



THE DETERMINANTS OF TRANSFER PRICING: EVIDENCE FROM TUNISIAN LISTED FIRMS

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Abstract

The aim of this paper is to detect the determinants of transfer pricing in the Tunisian economic context. This study uses secondary data from financial statements of listed firms on the Tunis Stock Exchange (BVMT), as well as the notes published in the official bulletins and annual reports provided by the Tunisian Financial Market Council (CMF). The study period covered 10 years, from 2010 to 2019 with 310 observations. We use random effect model to verify financial and economic hypotheses in the Tunisian context. Robustness tests are also used to investigate the transfer pricing determinants'. We find that firm size, sector of activity, reinvestment of profits and tax loss' imputation have a significant positive impact on the practice of transfer pricing. The originality of this study lies in the importance of the transfer pricing at the level of local companies with the presence of several tax rates in the same tax system, a range of tax incentives granted by the government and the imputation of perpetual loss over several years. These findings may serve the Tunisian government in its fight against transfer pricing.

Keywords: Tax Avoidance, Transfer pricing, Tunisia

INTRODUCTION

Several studies have used multinational companies as a sample to explain transfer pricing. Multinationals use a variety of techniques to reduce tax burden in the territory where they operate. Transfer pricing, the mechanism by which a company allocates profit or loss between its various subsidiaries or divisions. In addition, the tax challenges faced by governments in detecting tax evasion make profit transfer a major factor in the fight against tax base erosion.

The transfer pricing trend is becoming a target factor for the American authorities as a basis for fighting tax evasion. The project to tackle tax base erosion and profit shifting (BEPS) has been initiated by a group of countries such as the OECD, G20 countries and the European Commission (OECD, 2016). Several jurisdictions cite different definitions of transfer pricing, such as the United States, where paragraph 482 of the US tax code stipulates that the determination of the fair value of a non-arm's length taxpayer's transactions is the same as that of another taxpayer ("arm's length principle"). According to the definition of the Organisation for Economic Co-operation and Development (OECD, 2022), transfer prices are "the prices at which a firm transfers tangible property, intangible assets, or renders services to associated enterprises".

Article 57 of the French General Tax Code enables the tax authorities to ensure compliance with the arm's length principle, and to rectify declared results when profits have been indirectly transferred abroad, either by increasing or decreasing purchase or selling prices, or by any other means. This conforms to Article 9 of the OECD Model Tax Convention, which states: "Where the two dependent companies are, in their commercial or financial relations, linked by agreed or stipulated conditions which differ from those which would be agreed between independent companies, the profits which, without these conditions, would have been made by one of the companies, but could not in fact be made because of these conditions, may be included in the profits of this firm and taxed accordingly".

However, the researchers do not take into consideration the importance of transfer pricing at the level of local companies. with the presence of several tax rates in the same tax



system, a range of tax benefits granted by the government and perpetual imputation of the tax loss over several years.

In the Tunisian context, Article 48 septies of the IRPP and IS Code stipulates that: "When it is established for the tax authorities that there are commercial or financial transactions between an Enterprise and other Enterprises in a relationship of dependence which, for the determination of their value, obey rules which differ from those governing relations between independent Enterprises, the reduction in profits resulting from the adoption of these different rules is reintegrated into the results of the said Enterprise...".

In the same way, DGI joint note no. 33/2010 explains the existence of links of dependence as follows: (1) Legal dependence means any enterprise in which another enterprise exercises decision-making power, either directly or through intermediaries, by virtue of a preponderant share in the capital or an absolute majority of shareholder votes, even if the head office of the managing enterprise is located outside Tunisia. (2) De facto dependence through the existence of a contractual independence which sets out the rules for buying and selling.

The transfer of profits by any other means, such as the granting of unjustified commercial discounts or discounts exceeding those granted to other companies, and the granting of interest-free loans or loans on flexible terms (interest rates lower than those prevailing in an arm's length market). The financial or commercial transfer lies mainly with oil companies and financial institutions. Rationalization of the tax benefits granted to Tunisian companies, together with the allocation of loss carried forward - two alternative sources for maintaining a credit balance and lowering taxable income - is a necessity in order to improve the tax contribution of companies.

The objective of this study is to detect the determining factors of transfer pricing in the Tunisian context. In addition, our aim is to test the variables that explain transfer pricing. Firm size, sector of activity, tax rate difference, reinvestment of profits and loss carryforwards affect transfer pricing activity.

