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ECONOMICS OF BUSINESS AND STRATEGY

The evolution and the requirements of Transfer Pricing in Portugal: the study of a Portuguese company perception of Transfer Pricing in the light of institutional theory

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2023

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UNIVERSIDADE DO PORTO

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Internship report
Master's degree in Economics of Business and Strategy

Supervised by
Vítor Manuel da Silva Macedo

2023

Dedicated to my parents

"Thus, the task is not so much to see what no one yet has seen, but to think what nobody yet has thought about that which everybody sees."

Arthur Schopenhauer

Biographical Note

Joaquim Couto was born in Lourosa, Santa Maria da Feira on May 14, 1999.

He graduated in Economics from FEP – School of Economics and Management of University of Porto in 2021. That same year he started his master's degree in Economics of Business and Strategy at the same Faculty, having completed the curricular part of the same master's degree in January 2023.

During the master's degree, he studied one semester, under the Erasmus program, at SDU-University of Southern Denmark.

In February 2023, he started a curricular internship to complete the master's degree in the transfer pricing team of Deloitte where he currently works as an analyst.

Acknowledgements

As I finalize this important stage of my life, it is time to express my deep gratitude to all those who have been with me on this journey that culminated in this work.

To my parents, I cannot fail to give the greatest of thanks being that I dedicate this work and all that I have achieved. Thank you for the strength and motivation you have always given me so I could always go further and believe in my abilities.

To my friends, thank you for the genuine friendship and good times we shared together.

To my supervisor, Professor Vítor Macedo, for all the availability and motivation he gave me. I was fortunate to have an exceptional supervisor who was always willing to make good contributions and point out possible research paths.

To the entire Deloitte's transfer pricing team, my thanks for all the knowledge about the area that they transmitted to me. Writing a paper on a topic that is unknown at the beginning of the internship is an impossible task that only became possible thanks to the contribution of all my colleagues, who were always helpful and extremely available in transmitting knowledge.

To FEP and to all the professors, who in addition to sharing knowledge have fostered in me a critical spirit fundamental to knowing how to interpret reality, my thanks.

Abstract

Multinational enterprises have acquired great importance in the global economy in recent decades. The growing number of companies with subsidiaries in several countries has brought advantages for economic actors, but also challenges. Such challenges affect both Multinational Enterprises and sovereign states.

One of the main problems that has arisen is the issue of transfer pricing. Transfer pricing is the price that one unit of an enterprise charges another unit of the same enterprise for the goods (tangible or intangible) and services it provides.

In this area, several problems have arisen over the years leading to the need for strong transfer pricing regulation.

Throughout this report a review of the existing literature on this topic is provided. It is then shown how a firm resident in Portugal should behave to prove that its transfer prices are within the arm's length range.

Institutional theory was also used to study the perception that the Portuguese firm studied has about the same transfer prices.

Through semi-structured interviews with professionals in the area and an academic, it was realized that the area is still underexplored, due to the small size of Portuguese companies and the lack of technical knowledge among companies. In addition, the greater experience held by specialized consulting firms, together with financial issues, such as access to a database or the fact that it is cheaper to pay for documentation than to have professionals allocated to it, lead to companies not showing much interest in exploring the area.

Suggestions that could improve the company interest and practice in transfer pricing are also pointed out, as well as the limitations of this research and paths for future research.

Resumo

As empresas multinacionais adquiriram nas últimas décadas uma grande importância na economia global. O número crescente de empresas com filiais em vários países trouxe vantagens para os agentes económicos, mas também desafios. Tais desafios afetam tanto as empresas multinacionais como os Estados soberanos.

Um dos principais problemas que se colocaram foi a questão dos preços de transferência. Os preços de transferência são o preço que uma unidade de uma empresa cobra a outra unidade da mesma empresa pelos bens (tangíveis ou intangíveis) e serviços que fornece.

Neste domínio, surgiram vários problemas ao longo dos anos, os quais conduziram à necessidade de uma forte regulamentação dos preços de transferência.

Ao longo deste relatório é feita uma revisão da literatura existente sobre este tópico. De seguida demonstra-se como é que uma empresa residente em território português deve proceder de forma a provar que os seus preços de transferência estão dentro do intervalo de plena concorrência.

Recorreu-se também à teoria institucional para estudar a perceção que a empresa portuguesa considerada tem sobre os mesmos preços de transferência.

Através de entrevistas semiestruturadas a profissionais da área e a um académico, percebeu-se que a área ainda não tem o seu potencial totalmente explorado devido à reduzida dimensão das empresas portuguesas e à falta de conhecimentos técnicos por parte das empresas. Além disso, a maior experiência detida pelas consultoras especializadas e também as questões financeiras, como o acesso a uma base de dados ou o facto de ser mais barato pagar a documentação do que ter profissionais alocados a isso, leva a que as empresas não demonstrem muito interesse em explorar a área.

São também apontadas sugestões que podem melhorar as relações das empresas com os preços de transferência bem como as limitações desta investigação e futuros caminhos de investigação.

List of abbreviations

BEPS - Base Erosion and Profit Shifting

CPM – Cost Plus Method

CUP – Comparable Uncontrolled Price Method

IRC - *Imposto sobre o rendimento de pessoas coletivas*

MNE – Multinational Enterprise

OECD - Organisation for Economic Co-operation and Development

PSM – Profit Split Method

RPM – Resale Price Method

SME – Small and Medium Enterprises

TNMM – Transaction Net Margin Method

Table of Contents

List of Tables

List of Figures

1. Introduction

1.1. Context

Over the last decades, international trade and economic relations between countries have become more and more relevant and, in addition to that, multinational companies are increasingly important in international trade. Focusing on the specific case of multinationals, the following should be noted: in situations where firms trade goods or services among themselves, the prices of those goods or services are defined by market supply and demand. In cases where companies of the same group transact products or services between themselves, market forces no longer have the same effect on the transaction. There can be an incentive to shift profits between companies, which amounts to manipulation and tax avoidance (OECD Guidelines, 2022).

The world economy has seen significant advances in technology, transportation, and communications over the past decades. Because of this, multinationals increasingly have greater flexibility to locate their companies and activities anywhere in the world, thereby maximizing their profitability. About eighty percent of the transactions that take place in the global economy today are the result of transactions between companies in the same corporate group (UNCTAD, 2013).

One of the biggest challenges for multinationals is the valuation of transactions between different companies in the same corporate group. Not only for tax reasons, but because in certain situations there may be a real difficulty in determining the transfer price of some traded products or services in the absence of market conditions, or even because the company intends to adopt a particular commercial strategy (OECD Guidelines 2022). Therefore, transfer pricing acquires particular importance for multinationals and should be given considerable attention by them (Kumar *et al.*, 2021).

In an increasingly globalised world economy, it is increasingly difficult to allocate profits to individual countries and attempts to do so are fraught with opportunities for tax evasion (Avi-Yohan, 2009). The great internationalization we have witnessed raises important questions including how governments should tax corporate profits and to what extent they should coordinate their efforts to combat tax avoidance.

Transfer pricing is then a general term that is used to value intra-group transactions. The objective is to ensure that revenues and costs are allocated fairly among group entities, according to the functions, risks, and assets that each entity incurs and develops in the process. The OECD (Guidelines 2022) recommends five potential transfer pricing methods that can be used to assess whether intra-group transactions within a given corporate group have been made on terms like those that would be practiced in a market situation.

Transfer pricing, despite its growing importance, has not yet reached its full potential. Being a concept that comes from management, it is seen by many companies only just a tax documentation obligation. Throughout this report, I try to understand why this happens through semi-structured interviews with an academic and professionals in the field. Combining these interviews with institutional theory and institutional logics, it was possible to understand that there are social and institutional dimensions that do not allow companies to exploit the full potential of the area, both in terms of taxation and in terms of optimizing the value chain.

1.2. Research Objectives and Questions

Over the last few months, I did an internship in transfer pricing. I realized, among other things, that few companies in Portugal have a specialized team in the area and professionals dedicated to it. One of the questions I tried to reflect on started precisely there, that is, trying to understand why few companies have these internal resources.

An interview with a professional with extensive experience in the area helped to realize that one of the reasons is related to the financial issue:

> *"If we look at the work of transfer pricing in the documentation aspect (where there is a large expenditure of man hours) it does not justify hiring and training this resource and paying him a salary to make one, two or three dossiers."* (TP Documentation).

In other words, there is an inherent cost-benefit analysis here.

I have therefore identified two research objectives throughout the internship. The first one is the most general. It is to understand how a company acts to demonstrate that its transfer prices have been set correctly. This first objective will consist in demonstrating the documentation requirements demanded by the Portuguese Tax Authority in line with the OECD rules.

The second research objective relates to the fact that very few companies have their own in-house transfer pricing department and thus choose to outsource these responsibilities.

This objective also encompasses the almost exclusive treatment of transfer pricing from a tax perspective.

Therefore, the research questions are as follows:

Question one: What are the transfer pricing requirements to be met by entities resident in Portuguese territory?

Question two: Why do most of these entities choose to outsource the production of transfer pricing tax documentation and why do transfer prices only seem to have relevance from a tax perspective when they are also a management issue?

1.3. Research Methodology

In the literature review by Kumar *et al.* (2021) on transfer pricing, the authors make an extensive review of transfer pricing articles published in the last 50 years, concluding that this topic has been treated from five main perspectives: tax policy, international trade, organizational management, value chain management and relations with the institutional environment.

Within this research and given the experience gained throughout the internship, it was realized that transfer pricing despite being a concept originating from management is treated almost exclusively by companies for tax documentation purposes. The objective of this report is to contribute to the transfer pricing literature by studying why organizations perceive transfer pricing only as a tax obligation and do not go further in this matter by seeking to optimize their value chain and the amount of tax they pay. I intend to use a qualitative methodology to understand the reasons behind this.

Given the nature of my research objectives, qualitative methodologies are the most adequate. Social sciences study the processes of social relations, and these relations are complex given the plurality of universes of life (Flick, 2005). Nowadays, the world is changing at an accelerating pace, so these same pluralities of universes of life are changing more and more constantly. This means that deductive methods, where theoretical models are used to develop empirical tests, find it increasingly difficult to differentiate between subjects. Alternatively, researchers can opt for inductive methodologies, where they can build a theory from data collected in concrete cases.

There are several possible methodologies within qualitative methods, among which are ethnography/participant observation, qualitative interviewing, focus groups, language-based approaches to the collection of qualitative data (Bryman & Bell, 2015) and the case study (Yin, 2015). Both questions will be answered through qualitative research.

After deciding the strategy, the research was defined as a case study, focusing on the transfer pricing policies of a model company in the food sector integrated in a multinational group whose parent company is in Portugal.

The case study will be the methodology adopted in this report for two reasons that can be briefly described: firstly, the objectives of this report are to understand why Portuguese companies give little importance to transfer pricing, almost always seeing it as a mere documentation obligation. In order to understand them, we must first answer the question "why", that is, try to understand the reasons for the existence of transfer prices and why they are subject to tax treatment by companies and tax authorities. It is also necessary to understand "how" the documentation process is done, what are the requirements that need to be proved and through which methodologies companies prove that they are complying with the transfer pricing rules. Secondly, we are analysing a contemporary phenomenon, so the case study is the most appropriate method (Yin, 2015).

We can define case study as a methodology that investigates a contemporary phenomenon in the reality in which it is inserted, especially in cases where there is no well-defined boundary between the case and the surrounding context.

Throughout the internship carried out in transfer pricing I had the opportunity to contact various challenges that companies face in this area and with the very way they analyse this theme. To understand these issues, I developed a case study that aims to answer the two research questions underlying this report: first, I briefly demonstrate how a Portuguese company should proceed to demonstrate that it has complied with the arm's length principle when defining its transfer pricing policies. I chose a company that does not fall into the Small and Medium Enterprises (SME) group to demonstrate the documentation model consisting of a Master File and a Local File instead of a simplified dossier.

To answer their research question, *i.e.*, to try to understand why transfer pricing in Portugal is often seen from a purely tax documentation perspective, contributions were obtained from an academic and several professionals in the field, to study the use of transfer pricing by companies from the point of view of institutional theory and institutional logics. Therefore, a case study means that during the research, the researcher must be prepared to make use of different sources of information, prepare a research strategy, interpret the data and ensure the triangulation of the information obtained (Bryman & Bell, 2015).

