FLORIDA TAX REVIEW

Volume 22 *2018* *Number 1*

Taxing Income Where Value is Created

by

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Abstract

Subscribing to the core idea that income should be taxed where value is created, the international community has devised a set of tax base protecting rules to counter a world in which highly profitable multinational companies like Apple, Google, and Amazon pay very little in taxation. But these rules rely on assumptions about value that tend to allocate most revenues from international trade and commerce to rich countries while, whether intentionally or not, depriving poorer countries of their proper share. This Article argues that a rigorous examination of what we mean by value could prompt changes in the consensus on allocation. To demonstrate with a concrete example, the Article examines wages paid to workers in low-income countries and reveals a clear and well-documented gap between market price and fair market value resulting from labor exploitation. It then demonstrates how to apply this knowledge to existing international tax rule sets to reallocate profits to align more closely to the value-based ideal. If accepted in principle, the proposed approach could be expanded beyond wages to consider other areas in which prices do not align with value creation. Ultimately this could provide a more detailed template to reallocate

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For helpful comments on an early draft, we thank Yariv Brauner, J. Clifton Fleming Jr., Charlene D. Luke, Joost Pauwelyn, Adam Rosenzweig, and the participants of the 2017 University of Florida Levin College of Law International Tax Symposium.

multinational revenues in a way that does not inappropriately benefit richer countries at the expense of poorer ones.

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Introduction

Highly profitable companies like Apple, Google, and Amazon pay very low rates of taxation around the world because their profits are allocated strategically to take advantage of favorable tax conditions. Governments have participated in creating this environment through tax competition, but they simultaneously seek to protect their own taxing rights. They do so by devising tax base protecting rules to counter the status quo, most recently on an internationally cooperative basis through the "Base Erosion and Profit Shifting" (BEPS) initiative spearheaded by the G20 and Organisation for Economic Co-operation and Development (OECD).[1]

However, whether intentionally or not, the foundational allocation rules embraced and enforced by BEPS ensure that highly productive, higher income countries are systematically assigned a larger share of revenue than less productive, lower-income countries. Lower-income countries are thus systemically deprived of the revenues necessary to improve their productivity and therefore unable to claim an appropriate

1. OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Explanatory Statement: 2015 Final Reports* (2015); *BEPS Actions*, OECD, http://www.oecd.org/tax/beps/beps-actions.htm (last visited Sept. 22, 2018).

share of global profits despite making key value contributions to the global economy.

This Article argues that this status quo is objectionable and inconsistent with stated goals. Taking as a given the core principle that income should be taxed in accordance with value creation,[2] the Article proposes an approach to more appropriately allocate profits to value-adding jurisdictions, while maintaining consistency with established legal principles. The approach requires a rigorous application of the principle of fair market value to the profit allocation rules applicable to multinational groups.

To demonstrate with a concrete example, the Article examines wages paid to workers in low-income countries and shows that in specified sectors and geographic locations, there is a gap between market price and fair market value that distorts the allocation of tax revenues, assigning too little to the country of production. This gap is the result of labor exploitation that has been well documented in multiple forms across multiple disciplines, even leading to anti-dumping measures.[3] The analysis illustrates how assigning income based on value creation is an

2. This Article does not attempt to dispute the core goal but rather works with it as a guiding principle on the assumption that having built a vast cooperative consensus around it, the OECD and G20 are likely to seek to adhere to it going forward, so that engaging with existing rule sets is appropriate. Nevertheless, there are good reasons to question the coherence of the core goal on its own terms and to consider alternative allocation methods that would satisfy tax and other policy goals. For a critique of the notion that value creation is a conceptually coherent or appropriate standard for international taxation, see Allison Christians, *Taxing According to Value Creation*, 90 Tax Notes Int'l 1379 (June 18, 2018) (explaining that the concept is pernicious because it equates the assignment of the primary right to tax to the assignment of an economically correct jurisdiction to tax, thus masking an underlying commitment to a status quo that is primarily political rather than economic in nature). The authors are exploring alternative allocation principles in forthcoming work.

3. *See, e.g.*, *United States Proceeds with Labor Enforcement Case Against Guatemala*, Off. U.S. Trade Representative, (Sept. 2014), https://ustr.gov/about-us/policy-offices/press-office/press-releases/2014/September/United-States-Proceeds-with-Labor-Enforcement-Case-Against-Guatemala (the United States objected to the non-enforcement of labor standards in Guatemala, which it claimed allowed Guatemalan companies to "dump" discounted goods in the U.S. market in contravention of an agreement between the countries).

inherently imperfect exercise that overtly rejects market distortions in some cases while ignoring them in others. It demonstrates how allocating income to take more distortions into account would be possible using established methods.

By engaging with the underlying idea that income should be taxed where value is created, the proposal would fundamentally align with the international tax system while also moving toward other international goals, including development goals. Were countries to adopt the proposal, the revised allocation outcome ought to be accepted by countries where the world's multinationals are headquartered.[4]

Part I outlines the core role valuation plays in income taxation and explains why fair market value is viewed as key to allocating profit to the proper taxpayer and, by extension, the proper government. Part II analyzes the labor price-value gap and proposes that in order to more accurately assign income where value is created, governments would be justified in reallocating profits of multinationals to low-wage countries, even when labor continues to be underpaid. Part III demonstrates how to implement the proposal, using a test case to lay out the circumstances under which profits could be reallocated for tax purposes to adjust for the effect of labor exploitation on the fair market value of goods produced by multinationals. The Article concludes that while the proposal may be perceived as provocative by some, it is consistent with the universally embraced goal of taxing where value is created, should that remain a core international tax goal.

I. The Key Role of Value in Income Taxation

One of the main problems in designing an income tax regime is that taxpayers will inevitably—whether intentionally or otherwise—incorrectly identify or undervalue their sources of income.[5] They may

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4. In practical terms, this would mean that the tax authorities of all relevant jurisdictions would accept transfer pricing positions and requests for conforming adjustments where relevant. This is, of course, a complex issue in its own right. For discussion, see Allison Christians, *How Nations Share*, 87 Ind. L.J. 1407 (2012).

5. The discussion that follows is not a comprehensive comparative study but rather an attempt to survey some of the main doctrines and principles drawn mainly from U.S. and, to a lesser extent, Canadian, European, and other legal sources. The emphasis on these sources may be viewed as appropriate for

use legal structures and entities where available to shift income sources to jurisdictions that tax them less, and away from jurisdictions that would tax them more. Which country ought to tax a given income stream is therefore a continuous question for lawmakers. The foundational principle that guides their response is that income ought to be taxed in the country or countries where value is created.

The recently adopted U.S. tax reforms prioritize this principle by proclaiming that the income of U.S.-based multinationals can no longer be diverted out of the U.S. taxing net by artificially shifting profits overseas.[6] Similarly, the OECD put this aim center stage in its BEPS initiative.[7] The European Union followed suit in its Anti-Tax Avoidance Directive[8] and in the development of its Common Consolidated Corporate Tax Base proposal.[9] The G-20 agrees this is the appropriate guiding

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contemporary analysis in light of the focus of this Article on the U.S. and OECD arm's length transfer pricing standard, because, as the discussion below explains further, this standard is heavily influenced by prior U.S. law and ongoing U.S. influence.

6. Tax Cuts and Jobs Act, Pub. L. No. 115-97, §§ 14221–23, 131 Stat. 2054 (2017) [hereinafter TCJA].

7. OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* 1 (2017) (signed by representatives of over 70 countries and declaring the "importance of ensuring that profits are taxed where substantive activities generating the profits are carried out and where value is created"); OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10: 2015 Final Reports* (2015).

8. Council Directive 2016/1164 of 12 July 2016 Laying Down Rules Against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market, 2016 O.J. (L 193) 1, 1 (EU) (stating that "the current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated").

9. *Proposal for a Council Directive on a Common Corporate Tax Base*, at 2, COM (2016) 685 final (Oct. 25, 2016) (stating that "CCCTB features as an effective tool for attributing income to where the value is created"). The European Commission also explains that its apportionment-based design "will eliminate mismatches between national systems, preferential regimes and hidden tax rulings" and "will remove the need for transfer pricing, which is a primary route for profit shifting." *Common Consolidated Corporate Tax Base (CCCTB)*, Eur. Comm'n Tax'n & Customs Union https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en (last visited Sept. 22, 2018).

principle for taxation.[10] Non-governmental organizations and activist groups such as Oxfam and the Tax Justice Network embrace the goal as essential for fair taxation.[11] Finally, representatives of multinational companies also make the same claim.[12] The idea may be simply stated and intuitively appealing, but experience demonstrates that it is complicated to achieve in practice.

In pursuing the ideal, tax policy leaders of the past century, namely the member countries of the OECD, have worked resolutely to settle their own most pressing concerns while less attentive to those of

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10. G20 Leaders' Declaration, St. Petersburg Summit, ¶ 50 (Sept. 5–6, 2013), http://www.g20.utoronto.ca/2013/Saint_Petersburg_Declaration_ENG.pdf (stating that "[p]rofits should be taxed where economic activities deriving the profits are performed and where value is created").

11. *See, e.g.*, Christian Aid et al., *Getting to Good: Towards Responsible Corporate Tax Behavior*, Oxfam 15 (Nov. 2015), https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/dp-getting-to-good-corporate-tax-171115-en.pdf; *Tax and Sustainability: A Framework for Businesses and Socially Responsible Investors*, Christian Aid 4 (Oct. 2011), https://www.christianaid.org.uk/sites/default/files/2017-08/accounting-for-change-tax-sustainability-october-2011.pdf; *Making Tax Vanish*, Oxfam 38 (July 2017), https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/bp-making-tax-vanish-rb-130717-en.pdf; Oxfam Int'l, *Pulling the Plug: How to Stop Corporate Tax Dodging in Europe and Beyond*, Oxfam 1, 8 (Mar. 2015), https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/bn-pulling-plug-corporate-tax-eu-190315-en.pdf; Sol Picciotto, *Taking the Tax Justice Debate Forward: Including Learning to Digest the "Double-Irish Dutch Sandwich,"* Tax Justice Network 8 (2016), https://www.taxjustice.net/wp-content/uploads/2016/10/NewEarthText_FINAL.pdf. For a more detailed overview of the consensus on the importance to tax where value is created and why the idea is appealing, see Laurens van Apeldoorn, *Exploitation, International Taxation, and Global Justice*, Rev. Soc. Econ. (forthcoming 2018).

