Sharing income or Profit split: A sovereign method in Transfer pricing?

Partage de bénéfice: Est- elle souveraine comme méthode de Prix de Transfert

SIHAM SAMHANE
Doctorante, Expert comptable DPLE
Institut Supérieur de Commerce & d'Administration des Entreprises
Laboratoire CIREG-ISCAE-CASABLANCA
ssamhane2005@yahoo.fr

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Abstract

Transfer Pricing represents the non-operational challenge having the strongest impact on a Group's results. The question which is frequently asked is how to define the most effective strategy in terms of method selection, documentation and defense in case of a tax inspection.

Indeed, the theory has examined in-depth the issue of Transfer Pricing before its regulation by the OECD, which presents numerous methods for determining Transfer Pricing. These are: Comparable Uncontrolled Price method (CUP), Resale Price method (RP), Cost Plus method (CP), Transactional Net Margin method (TNM) and Profit Split method.

In view of this varied landscape of methods for determining Transfer Pricing, we focused in this article to shed light on the Profit Split method through shedding light on its strengths and weaknesses with regard to the OECD and BEPS, the difficulties hindering its practical implementation as well as the extent of its implementation in the Moroccan context.

Keywords*:* Transfer pricing; profit split method; BEPS action plan; OCDE Guidelines

Résumé

Les prix de transfert représentent l'enjeu non opérationnel doté du plus fort impact sur le résultat du Groupe. La question qui est fréquemment posée à ce sujet est celle de la stratégie la plus efficace en terme de choix de méthode, de documentation et de défense en cas de contrôle fiscal.

Certes, la théorie a traité profondément cette problématique de Prix de Transfert avant d'être réglementée par l'OCDE qui dresse une panoplie de méthodes pour déterminer les Prix de Transfert qui sont : Prix Comparable sur le marché libre (CUP), le prix de revente minoré (PRM), le coût de revient majoré (CRM), la marge nette transactionnelle (MNT) et le partage de bénéfices.

Devant ce panorama de méthodes de détermination des Prix de Transfert, nous avons opté dans cet article de passer la lumière sur la méthode du partage de bénéfices ou split profit en mettant en exergue ses forces et ses faiblesses au regard de l'OCDE et de BEPS, ses difficultés de mise en œuvre pratique ainsi que son degré d'applicabilité dans le contexte Marocain.

Mots clés: Prix de Transfert; Méthode de partage de bénéfice; Actions BEPS; Directives OCDE

Introduction

In 2015, the OECD published numerous reports (in the form of several actions) referred to by the acronym "BEPS[1]: Base Erosion and Profit Shifting". It is a project aimed at fighting the erosion of the tax base and transfer of profits (BEPS) and which provides States with solutions to eliminate the gaps that remain in the current international rules and allow companies to organize the "disappearance" of their profits or to artificially transfer these profits to some countries that apply a low or no taxation, even though these companies carry out limited or no economic activities there. Among the objectives assigned to these reports is that "calculated Transfer Pricing should be in line with value creation"[2]. Indeed, among the actions put forward in Transfer Pricing is ensuring that "the profits associated with the transfer and use of intangible assets should be properly allocated based on the creation of value ". Therefore, we can infer that it is not only a question of determining arm's length price (a customary notion of Transfer Pricing), but rather it revolves around distributing profits according to value creation. Certainly, the two methods (the one based on the comparable price and the one based on profit split) are not inconsistent, yet the profit-based method seems to proceed from a narrower notion based on the value analysis and wealth creation and not on the price.

Numerous OECD, UN guidelines highlight this method which is effective and intellectually satisfactory. In addition, for some stakeholders (business representatives, trade unions, researchers….) in the BEPS project consider that the profit split method should be the standard method to fix Transfer Pricing instead of being used as a last resort method.

So what is the theoretical underpinning of Transfer Pricing methods? How can we define the split profit method? What are its specificities compared to other methods? What are the difficulties for its implementation? And what is the extent of its applicability in the Moroccan context?