LITERATURE REVIEW

According to Pellefigue (2012), transfer pricing should be divided into two independent branches : economic prices, which refer to the intra-group allocation of resources and ensure the proper incentives for subsidiary managers, and transaction prices, which are used to draw up firm accounts and calculate each subsidiary's tax liability. The design of optimal tax rules determines the allocation of profit between the subsidiaries of the corporate group in order to maximize pre-tax profit and at the same time minimize tax liability. The maximization of corporate value is achieved both by maximizing pre-tax profit through economic transfer pricing and by minimizing the total tax burden within the limits of current tax regulations through monetary transfer pricing.

Economic transfer pricing is the development of systems for maximizing the consolidated profit of a multi-division firm using a decentralized pricing mechanism (Hirshleifer, 1956). With regard to the price of monetary transfers in the European context, Huizinga & Laeven(2008) estimate that the magnitude of these transfers varies between a 22% gain in the tax base in Hungary and a 14% loss in the tax base in Germany. Jacob (1996), for his part, relates the level of tax payable by the firm and taxable results in different geographical areas to the volume of intra-group transactions. This work shows that this technique of transfer pricing to minimize the tax burden is due to opportunistic behavior on the part of managers.



Large firms are more involved in financial operations and commercial activities than small firms. Various studies show that large firms have an opportunity to better plan their tax situations in order to minimize corporate tax payments (Elitzur & Mintz, 1996). For instance, the Political Visibility Hypothesis states that firm size is generally used as an important indicator of firm political visibility (Yoo, 2022). This hypothesis argues that large firms are more vulnerable to political pressure than small businesses, given that large size indicates that the firm generates more profits and consequently has a greater capacity for tax contributions (Watts & Zimmerman, 1990; Raffournier, 1990). In the same way, (Manzon Jr & Plesko, 2001) point out that large firms have the capacity to invest in fixed assets and draw tax benefits through the deduction of expenses such as depreciation allowances.

H1 : Firm size has a positive impact on transfer pricing

Richardson & Lanis (2007) highlight the importance of the industry sector in determining the effective tax rate for Australian firms. However, political power theory proves the importance of industry as an effective variable in significantly explaining the transfer of profit through several categories of commercial and financial transactions. This is explained by several works that introduce the sector of activity as an explanatory variable. (Mills et al., 2002) through an analysis conducted in the US context from 1991 to 1998 explain that sector of activity among financial firms studied has a positive and significant effect on the discretionary divergence. In the same context, Tang and Firth (2011) introduce industry as an explanatory variable for discretionary divergence in the Chinese market. In this work, they show that the sector of activity is crucial in determining transfer pricing.

H2 : Sector has a positive impact on transfer pricing

In order to ensure tax optimization, the strategy of firm directors is to move towards a tax situation where the tax rate is more favourable. The more attractive tax rate, the more nondeductible tax burden aggravates the firm's financial equilibrium, enlarging the gap between the two reported results (Shunko et al., 2014). Based on a conceptual framework developed by Hines & Rice (1994) and then extended by Huizinga & Laeven (2008), by examining several empirical works, the authors elaborate the relationship between profit transfer and the difference in tax rate between tax systems. In the Chinese context, Tang & Firth (2011) use the different tax rates applicable in China to detect discretionary divergence as an earnings management strategy and tax management. In the same context, (Tang, 2015) to measure tax management for several different tax legislations, uses the difference between the tax rate and the effective tax rate for each country.

The tax rate is higher, the tax burden on the firm increases, aggravating the financial situation, leading to discretion in minimizing the taxable base and a significant difference between the two types of reported results (Richardson et al., 2013). This high tax rate, compared to other legislation and the same tax law, creates distortions in the tax system (Hanlon et al., 2012). Raedy et al. (2010) show that the variation in tax rates between states in the US context is significantly positive with the difference between accounting and tax income. This result is perfectly at odds with the various studies that show that the tax rate is negatively correlated with the divergence between reported earnings.

In the tax planning literature, the explanatory factor for corporate tax management is the tax burden payable (Hanlon et al., 2012). For Tang & Firth



(2011), China's context is characterized by a variety of applicable tax rates that vary according to the purpose of the investment, the location of the investment and the sector in which firms operate in that country. The applicable rate or range of rates varies from 0% to 33%. With this range of rates, Chinese companies have set themselves a strategy of tax management.

Tunisian companies benefit from two advantages that reduce the tax rate. The first reduction is linked to the standard rate, which has been reduced from 35% to 30%. This rate applies from the 2006 financial year. The second reduction relates to companies whose ordinary shares are listed on the stock exchange at a rate of at least 30%. For companies whose ordinary shares are listed on the BVMT at a rate of less than 30%, and which proceed to open their capital to the public (at least equal to 20%) for a period of five years, benefiting throughout this period from a corporate income tax rate of 20% for five years from the date of their admission.