I started by preparing a case study of a model company that fits the Portuguese reality and, thus, in a first phase, demonstrate how a company with tax residence in Portugal should proceed to demonstrate that it has complied with the legal transfer pricing rules. For this, I used the *Orbis Bureau Van Dijk* platform to find comparable entities in order to assess the profitability of the production activity of the company under analysis. The data obtained in the database were processed to be left with only the best comparable entities. Then, calculations were made to understand whether the company's profitability indicator fell within the arm's length range.

I then conducted four semi-structured interviews with three transfer pricing professionals (A,B and C) and one academic. These interviews allowed me to explore the best methodology to use in the case study. In addition, they allowed me to have a broader view of the reality of transfer pricing in Portuguese companies. They also allowed me to understand the reasons why transfer pricing is not yet fully explored in Portugal. The interviews were triangulated, which allowed to strengthen some conclusions since the interviewees touched on common points.

These interviews were focused interviews where the topic is presented first and then the perception of the interviewee is studied through the interview. The structure of the interviews was defined according to Flick (2005) having the following elements: firstly, non-directiveness, achieved through questions with a defined subject and open response. The script was also used in a flexible way so that it was possible to capture as much information as possible. Secondly, the interview was specific by targeting concrete questions on issues that impact transfer pricing. The interview was also broad to ensure that all relevant aspects were asked about, and, finally, in-depth to obtain as much detailed information as possible.

All interviews were recorded and transcribed in full, to aid triangulation and to ensure that the content was rigorously treated.

1.4. Structure of the Report

This paper is organized into six chapters. In chapter two, which follows, the literature review is developed, where key concepts are presented and the main research topics in the context of transfer pricing and institutional theory are analyzed. Chapter three details the legal framework, both nationally and internationally, of transfer pricing. The fourth chapter presents a brief description of the case study, and the main technical results of the case study are discussed. Chapter five discusses and analyzes the results of the semi-structured interviews in the light of institutional theory. Chapter six addresses the work developed in the curricular internship at Deloitte as well as an analysis of the proposed and achieved objectives. Finally, in the conclusions, the main results and the research limitations of the case study, together with the main implications for the work of transfer pricing professionals, are presented.

Chapters three and four jointly answer the first research question, *i.e.*, to show how a company should proceed in order to demonstrate that its intra-group transactions have been made in accordance with the arm's length principle. Chapter three introduces the theoretical basis for this, and chapter four presents a case study.

Chapter 5 answers the second research question.

2. Literature Review

2.1. Transfer Pricing Literature

Borkowski (1997, p.2) defines transfer pricing as "a strategy for pricing tangible goods and intangible services transferred between parent and subsidiaries, or between subsidiaries, to maximize profits, minimize taxes, maintain goal congruence, and/or evaluate managerial performance." A transaction between two companies of the same group, referred to as related entities, has the technical name of a controlled transaction.

The literature on transfer pricing dates to the 1950s and the contributions of Hirshleifer (1956). At the beginning of the academic debate on transfer pricing, the objective was to understand how the goods and services that were exchanged between the various divisions of a company should be valued. It was also to understand how this valuation should be defined so that each division acted in such a way as to maximize the profit of the company. The conclusions reached showed that the transfer price to be used should be the market price and only if the product was produced in a competitive market where no producer had sufficient market power to influence the market price.

Horst (1971) discusses the possibility of the existence of an optimal transfer pricing strategy. That is, whether there are optimal quantities produced and optimal consumer prices. The research focuses on specific cases and shows that cost technologies constrain fiscal policy.

These first two articles were unique contributions to transfer pricing research. It is worthwhile stressing that at the beginning of the research on the field, such as in the mentioned cases of Hirshleifer (1956) and Horst (1971), the research on transfer pricing was based on neoclassical economic theory, leading the authors to investigate transfer pricing within the formal framework of economic theory.

Following the already mentioned bibliometric analysis by Kumar *et al.* (2021), the most important cluster is the study of the relationship between transfer pricing and tax policy. This is followed, in this order, by the study of transfer pricing and international business, organisational management, value chain management and the institutional environment.

2.1.1. Transfer Pricing and Tax Policy

According to Klassen *et al.* (2016, p.2) "more recently within the accounting,

economics, and law literatures, interest in transfer prices has focused on transfer prices as a tool for multinational firms to reduce global taxes."

Because of this problem of tax evasion by multinationals, issues related to the ethical behavior of multinationals and tax evasion have aroused the interest of several national governments (Barrera and Bustamante, 2017) and, in addition, the discussion has focused particularly on the role that countries with low tax rates play in manipulating transfer pricing to evade taxes (Taylor & Richardson, 2014).

Focusing on the study of the relationship between transfer pricing and tax policies we can state that the relevance of this topic arises from the fact that intra-group transactions that cross borders are an important accounting aspect that has relevance in the earnings and tax strategies of multinationals (Olibe & Rezaee, 2008). Transfer pricing for tax purposes is a field of international taxation (Rogers & Oats, 2022).

The subprime financial crisis brought with it increased public scrutiny for corporate tax optimisation/minimisation strategies. Although the legitimacy of tax optimisation practices is nowadays more debated, the truth is that these strategies continue to exist. The lack of capacity to prevent this type of strategies arises from the fact that there is a lack of practical means to implement a moral vision that would lead to the removal of this type of practice (Anesa *et al.*, 2019).

It is important at this stage to define two concepts to better frame transfer pricing in the tax strategies adopted by companies. Tax avoidance is understood as the use of legal instruments to pay the least amount of tax possible. This concept includes, for example, the transfer of profits to jurisdictions where taxation is lower. Tax fraud refers to the use of instruments to pay as little tax as possible (European Parliament, 2016).

One concrete strategy for tax optimisation/minimisation strategies by companies is related to transfer pricing. Davies *et al.* (2018) analyse the transfer pricing of multinationals. In this paper, the hypothesis that prices of controlled transactions deviate from market prices for two reasons is studied: pricing to market and tax avoidance. They compare inter-independent exports with intra-group transaction exports and conclude that there is a price sensitivity of intra-group transactions to foreign taxes. This sensitivity is even more noticeable when analysed separately from the determinants of market pricing. Moreover, this study only finds evidence of tax avoidance when tax havens are considered. They find evidence of profit shifting from countries with high tax rates to countries with lower rates. Other authors have reached similar conclusions (Klassen, Lisowsky & Mescall, 2017; Yao, 2013).

Another interesting point from the literature is that firms are not homogeneous in their ability to manipulate transfer pricing. The ability to coordinate internal pricing methodologies and production decisions is not the same across firms, hence the lack of homogeneity. Companies may be able to manipulate their transfer prices based on their R&D structure (Desai *et al.*, 2004). Azémar & Corcos (2009) show that R&D-intensive firms that wholly own their subsidiaries have a higher propensity to manipulate transfer prices for tax purposes.

There are several approaches to the determinants of tax rates. The return on investment and the tax rate increase with the size of intra-group transactions. On the other hand, the overall effective tax rate decreases. There is also evidence that firms that are more involved in cross-border intra-group transactions are the largest and most profitable (Olibe & Rezaee, 2008).

In recent years, the implementation of stricter transfer pricing rules has led to companies becoming less motivated to adopt practices to adhere to their tax base (Riedel *et al.*, 2015; Marques and Pinho, 2016). Departments have become more focused on considering tax and meeting the document requirements required by tax authorities (Chen *et al.*, 2021).

In a globalized economy, where a significant part of international trade takes place within multinationals, transfer pricing can eventually be used as a tax evasion scheme, thus having some impacts on government tax revenues (Sikka, 2010).

A multinational, through the resources it has at its disposal, may also choose to explore existing gaps in the current laws that regulate transfer pricing (Mashiri *et al.*, 2021). At the limit, we can say that there are antagonistic interests between the multinational company and the tax authorities, as on the one hand there is a desire to pay the smallest possible amount of tax and, on the other hand, there is a desire to make a rigorous collection of all tax that must be collected (Uyanik, 2010).

Another interesting topic is the study of the ability of tax authorities to carry out a rigorous analysis of the amount of tax that must be paid by companies (Klassen *et al.*, 2016). Since the tax authorities do not have professionals who can efficiently assess issues of transfer pricing and subsequent tax evasion, this makes it easier for companies to manipulate their methodologies for valuing transactions intragroup.

Transfer pricing is not the most widespread and understood tax area by professionals in the areas of economics and management. They are a subject of constant debate, but not always well understood by those who analyze them (Hunter *et al.*, 2015). The main problems in this area arise from the fact that it is complex to carry out a comparability analysis in the parameters of the arm's length principle (Brychta *et al.*, 2020).

Companies define their transfer pricing policy, and this definition can be made by company professionals or by a third party to whom the company has assigned the responsibility of preparing the documentation that proves that its intragroup transactions are governed by the principle of full competition. Once this policy has been defined, it will be audited and subject to possible corrections by the tax authorities. In case of disagreement between the authorities and the company, the matter will be brought before a court.

An audit generally encompasses several technical issues (Schogewe, 2019) and national authorities in countries, especially developing countries, often do not have sufficient resources to carry out audits (Cooper *et al.* 2016).

Determining the transfer price is then understood as a difficult exercise, as companies determine them fundamentally for fiscal reasons and to prevent the risk of being audited (Bateman, 2007). Hiring transfer pricing consultants can be a solution since they have greater know-how in the area in question and, in this way, companies will be able to present a more robust analysis of their policies and methodologies to the tax authority.

An important challenge within the scope of tax audits has been the treatment given to intangibles. Transfer pricing regimes were not prepared to deal with issues related to intangible assets, such as intellectual property (Garcia, 2016).

2.1.2. Transfer Pricing and International Business

Another area where transfer pricing is important is the area of International Business.

The existing literature on international trade and prices is very scarce. Over the years, much research has been carried out in the field of studying the factors that influence foreign direct investment, but no relevance has been given to its relationships with transfer pricing.

The literature on the investment of multinationals in foreign countries has studied, over the years, various factors that determine the value of this investment, including the size of the market (Markusen & Venables, 1997), differences in skills between countries or the quality of institutions in those countries. (Zhang & Markusen, 1997; Wei, 2000).

The conclusions that exist on the relationship of transfer pricing with international trade are related to the sanctions that can be applied in matters of transfer pricing. Companies located in OECD countries are obliged to follow the principle of arm's length competition when defining the price in transactions that are carried out between entities of the group. If these recommendations are not followed, there will be corrections and possible sanctions by the national tax authorities. These corrections and sanctions can have an impact on the profitability of multinational companies (Eden *et al.*, 2005).

As for the motivation of companies to invest in countries where transfer pricing regulations are in place, there does not seem to be evidence that this is a preponderant factor. Factors such as market size, trade openness, geographical proximity to the country of origin as well as taxation seem to have more impact than transfer pricing on international trade (Hung, 2011).

2.1.3. Transfer Pricing and Management Organization

Over the past decades, the international focus and literature on transfer pricing has been focused on the fiscal perspective (Davies *et al.*, 2018). But transfer pricing can also be used to rationalise production processes and make them more efficient. The excessive tax focus on transfer pricing should be reduced as it can lead to underperformance in multinational enterprises (Kumar *et al.*, 2021).

Although it is not the focus of the literature in the area, the study of organizational performance has started a few decades ago. Lall (1973) studied the determinants and implications of valuing intra-firm trade by multinationals operating in different countries. In this study, technology and services are excluded from the analysis. They are considered tradables, such as finished goods and services or capital. Only firms in the manufacturing sector are considered. In a transaction between two firms of the same group the parties are trying to maximise their joint profits and price is merely an accounting aspect. In a free-market transaction sellers and buyers are trying to maximise their profits at each other's expense.

One of the first conclusions reached in this area was that if a firm competing in an imperfect competition market or has non-constant costs, then its arm's length price limits will be a function of the firm's activities (Samuelson, 1982).

In the management of a company, transfer prices acquire a fundamental relevance at the decision-making level, especially when it comes to defining the final price of the company's products. These final prices will be the prices that the company practices in the market, which will define its performance and profitability and its strategy vis-à-vis competitors in the market.

Let us imagine a group whose entity that produces is not the same entity that sells the product. That is, the product passes from the producing entity to the distributing entity and in this transaction a transfer price is defined. This price will have an impact on the final price because the distributor will work with a margin on this price, and this transfer price is nothing more than the marginal cost of the distributor (Schjelderup, 1999).