[1] BEPS presentation on the OECD website: http://www.oecd.org/en/ctp/beps/

[2] BEPS Action 9, which requires that revenues transferred as part of an intergroup transaction be proportional to value creation.

1. Theoretical underpinning of Transfer Pricing methods

In his own research conducted in 1985, Eccles[3] aimed to understand how Transfer Pricing is managed in practice: He wanted to understand why choosing Transfer Pricing policies and how these policies are implemented within businesses. His approach was qualitative with an interpretative epistemological anchorage, through conducting interviews with 144 different managers (General Managers, Financial Director or other managers) in 13 companies in three sectors (Chemistry, Electronic, Heavy Industry) for 44 days. The questions asked revolved around the current strategy, organizational structure, current Transfer Pricing policy, the most critical situations of Transfer Pricing, priority and vision of the management.

Thus, the synthesis of Eccles' research (1985) led to the construction of an autonomous theory of Transfer Pricing based on the practices of successful firms[4]. It shows:

• That internal selling pricing policies (Transfer Pricing) should accompany strategic choices,

• That it is essential to pay attention to the administrative process (structure, management) necessary for the implementation of these policies,

• That there is no single policy as a solution for all situations; Transfer Pricing practices need to be adapted to changing circumstances.

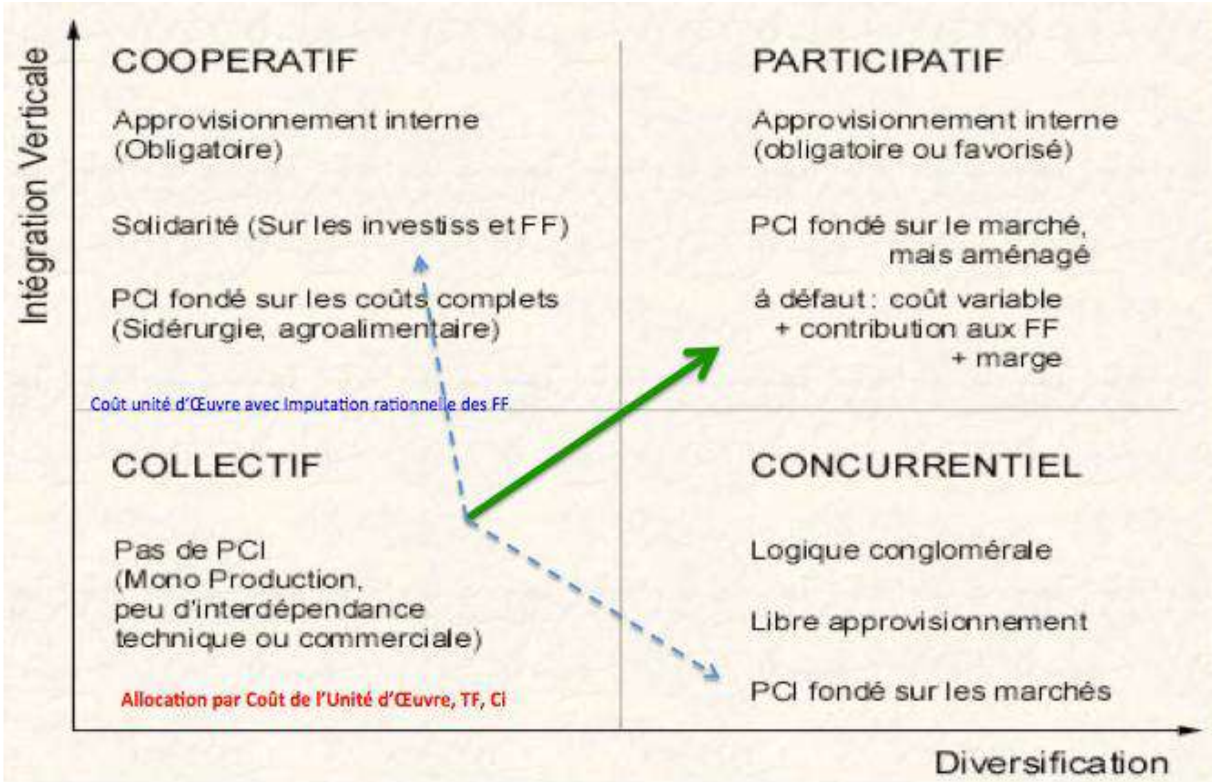
All of his analysis allows him to suggest a prescriptive model illustrated by the decision maker's analytical schema. This model is based on two dimensions of strategic choices, diversification strategy and vertical integration strategy, which, in order to bear fruit, must be associated with appropriate choices in the setting of internal selling Pricing or Transfer Pricing.