12. Tim Cook, *A Message to the Apple Community in Europe*, Apple.com (Aug. 30, 2016), https://www.apple.com/ie/customer-letter/ (arguing against a European Commission determination involving Apple's dealings in Ireland because it violated the principle that a "company's profits should be taxed in the country where the value is created"); *see also* Maya Forstater, *Publishing Corporate Tax Strategies*, Tax J. (Aug. 4, 2016), https://www.taxjournal.com/articles/publishing-corporate-tax-strategies-04082016 (reviewing statements on tax strategies published by FTSE 100 companies, which revealed that about 25% are committed to paying the right amount of tax "where value is created").

lower-income countries that are not in global leadership positions.[13] An unsurprising result of this imbalance of policy attention is that the income tax allocation standards embodied in OECD models and guidance systematically under-assign profits to low-income countries. These countries contribute vast stores of value to the global economy, including core natural resources that are integrally necessary to produce virtually everything delivered through global supply chains. The struggle to raise revenues from these contributions to the global economy has led countless tax law and policy observers to wonder why low-income countries appear locked in a perpetual state of "inability to tax."[14]

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13. The OECD membership comprises mostly high-income industrialized countries, including the United States, Canada, Australia, and most of Western Europe. *See List of OECD Member Countries—Ratification of the Convention on the OECD*, OECD, http://www.oecd.org/about/membersand partners/list-oecd-member-countries.htm (last visited Sept. 23, 2018). The role of the OECD as global tax policy leader is widely acknowledged. For discussion, see PETER CARROLL & AYNSLEY KELLOW, THE OECD: A STUDY OF ORGANISATIONAL ADAPTATION (2011) (analyzing the OECD's institutional history and role in global governance, including in taxation); Allison Christians, *Networks, Norms, and National Tax Policy*, 9 WASH. U. GLOB. STUD. L. REV 1 (2010) (explaining OECD's key importance as a global epistemic community creating persuasive tax policy norms and standards through network-based consensus, modeling, and peer pressure). The greater capacity of OECD member countries to protect their own tax policy interests in comparison to that of non-member countries is similarly well established. *See, e.g.*, Neil Brooks & Thaddeus Hwong, *The Social Benefits and Economic Costs of Taxation: A Comparison of High and Low-Tax Countries*, CAN. CTR FOR POL'Y ALTERNATIVES 25 (Dec. 2006), https://www.policyalternatives.ca/sites/default/files/uploads/publications/National_Office_Pubs/2006/Benefits_and_Costs_of_Taxation.pdf ("high-tax countries have been better able to achieve their social objectives than low-tax countries").

14. For a classic view, see Nicholas Kaldor, *Will Underdeveloped Countries Learn to Tax?* FOREIGN AFF., Jan. 1963, at 410–19. For some more recent evaluations of the question, see, for example, TSILLY DAGAN, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION (2018); William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All About Source!*, 29 U. PA. J. INT'L L. 349 (2007); Ilan Benshalom, *The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law*, 85 NYU L. REV. 1 (2010); Kim Brooks, *Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?*, 34 QUEEN'S L.J. 505 (2009); Allison

Focusing on the tax policy problems that the global tax system has addressed, even if not yet fully resolved, reveals a structural explanation. We may observe from a century of experience with international taxation across the globe that taxing income where value is created, especially in the context of integrated enterprises operating across borders, is associated with adjusting stated prices to account for various sources of distortion. To date, distortion has been readily recognized in the case of related parties: when members of a group are related through legal ownership and control, the tax system routinely investigates the prices they set in transfers among themselves.[15] Because this distortion is so pervasive and has such an impact on global tax outcomes, OECD member countries developed consensus on the concept of arm's length transfer pricing over several decades and recently reaffirmed their commitment to the paradigm.[16]

Yet related parties are not the only subjects that require scrutiny in the tax system: neglect or mistake that assigns income to the wrong taxpayer may originate in any number of phenomena. One example of these, which serves as a point of focus for this Article, involves valuation errors that result from cases of labor exploitation in which workers are compelled to trade their labor for less than a living wage. Where it is possible to measure the fair market value of labor exchanged

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Christians, *Drawing the Boundaries of Tax Justice*, *in* The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later 53 (Kim Brooks ed., 2013); Deborah Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 Can. Tax J. 879 (2001).

15. Mechanisms other than price adjustment are available to allocate profits from integrated enterprises, namely combined reporting with formulary apportionment. The valuation problems discussed in this Article are the same regardless of the profit allocation method, but the focus in the present Article is on the legal principle of value that drives the price adjustment mechanism. An application to the formulary apportionment mechanism of the interpretive principles of value laid out herein is beyond the scope of the present discussion but would be a welcome addition to the literature.

16. OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 43 (July 2017) [hereinafter *OECD Transfer Pricing Guidelines*] ("OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected."); *see also* TCJA, *supra* note 6, §§ 14221–23.

under such circumstances by reference to reliable external data, a correct tax assessment would adjust prices according to standard globally recognized principles.

To set the stage for a proposal to make these kinds of corrections, this Part explains why the concept of market value is centrally important to the concept of income and how tax systems normally detect and respond to common sources of valuation errors, with arguably the most emphasis on the mechanism of transfer pricing.

A. Measurement of Income

The term "market," "fair," "true," "clear," or "actual," when applied to value, reflects an idea fundamental to the measurement of income that when unrelated parties willingly transact, neither being compelled to trade and both having reasonable knowledge of the material facts, the price thereby agreed reflects the accurate and appropriate value of the transaction between them.[17] Thus, being unrelated, being uncompelled, and having adequate information are key to establishing market value.

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17. This is a common definition in substance, variants of which are found across legal subject areas where appraisal of value is relevant, including taxation, banking, labor law, competition, bankruptcy, expropriation/eminent domain, and consumer protection. For uses in U.S. legislation, see, for example, 29 U.S.C. § 1002(26) (Westlaw, Sept. 2018) (Labor) (defining the term "current value" as "fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary"); 12 C.F.R. § 703.11 (2018) (Banks and Banking) (using the term fair value in regulations for valuing securities); 18 C.F.R. § 4.10 *et seq.* (2018) (Conservation of Power and Water Resources) (using the term fair value for purposes of appraising specified constructed projects); 19 C.F.R. § 351 *et seq.* (2018) (Customs Duties) (explaining calculations of export price, fair value, and normal value). In Canadian legislation, see, for example, Competition Act, R.S.C. 1985, c C-34 s. 52.1(3)(c) and (d) (using the concept of fair market value in restricting deceptive telemarketing practices); Bankruptcy and Insolvency Act, R.S.C. 1985, c B-3 s. 2 (defining "transfer at undervalue" as "a disposition of property or provision of services for which no consideration is received by the debtor or for which the consideration received by the debtor is conspicuously less than the fair market value of the consideration given by the debtor"). For Canadian jurisprudence interpreting the definition of fair market value, see, for example, Lake Erie & N. Ry. Co. v. Brantford Golf & Country Club, [1917] 32 D.L.R. 219, 229 (citing Pastoral Fin. Ass'n v. Minister,

Often cited by courts and scholars for this general legal proposition, *Black's Law Dictionary* adds that a price obtained from a sale "forced by the necessities of the owner" is not a market price, that is to say, does not reflect its fair value.[18] *Black's* further notes that a market price is one that "would be fixed by negotiation and mutual agreement, after ample time to find a purchaser, as between a vendor who is willing (but not compelled) to sell and a purchaser who desires to buy but is not compelled to take the particular article or piece of property."[19]

Thus characterized, the price determined by parties in such a market is appropriately adjudged a "market price" and therefore accorded deference for tax purposes with consequences for both parties. It is on the basis of the idea of market value or fair market value (often used interchangeably to mean the same thing) that income tax systems assign income to parties in all kinds of transactions involving exchanges of

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[1914] AC 1083 (PC) (appeal taken from N.S.W.) and stating that the selling price of land taken from an owner by compulsion may be less than its real value owing to his particular use or planned use thereof); Woods v. The King, [1951] S.C.R. 504 (citing the above cases in determining an adjustment to a market price to account for uncompensated value in an expropriation). *See also Pastoral Fin. Ass'n*, [1914] AC at 1088 (fair market value means that the owner is "entitled to that which a prudent person in his position would have been willing to give for the land sooner than fail to obtain it").

18. *Market Value*, BLACK'S LAW DICTIONARY (6th ed. 1990) [hereinafter BLACK'S 1990]; *Market Value*, BLACK'S LAW DICTIONARY (2d ed. 1910) [hereinafter BLACK'S 1910]. The list of cited case law was already lengthy in the 1910 edition and has only expanded since then. *See, e.g.*, BFP v. Resolution Trust Corp., 511 U.S. 531 (1994); Muser v. Magone, 155 U.S. 240 (1894). This general definition is repeated in a wide range of scholarship on the role of valuation in taxation. *See, e.g.*, Howard L. Braitman, *The Eye of the Beholder: A Fresh Look at Fair Market Value*, 52 TAXES 269 (1974) (echoing the definition and examining its use in U.S. tax statutes and regulations); Kim Brooks, *Delimiting the Concept of Income: The Taxation of In-Kind Benefits*, 49 MCGILL L.J. 255 (2004) (examining the application of fair market valuation to employee non-cash benefits in Canadian tax law); Bernard Marks, *Valuation Principles in the Income Tax Assessment Act*, 8 BOND L. REV. 114 (1996) (reviewing the concept of valuation in Australia's tax law by reference to the same elements as those laid out in *Black's Law Dictionary* and analyzing each of the elements of the definition).

19. *Market Value*, BLACK'S 1990, *supra* note 18; *Market Value*, BLACK'S 1910, *supra* note 18.

tangible and intangible goods and services.[20] A tax system could not function if it could not generally defer to prices set in market transactions, while remaining vigilant to the need to inspect stated prices when circumstances warrant.