In markets where there are a small number of firms operating, the relationship between transfer prices and the final price of the product is of particular importance. Most research in the area is focused on imperfect competition markets, where transfer prices are set centrally within the group (Hung, 2011).

But if we look at the principal-agent literature, the parent company may benefit more from delegating responsibilities to the subsidiary because it knows better the specific circumstances surrounding production (Vickers, 1985).

Firms may revise their transfer prices based on previous period transfer prices. This should happen only in cases where the realized cost can help predict future costs, in which case there is an improvement in trading decisions (Brunner & Schäfer, 2022).

In the relationship between transfer pricing and management, there is a very important factor, which is the autonomy given by the administration to the managers of the various departments to define their transfer prices. Transfer pricing tends to be understood as fairer within the company when its characteristics allow greater autonomy in defining them. (Chen *et al.*, 2014). In addition, Chen et al. (2014) predict that autonomy is influenced by four factors: intermediate product standardization, foreign investment, tax rate difference, and the weight on firm-level performance measures in the department manager's performance evaluation.

Managers often prefer the use of transfer pricing based on total cost (Ernst & Young, 2010) even though these can distort efficiency and start a downward spiral for companies that opt for this practice. In this practice, companies will have to increase transfer prices in the event of a reduction in volume because in this type of case the unit cost becomes higher. In turn, price increases will lead to further reductions and so on. But the evidence shows that department managers manage to reduce costs so that their companies do not run the risk of bankruptcy, mainly through variable costs and in products with better sales prospects. Therefore, this practice of transfer pricing can demonstrate that managers are available to reduce costs (Bouwens & Steens, 2016).

2.1.4. Transfer Pricing and Value Chain Management

Managing a value chain can benefit immensely from efficient management of transfer pricing within a multinational company. Transfer pricing will make it possible to optimize intra-group transactions and thus generate the greatest possible value at each stage of the production process.

Over the last few decades, supply chains have tended to become increasingly global due to the liberalization of international trade.

There is a trade-off between centralizing all the activities of the same group in one country and outsourcing them. If the group concentrates all activities in the same country, it can benefit from more efficient management and have a higher total pre-tax profit. On the other hand, if the company outsources some activities, the company may have a lower tax rate on its productive activities, but operational management will not be as efficient due in part to double marginalization (Kim *et al*. 2018).

Over the last few decades, several studies have been carried out to understand how multinationals locate their entities through the approach to various taxes, including value added tax or income tax, concluding that the ideal structure of a supply chain depends on much of the purpose of the product (Li, Lim and Rodrigues, 2007; Hsu and Zhu, 2011).

Allied to this, the problem of supply chains has also been studied from the point of view of outsourcing the group's economic activities through offshoring and outsourcing practices.

Studies have been dedicated to trying to understand decision-making regarding the place where activities will be carried out in a context of uncertainty. If there is a rival at the retail stage, the entity responsible for production can be outsourced even if the cost of outsourcing is higher than vertical integration (Arya *et al*., 2008). Uncertainty can also have an impact on a supplier's costs, which leads to it incurring the risk of default and, in this way, the manufacturer's profitability may be affected (Swinney & Netessine, 2009). In addition, competition between suppliers may also be important in deciding whether to outsource production (Li, 2013).

The established rules regarding transfer pricing can have an impact on decision-making by a multinational when organizing the supply chain. The relationships between transfer pricing and supply chains have not received as much attention in the literature as the strict relationships between transfer pricing and taxation.

Although the literature is not extensive on this point, the existing research goes towards confirming that there is a relationship between transfer pricing, company profit and social welfare (Autrey & Bova, 2011) and that the pricing policy used can help to maximize the company's decision-making capacity, which has a positive impact on its competitiveness.

However, this topic has gained relevance over the last few years due to different tax rates in different jurisdictions. This means that multinationals are encouraged to optimize their supply chain to maximize their tax savings and optimize their organizational decision-making capacity. The fact that companies are required to demonstrate that their intra-group transactions were carried out in accordance with the arm's length principle means that they cannot artificially increase their profits, *i.e.*, they cannot profit more than what they would profit in a situation of competitive market (Kim *et al.* 2018).

To conclude, there are several perspectives in which transfer pricing can be used, but undoubtedly taxation has been the most relevant factor (Kumar *et al.*, 2021). This is due to the possibility of using transfer pricing for profit manipulation by multinational companies and consequent loss of tax revenue by national governments.

Despite this, it is important to note that it is also important to analyse transfer pricing from other perspectives to understand, among other things, how a company can use it to maximize its value chain or how management and market structure can influence the transfer pricing policies and methodologies followed by a company.

The relationships between transfer pricing and the institutional environment have been dealt with implicitly in the other sections mainly through the analysis of the research on audits that there is a lack of resources and knowledge on the part of the tax authorities, which often limits them. Also, in the context of institutions, it was noted that governments have tried to legislate to prevent artificial profit shifting between firms.

2.2. Institutional Theory Literature

2.2.1. The Institutional Theory

During the last century, more precisely around the 1970s, a new approach to analyze organizations emerged. We are talking about the Institutional Theory, that extended the analysis to the culture, social and institutional dimensions of organizations, as well as to the very environment in which they are inserted (Moll et al. 2006; Thornton and Ocasio, 2008), contrasting therefore with the models of analysis that focused essentially on the rationality of economic agents and the optimization of the cost/efficiency ratio (Scapens, 1994;

Guerreiro et al. 2012). Therefore, the fact that organizations include these new dimensions does not automatically make them more efficient, but rather increases their chances of survival in the market (Greenwood et al., 2014).

This new perspective introduces the fact that organizations can eventually be affected by both internal and external pressures, pressures that being exerted by external entities or by employees of the company, legitimize behaviours on the part of the company's employees, making the company more likely to survive (DiMaggio and Powell, 1983). These processes in a way replace the market logic (DiMaggio and Powell, 1983) and the bureaucratic processes of building organizations (Greenwood et al., 2014).

In modern societies, organizations tend to have a complex functional structure to achieve easier access to resources, legitimacy and to increase their survival prospects (Meyer and Rowan, 1977; Greenwood et al., 2014).

Early studies of this theory focused heavily on the environment outside the organization (Thornton and Ocasio, 2008; Kraatz and Block, 2008). The aim of these studies was to understand how an organization as a whole could make collective efforts to achieve the organization's goals (Meyer et al., 1993), these efforts being conditioned by both the institutional and social environment or regulatory practices imposed by political authorities (Meyer and Rowan, 1977; DiMaggio and Powel, 1983). The problem with this first phase of institutional theory studies is that it would make organizations similar (Guerreiro et al., 2012), thus failing to explain the differences observed between organizations (Greenwood et al., 2014).

Thus, it is necessary to understand how and why there is a stimulus for change (Dacin et al., 2002).

There are three main theoretical trends in institutional theory. First, with organizations responding to external shocks. The second focuses on bottom-up change through entrepreneurial agents. Finally, and more recently, improvisations and everyday practices have been studied (Micelotta et al., 2017). Authors in this third and current trend are concerned with the study of the evolution of enduring sociocultural structures, which serve for organizations to adapt to change, through these "institutional logics".

2.2.2. Institutional Logics

Thornton and Ocasio (1999, p. 804) defined Institutional Logics as "the socially constructed, historical patterns of material practices, assumptions, values, beliefs, and rules by which individuals produce and reproduce their material subsistence, organize time and space, and provide meaning to their social reality".

The behaviour of individuals must be contextualized at various levels, such as the historical and institutional levels. This serves to answer an existing problem in neoclassical theory that fails to explain how and when individuals form their preferences (Thornton and Ocasio, 2008).

Stakeholders involved with organizations have a motivation to demand access to financial information from companies when establishing relationships with them. This happens in order to minimize their risks and serve their interests. The level of demand for access to information depends on the internal daily practices of the company, i.e., its institutional logics (Goncharenko, 2019). Durocher & Fortin (2021) concluded that the factors that most influence stakeholders in requests for access to financial information are due process issues, readiness and relevance for use, comparability and consistency, and cost-benefit issues.

Organizations tend to change rapidly (Waldorff, 2013), so they define their ambitions through their reading of society. Change in organizations is likely not to be limited to the organization itself but will also have an impact on society.

Incremental changes are the most likely to occur over long periods, and this happens because of the ability of the actors involved to maintain the current state within the organization or force small changes in the way the organization is run (Scott et al., 2000; Kraatz and Block, 2008). The actors within the firm who can combine the greatest number of competencies will be the ones who can tip the balance of power within the organization in their favour (Kraatz and Block, 2008; Dunn and Jones, 2010). However, larger events can lead to a more drastic change. These more drastic changes are usually the consequence of political, economic, or social changes (Scott et al., 2000; Reay and Hinings, 2005; Kraatz and Block, 2008; Kyratsis et al., 2017).

Many of the studies on organizations and on the economy, itself have limited validity (Friedland and Alford, 1991). That is, in addition to the study of institutional logics, it is also necessary to study the pace at which society is evolving to understand whether these studies still make sense.

3. Legal Framework

This chapter will provide a legal framework for transfer pricing. There are important legal issues both at international and national level that Portuguese companies should take into consideration when defining their transfer pricing policies.

Over time, Portuguese legislation has followed the recommendations of international organizations in this area, mainly the OECD.

3.1. International Legal Framework

3.1.1. The evolution

Before starting specifically with the approach on the OECD Guidelines 2022 it is important to make a short historical context of international transfer pricing regulation. In the 1920s, the US Treasurer, through the Revenue Acts of 1921 (Blakey, 1922) and 1928 (Blakey, 1928), introduced income tax allocation mechanisms to prevent tax evasion. About a decade later, still in the inter-war period and under considerable political tensions, the League of Nations through Mitchell B. Caroll coordinated a tax committee study to accommodate the provisions of model tax treaties for multinationals (Picciotto, 2013). In 1963 the first international reference to the arm's length principle appeared in the OECD Model and this principle was added to Article 9 of this model (Draft Double Taxation Convention on Income and Capital, 1963). About a decade and a half later, in 1979, the first OECD guidelines specifically devoted to transfer pricing appeared, guidelines that have been continuously revised and adapted to new challenges as they arise (OECD Guidelines, 1979). The last two revisions were made in 2017, which allowed incorporating the contributions of the BEPS (Base Erosion and Profit Shifting) program, and finally in 2022.

In 1980, the UN model for transfer pricing was also created by adding the arm's length principle to article 9 of this model. The model was revised in 2001, in 2011 and in 2017 (UN Model Convention).

3.1.2. OECD

3.1.2.1. BEPS

BEPS "refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax”. (Base erosion and profit shifting - OECD BEPS). To respond to this problem, *i.e.*, to address the growing concerns about base erosion and profit shifting, the OECD decided to develop the BEPS project. Developing countries are more dependent on corporate tax which means they will feel a greater impact under this project. There are now 135 countries and jurisdictions working to collaborate and implement measures to tackle tax avoidance and make international tax rules more consistent (Base erosion and profit shifting - OECD BEPS).

3.1.2.2. Guidelines 2022

The OECD transfer pricing guidelines provide tools for the application of the arm's length principle in the analysis of controlled transactions. The current version, published in 2022, provides help for the application of the profit split method, indicating in which situations it is most appropriate to use this method. It also provides information on how to treat hard-to-value intangibles and financial transactions (Deloitte, 2022).

3.2. Portugal

The Portuguese legislation on transfer pricing is based on the OECD Guidelines and its main legal documents are article 63 of the Corporate Income Tax Code and the Ministerial Order and Ministerial Order no. 268/2021 published on November 26 that revised the transfer pricing regulations, revoking Ministerial Order no. 1446-C/2001, of December 21. This revision follows not only the changes already introduced in article 63 of the IRC Code, but also considers the developments resulting from the OECD's work on this matter.

The next four subsections will discuss article 63 of the IRC Code, the two Ministerial Orders, and a subsection explaining the differences between the two Ministerial Orders.

3.2.1. Article 63 of *IRC* Code

The purpose of this article is to regulate transfer pricing in Portugal. Paragraphs a) and b) of number 3 of this article define the five conventional methods that may be used and the second part of paragraph b) also establishes the possibility of using other methods in cases where it does not seem possible to use any of the five conventional methods.