The following figure summarizes Eccles' remarks on the relationship between the strategy / Structure and Transfer Pricing policy:

[3] : Eccles is the first reference in TP. His work ise based on contingency theory and the works of his predecessors (National Industrial Conference Board, 1967, Mautz, 1968, Vancil, 1978, Tang, 1979, Waterhouse, 1984) to develop his model.

4 The profit centers of these firms have a real existence only to the extent that their performance can be evaluated (Ezzamel, 1985). Transfer prices to measure the performance of their units (profit, innovation, productivity)

Figure 1: Relationship Strategy / Structure and Transfer Pricing Policy



Source: Eccles model in A theory for Practice -1985

To the four categories of strategies and structures, (Eccles, 1985) applies four types of organizations with different Transfer Pricing policies, control systems and processes. These organizations are in the form of:

1- **Collective:** These are simple and small structures with managers involved in the control process and where Transfer Pricing is not relevant.
2- **Cooperative:** These are highly-integrated organizations whose structure is generally functional with a domination of the control of execution. Its organizational structure is the main control mechanism. Transfer Prices are mandatory in this type of organization and are valued either at standard full cost, or at full cost plus a margin.
3- **Competitive:** These are organizations whose activities share few common resources (conglomerate or holding company). Diversification is strong, and integration is limited to a financial logic. Market price is the norm in determining Transfer Pricing.

4- **Participative:** These are organizations that combine the characteristics of cooperative and competitive-style organizations. Consisting of several profit centers that cooperate within a matrix structure based on the negotiation of objectives. Transfer prices are imposed or negotiated based on market prices.

In his statistical survey of a sample of 168 firms, (Borkowsky,1990) highlighted that the organizational variables (size, company objectives, performance assessment systems, conflict management, degree of decentralization) and the environmental variables (existence of market prices, sector of activity) impact the methods of Transfer Pricing.

The table below summarizes the linkages between these different elements and the Transfer Pricing methods:

Table N° 1: Table summarizing links with TP

Strategy	Transfer Pricing is imposed when the company operates a vertical integration and free strategy when the company pursues a diversification strategy
Decision-taking	Transfer Pricing is free (negotiated or at market price), when decision-making is decentralized and imposed when decision making is centralized
Size	Large firms use market-based Transfer Pricing methods, smaller firms use cost-based methods
Technology (activity sector)	Companies operating in processing industries prefer cost-based Transfer Pricing methods, and those operating in the metallurgy / mining sectors, assembly industry), use market price-referenced methods.

Source: Thesis of Mr. JG MBIANGA in Paris Dauphine -1998.

To conclude, and although still very few, some works (Eccles, 1984), (borkowsky, 1990) aimed to build up a general theory of transfer pricing based on practices, without developing a reference paradigm in which the best transfer pricing can be drawn up, nor adopt a transversal approach in view of the multidimensional nature of transfer pricing. Eccles (1985), for instance, makes no reference to the new theories on companies in his study. However, the works of (Meer-koostra ,1994) and (Spicer & Colbert, 1995) showed that the characteristics of transactions as well as the behavior of the parties also condition the definition of transfer pricing policies by referring to the transaction costs theory5.

Thus, we can suppose that the various researchers, including Eccles, have laid down the theoretical bases of Transfer Pricing methods that the OECD classified and referenced in July 1995 in two big categories: Traditional transactional methods and profit-based transactional methods.