To state the principle of market value is to highlight its many embedded assumptions. Some of these have been discussed at length by scholars, policymakers, and judges, and have been accounted for in specific tax rules.[21] For example, that parties must be unrelated is key to determinations of market value. This is because the freely transacted prices of related parties might reflect noneconomic decisions. The most feared of such decisions from a tax perspective is the propensity of taxpayers to conspire together in mutual advantage to reduce their collective tax obligations.[22] When parties do not deal with each other at arm's length, the tax system adapts by pricing their transactions at fair market value for tax purposes regardless of the amount actually paid.[23] To be clear, the tax system does not force the parties to agree to a different

20. *See, e.g.*, Marks, *supra* note 18, at 117 ("[C]ourts and administrators have generally treated the meaning of the terms 'value', 'market value', 'fair market value' and 'open market value' as both equivalent and interchangeable whether they applied to income tax, capital transfer, death and estate duties or stamp duties.").

21. For some comprehensive analyses, see Braitman, *supra* note 18; M.G. Kemp, *The Meaning of Market in Fair Market Value,* 2 U.B.C. Legal Notes 593, 602 (1958); Daniel S. Goldberg, *Fair Market Value in the Tax Law: Replacement Value or Liquidation Value*, 60 Tex. L. Rev. 833 (1982); Emanuel L. Gordon, *What Is Fair Market Value?*, 8 Tax L. Rev. 35 (1952); Marks, *supra* note 18; Harold Wurzel, *The Tax Basis for Assorted Bargain Purchases or: The Inordinate Cost of "Ersatz" Legislation*, 20 Tax L. Rev. 165 (1964).

22. *See, e.g.*, Swiss Bank Corp. v. Minister of Nat'l Rev., [1974] S.C.R. 1144, 1152 (Can.) (when parties are not dealing at arm's length, nothing can ensure that the transaction "will reflect ordinary commercial dealing between parties acting in their separate interests").

23. Canada v. McLarty, [2008] 2 S.C.R. 79, 97 (Can.). ("The provisions of the *Income Tax Act* pertaining to parties not dealing at arm's length are intended to preclude artificial transactions from conferring tax benefits on one or more of the parties. Where the parties are found not to be dealing at arm's length, the taxpayer who has made an acquisition is deemed to have made the acquisition at fair market value regardless of whether the amount paid was in excess of fair market value.")

transaction or to exchange different items or amounts in terms of real currency; it only adjusts the parties' positions for tax purposes.[24]

Whether parties willingly transact is equally key to determining fair market value. Whether related or not, if either or both of the parties to an exchange are compelled to transact, the market outcome will be guided by a price-setter that serves its own interests in violation of the economic logic derived when parties willingly transact to gain maximum value for themselves.[25] If coercive conditions exist such that one party or group systematically suffers a disadvantage against the other, it is clear to everyone that prices will not reflect market value.[26]

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24. Whether and how the parties respond to the tax system in their dealings with one another is an important question, but it is distinct from the matter at hand, namely, identifying value for tax purposes.

25. For a classic description of this basic principle of economics, see Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, bk. IV ch. 2, at 181 (9th ed. 1799) (1776) ("As every individual . . . endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value . . . he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."). Since there is no baseline scenario market without institutions, the state is typically advanced as the relevant institution for these purposes.

26. This is a basic principle of economics. *See, e.g.*, Marcy Satterwhite, *Competition*, *in* 1 Encyclopedia of Business and Finance 152, 154–55 (Burton S. Kaliski ed., 2001) (explaining that "[b]eing the only provider of a certain good or service gives the seller considerable control over price" and that monopolies can persists despite regulation owing to the scale of investment needed to enter a given market); Michael W. Spahr, *Monopoly*, *in* Encyclopedia of Business and Finance, *supra*, at 614, 614–15 (stating that monopoly results from barriers to entry including technological or economic conditions "that raise the cost for firms wanting to enter the market above the cost for firms already in the market, or otherwise make new entry difficult," and providing by way of example the case of Microsoft, which lost an antitrust suit brought by the United States when a U.S. federal court judge ruled that the company's dominant position in the computer operating software market was not in the public interest because it created insurmountable hurdles for prospective competitors); *see also* United States v. Microsoft Corp., 253 F.3d 34 (2001); Steve Lohr & Joel Brinkley, *Pricing at Issue as U.S. Finishes Microsoft Case*, N.Y. Times (Jan. 6, 1999), https://www.nytimes.com/1999/01/06/business/pricing-at-issue-as-us-finishes-microsoft-case.html (exploring testimony of government expert Franklin M. Fisher, an economist

Prices in these conditions reflect the value created from the ability of one or more parties to repeatedly exploit a situation.

Establishing fair market value may be difficult, but it is a vital function for determining income.[27] Depending on one's preferred starting point (or ultimate goal), income may be defined in terms of outcomes or inputs, with valuation always at the center of the analysis. Thus, the role of valuation is explicit when income is defined as the sum of the value of goods and services consumed over a period and the change in net worth over the period (the ubiquitous Schanz-Haig-Simons definition).[28]

Valuation is similarly central to the analysis when income is defined as an accretion to wealth, where accretion is the measure of gross receipts less deductible expenses (the comprehensive income definition).[29] Under that definition of income, gross receipts must be identified by reference to the value of cash as well as non-cash items received by the taxpayer.[30] Similarly, deductible expenses must be limited as to reasonableness in the assessment of value, which may be established using fair market prices (even if sometimes capped when deemed to be

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at the Massachusetts Institute of Technology, who "assert[ed] that Microsoft commits predatory pricing by giving away its Internet Explorer browser").

27. Since it is necessarily flawed, as applied it is subject to frequent contestation among taxpayers and governments, and must often be resolved by judges. The literature and case law are vast. For a few common favorites among law teachers and students, see United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968) (determining the fair market value to a potential investor and his spouse of an expenses-paid trip to Germany to tour the facilities of a Volkswagen manufacturer); McCann v. United States, 1981 U.S. Ct. Cl. LEXIS 1495 (1981), *aff'd*, 696 F.2d 1386 (Fed. Cir. 1983) (determining the fair market value of an expenses-paid trip to Las Vegas furnished to an employee); Phila. Park Amusement Co. v. United States, 130 Ct. Cl. 166 (1954) (determining the fair market value of the Strawberry Bridge traversing the Schuylkill River and that of a ten-year extension of a railroad franchise, both situated in Philadelphia). For a survey of the Canadian principles and cases, see Brooks, *supra* note 18.

28. HENRY SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 49 (1938); Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1–28 (Robert M. Haig ed., 1921); Georg von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZARCHIV 1 (1896).

29. For example, see I.R.C. § 61; Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

30. *See, e.g.*, I.R.C. § 61; *Glenshaw Glass*, 348 U.S. at 431.

excessive in the circumstances).[31] Valuation is inescapable in income taxation, and market value is the archetype.

B. Error Detection and Correction

Because the concept of valuation is so embedded in the concept of income, the architects of income tax regimes regularly encounter valuation errors or potential errors that require correction. Some of these arise because of actual errors made by parties in market-based dealings and transactions, which the parties remediate in real terms by effecting additional exchanges of value. Purchase price adjustments are a ready example of this phenomenon.[32] Others involve distinct forms of market-distorting coercion resulting from asymmetric information and systemically unequal bargaining power. Regulatory responses are readily recognizable in antitrust (competition) law, consumer protection law, and labor law, among other regimes.[33]

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31. Seen, for example, in the limitation of deductibility for business expenses to those that are reasonable, ordinary, and necessary under the circumstances, including the limitation on compensation to that which is "reasonable." *See, e.g.*, I.R.C. § 162 and regulations thereto.

32. *See, e.g.*, I.R.C. § 108(e)(5) (purchase-money debt reduction for solvent debtor treated as price reduction).

33. *See, e.g.*, *Competition*, Eur. Commission, http://ec.europa.eu/competition/index_en.html (last updated June 20, 2018); *Competition Bureau Canada*, Gov't Can., http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/home (last modified Sept. 28, 2018); *Consumer Protection*, Eur. Commission, https://ec.europa.eu/info/policies/consumers/consumer-protection_en (last visited Oct. 7, 2018); Fed. Trade Commission, https://www.ftc.gov/ (last visited Oct. 7, 2018); *Office of Consumer Affairs*, Gov't Can., https://www.ic.gc.ca/eic/site/icgc.nsf/eng/07554.html (last modified Feb. 28, 2018). The latter has recently become more visible in tax policy circles owing to the increasing application of European competition law to tax regimes under the "fiscal state aid" provisions of the Consolidated Version of the Treaty on the Functioning of the European Union of 9 May 2008, 2008 O.J. (C 115) 1, 91–93. *See* De Gezamenlijke Steenkolenmijnen in Limburg v. High Auth. of European Coal & Steel Cmty., 1961 E.C.R. 50 (early case stating that EU state aid provisions apply to tax measures); Anna Gunn & Joris Luts, *Tax Rulings, APAs and State Aid: Legal Issues*, 24 EC Tax Rev. 119, 119–25 (2015); Allison Christians, *Friends With Tax Benefits: Apple's Cautionary Tale*, 78 Tax Notes Int'l 1031 (June 15, 2015).

For the tax system, the difficulty to be solved is whether the price set under such circumstances properly reflects market value.[34] If not, a price adjustment mechanism is warranted to ensure that for tax purposes, income and deduction items are assigned to the correct taxpayer. As implied by the need for parties to be unrelated in order to assume that transacted prices reflect fair market value, a tax system constantly confronts the reality that taxpayers may use personal or legal relationships primarily or solely to produce favorable tax outcomes.[35]

Owing to the ubiquity of the taxpayer as legal planner, income tax systems routinely adopt safeguard rules to assign income to the proper parties when personal or legal relationships potentially influence self-assessments of value transfers among them. These relationships may involve individuals engaged in transactions with other individuals, individuals engaged in transactions with legal entities in which they are members or shareholders, and legal entities engaged in transactions with other legal entities with common ownership or control, as the case may be.[36] The corresponding safeguards may be found in related party

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34. A similar inquiry would arise in a forced sale, such as owing to expropriation or foreclosure. Valuation questions are central to legal regimes governing such transactions. *See supra* note 17.