In addition, the corporate income tax rate is set at 10% for certain companies, including those engaged in craft, farming, fishing or fishing boat outfitting activities. For other companies, such as credit institutions, telecoms network operators, service companies in the hydrocarbons sector and companies involved in the production and transport of hydrocarbons subject to a tax regime under special agreements, the rate is 35%. Finally, a tax deduction for revenues from exports up to one hundred percent.

H3 : Tax rate difference has a positive impact on transfer pricing

The opportunities offered by the Tunisian legislator with regard to tax relief encourage self-financing, to the extent that, when the firm reinvests part or all of its profits within the firm itself, or in the initial capital, or in the capital increase of another firm, it benefits on the one hand from the tax saving achieved, which constitutes additional cash flow, and on the other, from the investment operation itself by the firm's own means.

As for tax management, the Tunisian tax system offers a number of opportunities, in particular those that enable the tax base to be minimized. These include tax breaks for exempt reinvestments. Indeed, the Tunisian lawmakers, seeking to encourage investment, have provided for such tax relief through the Investment Incentives Code. These allowances can be in two forms: either a financial allowance in respect of new shares subscriptions, or a physical allowance in respect of physical reinvestments within the firm itself. In this case, to meet their own aspirations, managers, concerned to pay less tax, are seeking to improve current earnings to benefit first from the advantage of reinvesting tax-exempt profits, and then from the tax savings. We therefore propose that firms that use tax-saving reinvestment financing should record a transfer of profits (Shunko et al., 2014; Huang & Chang, 2016).

H4 : Reinvestment of profits has a positive impact on transfer pricing

The use of loss carryforwards has become a method frequently used by companies to reduce their tax burden (Hanlon & Heitzman, 2010). Boadway & Wildasin (1984) show that a loss-offset regime enhances risk tolerance. The optimal portfolio then tend to include more risky assets. A reduction in corporate tax reduces this risk propensity, unlike other tax incentives (other than direct taxes) and financial subsidies linked to investment, which are neutral to direct taxation of firms. Auerbach & Poterba (1987) corroborate that loss carryforwards and carrybacks occur in the US context, representing 15% of a sample of 1,425 observations over the period 1981 to 1984. Similarly, referring to the work of Tang & Firth (2011), the



imputation of tax loss carryforwards has a significantly positive impact on the divergence between the two results, with the imputation of 1% of tax loss carryforwards generating a 79.5% increase in divergence.

The deduction of tax loss carryforwards over several fiscal years is a tool used by the political authorities to attract investment and reduce the risk premium borne by companies in order to minimize tax payments (Auerbach & Hassett, 1992). This risk-sharing with the government through the use of prior losses creates a wide divergence between accounting and tax income. Previous ordinary losses thus provide an incentive to manage accounting results in order to practice tax management linked to the allocation of loss carryforwards, and finally to minimize tax charges (Manzon Jr & Plesko, 2001). Authors find a positive relationship between loss carryforwards and accounting-tax divergences, observing that firms with loss carryforwards seek to increase current earnings to benefit from the allocation of these carryforwards and the resulting tax savings. We therefore suggest that the tax treatment of previous losses leads to significant transfer pricing activity.

H5 : Loss carryforwards has a positive impact on transfer pricing

METHODS

The empirical study is based on 31 listed companies on the Tunis Stock Exchange (BVMT) that operate in different business sectors. The study period covered 10 years, from 2010 to 2019, at <https://www.bvmt.com.tn>. Furthermore, the data used for tax purposes was taken from the financial statements and auditors' reports issued by the companies under study. To collect the data used for our empirical analysis, we have used various sources of information. These include the financial statements (balance sheets, income statements, and cash flow statements), the supplementary information published by the Tunis Stock Exchange in order to screen the data, and the notes published in the official bulletins and annual reports provided by the Tunisian Financial Market Council (CMF) at <https://www.cmf.tn>. The initial population consisted of 73 companies. We have excluded financial companies such as insurance companies, banking groups, and leasing companies. As well, we disposed of holding companies, whose revenues are derived from dividends paid out by subsidiaries and capital gains realized on the sale of securities or other equity. This category of companies is characterized by a specific governance system, whose accounting and tax regime differ from those of non-financial companies (Adams & Mehran, 2003).

Consequently, the inclusion of such companies may bias the empirical results and their interpretation. For example, the income of holding companies consists of dividends and other securities income. Moreover, in the absence of available data for certain companies over the entire study period, we have eliminated companies that have been delisted from the Tunis Stock Exchange.