Number 4 of this article establishes the eight situations in which the Portuguese legislation considers the entities to be entities between which there are special relations, that is, a significant influence of one over the management decisions of the other. The eight situations are as follows (set out from paragraph a) to h) of the said number): an entity and the holders of its capital, or their spouses, ascendants or descendants, who detain, directly or indirectly, a holding of not less than 10 % of the capital or of the voting rights; entities in which the same holders of the capital, their spouses, ascendants or descendants detain, directly or indirectly, a holding of not less than 10 % of the capital or of the voting rights; an entity and the members of its corporate bodies, or of any administrative, direction, management or supervisory bodies, and respective spouses, ascendants and descendants; entities in which the majority of the members of the corporate bodies, or of the members of any administration, direction, management or supervisory bodies, are the same persons or, being different persons, are linked to each other by marriage, legally recognized *de facto* union or kinship in direct line; entities linked by a subordination contract, group parity contract or other contract of equivalent effect; companies in a control relationship, as defined in the diplomas that establish the obligation to prepare consolidated financial statements; entities between which, by virtue of commercial, financial, professional or legal relations established or practiced between them, directly or indirectly, a situation of dependence in the exercise of the respective activity is verified; a resident or non-resident entity with a permanent establishment located in Portuguese territory and an entity subject to a clearly more favorable tax regime resident in a country, territory or region included in the list approved by administrative ruling of the Minister of Finance.

3.2.2. Ministerial Order no 1446 -C/2001 of December 21st

Ministerial Order no 1446-C/2001 of December 21st was the first ministerial order to regulate transfer pricing in Portugal. The Ministerial Order was based on "the arm's length principle, around which a broad international consensus was being built, as it was understood that its adoption allows not only to establish parity in the tax treatment between companies integrated in international groups and independent companies but also to neutralize certain tax evasion practices and assure the consequent protection of the internal tax base" (Ministerial Order no 1446 -C/2001 of December 21st).

According to the same document the goal was to align the Portuguese transfer pricing legislation with the OECD guidelines.

According to paragraph a) of number 2 of article 1 of this ruling, the rules defined in the ruling should be applied to three types of transactions: in situations where there is a continuous supply of goods or services, there is a transfer of the right to exploit intangible elements accompanied by other services and, finally, in cases where there is the pricing of goods that have functional complementarity or typological identity, such as those included in a product line.

The Ministerial Order provided for the use of the five conventional methods already mentioned throughout this report (Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Profit Split Method, Transactional Net Margin Method).

About documentation, this was regulated by article 13 of the Ministerial Order. In the first paragraph of this article, it was foreseen that the company must have information and documentation concerning the policy adopted in the determination of the transfer prices that proved two things: the market parity under the terms and conditions adopted and the selection and use of the most appropriate method or methods of determination of the transfer prices.

3.2.3. Ministerial Order no 168/2021 of November 26th

Ministerial Order 168/2021 published on November 26th was issued to replace Ministerial Order 1446-C/2001 of December 21st. In the next subsection the differences between the two Ministerial Orders will be explained, so in this subsection the focus will be on the detailed analysis of this legal document.

According to article 1, number 1 of this legal document, it applies to operations carried out between companies that are linked by special relations defined in article 63 of the IRC (*Imposto sobre o rendimento de pessoas coletivas*) Code. In line with the OECD (Guidelines 2022), it establishes that the terms of intra-group transactions must be similar to the terms that are practiced in market conditions, *i.e.*, between independent entities.

Article 1(a) sets out the type of transactions that should be subject to transfer pricing regulation. Firstly, commercial transactions, with relevance for intra-group cost-sharing and service agreements. Secondly, financial transactions, such as transactions involving granting or obtaining credit of any nature, derivative financial instruments, implicit or explicit guarantees, cash centralization agreements and transactions involving equity holdings. Thirdly, corporate restructuring or reorganization operations that have an impact on the company's business or functional structure.

Article 4 establishes what must be included in the determination of transfer prices to ensure the arm's length principle. According to paragraph a) of number 1 of the article, the intra-group transactions should be delineated, *i.e.*, the transactions that should be subject to analysis should be identified. Then, according to paragraph (b), an economic analysis must be made, or, in the terms of the paragraph, a comparison must be made between the terms of the intra-group transactions and the terms of comparable transactions carried out under market conditions.

Article 5 defines the actions that must be taken to make the comparison between intra-group and independent transactions. These actions include an analysis of the circumstances, a functional analysis of the parties involved in the transaction in order to select the tested party, the definition of the periods to be considered in the search for comparable transactions, the evaluation of possible internal comparables, the identification of available sources of information regarding external comparables, the selection of the most appropriate method, the selection of potential comparables, the determination and execution of the comparability adjustments to be made and, finally, the treatment and interpretation of the data collected on the comparable transactions.

The comparability factors are stipulated in article 7 of the ministerial order and include the specific characteristics of the goods, rights or services under operation, the functions performed by the entities involved in the operations, the contractual terms and conditions that define how responsibilities, risks and profits are shared between the parties, the economic circumstances prevailing in the markets where the parties operate, the strategy of the companies and other characteristics that may be relevant to the operation under analysis.

The method must be determined from a set of five methods that will be explained individually in a separate section of this report. At this stage only the methods: CUP, RPM, CPM, PSM and TNMM will be identified.

The Ministerial Order gives special emphasis to four specific types of transactions that deserve treatment under the scope of transfer pricing and are regulated between Articles 13 and 16 of the legal document: cost-sharing agreements, intra-group services, transactions involving intangibles, and restructuring operations.

The ministerial order also establishes that companies that meet the criteria to prepare documentation must have a Master File and a Local File in order to comply with the documentation obligations established by the ministerial order. Companies classified as SMEs must have a simplified file. Throughout this report, a specific section will be dedicated to documentation obligations.

3.2.4. Differences between Ministerial Orders

After explaining the content of both Ministerial Orders, a brief explanation of the differences between the two Ministerial Orders follows. The differences between the ministerial orders can be seen in three main aspects: obligation to prepare transfer pricing documentation; documentation structure; and supplementary obligations (PWC, 2021 IRC - Changes to Transfer Pricing rules | Flash fiscal | PwC Portugal). These changes were introduced to accommodate in the Portuguese legislation the recent OECD developments in the area of transfer pricing.

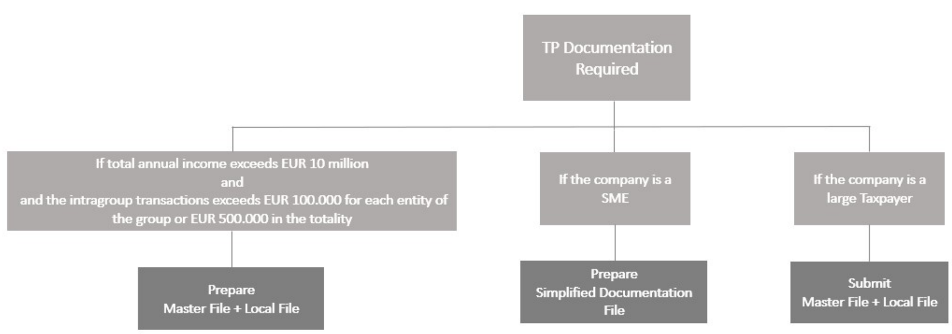
Regarding the obligations to prepare documentation, it should be noted the increase in the minimum threshold of annual income so that companies are obliged to prepare the documentation. The amount has increased from three million euros to ten million euros, *i.e.*, only companies with annual income exceeding ten million euros are obliged to prepare documentation. The new ministerial order has also safeguarded companies that do not have significant operations with related entities. This translates as follows: companies that reach the ten-million-euro limit, but whose transactions with related entities do not exceed 100,000 euros per counterparty or 500,000 euros in total are exempt from preparing the documentation.

As for the structure of the documentation, a change was made to accommodate the most recent OECD developments in the matter (Guidelines, 2022). A double structure is now foreseen, translated into the preparation and maintenance of a Master File and a Local File. SMEs may now only have a simplified file where their transfer pricing policy is explained.

Finally, regarding additional obligations, specific guidelines were introduced for four types of operations: cost-sharing agreements, intra-group services, operations involving intangibles, and restructuring operations. The requirements and procedures to initiate a mutual agreement request were also introduced (PWC, 2021 IRC - Changes to Transfer Pricing Rules | Tax Flash | PwC Portugal).

3.3. Mandatory Documentation

Figure 1- Documentation Requirements



Chapter V of the OECD guidelines helps tax administrations understand what documentation they should request from taxpayers involved in intra-group transactions. This chapter also demonstrates to taxpayers the best ways to prove that their intra-group transactions have complied with the arm's length principle (paragraph 5.1.).

According to the OECD, there are three objectives that should be achieved with transfer pricing documentation: the first, and most direct of the objectives, is to ensure that taxpayers properly consider transfer pricing requirements when entering into intra-group transactions. The second objective is related to the role of tax administrations. The documentation ensures that tax administrations have the necessary information to make an informed assessment of transfer pricing risks. Finally, it also serves to ensure that tax administrations have useful information when conducting tax audits of transfer pricing practices (paragraph 5.5.).

Focusing now on the Portuguese legislation, the documentation obligations are described in article 17 of the Ministerial Order 268/2021 of November 26th . Article 17(3) provides that only taxpayers with a total annual income exceeding EUR 10 million are required to have documentation concerning the transfer pricing policy. In addition to the limit set in the referred number, number 5 of the same article provides that entities that, even having reached a total annual income of 10 million euros, have not reached the following amounts in controlled transactions: 100.000 euros for each entity of the group or 500.000 euros in the totality of the intra-group transactions carried out within the group, will also be exempt.

It should also be noted that the exemptions listed above do not apply to related transactions carried out with entities established in tax havens (article 17(6)).

As will be discussed later in this section, entities that are required to prepare documentation must have a Master File and a Local File, as provided for in Article 17(9). Taxpayers whose situation is monitored by the Large Taxpayers Unit are required to deliver documentation under the terms of numbers 2 and 3 of Article 121 of the IRC Code. The documentation must be submitted to the tax authorities by the fifteenth day of the seventh month after the end of the tax year.

Also in accordance with number 1 of article 19 of Ministerial Order 268/2021 of 26 November the entities classified as SME must have a simplified file that concerns the transfer pricing policies adopted.

3.3.1. Master File

According to the OECD guidelines, the Master File should be a document that provides process stakeholders with an overview of the group, including the nature of its global operations, the global transfer pricing policies and the global allocation of the group's economic activity and income (paragraph 5.18).

Also according to paragraph 5.19 the Master File must contain the following five categories of information: the organisational structure of the group; a description of the group's business; the intangibles held by the group; the intra-group financial transactions; and the financial and tax positions of the group.

Turning now the point of analysis to the Portuguese legislation, number 8 of article 17 of the Ministerial Order 268/2021 of November 26th establishes that the Master File must contain the aspects set out from number 1 to number 6 of Annex I of the Ministerial Order.

3.3.2. Local File

Chapter V of the OECD guidelines also sets out the requirements to be met in the organisation and preparation of a Local File, specifically in paragraphs 5.22 and 5.23.

The Local File is a document whose main purpose is to document more detailed information on specific intra-group transactions. While the Master File is a more general file that concerns the transfer pricing policies of the group, the Local File is more specific, so the documentation is complementary, and it is necessary to prepare both documents. The information in the Local File makes it possible to understand whether the entity has complied with the arm's length principle in specific jurisdictions (paragraph 5.22). This document concerns information relevant to the transfer pricing analysis of transactions that have taken place between a group subsidiary and related entities in different jurisdictions.

In the Portuguese legislation, the requirements that must be considered in the Local File are stipulated from number 7 to 11 of Annex I of the Ministerial Order 268/2021 of 26 November.

3.3.3. Simplified Documentation File

In Portugal, Decree-Law no. 372/2007 of November 6th establishes that a small and medium-sized enterprise employing less than 250 employees has an annual turnover not exceeding 50 million euros or alternatively its annual balance sheet total does not exceed 43 million euros.

Companies falling under this criterion are not required to prepare transfer pricing documentation in the conventional format (Master File and Local File). This entity is only required to have a simplified file as set out in Article 19 of Ministerial Order 268/2021. That article establishes that the simplified file must contain the following elements: identification of the entities involved in the controlled transactions performed; description of the typology, characteristics and value of the controlled transactions; identification of the methods used to comply with the arm's length principle; and comparable data obtained because of the application of the transfer pricing methods.