2. Various Transfer Pricing Methods

OECD guidelines on Transfer Pricing[6] distinguish between "traditional transactional methods", notably:

• The comparable Uncontrolled Price method (CUP),

• The Resale Price method,

• An the cost-plus method.

And "profit-based transactional methods", notably:

• The Transactional net margin method (TNMM)

• The transactional profit split method[7].

[5] : The main characteristic of this theory is to rely on micro-analytical foundations to analyze contracts. Two major assumptions characterize contracts according to Williamson: Behavior of the parties (rationality, opportunism) and characteristics of the transactions (Uncertainty, specificity of assets and frequency of the transactions)

[6] Applicable OECD transfer pricing guidelines for multinational enterprises and tax administrations, (July 2017)

OECD as well as UN guidelines do not set a hierarchy between methods, even if profit split was always considered a last resort method. They recommend using the "most appropriate" method, which depends on the transaction at hand, the functional analysis and the availability of comparable data, and indicate that it is not possible to provide an appropriate rule or one that would fit all transactions. Indeed, as a result of the functional analysis, the selection of the most appropriate method requires firstly to isolate "the value function" or "Entrepreneur", which implements all the others, which brings the most added value, which holds the most strategic assets, and which bears the most important risks. The other functions are called "routine". It is for this value function or entrepreneur "**tested party**" that the margin should be within the arm's length range defined by the "appropriate" method, such as the cost-plus method or the TNMM for a service provider or an industrial subcontractor, or the resale price method or the TNMM for a distributor or agent. These three methods are also called **unilateral methods** because the margin of **only one of the parties** to the transaction shall form part of an arm's length interval.

The comparable uncontrolled price method and the profit split method are, on the other hand, called **bilateral methods**: the comparable uncontrolled price method directly determines the arm's length price for the transaction, and implicitly justifies the margin realized by **the two parties,** while the profit split method explicitly justifies these margins. Indeed, the transactional profit split method may be the most appropriate[8] when:

- The activities of the associated companies are strongly integrated, and/or
- the two parties make unique and valuable contributions, particularly when both parties are entitled to the returns on the use of unique and valuable intangible assets[9].

This bilateral aspect is considered to be the main advantage of the two methods. An additional advantage of the profit split method is that it more accurately reflects the complexity and difficulty of some transactions. It is oftentimes difficult to identify the function or value-creating

[7] This method aims to determine a fair formula for sharing the combined profit between the associated companies
[8] Applicable OECD transfer pricing guidelines (2017) and the United Nations practical Manual on transfer pricing in developing countries (2017) present in more detail the strengths and weaknesses of the profit split transactional method.
[9] These may include, for example, patents, know-how or trade secrets related to engineering or manufacturing processes, but also trademarks, brands and other intangible marketing properties.

business in a complex process or transaction to allocate a price to it or in the event that both parties to the transaction make unique and highly valuable contributions (unique intangible assets, for example).

Another advantage of the transactional profit split method is its flexibility by taking into account the specific factual situation of the associated companies, which may be exceptional and not exist in the case of independent companies, while still constituting an arm's-length approach to the extent that it reflects what would have been done by independent companies, faced with similar circumstances.
Thus, the OECD guidelines indicate that the profit split method may be the most appropriate approach for highly-integrated transactions or when each party to the transaction makes specific and high added-value contributions, whether through strategic functions or intangible assets.

3. Position of BEPS with respect to the "Split profit" method

As mentioned above, BEPS identifies 15 actions structured around three core principles: Coherence, substance and transparency. The majority of these actions make a reference to the profit split method.

Among these actions, the action plan 8[10] on intangible assets and aimed at drawing up rules to prevent the transfer of profits through the sale of intangible assets among members of the same group refers to profit split in the developments related to the ownership of intangibles and their valuation.