Table 1 : Sampling procedure

Criteria	Total
Tunisian listed companies	68
Compniaes operate in financial sector	(26)
Delisted companies	(2)
Companies with unavailable data	(9)
Total sample	31
Total observations	310

To test the hypotheses, we use the multi-linear analyses for cross sectional data regression.



$$\text{PRIXT}_{i,t} = \beta_0 + \beta_{1,i} \text{SIZE}_{i,t} + \beta_{2,i} \text{SECTOR}_{i,t} + \beta_{3,i} \text{DIFFRATE}_{i,t} + \beta_{4,i} \text{REINVEST}_{i,t} + \beta_{5,i} \text{REP.DEF}_{i,t} + \beta_{6,i} \text{ROA}_{i,t} + \varepsilon_{i,t}$$

Where

PRIXT	Transfer pricing
SIZE	Firm size
SECTOR	Sector of activity
DIFFRATE	Difference in tax rate
REINVEST	Financial and capital reinvestments
REP.DEF	Tax loss
ROA	Company profitabilty
ε	Error

The explained variable is the transfer pricing (PRIXT). We develop a score for each firm, based on the aggregation of five components (scores):

- Score1 : existence of interest-free credits between related parties, we assign 1, if not 0 (Richardson et al., 2013).
- Score2 : existence of waived receivables between related parties, assigned 1, 0 if not.
- Score3 : existence of shareholder current account between related parties, we assign 1, 0 if not.
- Score4 : existence of commercial transactions with a subsidiary operating in a regional development zone - 1, 0 if not (article 48 septies of the IRPP and IS code).
- Score5 : shareholding in a subsidiary exceeding 50% of capital : 1.0 if not (article 48 septies of the code l'IRPP et de l'IS).

Commercial and financial transactions between related parties differ from those with legal and financial independence. For the tax authorities, the presence of dependency between transferee companies constitutes a tax risk that results in a reduction in the tax base. The existence of one of these criteria enables us to detect, in the financial statements and notes to the financial statements, a sign of transfer pricing activity between related parties. The aggregation of these five components measures the level of profit transfer activity between dependent companies (Richardson et al., 2013).

The explanatory variables are the size of the Tunisian firm listed on the BVMT (SIZE), the sector of activity (SECTOR), the difference between tax rates presented in the Tunisian tax system (DIFFRATE), financial and capital reinvestments in the group (REINVEST) and, finally, the presence of losses carried-forward (REP.DEF). SIZE is measured by the natural logarithm of the firm's total assets, in the same way as in several previous works (Mills, 1998; Conover & Nichols, 2000; Richardson et al., 2013). SECTOR is a binary variable with 1 if the firm operates in the industrial sector, 0 if not. DIFFRATE is the difference in the tax rate between related parties in the group ((Shunko et al., 2014), (Huang & Chang, 2016)). Finally, REP-DEF is the presence of a tax loss 1, if not, we assign 0 for the opposite case.

We integrate profitabilty (ROA) as a control variable for our regression model. ROA defined by the following equation :

$$ROA = \frac{\text{Net income}}{\text{Total Assets}}$$



Firms with high profits, such as Google, Apple, and Microsoft, have the ability to manage their tax liabilities via transfer pricing strategies (Richardson et al., 2013). According to Brummer (2017), Finnish firms use discretionary accruals, profitability, and the tax rate as explanatory variables for non-discretionary divergence. For Manzon Jr & Plesko (2001), in order to calculate this difference called SPREAD, the authors use as an explanatory variable the profitability of the firm with a loss or profit pre-tax accounting income (ROA). In this study, we use the company's profitability to control the regression model.

RESULTS AND DISCUSSION

Table 2: Descriptive statistics for explanatory variables

Variables	Observations	Average	Ecart-Type	Minimum	Maximum
PRIXT	310	0.274	0.112	0.000	0.643
SIZE	310	17.71	1.244	14.91	20.55
SECTOR	310	0.580	0.494	0.000	1.000
DIFFRATE	310	0.014	2.923	0.000	0.100
REINVEST	310	0.006	0.015	0.000	0.073
REP.DEF	310	0.294	0.457	0.000	1.000
ROA	310	0.046	0.094	-0.228	0.276

Descriptive statistics confirm that the economic structure of Tunisian companies is fragile, at least for the period of our study, since the variability of profitability is very remarkable, as is the presence of an imputable loss carryforwards in the calculation of taxable income, with an average of 29.5%. The control variable (ROA) shows an average of 4.68% of total assets, with a variability of 9.4% between the companies studied. Similarly, this ratio gives us a lowest of -22.8%, explaining the presence of economically loss-making entities.