The following elements should also be included: any intra-group transactions established with entities located in tax havens; transfers of business, of securities or interests representing parts of the capital of any type of entity, business reorganisation or restructuring operations; operations over real estate; and operations over intangible assets.

3.3.4. Country-by-Country report

This documentation is required for all multinationals operating in the European Union whose total consolidated annual income is equal to or greater than EUR 750 000 000. Once the documentation has been completed, the tax authority of the country where it was completed must automatically report the information to the authorities of the member states in which that group has entities.

This report will include information for all tax jurisdictions in which the multinational has business about the following indicators: amount of revenue, the profit before income tax, the income tax paid and accrued, the number of employees, the stated capital, the retained earnings and the tangible assets (European Commission, 2017).

Multinational groups must complete this documentation no later than 12 months after the end of the fiscal year. It should be completed according to the template provided by the OECD in the Action 13 Report.

3.4. Important Concepts

3.4.1. Arm's Length Principle

This principle is the basis of transfer pricing rules in immense countries and is used to determine the arm's length price in intra-group transactions (Rogers & Oats, 2022).

The arm's length principle states that entities belonging to the same group should be treated as entities operating separately and not as inseparable parts of the same business. In addition, the transfer price must be similar to the price that would be obtained in a similar transaction carried out under market conditions (Choi *et al.*, 2019).

Thus, companies are required to demonstrate that the price attributed to intra-group transactions are prices like those that would be set between two entities without any special relationship. This, by basing the prices of intra-group transactions on market prices, prevents multinationals from shifting profits between group entities (Treidler, 2020).

However, there may be a real difficulty for MNEs to determine the market price in the absence of market forces or when they wish to adopt a very specific business strategy. Where transfer pricing adjustments are made by the tax authorities, they should not alter the company's contractual obligations, nor should the tax authorities confuse transfer pricing with tax avoidance or evasion. (OECD Guidelines, 2022).

Returning to the issue of price identification, it should be borne in mind that valuing a good or service is not and has never been a consensual task throughout the history of economic ideas. For example, some authors have proposed the labor theory of value, others have proposed the subjective theory of value. From this, it can be drawn that the task of assigning a price to a good or service has never been a task in which there was only one single, correct, and universal truth (Treidler, 2020).

About Portuguese legislation, more specifically Ministerial Order No. 268/2021 of November 26, this principle is regulated by Article 1. Paragraph 1 establishes the general scope of the principle, that is, transactions carried out between companies that have special relations with each other, conditions similar to those that would be practiced between independent entities must be practiced.

3.4.2. Controlled Transaction

According to the OECD, a transaction can be considered a controlled transaction when it happens between related entities, *i.e.*, companies that have a special relationship with each other, either through management or capital control (Transfer Pricing Asia, 2018).

3.4.3. Related Entities

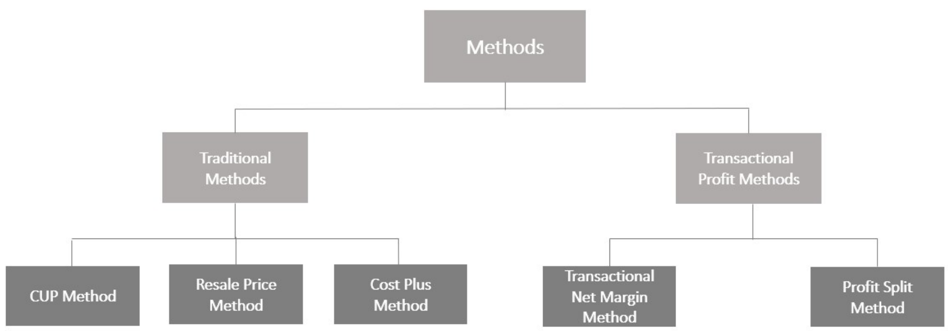
According to the OECD, two enterprises can be considered as related in two situations: when an enterprise from one OECD member state has a direct or indirect participation in the management or capital of an enterprise from another OECD country; or in situations where the same person has a direct or indirect interest in the management or capital of two enterprises located in two different OECD countries (OECD Model Tax Convention, 2017).

3.5. Transfer Pricing Methods

In this section the five Transfer Pricing methods will be described. These methods are explained in the OECD transfer pricing guidelines, specifically in chapter II. According to these guidelines, such methods "can be used to establish whether the conditions imposed in the commercial of financial relations between associated enterprises are consistent with the arm's length principle" (OECD Transfer Pricing Guidelines, 2022, p.93). Also, according to these same guidelines, it is important to highlight the two following points: the methods are divided between traditional methods and transactional profit methods, the former being pointed out as the most direct means to establish whether a transaction is in accordance with the arm's length principle or not; and transactional profit methods are considered by the guidelines to be more useful in situations where parties are highly integrated or transactions where parties make valuable and unique contributions to the transaction.

Having given a short introduction to the Transfer Pricing methods following there is a detailed description of each of the methods. The order followed will be the order in which it is described in the OECD guidelines. Throughout the description of each method, relevant information on the regulation of the methods in Portuguese law (Ministerial Order no 268/2021 of 26th of November) will be added.

Figure 2 – Transfer Pricing Methods



3.5.1. Comparable Uncontrolled Price (CUP) method

According to the OECD Guidelines (2022, p. 97) this method "compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances".

Through this method we can understand whether the arm's length principle has been met. If the price is not similar, then we can conclude that the price of the tied transaction does not meet the arm's length principle.

Still within this chapter (paragraph 2.15) it is possible to understand which conditions the OECD understands are necessary for the tied transaction to be comparable to an unbound transaction. The two conditions do not need to be fulfilled simultaneously, only one of them needs to be fulfilled: firstly in case there is any difference between the tied and the unbound transaction, none of these differences may affect the price on market conditions. Secondly, adjustments can be made to eliminate those differences.

Because it is the first method to be presented in the OECD guidelines it may convey the idea that it is the most straightforward and user-friendly method. But in reality the CUP may be the most user-friendly method since its scope is the most difficult to define of all the methods (Treidler 2020). Going back to the OECD guidelines (paragraph 2.16) we realise that the difficulty in defining the scope of the method relates to the difficulty in finding transactions between independent entities similar to the controlled transaction that one intends to analyse.

As far as Portuguese legislation is concerned, this method is provided for in Article 8 of Ministerial Order 268/2021 of 26 November.

3.5.2. Resale Price Method

According to the OECD Guidelines (2022) the basis of this method is the resale price that the company practices in a transaction with an independent entity. Next, the resale price is reduced by the resale price margin, *i.e.*, a margin that represents what the reseller charged to cover its costs of selling, other operating costs and an appropriate profit margin. Taking this margin away we have the arm's length price. This resale price margin for a tied transaction can be determined in two ways. It can have as a reference the gross profit margin that the same reseller earned on goods bought and sold in an independent transaction (internal comparable) or the gross profit margin earned by an independent entity in a comparable transaction (external comparable). Also, according to the OECD Guidelines (2022) this method is the most useful to apply to marketing operations. The comparability conditions for this method to be used are the same as for the CUP (paragraph 2.15).

It is a very popular method for the sale of products within a multinational and can harmonise the management accounting perspective and the transfer pricing tax perspective. On the management accounting side, the focus on market prices or end-consumer prices is understood to be sensitive, including different prices for individual markets. On the tax side, the focus on gross profit margin allows linking the pricing mechanism to functional and risk analysis (Treidler, 2020).

Focusing now on Portuguese legislation, this method is provided for in article 9 of Ministerial Order no 268/2021 of 26 November. comparable.

3.5.3. Cost Plus Method

The OECD Guidelines (2022) state that this method is based on the costs incurred by the property provider in a tied operation. Based on these costs a gross profit margin is added, similar to the profit margins used in comparable unrelated transactions. Adding this mark-up gives the arm's-length price of the transaction (paragraph 2.45).

The markup on the supplier's costs in a controlled transaction should ideally be based on the markup on the costs that the same supplier would earn in an independent ("internal comparable") transaction. If it is not possible to use an operation of the same company with an independent entity, then the margin over costs that would be earned by a company independent of the company we are analyzing ("externally comparable") should be taken as a basis (paragraph 2.46).

The comparability factors between transactions are similar to the other methods: none of the differences, if any, between the controlled transaction and the independent transaction can affect the mark-up. The same applies for the companies involved whose differences cannot affect the margin either. Otherwise, reasonable adjustments must be made to eliminate these differences (paragraph 2.47).

The cost-plus method is close to the net operating margin method. It is also catalogued as the "workhorse" of the transfer pricing methods because it is a method widely used in low value-added services and because the typical solution of the method (costs + margin) is the most widely adopted solution in transfer pricing on a global scale (Treidler, 2020).

Regarding the Portuguese legislation, this method is regulated in article 10 of Ministerial Order no 268/2021 of November 26.

3.5.4. Transaction Net Margin Method

This method starts from analyzing the profit relative to an appropriate base that a taxpayer earns on a controlled transaction. It is a method that has some similarities with the cost plus and resale price method. Specifically, the profit indicator used by the taxpayer to analyze its controlled transactions must be established in reference to the profit indicator that the taxpayer uses to analyze its transactions with independent entities. In this case, we are talking about internal comparables. But if it is not possible to have internal comparables to perform the analysis, then external comparables should be used, *i.e.*, profit indicators obtained by independent entities should be used as a basis. This method has the advantage that profit indicators are not as affected by transactional differences as price. On the other hand, it has the disadvantage that profit indicators can be influenced by factors that have little or no impact on prices and margins between independent entities (OECD Guidelines, 2022).

The rationale behind this method is not much different from traditional methods, it just makes it easier to apply. Treidler (2020, p.52) states that "While you will often have a hard time ascertaining an adequate degree of comparability for applying the RPM (see above) let alone identifying/obtaining the financial data required for conducting a comparability analysis, it will be feasible 100% of the time to identify external comparables that operate in a comparable industry and that are reasonably similar to a tested party exhibiting a routine functional profile. Also, importantly, for such routine comparables, financial data is readily available in the commercial databases."

The procedure of this method is done as follows: a range of variation is first determined for the financial indicator to be analyzed. This range results from the average of the values of the indicator for the comparable entities and for the three years under review. If the value for that indicator for the year under review of the tested entity falls within the range, then it can be stated that the company followed the arm's length principle. Otherwise, it will be necessary to indicate the factors that led to the value not fitting.

As far as Portuguese legislation is concerned, this method is provided for in Article 12 of Ministerial Order No. 268/2021 of November 26.

3.5.5. Profit Split Method

This method apportions the total profit resulting from complex transactions or series of controlled transactions carried out in an integrated manner by the entities involved according to the relative value of each entity's contribution to the transaction. The objective is that this division should be similar to what would occur if we were in the presence of transactions between two independent entities (OECD Guidelines, 2022).

This method is described as the most complex among transfer pricing methods and there is some fear on the part of practitioners to use it. This fear can be a bad strategy because the professional who never considers using this method is discarding one of the five possible methods from the outset. In the words of Treidler (2020, p.63) "It is akin to playing chess without ever truly utilizing the Knight, just because you do not fancy the way it moves across the board. Ultimately, you will not win against decent opposition."

In Portuguese legislation, this method is provided for in article 11 of Ministerial Order No. 268/2021 of November 26.

4. Case Study: Food Production XYZ

This case study will consist of the Transfer Pricing documentation of XYZ Food Production Ltd.

4.1. Case Study Framework

XYZ Group is a multinational group, based in Portugal, specialized in contract manufacturing services for the agrifood industry.

The group operates through several subsidiaries and related entities in different countries. They provide food manufacturing services, which include the production, packaging, and distribution of products.

To ensure compliance with transfer pricing regulations, XYZ Group needs to establish appropriate transfer pricing policies for its intra-group transactions. At the group level a Master File is prepared where the group's transfer pricing policies are demonstrated.

Throughout this case study, the group's production company, XYZ Food Production Ltd, will also be analyzed, looking at the controlled transactions that this entity establishes with other group entities and the main points that should be included in the Local File (specific dossier). This unit receives raw materials from XYZ Materials Ltd. and carries out the manufacturing processes, including assembly, quality control and packaging.

Below are the main points that should be included in the Group Master File and the Local File of XYZ Food Production Ltd. For the sake of simplification, and because they are not part of the main analysis underlying this report, macroeconomic and sectoral analyses have not been addressed.