35. How the tax system addresses tax planning is a matter of defining legal principles, since it is axiomatic that the individual has a fundamental right to arrange her affairs in accordance with the applicable regulatory landscape. It falls to the relevant lawmakers to determine how a given arrangement will be treated within that landscape. For discussion, see, for example, Allison Christians, *Avoidance, Evasion, and Taxpayer Morality,* 44 Wash. U. J.L. & Pol'y 39 (2014); Judith Freedman, *Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle*, 4 Brit. Tax Rev. 332, 332–57 (2004). This problem is pervasive and may be described as a matter of efficiency in the sense that a more neutral tax system will be one that introduces less distortion in the way taxpayers behave, relative to how they would behave were tax not a factor in their decision-making. The problem may also be described as an issue of fairness or equity, because taxpayers who can use personal and legal relationships to strategically shift income among themselves for tax purposes may pay less than others in the same economic circumstances who lack those planning opportunities. This question of equity is outside the scope of the present discussion.

36. *See, e.g.*, I.R.C. § 267 (defining related parties to include, inter alia, members of a family (as defined); an individual and a corporation where the latter is more than 50% owned, directly or indirectly, by the former; two

rules, assignment of income rules, deemed distribution rules, and transfer pricing rules.[37]

Accordingly, it is very common for a tax system to have a rule that reallocates a given price among two parties to a transaction to "better reflect economic reality," which is the same thing as saying "to approximate fair market value."[38] These rules do not change the actual transaction; instead, they simply re-assign the income therefrom for tax purposes. Judging from the ever-growing volume of error correction rules in many systems, multiple types of errors have been detected over the life of the income tax. However, others have not been detected or, if detected, have not been fully resolved. The following discussion explains.

C. Arm's Length Transfer Pricing

Consistent with the core concept of value, where the economic value of a transfer is relevant to the determination of tax, the tax system works on the baseline assumption that market prices are presumed to reflect parties bargaining under fair market conditions unless circumstances show that presumption to be suspect. This means that a given market price is generally viewed as fair market value for tax purposes unless there is reason to think otherwise. Once it appears there is reason to think otherwise, rules are established to identify deviations and force the tax outcome to (or at least closer to) the baseline scenario. That is the role of arm's length transfer pricing.

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corporations that are members of the same controlled group (as defined); and various corporate and partnership arrangements and groups involving shared ownership and control).

37. For example, this would include deemed distribution rules involving controlled corporate enterprises, deemed sale and income rules involving partners in their dealings with partnerships, constructive receipt rules, and the like. These frameworks mirror foundational assignment of income rules that prevent or allow income- and expense-sharing among spouses (where individuals are the relevant taxing unit, as in Canada), or with children or other family members. *See* I.R.C. § 267 ("Losses, Expenses, and Interest with Respect to Transactions Between Related Taxpayers"); I.R.C. § 482 ("Allocation of Income and Deductions Among Taxpayers"); I.R.C. § 707 ("Transactions Between Partner and Partnership"); I.R.C. § 951 ("Amounts Included in Gross Income of United States Shareholders"); Reg. § 1.451–2 ("Constructive Receipt of Income").

38. *See, e.g.*, Canada v. McLarty, [2008] 2 S.C.R. 79, 84–107 (Can.).

Transfer pricing rules fundamentally exist in order to address the possibility of valuation errors when parties transact with other parties that they control or that are under common control (collectively referred to as controlled affiliates). Arm's length pricing is, in effect, a method to police reported incomes of controlled affiliates by requiring them to use fair market value prices as a benchmark for their transactions.[39]

The key function of arm's length transfer pricing is therefore to scrutinize a stated price or transaction among non-arm's length parties for signs that it deviates from the baseline scenario, namely, that which would be derived if the parties were independent strangers seeking selfish interests as they would under fair market value conditions. Transfer pricing analysis typically commences by identifying relevant prices and transactions among uncontrolled parties to use as a benchmark for the expected market outcome of the price or transaction under scrutiny.[40] The transfer pricing regime provides a framework of established rules and an insertion point for a price adjustment to reflect what a fair market would produce if it existed.[41]

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39. *See, e.g.*, *OECD Transfer Pricing Guidelines*, *supra* note 16, at 38 (explaining the goals of arm's length transfer pricing, among them, to "provide[] the closest approximation of the workings of the open market" and to "adopt[] as a benchmark the normal operation of the market"); *see also* Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 Va. Tax Rev. 79, 104 (2008) ("The arm's length standard is basically an articulation of the traditional market approach to valuation.").

40. *OECD Transfer Pricing Guidelines*, *supra* note 16, at 38. For an overview explanation of the U.S. transfer pricing rules, see Allison Christians et al., U.S. International Taxation: Cases, Materials, and Problems 301–42 (2d ed. 2011). For a discussion of the evolution of the arm's length standard as a global consensus, see Brauner, *supra* note 39.

41. The operative statute in the United States is I.R.C. § 482, which authorizes the IRS to distribute, allocate, or apportion any item affecting taxable income among related parties if, inter alia, necessary to clearly reflect income. The IRS may adjust prices whenever it finds that a taxpayer's income, whether by inadvertence or design, is other than the "true taxable income" that would have arisen from arm's-length dealings. Motive and intent are irrelevant for these purposes. *See, e.g.*, Eli Lilly & Co. v. United States, 178 Ct. Cl. 666 (1967). A parallel Canadian regime originates in Income Tax Act, R.S.C. 1985, c 1 s. 247(2) (5th Supp.), which provides for appropriate adjustments for prices assigned in situations involving "a taxpayer or a partnership and a non-resident

Price adjustment is generally determined by finding transactions similar to the one being examined, except that they that are between uncontrolled parties and therefore thought to better reflect what a market would produce. However, no transaction involving controlled affiliates can ever be exactly comparable to transactions between uncontrolled parties, owing to synergies and other attributes of collective enterprises.[42] Therefore, a transfer pricing regime must either allow or require, as the case may be, adjustments to the comparable transactions as well, in order to better reflect the economic reality of the transaction at issue.

Comparability is therefore the threshold standard driving a transfer pricing analysis.[43] Taxpayers have considerable latitude in identifying transactions of uncontrolled parties against which to test their own transactions, and in making adjustments to comparable transaction prices to reconcile material divergence from the controlled transaction.[44] With market value as the benchmark for income assessment, comparability adjustments are intended to be based not on subjective factors but by reference to common commercial practices, economic principles, and statistical analyses.[45]

Transfer pricing rules require taxpayers to adequately reflect in their prices relevant differences in functions, contract terms, risks, economic conditions, and type of property or service. For example, quantity discounts generally offered by a controlled subsidiary to other

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person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length."

42. *See, e.g.*, Joel B. Rosenberg et al., *Transfer Pricing Comparability: Concepts, Methods and Applications,* Corp. Bus. Tax'n Monthly, Dec. 2003, at 4, 30. This factor has led many observers to skepticism regarding and, for some, a complete rejection of, the conceptual coherence of arm's length transfer pricing. For a particularly detailed and scathing account, see Brauner, *supra* note 39. Brauner and others who view transfer pricing as inherently flawed call for a change to combined reporting and formulary apportionment, a system that would compute the net income of the multinational as a whole and then allocate it among relevant taxing jurisdictions according to a pre-determined formula.

43. *See OECD Transfer Pricing Guidelines*, *supra* note 16, at 43 ("'comparability analysis' is at the heart of the application of the arm's length principle").

44. *Id.*

45. For this reason, a global industry of transfer pricing experts, databases, software, and tools has developed and multiplied over the course of the past several decades.

purchasers in uncontrolled sales would be a basis for making an adjustment to a price to better reflect economic reality despite a divergence from a comparable uncontrolled price or transaction.[46] Some of the economic conditions that may require or give rise to a transfer price adjustment in the United States include the relative size of each market and the extent of the overall economic development in each market; competition in each market with regard to the property or services under review; the economic condition of the particular industry, including whether the market is in contraction or expansion; and the alternatives realistically available to the buyer and seller.[47] Similarly, the *OECD Transfer Pricing Guidelines* explain that relevant economic conditions include, inter alia, the circumstances surrounding the transaction and industry practices, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties.[48]

Any one of these conditions could merit a decision by a tax authority to adjust a transfer price, regardless of the prices actually paid or reported paid by the taxpayer. A tax authority may apply a price adjustment to the transaction or price that is subject to the transfer pricing adjustment, but it may also apply the adjustment to the uncontrolled transaction, as the circumstances require.[49] The intuition that arises from this framework is that, consistent with the articulated principles and standards, any economic factor that measurably distorts market prices can and should be adjustable so as to ensure that related party transactions reflect, as closely as possible, fair market value.

II. Labor Exploitation as Market Distortion

The foregoing discussion explored why income tax systems must establish fair market value when determining income. This Part identifies

46. *See, e.g.*, Reg. § 1.482–1(d)(3)(ii)(C), Ex. 2. The inclusion of economic factors within the range of appropriate adjustments demonstrates that externalized costs are relevant to the transfer pricing picture because fair market value is the benchmark.

47. Reg. § 1.482–1(d)(3)(iv).

48. *OECD Transfer Pricing Guidelines*, *supra* note 16, at 45.

49. The 2017 *OECD Transfer Pricing Guidelines* explain that arm's length transfer pricing is a two-step exercise, in which first the economic aspects of the transaction are analyzed and second, the search for comparison is carried out. *Id.* at 43–45 (describing these phases as "separate but related").

one hitherto ignored valuation error that distorts the determination of income, namely, that market prices fail to reflect fair market value in cases where workers' human rights to a living wage are violated. In those instances, (labor) market transactions fail to satisfy the minimum condition of forming an uncompelled agreement between a willing buyer and seller. This Part shows how and why a tax authority could overcome this price distorting phenomenon using existing benchmarks, namely, living wage analyses, to adjust prices applicable to related party transactions.[50]

A. Rights Violations as Revealers of Compulsion

Not being compelled to transact is necessary to the definition of fair market value because prices are likely distorted when one or more parties has a systemic advantage over other market participants. A difficulty for valuation assessors is that compulsion may be difficult to detect, let alone measure and apply to a given set of circumstances. We may begin to overcome these difficulties by comparing a world in which individuals enjoy their basic human rights to the world in which they do not, and then analyzing the market implications of that division.