Indeed, this action stipulates that the owner of an intangible asset is supposed to receive all the gains only if he realizes and controls all the important functions related to the development, improvement, maintenance and protection of intangible assets, if he controls all other functions, holds the corresponding assets and assumes the associated risks. This analysis seems more

[10] Actions 8 – 10 contain transfer pricing guidance to ensure that transfer pricing outcomes are in line with value creation in relation to intangibles, including hard-to-value intangibles, to risks and capital, and to other high-risk transactions.

rational and logical, and in fact aims at extremely specific situations such as trademarks or patents of multinational businesses.

Let us take the example of a multinational company which decides to use a brand that is very well-established in a regional market, for example Northern Europe, in new markets where it is little known, for example North Africa. The rights of use for this new market are then transferred to a subsidiary located in a country with preferential taxation (Africa for the case) with a necessarily limited value. The European subsidiary owning the rights of the brand charges local subsidiaries on the basis of the cost plus method, which is justified by the fact that it assumes all the financial risks for the development of the brand of which it is, in fact, the economic owner. In the event the project proves a success in the North African market, the subsidiary owning the rights will gain considerable profits which will be taxed at a lower rate. It is worth remembering that if the marketing campaign is a failure, the group would have localized very significant expenditures in a tax haven, which would be a disaster in terms of the global effective tax rate.

Therefore, BEPS reports recommend the use of Transfer Pricing methods that are based on a comparable analysis (implicit reference to bilateral methods), for example the method of profit split or valuation techniques, in order to adequately remunerate these functions. However, the question remains about the consequences of such an approach for multinationals that divide their development efforts throughout the world based on local expertise.

The answer is clear, even BEPS action 8 refers to the most useful methods for evaluating intangibles which are those of the comparable uncontrolled price and the profit split method. While considering the usefulness of financial valuation techniques in determining comparable prices such as the DCF (discounted cash flows) method and their weaknesses with respect to the assumptions that may be revised (budgets, growth rates, discount, lifetime and final values, tax rate, etc.)

In short, with respect to intangibles, according to the OECD and BEPS reports, the profit split method is the best adapted and most appropriate.

With regard to BEPS action 13 on the documentation of Transfer Pricing[11] and country-by-country reporting, which will help increase the quality and volume of information available to the

[11] Action 13 of BEPS on transfer pricing documentation and CBC reporting.

tax administration, it introduces a new concept of declaratory obligation on the global distribution of income, economic activity and taxes paid in several countries by the same group. This action also refers, albeit implicitly, to the profit split method. Indeed, the local file, under this action, must present the most appropriate method for each transaction category and the grounds for its selection. It should also indicate which the tested party for each transaction: thus, unilateral methods have in principle a major role to play. However, one of the objectives of the Transfer Pricing documentation is to provide tax administrations with a risk assessment tool; as a result, a country-by-country or CBC "reporting" tool is proposed, in the form of a double-entry table entitled "overview of income distribution, taxes and operational activities country-by-country". This CBC reporting provides information for each host country such as, among other things, the turnover, the current result, income tax, number of employees, the amount of payroll expenses or the value of tangible assets. Oddly enough, intangible assets and risks are not part of the list. This is of course an advantageous tool for implementing the profit split method, since it gives the indicators that are most often used as distribution keys (turnover, wage costs, amount of assets).
To sum up, the new international guidelines and in particular BEPS actions are more in favor of the profit split method as a fair and rational method in determining Transfer Pricing for trans-border operations within the same group, whether for the taxpayer or the tax authorities.

4. Practical difficulties in its implementation

As highlighted above, the profit split method is an effective tool as it better reflects the complexity of certain transactions or functional analyses, and allows determining an arm's length price through a bilateral approach.

On the other hand, OECD guidelines on Transfer Pricing[12], which describe Transfer Pricing methods, do not appear to be on the agenda, at least as part of the BEPS action plan. Indeed, the transactional profit split method would generally not be used when a party to the transaction fulfills only simple functions and brings no unique and specific contribution of value (for instance, if it is a manufacturing subcontractor or a contracted service provider in the appropriate

[12] Chapter 2 on transfer pricing methods in the OECD guidelines, applicable to TP for multinational enterprises and tax administrations (July 2017).

circumstances), since in such a situation, the profit split method would generally not be appropriate in view of the functional analysis of this party.