Points 1 to 6 of Ministerial Order 268/2021 of November 26 must be included in the Group's Master File. In turn, points 7 to 11 must be part of the Local File.

4.2. Master File

4.2.1. Group Framework and Functional Analysis

The group's parent company (XYZ Holding) defines the group's overall strategy so that the group operates uniformly in the markets in which it operates. Strategic decisions involving more local knowledge are taken by the group company in the respective country.

The group's business model has been based on a strategy of focusing on maintaining the brand's reputation. The group has been strongly committed to a strong presence among consumers, by selling its products to the main food distribution chains, by valuing its human resources and by diversifying the group's sectors of activity.

The Group is dedicated to the production of agri-food industry products and its main offices are in Portugal, where the main activities of the group are carried out, such as production, a significant part of the distribution and shared services of the Group.

The company XYZ Materials Ltd., which is in the European Union, is responsible for the acquisition of raw materials and their storage at a stage prior to production.

In turn, XYZ Food Production Ltd. is dedicated to the manufacturing of the Group's products and its production is entirely sold to the Group's distributors. The distributors then sell the products to the Group's customers, which mainly include large food distribution chains. XYZ Distribuition is responsible for the distribution of products in Portugal, while XYZ Spain and XYZ Switzerland are responsible for distribution in Spain and Switzerland, respectively.

XYZ Accounting provides accounting and management services to the other entities of the Group.

Finally, XYZ Holding is dedicated to the management of holdings in the other entities of the Group and is also responsible for the Group's financing policy and institutional relations. This company also owns the brands belonging to the Group.

4.2.2. Intangibles

Over the years the group has developed new technologies to make its production more efficient and become a market leader. The holding owns several brands which it assigns to other companies in the group, receiving royalties in return.

4.3. Local File

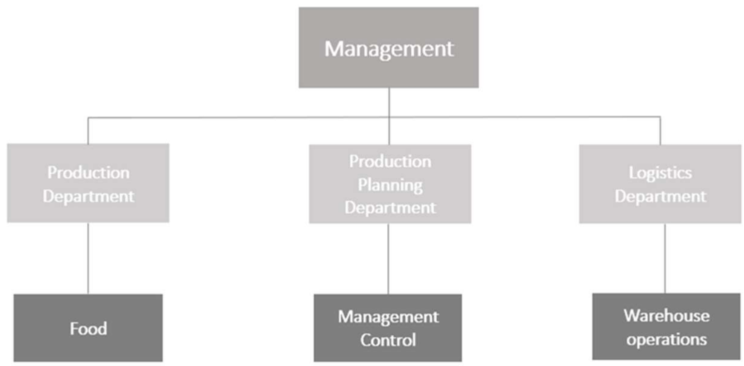
Under the terms of Ministerial Order, no 268/2021 of November 26, more specifically in number 3 of article 17, it is established that only companies whose total annual income is less than 10 million euros are exempt from preparing the documentation. In this case, we are dealing with a company (XYZ Food Production, Ltd) that has exceeded this amount and is not classified as an SME. In this case, the company must have a Local File prepared at company level in addition to the Master File prepared at group level.

4.3.1. Legal structure

XYZ Holding holds 100% of the capital of XYZ Food Production.

4.3.2. Functional Structure

Figure 3 – XYZ Food Production Functional Structure



4.3.3. Restructuring operations

Over the last three years the company has not carried out any restructuring operations or transacted intangible assets with an impact on its business and the functions it performs.

4.3.4. Functional Analysis

Table 1 - Main Functions performed by XYZ Food Production

Function	Entity responsible
Logistics management of the Finished Goods Warehouse	The company is responsible for this function within ensuring stock management of finished goods.
Production	This function is exclusively provided by XYZ Food Production Ltd.

4.3.5. Risk Analysis

Table 2- Risks incurred by XYZ Food Production

Risk	Description	Degree
Credit	The company does not deal directly with customers and is therefore not directly exposed to this risk, which is therefore low.	Low
Exchange	The Group's only activities in currencies other than the euro are with Swiss clients.	Low
Interest Rate	The company is financed by XYZ Holding so this risk is reduced.	Low
Liquidity	The company has current cash expenses and therefore needs liquidity to meet these needs.	Moderated
Product	The products manufactured by the company are perishable, so there is an inherent risk in them.	Moderated
Market	The company is indirectly exposed to the economic environment of the markets in which it operates.	Moderated

4.3.6. Related entities

According to number 8 of Annex I of the Ministerial Order it is necessary to identify the related entities of the company we are analyzing.

Table 3 – XYZ's Related Entities

Entity	Nature of the Relationship (Article no. 63 of Corporate Taxation (IRC) Code
XYZ Holding	a)
XYZ Materials, Ltd	b)
XYZ Accounting	b)
XYZ Distribution	b)
XYZ Spain	b)
XYZ Switzerland	b)

4.3.7. Amounts of Controlled Transactions

Table 4 - Amounts of Controlled Transactions

Transaction	**Counterpart**	**Amount 2020**	**Amount 2021**	**Amount 2022**	**%**
Active Optics					% operating income
Sale of Finished Goods	XYZ Distribution	45.000.000	53.500.000	55.000.000	62,15%
	XYZ Spain	13.000.000	15.700.000	16.000.000	18,08%
	XYZ Switzerland	10.200.000	14.300.000	17.500.000	19,77%
Passive Optics					% operating expenses
Purchase of raw materials	XYZ Materials	37.000.000	57.500.000	63.500.000	80,48%
Royalties	XYZ Holding	50.000	100.000	200.000	0,25%
Accounting and management services	XYZ Accounting	900.000	1.000.100	1.200.000	1,52%
Financial					% financial expenditure
Interest Expenses	XYZ Holding	2.500.000	2.500.000	2.500.000	100%

4.3.8. Economic Analysis of Overall Company Profitability

4.3.8.1. Transfer Pricing Analysis Methodology

This subsection aims to analyze the overall profitability of the company XYZ Food Production Ltd. In this sense, the economic analysis will consist of comparing the profitability earned by the company during its activity with the profitability obtained by the entities selected as the best comparables.

The company's controlled operations are very interconnected, so it makes sense to apply the TNMM in this analysis. This method will allow us to understand whether the company's profitability is being affected by the fact that the company establishes controlled operations with other companies in the Group.

These analyses require the use of financial information for more than one year (OECD Guidelines, 2022). The use of financial data for several years has two advantages: first, it allows the facts inherent in the controlled transactions to be better understood. Secondly, it allows to dilute possible distortions in the analysis arising from cyclical events that may affect economic activity, and thus have an impact on companies' financial results.

Thus, data for the years 2019 to 2021 were considered, because they are the last years with a wide range of information available for most companies.

4.3.8.2. Profitability indicator

In this case study and given the circumstances surrounding the company, the indicator considered was the Operating Margin. This indicator compares the operating result with the total operating income obtained by the company.

Operating Margin = Operating Income/Operating Revenue

4.3.8.3. Benchmarking process

The first phase of this process consisted of extracting data from potential comparables. For this data search, the Bureau van Dijk database was used because this database contains data for about 425 million private companies and banks worldwide. Thus, with this database it is possible to analyze, classify and compare companies from all over the world (FEP Website). This database works by searching for specific criteria. The search strategy is described below:

- Standardized Legal Form - Under this criterion, "Public limited company" and "Private limited company" were selected. Both public and private companies were selected;
- Status - Active companies were selected;
- Consolidation Code - Only non-consolidated accounts were used here in order to avoid duplication of financial information;

- Subsidiaries With Sharedholders by profile and Shareholders with subsidiaries by profile - These two criteria ensure that no subsidiary is more than 20% owned by any shareholder;
- Nace Rev. 2 (Primary codes only) - 1082 - Manufacture of cocoa, chocolate and sugar confectionery, 1083 Processing of Tea and Coffe - these codes were chosen in order to select entities whose economic activity is similar to that of XYZ Food Production Ltd;
- World Region / Country / Region in Country - European Union, EFTA, United Kingdom - markets with risk profiles similar to the markets in which the company operates were chosen;
- Year of Incorporation - companies incorporated between 2016 and 2021 were excluded to only consider companies with significant market experience;
- Operating Revenue - only companies that presented in 2019, 2020 and 2021 an operating revenue greater than 1 million euros were selected;
- Number of employees - companies with at least 1 employee were selected for the three years under analysis in order to exclude companies without any employee;

This search strategy led to an initial set of 364 potential comparable entities. In a first step, companies owned by other companies, *i.e.*, having shareholders designated as corporate, were excluded. Here 140 entities were excluded. Next, a manual analysis of the activity descriptions provided by the database was carried out, which allowed the exclusion of 182 entities.

To validate whether the remaining entities are comparable to the company under analysis, the websites of the respective companies were consulted. This same internet review led to the exclusion of 25 entities leading to a final set of 17 comparable entities.

4.3.8.4. Results and conclusions

This economic analysis led to a final set of 17 companies considered as the best comparables for the purpose of the company's operating profitability analysis.

In the table below, the Operating Margin indicator was calculated. This calculation was made through the weighted average of the 17 entities selected as best comparables for the three years analyzed.

Table 5 Results of the benchmark

Indicator	Minimum	1st Quartile	Median	3rd Quartile	Maximum	Number of Comparables
Operating Margin	-10,97%	1,96%	5,99%	10,07%	23,26%	17

XYZ Food Production's operating margin stood at 10.85%, so we can conclude that for the year 2022, the company's-controlled transactions were made following the arm's length principle.

The following elements have been referred to appendixes and should therefore be consulted there:

Group's Organizational Chart

Financial Analysis (Income Statement)

Asset Analysis

Detailed description of the nature of the controlled transactions

5. Analysis and Discussion of Findings

This chapter will discuss the results from the semi-structured interviews conducted with both academics and practitioners. The aim is to discuss, in the light of institutional theory and institutional logics, why transfer pricing is not yet a fully explored area by a Portuguese company, often summarizing itself as a mere compliance with the tax obligations underlying this issue.

5.1. The perception of Transfer Pricing in the light of Institutional Theory and Institutional Logics

Transfer pricing is a relatively recent topic in Portugal, with the first specific legislation on the area only created in 2001. It is therefore a sector with much still to be explored. In the words of professional A, who has a lot of experience in the area, the legislation itself has much to evolve:

> *"The tax legislator, out of ignorance or neglect, especially in the second ministerial order, is concerned with translating OECD paragraphs into Portuguese. Therefore, Portuguese legislation is based on doctrine, which causes a bias. It is not a clear and objective legislation that introduces legal certainty and security in the lives of taxpayers. If I have paragraphs of doctrine written in my legislation, I have to be proficient in transfer pricing to understand the context in which that should be applied."* (Question 6).

For this and other reasons that will be explored below, the interest and knowledge of the company in the area is not yet as desired.

That said, the treatment given by this Portuguese company to transfer pricing can be analyzed in the light of Institutional Theory and Institutional Logics.

As described in the literature review, transfer pricing can be associated with tax optimization strategies (Klassen, 2016) or value chain optimization strategies (Autrey & Bova, 2011; Li, 2013). But as it was found in the interviews conducted, this is not always the case. Therefore, we are faced with a situation in which the firm decisions are not only affected by issues related to the rationality of economic agents and tax or value chain optimization.

The relationship of the company with transfer pricing over the last few years has been fundamentally at the level of transfer pricing tax documentation, which is usually commissioned from third parties. Issues related to tax optimization and the value chain take a back seat. This is to some extent because the most urgent need of a company as a taxpayer is to have the documentation that proves that its intra-group transactions have been made in accordance with the arm's length principle. According to professional A:

> *"It is much simpler for the client to think about the business and not think that he has to take transfer pricing into account because he is unaware of it or because he understands that the risk is low. Either they do not know or even if they do know they already have some mastery of the subject and realize that there is no great risk in what they are doing."* (Question 2).

The other professionals and the academic heard in this research agreed with this approach. There is a risk of paying a fine if the documentation is not produced, but the remaining price potential is not yet fully appreciated by the company.

There are therefore some institutional and social factors that influence the decision of the company. First, an approach to external factors will be made in line with early work in the field of Institutional Theory.

As already mentioned, the biggest external pressure factor is the possibility that the company may be fined by the Tax Authority if it does not submit its transfer pricing documentation (it should be noted that not all companies subject to transfer pricing rules must submit their documentation). On this point, the interviewees recognized good relations between the Tax Authority and companies, although the academic showed some caution in these relations:

> *"Already with the authority there are some misgivings. The idea is to provide the necessary information and sometimes deliberately vague."* (Question 1).

