that the current assets of the companies are being managed more efficiently as compared to the domestically controlled oil companies in Saudi Arabia. Similarly, the ratio of total revenue generated by the company in a year to the total assets employed by the company is at 1.70 which shows that the foreign controlled companies are significantly less efficient and effective at using their resources compared to domestic companies. At least 69% of the assets of the companies are funded by the equity of the company at average which shows that these companies have a low degree of leverage at average. The equity holders of these companies receive a low dividend payout compared to domestic companies with dividends amounting to nearly 3.6% of the total revenues of the companies for the last three years.

Table 6: Correlation Analysis for Foreign-Owned Companies

	Tax	Age	Current Ratio	Equity	Total Assets	Dividend	Leverage
Tax	1						
Age	-0.318	1					
Current Ratio	0.0757	-0.301	1				
Equity	0.1138	-0.074	0.0761	1			
Total Assets	0.3188	-0.401	0.0268	-0.1702	1		
Dividend	-0.524	0.3122	0.021	0.3128	0.1155	1	
Leverage	-0.227	0.2997	-0.014	-0.4102	-0.4850	-0.1610	1

Table 6 shows the results of the correlation analysis for the variables, from the companies that are foreign controlled and operate in the oil industry in Saudi Arabia. The results of the correlation analysis showed a moderate correlation between taxes and total assets, age and total assets, equity and dividend, leverage and equity and leverage and total assets. A moderate relationship of taxes with age, total assets, dividends and leverage was also shown by the results of correlation analysis. The results also showed a weak correlation between age and current ratio and leverage and taxes. The rest of the variables used in the analysis showed a very weak and insignificant relationship.

Table (7): Linear Regression Results for Foreign-Owned Companies

	Coefficients	Standard Error	t Stat	P-value
Intercept	-0.0791	0.1493	-0.5299	0.6030
Age	0.0023	0.0019	1.1952	0.2484
Current Ratio	0.0170	0.0252	0.6755	0.5084
Equity	0.0557	0.0215	2.5897	0.0191
Total Assets	0.0367	0.0125	2.9247	0.0095
Dividend	-4.0830	0.9257	-4.4108	0.0004
Leverage	0.0118	0.0245	0.4824	0.6357
Adjusted R Square	0.4731			

$$Tax = -0.0791 + 0.0023a + 0.017c + 0.0557e + 0.0367ta - 4.0830dp + 0.0118dl$$

Table 7 shows the results of the regression analysis conducted on the data set for the variables for foreign controlled companies operating in Saudi Arabia in the oil and chemicals industry. The linear regression analysis indicates that the adjusted R-squared value for this model is a negative 47.31%. This indicates that a major portion of the variance in the tax ratio for these companies can be explained by the variables in this model. The percentage of adjusted R-squared value is a moderate percentage, considering the number of variables and what they represent. The adjusted R-squared percentage shows that the linear regression model based on the selected variables accounts for nearly half of the change in tax ratio of the companies in the analysis. The level of significance based on the p-value of the regression test is high and significant for equity, total assets and dividend. The remaining variables in the model have very low values of significance which shows that these variables do not have a significant impact on the tax ratio of the companies. Furthermore, regression analysis showed that dividends payout ratio of the company has a negative impact on the tax ratio. An increase in the value of this variable will result in a decrease in the taxes paid by these companies as a percentage of the total revenues of the company. On the other hand, total assets and equity variables have a positive impact on the tax ratio which means that an increase in either of the two variables will result in an increase in the tax ratio.

7. Summary and Conclusions

This research was conducted to measure the differences in the taxes paid by the domestic and foreign companies operating in Saudi Arabia. The analysis was mainly focused on the companies operating in the oil and chemicals industry of Saudi Arabia. There has been significant research that focused on identifying the impact of using different transfer pricing methods for tax expenses minimization as well as shifting profits to low tax jurisdiction. There are very few examples of research on the companies operating in Saudi Arabia. Furthermore, the impact of location of the company has not been thoroughly researched with relation to the usage of transfer pricing methods for tax minimization and profit shifting. This study focused on the internal factors of the companies to identify their impact on tax expenses of the companies in relation to their revenues. This research identified the

main internal financial factors that play a role in the determination of tax expenses of the companies used for analysis. The research also intended to identify whether the differences in taxes paid by domestic and foreign countries in Saudi Arabia have changed over the years after the implementation of new regulatory tools that focus on curbing tax minimization and profit shifting using transfer pricing.

The analyses conducted for the purpose of this study identified a significant difference in the taxes paid by foreign and domestic companies based on the location of the companies. The foreign companies operating in Saudi Arabia pay more taxes as a percentage of their total revenues as compared to the domestic companies operating in the same industry. The analyses showed that there is a mean difference of nearly 1.8% in the taxes paid by the companies, based on their locations. This study was based on the research conducted by Alhassan and Bajaher (2016) on the Saudi oil industry players that was modeled on the study of Borvornboonrutai (2001) on the companies operating in Thailand.

The authors, Alhassan and Bajaher (2016) concluded that there is a significant difference in the taxes paid by the domestic and foreign companies in the Saudi oil industry. In their study, they showed a difference of 4.5% with the domestic companies paying less taxes compared to the foreign companies. This study, on the other hand, shows a slightly different picture. The tax differentials have reduced and the domestic companies are now paying more taxes as compared to the foreign companies operating in Saudi Arabia.

This shows that the different anti-avoidance policies implemented by the Saudi government and tax authorities on a unilateral level as well as multilateral level by cooperation among OECD states and other governmental bodies have had positive results. The regulations have increased the costs of using transfer pricing methods for tax minimization by standardizing the tax policies implemented by Saudi Arabia as well other states. The evidence shows that a difference still exists which is not a bad notion. The government needs to manage the regulations after taking into account the costs and benefits of the tax regulations since stringent tax policies have the potential to result in negative connotations for the investments in the country.

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