Still according the OECD, another weakness in the transactional method of profit split lies in the difficulties of its implementation. At first glance, the profit split method seems to be more accessible to taxpayers and tax authorities as it tends to rely less on information about independent companies. However, it can be difficult for associated companies as well as for tax authorities to obtain information from foreign affiliates. Surely, practitioners know how difficult it is to have access to reliable information on prices between affiliates for the implementation of the comparable uncontrolled price method, and that it is virtually impossible to obtain information on the level of profitability obtained by a third party, even when the taxpayer is a party to the transaction (case of internal comparables). In order to address this difficulty, OECD guidelines recommend allocating profits based on the division of functions (taking into account the corresponding assets and risks). In other words, it is necessary to define appropriate allocation keys (turnover, assets, costs or expenses, number of employees...). Yet, it remains necessary to find the appropriate allocation keys or a weighting to determine the contribution of each of the parties to the realization of the combined profits[13].

Overall, the transactional profit split method allows determining or checking the results of a transaction between related parties based on the sharing of profits between them. The allocation should be made with reference to the sharing that would have occurred if the parties had not been related. Profit split data in comparable uncontrolled transactions are relevant to such an analysis, but are sometimes difficult to find, or even nonexistent. For this reason, profit split may be carried out through another valid economic basis, such as the analysis of the economic and trade processes that were used to identify the respective contributions of each party to the transaction. These analyses do not necessarily rely on data on comparable uncontrolled transactions or do not necessarily require the availability of such data[14].

In addition, it may prove difficult to determine the combined revenues and expenses of all associated companies participating in the controlled transactions, as this would require establishing the accounts on a common basis and making adjustments relating to differences in

[13] They correspond to the total profit from the transactions between the associated companies in which each company significantly contributes (co-research and development in the Pharmaceutical or oil industry).
[14] Conclusion from the Toolbox Report to Address the Difficulties relating to lack of Comparability Issues in Transfer Pricing Analysis as developed by IMF, WBG, OECD and UN in January 2017

accounting standards and currency. Moreover, when applying the profit split method to operating profit, it may be difficult to identify the operating expenses associated with the transactions analyzed and to break down the costs between these transactions and the other activities of associated companies.

In the same vein, the implementation of this method may face the constraints of BEPS action 5[15], which requires a transparency framework that applies to tax administration decisions ("The transparency framework"). Indeed, the minimum standard defined by Action 5 includes two aspects: a process of examining preferential tax regimes to ensure that they are not harmful, and a framework of transparency that applies to decisions of tax administrations (the "transparency framework").

As a conclusion, the need for tax administrations to develop a simple tax risk assessment tool is well-understood, but this tool cannot be readily transposable for the implementation and documentation of a Transfer Pricing policy. The situation becomes all the more delicate when the transaction results in an overall loss: it is not uncommon then to see the tax administrations return to the implementation of a unilateral method in order to generate a taxable basis at the level of one of the countries.

5. Applicability of the profit split method in the Moroccan context

Until quite recently, there was no legal or tax standard in Morocco concerning Transfer Pricing methods: The General Tax Code and circular note 717 mention nowhere the existence of Transfer Pricing methods except in the context of their documentation (GTC, Article 214). In fact, the article stipulates that the tax administration may require the taxable company in Morocco to communicate the information and documents relating to:

1- The nature of the relationship between the taxable company in Morocco and that situated abroad;
2- The nature of given services or marketed products;
3- <u>*The method for determining the prices of the transactions carried out between the said companies and the factors justifying it;*</u>
4- and the regimes and corporate tax rates for companies located outside Morocco.

[15] Entitled "Fighting more effectively harmful tax practices, taking into account transparency and substance" (OECD, 2016),it establishes one of the four minimum standards of the BEPS project.

The introduction of this concept of Transfer Pricing documentation in 2009, was really vital for the Moroccan tax legislation which has always been campaigning to comply with the OECD guidelines and to be part of BEPS action plans, particularly the automated data interchange (CRS)[16].