According to professional B:

> *"The tax authority often asks taxpayers questions, and they answer. There is always a question of cooperation and sharing information when requested."* (Question 1).

There are other external regulatory factors mainly at the political level that influence the relationship of companies with transfer pricing. Let us start with the international influence that is made by the OECD, when updating the guidelines that regulate the area. The guidelines are a very specific document on transfer pricing requiring the reader some knowledge in the area to be able to interpret them. We are talking about a documentation that has been updated with an average periodicity of five years, the first guidelines were launched in 1995 and the last update was made in 2022. This organization has a specific team that is dedicated to listening to stakeholders on a regular basis, thus gathering information to update the guidelines. We are also talking about a document that is alive and constantly changing, so it can be considered an institutional factor affecting the behavior of the company. According to the academic heard, this document may often fail to keep up with what is business dynamics, which reinforces the idea that it is an institutional factor that can affect the company and lead it to think beyond issues of purely economic rationality.

In addition, there are also pressures from national legislation. In 2021 there was a change in the ministerial order that regulated transfer pricing in Portugal so that Portuguese standards were in line with those of the OECD. According to professional A:

> *"We have an alignment with the OECD, and, in addition, we still have some additional requirements. Therefore, a transfer pricing professional needs to know the OECD model and needs to know what the Portuguese legislation adds to that documentation. And then you must structure the documentation around that."* (Question 4).

The fact that we have legislation that is being amended on a regular basis also introduces a challenge. In addition, this more recent change in Portuguese legislation meant that it was necessary to know the OECD rules to contextualize Portuguese legislation. Also, according to professional A:

> *"It is much more useful for the taxpayer to have a clear and objective law on transfer pricing on what documentation must have and not to have to be discussing descriptive processes of the value chain in which the taxpayer is thinking: I can put anything. How can the Portuguese Tax Administration assess whether this information is true or not?"* (Question 6).

In this case, we have an external factor that complicates the action of the company regarding transfer pricing, because all these differences and the need for knowledge of various legislations make it more difficult for the company to identify what is relevant and should be dealt with in this area.

Focusing specifically on the pressures that can be placed by the current documentation model we can observe that, according to the professionals heard, the Master File model accompanied by a Local File is good for identifying opportunities, and it poses an added influence for organizations since according to professional B:

> *"We now have a lot more specific information requirements that we didn't have before."* (Question 3).

These statements are in line with what is advocated by Moll *et al.* (2006) & Thornton and Ocasio, (2008), who state that organizations are influenced by a whole social, environmental, and institutional context that is created around them. They are also in line with the study of everyday practices as institutional logics developed by Micelotta *et al.* (2017).

Regarding the possibility of documentation being useful, and consequently, transfer pricing being useful for better management and negotiation decisions, professionals recognize that it can happen, in line with the conclusions of Brunner & Schäfer (2022). However, there is a small remark made by professional A, that when the company uses the information from the previous year to improve its decisions, this improvement is already a year late.

Turning now the focus to internal pressures, we can tackle a point that was touched by all interviewees and that is corroborated by official statistics. The size of Portuguese companies is small with 99.9% of Portuguese companies being classified as SMEs and within these 96.1% are micro companies (Pordata).

According to professional B, "*More and more companies are seeing the advantages of tax consultancy, whether it is stamp duty, VAT or international taxes. There is a growing but still slow wave for the potential of transfer pricing.*" (Question 2), which leads to the conclusion by professional C that the company "*Can't have a long-term vision. Can't see it as an investment.*" (Question 2).

An important point in this issue and raised by the academic is related to the shareholder structure and the variable remuneration of management. Entities in the same business group do not necessarily all have to have the same capital composition. To be related entities they need to be controlled by a common company, but the remaining part of the capital may be dispersed, and the shareholders may not be the same in all entities of the group. Shareholders' interests may therefore be divergent, and it is therefore important to have arm's length transfer pricing. In addition, where management is variably remunerated and managers differ from one group entity to another, they have an interest in transfer pricing and in transfer pricing being set correctly. The latter is consistent with Chen *et al.* (2014).

Another internal social dimension that should be considered is the know-how that business professionals, with basic training in economics, management, or finance, have on transfer pricing. Contextualizing, it is possible to notice through the interviews that this is not a topic that is much referred to in Portuguese universities. According to the academic:

> *"The low relevance stems from being a technical issue and academia focuses more on theoretical issues where there is no consensus. Transfer pricing is a more technical issue where there is not such a big discussion. There is not much room for hypothesis testing."* (Question 2).

Being a very specific topic that is rarely relevant in academia, so there are few professionals in companies (except for companies that do specialize transfer pricing services) with knowledge of the area. This can lead to management sometimes being done with some ignorance and not taking advantage of the existing benefits in the area. According to professional A:

> *"Transfer pricing is a management concept that then has tax implications. The taxation of transfer pricing is not a concept itself but a concept that comes from management. There is a whole important area of management knowledge and management control."* (Question 10).

This last statement brings us to another institutional dimension that comes out of the work of academia, which stems from the fact that most academic articles on transfer pricing deal with issues related to tax policy rather than management areas. The academic regrets this but acknowledges that the wealth effect of tax management is more immediate as it is wealth that leaves the organization as a whole. In the case of the value chain, this wealth, despite changing entities, remains within the organization.

We are therefore facing yet another social and institutional dimension that influences organizational behavior in line with Thornton and Ocasio (2008).

In view of this lack of knowledge and based on financial criteria, the decision to outsource the production of transfer pricing documentation arises for many companies including the company studied.

In view of this, two types of entities outsourcing their transfer pricing documentation should be distinguished: Portuguese multinational companies that are based in Portugal and foreign multinational companies that have one or more subsidiaries in Portugal. In the second case, there are already quite a few organizations with a transfer pricing department at the central level of the group, and this department prepares the Master File, and the Portuguese entity is responsible for preparing the Local File. This gives rise to an institutional dimension detected by professional C:

> *"When the subsidiary's activity is small compared to the total turnover of the group, it is difficult for the company to request information from the central entity of the group."* (Question 3).

Here there is a power struggle between people in the same group to provide the information needed to prepare the documentation.

Among the companies that outsource the production of their documentation, there is another problem that applies to the two types of companies mentioned above and that stems from internal daily logics, more precisely from the fact that the person who awards the tender is not the person who will send the necessary information to the consultants for the documentation to be produced. According to professional A:

"When can we have collaboration issues? When the person who awards the tender and the person who is interested in the service from the client is not the same person who is going to give me information to do the work. Imagine that we have a financial administrator awarding a proposal with a certain scope of transfer pricing because he has an interest in that work being done, but then the people from the client with whom we are going to deal are not the same and they may not have the same rush and interest in collaborating." (Question 1).

In this decision to outsource, there is also an economic and financial concern. In financial terms, it is necessary to understand what is most profitable for the company. In the experience of the professionals interviewed, the business group must be of a certain size to justify the existence of an internal transfer pricing team. First, because of the salary issue. It is necessary to make a comparative analysis between the salaries that will be paid and the cost of outsourcing the preparation of the documentation. Secondly, to make the transfer pricing documentation and to find comparable entities it is necessary to have access to a database which according to professional C "*are necessary and very expensive* (Question 7)".

Throughout the interviews, some suggestions emerged from the interviewees that could improve the institutional framework of transfer pricing in Portuguese companies. Firstly, it is important to highlight the importance given in the interviews to relations with the academy. To fill the existing gaps in training in this area, professional B stated that this topic can be better taught by "*A career academic who has had some professional experience in the area. The ideal is someone who does research in the area, but at the same time has some experience to prepare students for the job market* (Question 12)". Conclusion that was reinforced by the academic who recognized that this area is much easier to be taught by those who have access to practical cases of it. On the contrary, a career academic is exposed to a lot of topics and therefore will not be able to focus as much on a specific area as a transfer pricing professional. Another point that practitioners were unanimous in pointing out about academia was the lack of literature in the area that would be useful to the work of a transfer pricing practitioner and that research has been more focused on tax policies. Once again, the existence of academics with relevant professional experience could be useful to produce research relevant to the daily work in the area.

Secondly, there is also the role of sectoral associations that are part of the social dimension in which companies are involved. In this way, these associations can be an external pressure factor to facilitate change in some aspects that lead companies not to exploit the full potential of the transfer pricing area. According to the academic, "*sectoral business associations should have* *a more relevant role in the specific training of each sector through the organization of more conferences/seminars* (Question 5)", recalling that universities can be part of the solution by creating debates between the various actors involved in the area. The professionals recalled the fact that the Forum of Large Taxpayers already exists in Portugal where issues related to the companies involved are discussed and that according to professional A "*in this forum quality time is dedicated to transfer pricing issues* (Question 8)".

These debates and forums could also be an opportunity to discuss the new issues and challenges in the field, which all interviewees recognized as being related to digitalization, automation, and the increasing openness of economies. Professional C pointed out the main challenge resulting from the increased openness of economies:

> *"It is very difficult to track the flow of income. How do we create tax withholding for an increasingly digital economy? How are you going to track this digital economy? Content production, advertising. How can you tax in the right way?"* (Question 9).

Related to the automation of the area, there may be an underlying paradigm shift in the way documentation is produced, and the company itself may become more efficient in producing it. It can also be pointed out that the existence of debates and forums, in addition to influencing the institutional context, can also help companies to accommodate other external pressures such as all movements in international taxation that may arise either from the EU or the OECD in Europe and other bodies that arise in other parts of the world, such as Pillars I and II.

Thirdly, an improvement can be made to the way Portuguese legislation is structured. As mentioned above, it is a legislation that merely replicates the OECD standards, so it would be more beneficial, according to the professionals heard, for companies to have a clearer law explaining clearly what should be included in the documentation and not focusing on very vague aspects such as discussing the value chain. In the words of professional A:

> *"It would benefit to have a simpler template and then it is up to the Portuguese Tax Authority to do a risk analysis."* (Question 6)

6. The curricular internship

This chapter is dedicated to a brief overview of the curricular internship that led to this report. The internship, carried out within the scope of the master's degree in Economics of Business and Strategy (MEEE), was done in the Transfer Pricing team of the company Deloitte Tax – *Economistas Especialistas em Fiscalidade, S.A*. The internship lasted approximately four months between February and July 2023. Throughout the chapter, the company will be described, as well as the objectives and activities carried out during the internship.

6.1. Deloitte[1]

Deloitte Portugal is a member firm of DTTL (Deloitte Touche Tohmatsu Limited), which is headquartered in New York. DTTL operates worldwide, with member firms in over 150 countries. The Portuguese firm has offices in Lisbon, Porto and Faro and has a technology center in the city of Viseu. The company was founded in London in 1875.

The company is dedicated to the global provision of professional services, being a reference company in the areas of auditing, tax consultancy, business consultancy, financial advisory and technological services with clients spread all over the world. Deloitte is part of the "Big-Four", the top four professional services firms worldwide.

In Portugal, the company is divided into several business areas including auditing, outsourcing services, tax, business consulting, technology consulting, risk advisory and financial advisory.

The curricular internship was carried out in the Tax area, more specifically in the Transfer Pricing area. Deloitte offers a wide range of integrated tax services in this business area. The firm's approach to the business combines information and innovation from various disciplines with business and industry knowledge to help the firm's clients. Within the Tax area, Deloitte provides Global Business Tax, Indirect Tax, Global Employer Services and Transfer Pricing services.

In the Transfer Pricing area, the firm aims to assist its clients in the design and realignment of their intra-group relationship model and in the preparation of strategic documentation to support their transfer pricing practices and dispute resolution in this area.

[1] Source: Deloitte Portugal Official Website

6.2. Duties performed during the internship

During the internship I worked in the transfer pricing team at Deloitte Tax - *Economistas Especialistas em Fiscalidade*, which in very brief terms helps the firm's clients with projects related to value chains and intra-group transactions and with the preparation of the transfer pricing tax documentation required by Portuguese legislation.

The main objective of this internship was to provide the first contact with the labor market and to enable the achievement of the master's degree in Economics of Business and Strategy (MEEE).

As mentioned above, the internship lasted 4 months, and the main objectives defined by the host entity for it are summarized in the table below.