The right to a living wage is one of the basic entitlements identified in the 1948 Universal Declaration of Human Rights.[51] The Declaration states that workers have "the right to just and favourable remuneration" allowing them to ensure for themselves and their family "an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection."[52] The 1966 International Covenant on Social, Economic and Cultural Rights further elaborates that workers ought to be provided at a minimum, "[f]air wages," as well as safe

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50. The same logic could in theory be applied to unrelated party transactions, but this would potentially require significant legislative or administrative changes. Since this Article seeks to critically examine and challenge the existing scope of the concept of value in the context of existing international standards, it confines the analysis to related party transactions.

51. G.A. Res. 217 (III) A, Universal Declaration of Human Rights art. 25(1) (Dec. 10, 1948), http://www.un.org/en/universal-declaration-human-rights/index.html [hereinafter UDHR].

52. UDHR, *supra* note 51, art. 23(3). For an overview of the widespread international support for a living wage, see Richard Anker, Estimating a Living Wage: A Methodological Review (Int'l Labour Office 2011).

and healthy working conditions and rest, leisure, and reasonable limitation of working hours.[53]

A living wage is one, and perhaps the most important, factor necessary to fulfill the right to an adequate standard of living.[54] The right to a living wage protects the bare subsistence interests of individuals and families. Subsistence interests, as the political philosopher Charles Beitz notes, "are among the most uncontroversially urgent of all human interests and the least open to variation by culture."[55] The right to a living wage corresponds, for instance, with the conception of human rights advanced famously by then U.S. Secretary of State Cyrus Vance in his Law Day Address at the University of Georgia in 1977, which, inter alia, declared human rights to "the fulfillment of such vital needs as food, shelter, health care and education."[56]

Exploitation may be conservatively defined as system-wide advantage-taking that occurs because workers are, within a given market, unable to command wages that would sustain their lives in accordance with what is generally accepted as their minimum or basic human right.[57]

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53. G.A. Res. 2200A (XXI), International Covenant on Economic, Social and Cultural Rights art. 7 (Dec. 16, 1966), http://www.ohchr.org/EN/ProfessionalInterest/Pages/CESCR.aspx [hereinafter ICSECR]. There have been long-standing debates about the status of the social and economic rights, particularly as outlined in this covenant. *See, e.g.*, David Beetham, *What Future for Economic and Social Rights?*, 43 Pol. Stud. 41 (1995).

54. *See* UDHR, *supra* note 51, art. 25(1) (listing as requisite "food, clothing, housing, and medical care and necessary social services"); *see also* ICSECR, *supra* note 53, art. 11(1) (declaring the "right of everyone to an adequate standard of living for himself and his family, including adequate food, clothing and housing").

55. Charles R. Beitz, The Idea of Human Rights 163 (2009). There must therefore be a broad consensus that violations of the right to a living wage are unjust and morally unacceptable. They are unjust directly insofar as they violate the human right to a living wage itself, but they are also unjust indirectly insofar as they leave workers and their families unable to sustain the conditions for a minimally decent life.

56. Cyrus Vance, *Human Rights and Foreign Policy*, 7 Ga. J. Int'l & Comp. L. 223, 223 (1977). For the further development of this "Vance conception" of human rights, see James W. Nickel, *Poverty and Rights*, 55 Phil. Q. 385, 386–89 (2005).

57. In an exploitative transaction, both parties can benefit from this situation in the sense that both would have been worse off had the transaction

Exploited workers may choose to accept work under such conditions, since all other alternatives may in fact be worse.[58] However, their choice is compelled in the sense that they would not have accepted these conditions if their human right to a living wage had been fulfilled. Had their right to a living wage been fulfilled, we must assume that, in general, individuals would not voluntarily submit themselves to deprivation.

Market prices of goods and services accordingly may not reflect fair market value when produced by workers who are systematically exploited.[59] If not, by the same logic driving arm's length transfer pricing analysis, it is appropriate to scrutinize the market prices of the relevant labor and produced goods to see if they would more closely reflect fair market value with an appropriate adjustment. Consistent with transfer pricing principles, this task requires comparison to what would occur in a hypothetical transaction absent the factor of exploitation as a chronically market-distorting condition. Necessary to such a comparison is an objective measurement method. One that satisfies broadly accepted

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not taken place at all. The transaction is nevertheless problematic because the cooperative surplus is not distributed correctly among the parties, since one of the parties systemically receives some amount of value from the other without compensation. For an explanation of cooperative surplus and a proposal for allocating it across countries according to a metric other than the source of income, see Adam Rosenzweig, *Defining a Country's "Fair Share" of Taxes*, 42 Fla. St. L. Rev. 373 (2015) (proposing an allocation of cooperative surplus according to what would produce an efficient allocation of public spending). Rosenzweig's method would presumably allocate cooperative surplus to lower-income countries.

58. This observation leads to the well-known mantra that the problem is not the presence of sweatshops but the fact that there are not more of them. *See, e.g.*, Nicholas Kristof, *Where Sweatshops Are a Dream*, N.Y. Times (Jan. 14, 2009), https://www.nytimes.com/2009/01/15/opinion/15kristof.html.

59. This is explained in the U.S. trade case against Guatemala involving the failure of Guatemala to adhere to agreed labor standards. *See* Office of the U.S. Trade Representative, Exec. Office of the President, Initial Written Submission of the United States, In the Matter of Guatemala—Issues Relating to the Obligations under U.S. Article 16.2.1(a) of the CAFTA-DR, at 23 (Nov. 3, 2014) ("Guatemala's failure to effectively enforce Articles 10, 62(c), 209, 223, 379 and 380 allowed these apparel manufactures to evade the costs associated with the compliance of these laws. Consequently, Guatemala's failures affected the conditions of competition that these apparel exporters experienced compared to the conditions that would have been in place had Guatemala effectively enforced its laws.").

standards for transfer pricing would be preferable in terms of gaining broad acceptance by all the relevant parties in practice.

B. Calculating a Counterfactual: Unexploited Labor

The right to a living wage is relevant to a fair market value analysis because it demonstrates that there exists some minimum level of compensation that individuals would command for their labor were they not compelled to do otherwise. The challenge in applying the right to a living wage to a valuation assessment lies in the calculation of a living wage in concrete circumstances (reflecting the counterfactual of what workers would have minimally accepted had they been uncompelled).

Demanding that taxpayers undertake such an exercise might seem unusual and even speculative, yet analogies are commonplace in taxation where arm's length transfer pricing routinely requires companies to construct values for factors that have no ready benchmark.[60] Establishing the fair market value of unexploited labor could thus be compared in tax compliance terms to establishing the value of a hard-to-value intangible. The OECD has recognized the latter as a necessary function for tax compliance despite the conjecture involved.[61] It has therefore engaged in extensive discussion and developed guidance to facilitate a system for constructing value in these difficult cases.[62]

The same rigor could be applied to labor; furthermore, external resources exist to assist this effort. Recent efforts by a number of academics and non-governmental organizations have shown that it is possible to develop robust country- and region-specific living wage

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60. For a discussion, see Brauner, *supra* note 39.

61. *See OECD Releases a Discussion Draft on the Implementation Guidance on Hard-to-Value Intangibles*, OECD (May 23, 2017), http://www.oecd.org/tax/oecd-releases-a-discussion-draft-on-the-implementation-guidance-on-hard-to-value-intangibles.htm; *see also OECD Transfer Pricing Guidelines*, *supra* note 16, at 309 ("The term hard-to-value intangibles . . . covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was [sic] entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain. . . .").

62. OECD, *Base Erosion and Profit Shifting (BEPS), Public Discussion Draft, BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles* (May 23–June 30, 2017).

benchmarks that garner broad agreement across independent observers from the public and private sector. Two such approaches, discussed below, provide points of reference relevant to identifying where value is created using recognizable methodologies that are consistent with existing transfer pricing practices.

C. Living Wage Methodology

Two main living wage analyses are available to quantify the labor price-value gap, namely, the Anker method and the Asia Wage Floor. The Anker method has been adopted by ISEAL, the global association for sustainability standards,[63] as well as by six standard-setting organizations, including Fairtrade International, UTZ Certified, and Forestry Stewardship Council (FSC), together known as the Global Living Wage Coalition.[64] Reports by ISEAL on individual countries and specific industries include detailed estimates of the local living wage as well as an estimation of the prevailing wages (wages paid to the majority of workers). Their definition of a living wage is as follows:

> Remuneration received for a standard work week by a worker in a particular place sufficient to afford a decent standard of living of the worker and her or his family. Elements of a decent standard of living include food, water, housing, education, healthcare, transport, clothing and other essential needs including provision for unexpected events.[65]

The underlying methodology to estimate the cost of a decent standard of living is outlined in most detail in Robert Anker and Martha Anker's *Living Wages Around the World: Manual for Measurement*.[66]

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63. *See About ISEAL*, ISEALAlliance, https://www.isealalliance.org/about-us (last visited Oct. 7, 2018).

64. *See generally* Anker, *supra* note 52; Richard Anker & Martha Anker, Living Wages Around the World: Manual for Measurement (2017).

65. *Richard Anker & Martha Anker,* A Shared Approach to Estimating Living Wages: Short Description of Agreed Methodology*, Global Living Wage Coalition 2 (Nov. 2013), https://www.globallivingwage.org/wp-content/uploads/2018/06/anker_methodology.pdf.*

66. Anker & Anker, *supra* note 64.

Broadly speaking, this study is based on an assessment of the local cost of a low cost diet, adapted to local circumstances and based on World Health Organization guidelines; the local cost of acceptable housing using national and international standards for decency; and the cost of other essential expenses for basic healthcare, education, and transport.[67] The resulting data is used to determine the living costs for a typical family size with the typical number of full-time equivalent workers per family.