Table 3 : The correlation matrix: Pearson test (bottom) and Spearman test (top)

	PRIXT	SIZE	SECTOR	DIFFRATE	REINVEST	REP.DEF	ROA
PRIXT	1	0.04 (0.529)	0.23 (0.000)	-0.14 (0.043)	0.21 (0.001)	0.05 (0.425)	0.15 (0.024)
SIZE	0.03 (0.682)	1	0.19 (0.005)	0.15 (0.023)	0.23 (0.000)	0.09 (0.175)	0.07 (0.292)
SECTOR	0.20 (0.002)	0.16 (0.019)	1	0.00 (0.968)	0.08 (0.224)	0.12 (0.078)	-0.15 (0.026)
DIFFRATE	-0.11 (0.101)	0.16 (0.017)	-0.01 (0.9217)	1	0.01 (0.862)	-0.10 (0.144)	-0.10 (0.017)
REINVEST	0.23 (0.000)	0.33 (0.000)	-0.01 (0.881)	-0.02 (0.738)	1	-0.36 (0.000)	0.42 (0.000)
REP.DEF	0.00 (0.946)	0.050 (0.420)	0.12 (0.078)	-0.12 (0.075)	-0.29 (0.000)	1	-0.69 (0.000)
ROA	0.30 (0.000)	0.14 (0.037)	-0.13 (0.065)	0.19 (0.006)	0.37 (0.000)	-0.63 (0.000)	1



Before interpreting descriptive variables and estimating models, a thorough analysis must first be carried out to ensure the suitability of the variables used. It should be noted that the explanatory variables must be independent and uncorrelated. The problem of multicollinearity can lead to instability in the estimated coefficients, and may result in the non-significance of certain variables that are actually significant. To ensure that this problem has been solved, we need to observe the correlation coefficients between the independent variables and show the distribution of the dependent variables. The correlation coefficients, for each pair of variables, have values between ± 0.25 and ± 0.75 . This shows that the collinearity indicator is moderate between the independent variables (Hair et al., 1998).

Table 4: Transfer price estimation results using random effect model

Variables	Estimation	Standard deviation	t-value	Pr(> t)	
Constant	0.039	0.017	2.259	0.024	**
SIZE	0.002	0.001	2.834	0.005	**
SECTOR	0.007	0.003	2.264	0.024	**
DIFFRATE	-0.000	0.000	-1.067	0.286	
REINVEST	0.115	0.052	2.220	0.027	**
REP.DEF	0.010	0.001	5.153	0.000	***
ROA	0.095	0.010	8.932	0.000	***

* Significance at the 0.1 level.

** Significance at the 0.05 level.

*** Significance at the 0.001 level.

$R^2=38.28\%$

R^2 adjusted = 36.34%

p -value: $< 2.22e^{-16}$

In line with many previous studies, the variable SIZE, which measures company size, yields a positive and statistically significant coefficient (Hypothesis 1 confirmed). When company size increases by 1%, transfer pricing activity increase by 0.2%. This result strongly coincides with our theoretical predictions, notably the findings of (Hargiasto et al., 2024). Large companies have the ability to invest in fixed assets and reap tax benefits.

CONCLUSION

This study examines the determinants of transfer pricing among listed companies in Tunisia. The regression results show that firm size, as well as sector of activity, profit reinvestment, and loss allocation, have a positive and statistically significant impact on transfer pricing, controlled by the economic profitability of each economic entity. The firm with a large size is more engaged in the profit transfer process. Similarly, the industrial sector offers an opportunity for the management of commercial and financial operations transactions, which are integrated into the components of transfer pricing. In addition, the possibility of reinvesting profits generated by the firm in the current financial year makes the opportunity to transfer part of the credit result without paying corporate income tax a profit transfer mechanism. The presence of transfer pricing at the level of Tunisian listed companies with related parties helps



the tax authorities detect the tax adjustments needed to govern this process. Profit transfer becomes a tool for the Tunisian firm to disguise part of the profit via a tax-advantaged branch or subsidiary. Moreover, deducting the tax loss from the current year minimizes the tax due, even making it tend towards zero.

This work is subject to several limitations. Firstly, the lack of tax data for this type of firm limits the empirical results. This type of information remains discretionary between the taxpayer and the tax authorities. Secondly, the transfer pricing score may relate to real commercial and financial transactions, which do not reflect the economic situation between the related parties. For this reason, tax-related information must be published at least for this category of companies (public limited companies and listed companies).

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