Aside from this article, which refers to Transfer Pricing methods in their documentation and justification phase, the Moroccan legislation and doctrine do not specifically provide any further details on the Transfer Pricing methods. Nevertheless, while analyzing article 213 of the GTC before and after the 2009 FL, we find that the Moroccan legislator has tempered this time between the comparison of profits of similar companies and the purchase or sale price of the same companies. Indeed, after the flagship revolution of Moroccan tax law of 2009, auditors began to compare the profits and margins of the controlled taxpayers with those of similar companies without any comparison of the purchase prices.

Hence the conversion of our tax authority from the comparable uncontrolled price (CUP) or unilateral method to the profit split or bilateral method.

In fact, experts have found out that the Moroccan tax administration is not at all hostile to the implementation of the profit split method as the main method for fixing prices. Most often, the split is performed on the basis of predefined distribution keys, or even fixed percentages. Sometimes, the tax administration also uses the profit split method in the context of a negotiation to achieve a comprehensive settlement following a tax audit, either to tighten up an interval of competition that it considered too broad in the application of a unilateral method, or to find an agreement for a dispute of another nature.

For instance, during a control of a Chinese subsidiary in Morocco, the auditor found that this subsidiary only generated losses since its inception despite the failure to carry out any alleged cross-border transaction with a view to conceal profit transfer. The most legitimate question then is why do Chinese invest in Morocco?

[16] Common Reporting Standard validated by the OECD in July 2014, which binds the financial institutions of the signatory countries to exchange their customers' information.

Through further functional analysis, the auditor found that there is a relationship of economic dependence of this subsidiary with its Moroccan single-client, and that other Chinese sister companies, based outside Morocco, are carrying out highly beneficial transactions with this same customer and its subsidiaries around the world. In conclusion, the Moroccan tax administration requested its share in the profit of other sister companies via the profit split method based on the realized turnover.

Finally, in cases where the taxpayer himself has used the profit split method (outside the context of prior agreement on Transfer Pricing), it is not uncommon to see the tax administration questioning not this method, but its implementation criteria as drawn up by the taxpayer to determine the appropriate distribution of profits. In practice, it seems that the tax administration tends to focus on the functional aspect in calculating profit split, at the expense of assets and risks, using as a distribution key the number of employees or the turnover. In particular, such criteria inevitably involve a form of value judgment. Accordingly, this subjective questioning of a particular criterion (e.g. the contribution of a given entity to the commercial function should be estimated at 60% or 80%) will easily lead to a tax reassessment.

CONCLUSION: Profit split method: is it sovereign?

The OECD' BEPS initiative can only be encouraged when it aims to identify artificial arrangements which make it possible to dissociate the benefits of the economic functions that create them and to locate them in tax havens. In this regard, the profit split method, based on a detailed functional analysis, represents an excellent tool for reducing abuses. However, one of the OECD's founding objectives is to promote cross-border trade within a secure tax framework. Yet, BEPS initiative is still campaigning for full implementation of international standards seeking tax fairness; it would be unfortunate to weaken the impact of these standards by implementing only anti-abuse provisions.

It will therefore be important to apply the profit split method only when it actually serves as the most appropriate method, and to avoid questioning Transfer Pricing policies on the pretext that they are based on unilateral methods. Admittedly, it seems that there is a strong tendency to favor functions compared to assets and risks in the realization of a functional analysis. Accordingly, each method will find its context and its own situation in order to be able to defend its applicability.

In addition, and to broaden its application and implementation scope, the best solution would be to provide tax administrations and multinational companies with common tools and practical application guidelines so that they develop a common approach for the implementation of this method. Taxpayers can then check by themselves the result of their Transfer Pricing policy without the help of the tax administration!

In conclusion, in its BEPS action plan, the OECD declares on Transfer Pricing that it would be better to remedy the shortcomings of the existing system rather than attempting to replace it by a new profit distribution system, based on the application of a formula. It would represent, however, the outcome of the current system if it is dominated by the profit split method.

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