The second influential living wage benchmark is developed by the Asia Wage Floor Alliance, consisting of trade unions and labor rights activists in Asia and elsewhere.[68] The Alliance presents its campaign primarily as a collective bargaining strategy for workers in the Asian garment industry.[69] Similar to the Anker method in calculating a living wage based on needs and family composition, the Asia Floor Wage method extrapolates non-food costs from the cost of the estimated price of a food basket, and the method assumes that a family consists of two adults and two children rather than calculating average family size from government sources.[70] This method is included as a point of reference in the reports of the Global Living Wage Coalition, the Fair Labor Association, and others.[71]

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67. *Id.* at 17–30 (outlining the Anker living wage method, which draws on interviews and government data and excludes overtime pay, non-guaranteed productivity bonuses and allowances, and mandatory deductions, such as taxes and social insurance payments, while including in-kind benefits such as lunches and transportation to and from the workplace).

68. Asia Floor Wage, http://asia.floorwage.org/ (last visited Oct. 7, 2018).

69. Jeroen Merk, *Stitching a Decent Wage Across Borders: The Asia Floor Wage Proposal* 8–9 (Asia Floor Wage Campaign 2009), https://cleanclothes.org/resources/publications/afw.pdf. The Asia Floor Wage method is designed to tackle the threat that wage increases in one of the garment-producing countries will lead to a relocation of production to other countries in the region. The calculation of the living wage is therefore less tailored to specific geographical locations; the aim instead is to identify a wage floor that will guarantee a living wage for workers in the entire region. *Id.* at 30, 37.

70. *Id.* at 30; *see also* Junya Yimprasert & Petter Hveem, *The Race to the Bottom: Exploitation of Workers in the Global Garment Industry* (Norwegian Church Aid, Occasional Paper Series 01/2005), https://www.kirkensnodhjelp.no/contentassets/c1403acd5da84d39a120090004899173/2005/race-to-the-bottom.pdf.

71. *See, e.g.*, *Toward Fair Compensation in Global Supply Chains: Factory Pay Assessments in 21 Countries*, Fair Labor Ass'n (Aug. 2016),

The use of either living wage method to identify a price-value gap might be viewed skeptically since each uses estimates of need and family composition, which appear irrelevant to the economic value of a particular worker's effort.[72] However, tax law rules routinely demand and resolve similarly complicated valuation issues by constructing and comparing counterfactuals.[73] In this case, when workers are exploited, the price paid for labor falls outside of the legal definition of fair market value. Living wage analyses provide governments with a very conservative counterfactual amount that workers would, on average, be expected to demand were they not exploited.[74] As in any case involving the setting and adjusting of prices and values for tax purposes, taxpayers may propose alternative counterfactuals supported by contemporaneous documentation, as required under the arm's length pricing standard.[75]

Both the Anker and Asia Wage Floor methods reveal that prevailing wages paid to workers in many industries in low-income countries fall significantly short of living wages. For instance, using the Anker methodology, the Global Living Wage Coalition found that the

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http://www.fairlabor.org/sites/default/files/documents/reports/toward_fair_compensation_in_global_supply_chains_2016_report_only_0.pdf.

72. What inputs determine worker productivity is of course a vast subject. For an introductory overview, see, for example, Margaret McMillan & Dani Rodrik, *Globalization, Structural Change and Productivity Growth*, *in* Making Globalization Socially Sustainable (Mark Bacchetta & Marion Jansen eds., 2011).

73. The costs associated with administering a transfer pricing regime are high for this reason. Transfer pricing disputes make up the bulk of the caseload for international tax agencies under tax treaties, which has prompted increasing calls for more efficient dispute resolution mechanisms. For an explanation, see Christians, *supra* note 4. These difficulties are endemic to the problem of allocating income among competing jurisdictions. The addition of a labor exploitation adjustment would therefore produce no unduly burdensome addition to the existing administrative challenge of transfer pricing but would potentially create an additional point of contention in an otherwise crowded field.

74. Both methods emphasize their conservative assumptions, transparent methodologies, and detailed documentation to ensure credible estimations. *See, e.g.*, Merk, *supra* note 69.

75. *See, e.g.*, *OECD Transfer Pricing Guidelines*, *supra* note 16, at 231–38.

living wage is 24% higher than prevailing wages of workers in the seafood processing industry in rural Vietnam,[76] 34% higher than the prevailing wages of garment workers in urban Vietnam,[77] and 45% higher than the prevailing wages of sports ball stitchers in urban Sialkot, Pakistan.[78] In Dhaka, the capital and largest city of Bangladesh, the living wage for garment workers is calculated to be twice as high as prevailing wages, which place most of these workers at less than the World Bank poverty line.[79] Similarly, in the flower industry in Ethiopia, the living wage was estimated to be as much as three times higher than prevailing wages, which were close to the World Bank extreme poverty line.[80]

These observations are confirmed in more general assessments of labor conditions in low-income countries, some of which have led the United States to impose anti-dumping rules on the premise that using exploited labor distorts the price of imports and creates an unfair advantage in trade terms.[81] In contrast to anti-dumping duties, using arm's

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76. Research Ctr. for Emp't Relations, *Living Wage Report: Rural Vietnam* 44 (Global Living Wage Coal. 2017), https://www.isealalliance.org/sites/default/files/resource/2017-12/Rural_Vietnam_Living_Wage_Benchmark_Report.pdf.

77. Research Ctr. for Emp't Relations, *Living Wage Report: Urban Vietnam* 55 (Global Living Wage Coal. 2016), https://www.isealalliance.org/sites/default/files/resource/2017-12/Urban_Vietnam_Living_Wage_Benchmark_Report.pdf.

78. Asad Sayeed & Dawani Kabeer, *Living Wage Report: Urban and Rural Pakistan* 33 (Global Living Wage Coal. 2017), https://www.isealalliance.org/sites/default/files/resource/2017-12/Pakistan_Living_Wage_Benchmark_Report.pdf. The Global Living Wage Coalition identifies some of the largest wage gaps as being in Bangladesh and Ethiopia. *See infra* notes 79–80 and accompanying text.

79. M.E. Khan et al., *Living Wage Report: Dhaka, Bangladesh and Satellite Cities* 45 (Global Living Wage Coal. 2016), https://www.isealalliance.org/sites/default/files/resource/2017-12/Dhaka_Living_Wage_Benchmark_Report.pdf; *Toward Fair Compensation in Global Supply Chains*, *supra* note 71, at 26–30.

80. Ayelech (Ayu) Tiruwha Melese, *Living Wage Report: Non-Metropolitan Urban Ethiopia* 43–44 (Global Living Wage Coal. 2015), https://www.isealalliance.org/sites/default/files/resource/2017-12/Ethiopia_Living_Wage_Benchmark_Report.pdf.

81. See, for example, the decision of President Barack Obama to withdraw benefits under the Generalized System of Preferences for Bangladesh due to serious violations of internationally recognized workers' rights,

length adjustments as proposed herein would result in more profits allocated to, and therefore more taxes potentially being paid to, the government of the country in which the exploitation is taking place. The outcome of either tax is equivalent in the case of a multinational group, in that either tax brings the final price of goods produced under exploitative conditions closer to that of those produced under non-exploitative conditions. However, a transfer pricing adjustment would adhere to the principle of taxing income where value is created, while an adjustment achieved through anti-dumping duties does not.

Measurable gaps between prevailing wages and living wages provide objective comparable data about the labor prices that would arise in a market not distorted by systemic exploitation. Where application of such measurements demonstrates that workers are exploited, the exploitation is embedded as a discount in the price of the good produced thereby.[82] The living wage analysis thus provides information useful for

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particularly in the areas of freedom of association and acceptable conditions of work. *See Standing Up for Workers: Ensuring that the Benefits of Trade are Broadly-Shared*, Off. U.S. Trade Representative (Sept. 2014), https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2014/September/Standing-Up-for-Workers-Ensuring-that-the-Benefits-of-Trade-are-Broadly-Shared. The United States imposes duties on imported goods the U.S. Department of Commerce determines are being "dumped"—that is, sold at less than fair value into the United States and the U.S. International Trade Commission finds material injury or threat thereof to domestic producers. *See* Tariff Act of 1930, Pub. L. No. 71-361, 46 Stat. 590 (codified at 19 U.S.C. § 1654 *et seq.*) (amended over many years; see 1994 Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4809 (codified at 19 U.S.C. §§ 3501, 3511–3556, 3571–3572, 3581–3592, 3601–3624); Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (codified at 19 U.S.C. § 2901 *et seq.*); Trade and Tariff Act of 1984, Pub. L. No. 98-573, 98 Stat. 2948 (codified at 19 U.S.C. § 1654 *et seq.*); Trade Agreements Act of l979, Pub. L. No. 96-39, 93 Stat. 144 (codified at 19 U.S.C. §§ 2501–2581)).

82. Having identified a valuation error in a cross-border transaction, source comes into focus because it queries which country has the primary right to tax the income thereby produced. Questions of source ostensibly query which economic factors produced a particular value. While there are good arguments that the concept of source is incoherent, the ubiquity of the theory in income tax systems merits at least a minimal analysis. See, for example, Lawrence Lokken, *What Is This Thing Called Source?*, Int'l Tax J., May–June 2011, at 21, 53. What is the economic source of an externalized cost?

calculating an appropriate adjustment to stated prices in transfers among multinational groups, as discussed in the next Part.[83]

III. Adjusting Prices for Exploitation

When market prices fail to reflect the fair market value of labor due to exploitation, measuring the difference between non-exploitative and exploitative market prices for tax purposes becomes both necessary and appropriate in order to fulfill the principle that income should be taxed where value is created. As a point of departure for further development and expansion of the conceptual idea, this Part examines how a tax authority would apply a living wage measurement to a documented example of exploitation.

A. Case Study: Unilever

Identifying the need for an exploitation adjustment to ensure income is taxed where value is created involves a number of steps. First, the stated prices of the transfer of a relevant service or good must be identified. Second, it is necessary to determine how much of the price is attributable to the labor that went in to producing the good or service, as well as the amount that should have been attributed to labor had workers not

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There does not seem to be a ready precedent. It seems that the inequality among nations is what causes some to be incapable of protecting against human rights violations while others continuously benefit from the exploitation thus produced, so that the international system of states as a whole might be the economic source of systemic exploitation. This does not lend itself to applicability in assigning income for tax purposes. It is at least clear, however, that the source of services is routinely identified as the jurisdiction in which the services are provided. See, for example, I.R.C. § 861 and the regulations thereunder. It might therefore not be a great leap to conclude that the income derived from undercompensated transfers of the product of labor is in the same category as compensated labor, at least in terms of the economic value created. Accordingly, basic source principles (such as they may be) appear to be respected if transfer pricing methodologies allocate income to the country where exploitation occurs.