Table 6 - Objectives defined by the company within the scope of the curricular internship

Acquisition of experience and knowledge in taxation, in a real context, of the Transfer Pricing department
Support in the identification of the distribution of income / profits along the value chain and design of the respective relationship models
Support in transaction valuation projects (namely, services, product, tangible or intangible assets and financial operations)
Support in the preparation and participation in technical sessions regarding legislative news or hot topics.

Source: Deloitte (2022)

The following is a description of the tasks developed throughout the curricular internship in the various projects that were executed throughout this period.

Throughout the internship, several activities were developed related to the Transfer Pricing documentation process of several Portuguese companies, which allows the acquisition of knowledge in the area to elaborate a case study.

Several tasks were developed in each of the projects. For each company, a benchmarking study like the one presented in the case study of this report was initially carried out to select the best comparables. With these comparables it was possible to assess whether intra-group transactions were governed by the arm's length principle.

After this same selection of comparables, the most adjusted indicator for each case was calculated in each project to define the arm's length range.

In each case, a macroeconomic analysis, and a sectoral analysis of the sector in which the company operated were also carried out to provide a framework for the company's activity.

Throughout the process, and to comply with what is required by Portuguese legislation, an analysis of risks, functions and assets was carried out in order to understand the context in which the company's activity developed.

Next, and undoubtedly the most important part of the reports, the related entities, the controlled operations, and the methodology adopted in each of the transactions were described.

Throughout the internship, in addition to the functions related to the documentation, three other functions were also carried out: first, the preparation of a technical session to discuss among peers the actuality and evolution of the important concepts of transfer pricing. Secondly, transfer pricing case law was studied to investigate the decisions of Portuguese and international courts in the field of transfer pricing. Thirdly and finally, commercial research was conducted.

7. Conclusions and Limitations

7.1. General Conclusions

The economy is increasingly global, which means that value chains are increasingly global as well and a good part of trade is already carried out between entities of the same group. This growing intra-group trade means that transfer pricing began to be given importance mainly for tax reasons, as many companies were shifting their profits to more favorable tax regimes. To this end, the OECD has acted to regulate this area through the publication of guidelines that are being accepted by national legislation.

Transfer pricing is a relatively recent topic in Portugal, having been officially regulated since 2001 and its relevance is growing, but its full potential is still not used.

In the first part of the report, it was demonstrated how a company should proceed to demonstrate that it complied with the arm's length principle, that is, to demonstrate that its transfer prices were similar to what would be the prices in a market situation. Given the lack of internal and external comparables that would allow the use of the CUP, the net operating margin method was chosen, trying to understand whether our entity's operating margin was within a range of operating margins of entities that were considered comparable.

In a second phase, semi-structured interviews were conducted with professionals in the field and with an academic. In the light of the theoretical framework of institutional theory and institutional logics, these interviews were analyzed to understand what are the main institutional dimensions that influence the relationship of Portuguese companies with transfer pricing.

First, the external pressures that can be placed on companies were analyzed. It was noticed that these pressures may come from Portuguese legislation, the tax authority and from the OECD. On the one hand, Portuguese legislation being very much based on the OECD Guidelines turns out to be based on doctrine and not on taxpayers the objectivity and legal certainty they need. On the other hand, there is pressure from the Tax Authority and the risk perceived by the taxpayer of having to pay a fine if he does not have the documentation in his possession. In addition, the constant updating of OECD guidelines introduces new challenges. The current documentation model is also an important source of pressure as it introduced a lot of specific requirements that companies were not used to.

In the sense of analyzing the company's strategic thinking and daily practices, it was perceived by the research that most companies still cannot have a long-term vision and see transfer pricing as an investment. Companies could have an incentive to manage transfer pricing more comprehensively when shareholders and managers are not common to all group entities, but the small dimension of Portuguese companies reduces the importance of these internal problems, and transfer prices are faced as a mere tax liability.

Another conclusion was that there is little relevance given to the subject in Portuguese universities. The low relevance can be explained by the fact that it is a very specific technical topic. This lack of training means that many professionals are not prepared to face the challenges of transfer pricing and fail to understand the advantages that may exist for the value chain of managing them. Therefore, there is a need to outsource the production of tax documentation. This externalization arises not only from knowledge, but also from a trade-off. Transfer pricing work involves accessing a database, which is expensive, and paying salaries to specialized professionals assigned to the task.

Throughout the investigation, three possible institutional factors emerged that could be changed in order to improve the relationship of companies with transfer pricing: first, that of academic terms with professional experience in the area teaching transfer pricing in universities. Second, that industry associations and universities can play an important role in raising awareness among companies about this issue through the promotion of forums/debates. And, finally, that Portuguese legislation should not be so based on doctrine and be clearer to give companies more legal certainty.

7.2. Limitations and suggestions for future research

The first research limitation relates to the nature of a case study, that despite trying to be as comprehensive as possible in the type of controlled transactions it addresses, its conclusions cannot be generalized from a statistical point of view.

As for the interviews, although four people with relevant experience in the area were interviewed, it was not possible to involve those in charge of the company under study, including of transfer pricing issues, in order to try to perceive their understanding of transfer pricing, opening a door for future research.

This work provides evidence on the fact that Portuguese companies deliver the documentation work to consultants, but it was not studied why mid-level consultants are not relevant in this area.

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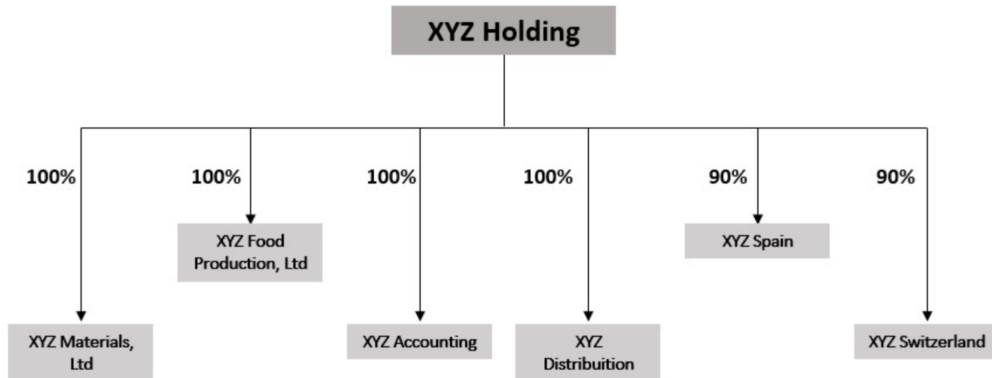
Appendix

Appendix I- Group's Organization Chart



Appendix II - Financial Analysis (Income Statement)

Item	2021	2022
Revenue	83.000.000	88.500.000
Cost of Goods Sold	(61.000.000)	(63.500.000)
SG&A[2]	(7.000.000)	(6.900.000)
EBITDA	**15.000.000**	**18.100.000**
Depreciation and Amortization	-7.000.000	-8.500.000
EBIT	**8.000.000**	**9.600.000**
Interest Expenses	-2.500.000	-2.500.000
EBT	**5.500.000**	**7.100.000**
Tax	-1155000	-1491000
Net Income	**4.345.000**	**5.609.000**

[2] The data included in this item are the equivalent of the Portuguese items of "*fornecimentos e serviços externos, gastos com o pessoal e outras despesas administrativas*"

In 2022 there was a slight increase in sales compared to 2021. This was due to the existence of restrictions related to covid 19 in 2021.

As a result of the increase in sales there was also an increase in Cost of Goods Sold and other administrative and operating expenses compared to 2021.

This operational activity allowed the company to obtain a positive operating result.

Also noteworthy is the amount of interest borne by the company, which remained unchanged compared to 2021 as no new loans were obtained from XYZ Holding.

Appendix III – Asset Analysis

Item	2022
Current Assets	**97.000.000**
Cash and cash equivalents	10.000.000
Inventory	45.000.000
Accounts Receivable	30.000.000
Other receivables	12.000.000
Non-current assets	**38.500.000**
Buildings	20.000.000
Furniture	3.000.000
Machinery	5.500.000
Investments	10.000.000

Appendix IV - Detailed description of the nature of the controlled transactions

Purchase of raw materials:

XYZ Group's subsidiary, XYZ Materials Ltd, located in a European Union country other than Portugal, is responsible for the procurement of raw materials for the manufacturing process. The group decided to place this subsidiary with a more central location in Europe in order to facilitate the acquisition of raw materials from various suppliers around the world and then sell them to the group's production unit.

Accounting and management services:

The group's subsidiary XYZ Accounting is the group company responsible for management and administrative services within the group. It provides accounting, treasury and tax services to the other entities in the group. In this sense, XYZ Food Production has operations with XYZ Accounting on a passive basis, *i.e.*, it purchases management support services from XYZ Accounting.

Intellectual property (IP) licensing:

XYZ Food Production uses certain intellectual property rights related to manufacturing processes. The intellectual property is owned by XYZ Holding, which owns and licenses the IP to the manufacturing unit. The manufacturing unit pays royalties to XYZ Holding for the use of the IP in its production activity.

Sales of Finished Goods:

Once manufactured, products are distributed and sold through various channels. A subsidiary, XYZ Distribution, is responsible for distribution activities in Portugal. It receives the finished products from the manufacturing units and distributes them to customers or other intermediaries. The company also has controlled operations with two other distributors of the group, XYZ Spain and XYZ Switzerland, responsible for the distribution of products in Spain and Switzerland, respectively.

Financing:

XYZ Food Production Ltd. receives financing from XYZ Holding and therefore pays interest on active loans.

Appendix V – Script for semi-structured interviews

<u>Transfer Pricing Professionals A, B and C</u>

1. In general, how would you rate the cooperation between actors with transfer pricing responsibilities?

2. Taking into account your relationship with transfer pricing for some years, how would you rate the interest of companies in transfer pricing? Is it only a relationship of help in the preparation of documentation or is it also a consultancy relationship?

3. Does the current documentation model (Master File + Local File) provide relevant information for companies to improve their value chain?

4. Has the change of ministerial order impacted much the work of a transfer pricing professional? If yes, how was this adaptation to the change?

5. Do you consider that the OECD through the Guidelines has followed the evolution of transfer pricing issues/challenges? If yes, can you give some examples of issues that have

been well followed by the OECD? If not, what do you think are the issues that deserve a differentiated treatment by this organization? Alternatively, can you point to situations that have been well followed up and others were not so much.

6. What do you believe are the main differences between OECD standards and Portuguese legislation?

7. Why do you think companies do not have a specific transfer pricing department and choose to use external entities? Is it related to know-how or access to information?

8. What kind of initiatives do you think could capture the attention of companies in this area?

9. In your view, what are the main challenges and opportunities for the future of the transfer pricing area?

10. How do you rate the way transfer pricing is approached in Portuguese universities? From your perception, do you think there are enough academics in the area?

11. What type of university professors would find it easier to teach transfer pricing issues (professionals teaching as guests or career academics)?

12. From what knowledge you have of the research done in the area, how does the professional practice of the area resemble the research produced? Has academia made good contributions to the practice of the transfer pricing profession?

13. What do you see in a candidate for this role? What requirements should someone who is recruiting for this area have, since there does not seem to be much training at this level in Portuguese universities?

<u>Academic</u>

1. In general, how would you rate the cooperation between all actors involved in the transfer pricing process?
2. How would you rate the relevance given to transfer pricing in academia?
    a. If low, what reasons do you give for its low relevance?
3. From the knowledge you have in the business environment, how do you classify the knowledge of Portuguese companies in the area of transfer pricing?
4. Is it a topic more linked to taxation or management control?
5. What actions could be taken to draw attention to the relevance of transfer pricing?
6. What has been the post-graduate offer in the scope of transfer pricing in Portuguese universities? And is there any approach to the subject at the undergraduate level?

7. What do you think a company sees in a candidate for these roles?
8. Do you consider that the OECD through the Guidelines has followed the evolution of transfer pricing issues/challenges? If yes, can you give some examples of issues that have been well followed by the OECD? If not, what do you think are the issues that deserve a differentiated treatment by this organization? Alternatively, can you point to situations that have been well followed up and others where not so much?
9. Most of the academic articles produced on this area are related to tax policy. Why do you think this is? Why is there not also a focus on the relationship with management control or international trade?
10. How do you think extensive transfer pricing can improve a company's performance?
11. Could efficient transfer pricing management have a positive impact on the company's value chain?
12. Do you think it is an area that should be taught by professionals or by career academics?

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