83. The causes and perpetrators of exploitation are irrelevant to this analysis, since the only goal is to properly allocate income by adjusting prices where exploitation is identified.

been exploited, such that other parties to transactions with them are receiving uncompensated value as a part of the exchange.[84] Where these two numbers differ, a price-value gap is revealed. The existence of a price-value gap demonstrates when profits allocated according to price do not accord with the principle that income should be taxed where value is created, thus providing the legal rationale for a reallocation of profit according to the arm's length standard.

An example using the Asia Wage Floor method and drawing from independent analysis of actual conditions is illustrative.[85] For purposes of this study we have chosen Unilever, a British-based multinational company that is listed on the New York Stock Exchange and has operations in multiple countries.[86] Unilever provides an appropriate case study because it has committed to sustainable growth, including

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84. If it is determined that goods are being produced by exploited labor (as described above), then the price of any good or service could theoretically be tested for signs of exploitation, even where the transaction is between wholly unrelated parties. This would be consistent, for example, with apportionment of value through the supply chain regardless of affiliation, such as was recently suggested by David Quentin, *Corporate Tax Reform and "Value Creation": Towards Unfettered Diagonal Re-allocation Across the Global Inequality Chain*, 7 Acc. Econ. & L, no. 1, 2017, at 1. The implications of this observation are beyond the scope of the present discussion, which confines itself to the allocation of profit in affiliated groups.

85. It should be noted that the chosen example risks being dismissed as a non-generalizable case in that it involves manufactured goods, which form a small part of global commerce and trade. The authors hope that the inquiry may be expanded in the future with other examples, thus incrementally expanding the range of application of transfer pricing rules to cover as many market distortions as necessary to ensure that income is taxed where value is created under all circumstances, or, if that is not possible, until lawmakers are willing to acknowledge that transfer pricing regimes cannot achieve this aim such that a more appropriate regime must be fashioned instead.

86. Unilever, https://www.unilever.com/ (last visited Oct. 7. 2018). The use of a case is appropriate to explore this area and support the proposal because the regime to which the proposal would apply is one that involves in-depth analysis of all relevant facts and circumstances on a case-by-case basis. As such, a template for analysis based on a given set of inquiries that may be applied across other cases is appropriate to the task. *See* Allison Christians, *Case Study Research and International Tax Theory*, 55 St. Louis U. L.J. 331 (2011).

"respecting and promoting human rights and good labour practices,"[87] as part of its Code of Business Principles.[88] The company also has a corporate statement of values on taxation that indicates its support for the OECD's work on BEPS and its intent to comply with "not only the letter of the law but also the underlying tax policy intent" in every country in which it does business.[89] Further, following concerns about the treatment of workers in its global supply chain, the company agreed to work with Oxfam to undertake a study on these issues.[90]

Using the available information from this study and other sources, we construct a template for reallocating profits when companies underpay workers relative to what they would accept if they were not forced by exploitative conditions to work for less than required to sustain their lives. This template extrapolates from the available data but necessarily makes simplifying assumptions in order to describe the potential tax implications of what Oxfam discovered in studying Unilever's operations. The actual tax implications of Unilever's operations are not available for study but would presumably be available to all the relevant countries in which Unilever does business.[91]

Unilever, headquartered in Britain, a high-income country, owns Unilever Vietnam (UNV), a subsidiary, which operates manufacturing

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87. *Unilever Sustainable Living Plan: Progress Report 2012*, Unilever 47 (2012), https://www.unilever.com/Images/uslp-progress-report-2012-fi_tcm244-409862_en.pdf.

88. *Advancing Human Rights in Our Own Operations*, Unilever, https://www.unilever.com/sustainable-living/enhancing-livelihoods/fairness-in-the-workplace/advancing-human-rights-in-our-own-operations/ (last visited Oct. 7, 2018); *Unilever's Human Rights Policy Statement*, Unilever, https://www.unilever.com/Images/unilever-human-rights-policy-statement_tcm244-422954_en.pdf (last visited Oct. 7, 2018).

89. *Tax*, Unilever, https://www.unilever.com/sustainable-living/what-matters-to-you/tax.html (last visited Oct. 7, 2018).

90. *See* Oxfam, Labour Rights in Unilever's Supply Chain: From Compliance Towards Good Practice (2013), https://www.unilever.com/Images/rr-unilever-supply-chain-labour-rights-vietnam-310113-en_tcm244-409769_en.pdf.

91. The purpose of this discussion is not to claim anything about the amount of tax that Unilever actually paid or should pay to any one country. Instead, it is to demonstrate how a country could adjust prices consistent with arm's length pricing methods in circumstances that involve workers trading their labor for less than its fair market value.

facilities in several regions and cities.[92] Vietnam is a "lower-middle income" country according to the World Bank.[93] Drawing from the Oxfam study and simplifying Unilever's supply chain substantially in order to isolate the relevant profits to be allocated, we focus on garments produced by UNV to be sold to Unilever, which we assume sells the garments in Britain and other high-income market countries.[94]

All wages in Unilever owned factories are above the applicable legal minimum wage as well as the international poverty line of $2 per day, but they are below the Asia Wage Floor as well as an Oxfam analysis of living wages in the region.[95] A 2012 study claims that the legal minimum wage, initially established in 1993, meets just 40–46% of workers' basic needs.[96] The average wages of the lowest-wage garment workers in Unilever's factory average 1.99m VND per month, which

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92. *See* Oxfam, *supra* note 90, at 21 (showing a map of operations studied and providing the study methodology).

93. *The World Bank in Vietnam*, World Bank, http://www.worldbank.org/en/country/vietnam (last visited Oct. 7, 2018).

94. In reality, UNV and other Unilever subsidiaries produce a variety of items, including personal care products, household cleaners, garments, and footwear. *See* Oxfam, *supra* note 90, at 32. The example given is, of course, a very simplified one that ignores common structural elements of multinationals, including the presence of intermediate entities and arrangements. For example, Unilever has 171,000 employees worldwide, multiple partnerships and subsidiaries, and manages its supply chain through a global buying center in Singapore, which in turn manages strategic sourcing in Asia, Africa, Central, and Eastern Europe. Oxfam, *supra* note 90, at 31. The complex structure of most multinationals, including Unilever, necessitates additional measurements and calculations of the kind that currently imposes tremendous pressure on lower-income countries. The OECD has committed to assist lower-income countries in implementing its revised transfer pricing guidelines following their accession to the BEPS platform via the Inclusive Framework. See Allison Christians & Laurens van Apeldoorn, *The OECD Inclusive Framework*, 72 Bull. for Int'l Tax'n 226 (2018). It remains to be seen whether the assistance offered will enable source countries to effectively implement transfer pricing. In any event, the addition of an exploitation adjustment to allocate more income to source countries, while potentially contributing to an already crowded field of complexity, should be seen as a valid and appropriate step.

95. Oxfam, *supra* note 90, at 9.

96. *Id.* at 34, 100 n.49 (citing *Hard Life for Labourers on Minimum Wage* (translated), Lao Dong (Dec.11, 2012), http://laodong.com.vn/Cong-doan/Nguoi-lao-dongsong-lay-lat-voi-muc-luong-toi-thieu/91341.bld).

would currently amount to approximately U.S. $88 per month, or $0.46 per hour assuming a 48-hour work week (8 hours per day, 6 days a week).[97] The average earned by all workers in Unilever factories is 3.7m VND, or approximately U.S. $163 per month, or $0.85 per hour.[98]

B. Application

The first question relevant to a transfer pricing adjustment is whether 46 to 85 cents per hour would constitute a living wage for workers in Vietnam. The Oxfam study provides a number of signs indicating that it would not. Among other indicators, the company has been the subject of multiple complaints under the OECD Guidelines for Multinational Companies on grounds that workers receive unfair treatment and have no role or rights in wage setting,[99] and it was the subject of over 900 wildcat strikes in one year alone.[100] The International Labor Organization observes that excessive working hours such as those observed in Unilever's structure can tip over into forced labor as workers face little choice but to meet employer demands.[101]

These descriptions suggest that Unilever's workers would command more for their labor were they not prevented from doing so because of the pervasive exploitative conditions in which they find themselves. Further evidence that workers are systematically underpaid for their labor is drawn from analysis under the Asia Wage Floor, which reveals that on average, a living wage for Vietnamese workers would

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97. 4 weeks (average) × 48 hours = 192 hours per month; $88/192 hours = $0.46 per hour. We conservatively assume that the monthly salary is based on 48 hours per week because the Oxfam Study describes this as the legal limit, even though it acknowledges that overtime is common and one survey estimated that Vietnamese factory workers in general average 67 hours of work per week. Oxfam, *supra* note 90, at 39, 40. If we assumed the monthly salary applied to 67 hours instead (that is, that the monthly average includes overtime pay), the average hourly rate would be $0.33 per hour.

98. Oxfam, *supra* note 90, at 71.

99. *Id.* at 9, 59

100. *Id.* at 34.

101. *Id.* at 78 ("Although workers may in theory be able to refuse to work beyond normal working hours, their vulnerability means that in practice they may have no choice and are obliged to do so in order to earn the minimum wage or keep their jobs, or both.").

be 4.04m VND, or U.S. $177.89 per month.[102] The Asia Wage Floor presents a minimally acceptable compensation amount, yet this is more than twice the average received by the lowest-wage garment workers in Unilever factories, and it is significantly higher than the overall average earned by all workers in Unilever factories.[103]

Using the Asia Wage Floor as a counterfactual of what, on average, an unexploited worker would demand in exchange for labor provides an average hourly wage of U.S. $0.93 per hour.[104] This provides the taxing authority with evidence that the price of goods that are produced for an average of between 46 to 85 cents per hour, do not reflect fair market value. As such, the price of such goods transferred among related parties may be subject to adjustment under standard transfer pricing principles.

In order to demonstrate to all the relevant tax authorities that the price Unilever pays to its subsidiary for garments produced by UVN represents an arm's length price, Unilever will no doubt identify as a comparable the price of goods produced by independent companies, also located in Vietnam.[105] However, these prices are likely to be

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102. *Id.* at 34, 69. Oxfam also provided its own independent living wage analysis of 5.42 VND or U.S. $239 per month. *Id.* at 9, 34.

103. *Id.* at 71.

104. Using current exchange rates, 4.04 VND is approximately U.S. $177.89 per month, at 4 weeks (average) × 48 hours = 192 hours per month; $179.89/192 hours = $0.93.

105. See *OECD Transfer Pricing Guidelines*, *supra* note 16, at 101–04. A similar outcome may be achieved via other methods. The taxpayer is required to identify the most appropriate method to achieve a price reflecting fair market value. *Id.* at 97. It is not possible to discern what method companies actually use, owing to tax confidentiality. *See, e.g.*, Joshua Blank, *Reconsidering Corporate Tax Privacy*, 11 N.Y.U. J.L. & Bus. 31 (2014). The introduction of country-by-country (CbC) reporting will presumably provide states with information that would be useful in making assessments. For an explanation, see *OECD Transfer Pricing Guidelines*, *supra* note 16, 233–36. The core idea of CbC reporting is that multinational companies should disclose how much tax they pay in each country in which they operate, and that every country in which a multinational company operates should have equal access to the information of the multinational group. See OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13–2015 Final Report* (2015) (providing a template for multinational enterprises to prepare annual reports for each tax jurisdiction in which they do business in accordance with the OECD Country-by-Country (CbC) Report standard); for discussion, see

similar if not identical, since all relevant goods are presumably produced under the same exploitative conditions.[106] Without an analysis of how exploitation distorts the price of labor in the relevant market, the price of goods produced by UNV and sold to Unilever would likely compare to uncontrolled prices, thus necessitating no adjustment even though it is now clear that they do not reflect fair market value. To reflect fair market value by accounting for the distortion caused by exploitation, the tax authority should be able to adjust the prices at which UNV sells goods to Unilever.

C. Implications

Having identified that a given set of prices do not reflect fair market value and located a reliable method to ensure they reflect fair market value more closely, the next step is to apply the relevant transfer pricing rules. Following the *OECD Transfer Pricing Guidelines*, a price adjustment would be merited under the general requirement to adjust prices to reflect fair market value according to the economic circumstances of the parties and of the market in which the parties operate.[107] Similarly,

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Allison Christians, *BEPS and the New International Tax Order*, 2016 B.Y.U. L. Rev. 1603. The possibility that such reports may at some point be publicly disclosed, as called for by the European Commission and others, might facilitate a more complete analysis than is possible under the current paradigm. *See Public Country-by-Country Reporting*, Eur. Commission, https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/public-country-country-reporting_en (last visited Oct. 8. 2018) ("The Commission has also proposed a new directive that will require large multinational companies to publish country-by-country information on where they make their profits and where they pay tax.").

106. The Oxfam Study is instructive in this regard because in addition to studying Unilever's direct employment, it also studies employment practices of independent suppliers contracted by Unilever to provide labor. The analysis reveals that Unilever's direct employees are generally paid at a slightly higher rate than those employed by an independent labor contractor. Oxfam, *supra* note 90, at 11. However, of three independent labor suppliers studied, Oxfam notes that one of the three generally paid a higher price than the others, and for no reason discernible to the researchers (that is, the researchers could find no reason for the persistent discrepancy in wages).

107. *OECD Transfer Pricing Guidelines*, *supra* note 16, at 45. The *OECD Transfer Pricing Guidelines* do not provide additional details regarding

following the U.S. transfer pricing regulations, a price adjustment would be merited to account for the vastly different size and level of development of the country of the subsidiary (Vietnam in this example) and that of the parent company (Britain in this example), or for the economic condition of the particular industry, which in this case is constructed on a base of labor exploitation.[108]

The Guidelines do not provide additional details regarding these kinds of circumstances or the modes for adjustment they necessitate. As discussed above, they require taxpayers to set prices among their controlled affiliates in accordance with the arm's length standard and provide contemporaneous documentation to support their positions.[109] Tax authorities, in turn, require legal authority to adjust prices, and such authority is generally broadly permitted to more clearly reflect fair market value.[110] The application of a labor-based exploitation adjustment to

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these kinds of circumstances or the modes for adjustment they necessitate. As discussed above, they require taxpayers to set prices among their controlled affiliates in accordance with the arm's length standard and to provide contemporaneous documentation to support their positions; tax authorities, in turn, require legal authority to adjust prices, and such authority is generally broadly permitted to more clearly reflect fair market value. *See, e.g.*, I.R.C. § 482. The application of an exploitation-based adjustment would therefore be a matter of the tax authority's application of the Guidelines or relevant domestic rules. The taxpayer would be entitled to object to the adjustment and engage in internal appeals as well as, where applicable, instigate a mutual agreement procedure under an applicable tax treaty. *See, e.g.*, OECD, Model Tax Convention on Income and on Capital: Condensed Version, arts. 9 & 25, Nov. 21, 2017; *see also* Christians, *supra* note 4 (detailing the procedures by which taxpayers may appeal tax assessments under domestic law and tax treaties). Perhaps more controversially, an exploitation-based adjustment could be part of an overall "location specific advantage" position. *See, e.g.*, Jinyan Li & Stephen Ji, *Location-Specific Advantages: A Rising Disruptive Factor in Transfer Pricing,* 71 Bull. for Int'l Tax 259 (2017). Because this position raises additional complexity and may increase the potential for contestation in competent authority terms, we leave this important analysis aside to focus on the core comparability analysis.

108. Reg. § 1.482–1(d)(3)(iv).

109. *OECD Transfer Pricing Guidelines*, *supra* note 16, at 97–101, 229–33.

110. *See, e.g.*, I.R.C. § 482 ("In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled

the cost of products sold from a controlled subsidiary to its parent would therefore be a matter of the tax authority's application of the relevant domestic rules.[111] The taxpayer would of course be entitled to object to the adjustment and engage in internal appeals as well as, where applicable, instigate a mutual agreement procedure under an applicable tax treaty.[112]

Under its transfer pricing regime, the revenue agency could increase the price of goods sold to the parent company (here Unilever) by as much as half a dollar per labor hour embedded in the otherwise market-consistent garment price. It might do so by calculating an amount attributable to labor hours, based on the difference between the Asia Wage Floor and the actual wages paid, and applying this amount to the stated price of goods sold to the parent company.[113] Following the observations noted in the Oxfam-Unilever study, this would entail adjusting the transfer price of goods by a factor of between 8 and 47 cents per labor hour.

It is important to emphasize that this adjustment does not force Unilever to pay UNV the difference in price thus calculated by the transfer price adjustment. Rather, the result is that the subsidiary is deemed for tax purposes to have received a higher price than it actually received, and accordingly its profit attributable to Vietnamese operations will rise for tax purposes, while a corresponding adjustment at the parent level will reduce the profit elsewhere, such as in the parent company's

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directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.").

111. The price to be adjusted would be the cost of the product sold between the related parties, which would in this case increase for tax purposes in order to reflect the higher embedded cost of labor assigned to the selling subsidiary.

112. *See, e.g.*, OECD Model Tax Convention, *supra* note 107; *see also* Christians, *supra* note 4 (detailing the procedures by which taxpayers may appeal tax assessments under domestic law and tax treaties).

113. This requires sufficient information regarding the number of employees and number of hours to produce a given amount of goods in the local subsidiary. As discussed *supra* note 105, this information is not available to the public but should be available to relevant tax authorities.

country of residence (Britain in this case) for tax purposes.[114] The outcome is not a change in the price of goods but a geographic reallocation of the profit therefrom for tax purposes, which is the point and purpose of the transfer pricing rules.[115]

The transfer price adjustment accordingly better reflects the true nature of the transaction among the parent and subsidiary companies by accurately measuring income and assigning it to the correct party in accordance with where value was created. The adjustment might have significant consequences for the distribution of the profit as tax base to the countries in question. Whether the recipient country chooses to tax this base and at what rate is a matter for its legislators. But it seems clear that at a minimum, it would not be correct for the country of the parent company to tax this income, since it was not derived from value created by the parent company but by the workers in the subsidiary company.

Extrapolating from the example, it is likely that in most transactions involving exploited labor, the parent company will be resident in a wealthy, high-wage country or a wealthy intermediary country with high wages in the legal and finance sector, such as Britain and the United States, while production occurs in poorer, lower-wage countries like Vietnam.

Under the transfer pricing rules as currently implemented, the failure to account for exploitation ensures that more profit is allocated to high-income countries for no reason other than perhaps a reluctance to accept objective measures of exploitation. It may be viscerally difficult

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114. A corresponding adjustment is called for in the 2017 Transfer Pricing Guidelines as well as in most tax treaties, following the OECD model tax convention. *See* OECD Model Tax Convention, *supra* note 107 (calling for countries to allocate income of affiliated entities as if at arm's length and for competent authorities to make pricing adjustments and resolve disputes where appropriate); *OECD Transfer Pricing Guidelines*, *supra* note 16, at 108–98; *see also* OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14–2015 Report* (2015).

115. A parent company might be expected to adjust its payments to ensure its subsidiary's ability to pay the higher tax bill associated with having a higher profit. An objection to this outcome could be that multinationals would effectively be forced into paying higher prices for goods than competitors in the country that are not members of a multinational group. The resulting pressure would incentivize companies to outsource their labor or fragment their supply chain. Since the object of the present inquiry asks how to tax income where value is created, these incentive effects would not change the analysis.

to accept that the living wage measurement reveals a gap between what individuals would command were they not exploited and what they command in the global order as conceived, built, and managed by the world's wealthiest countries. Yet, as the Unilever case demonstrates, it is not conceptually or legally difficult to incorporate the principle into the existing paradigm.

Conclusion

In a world in which highly profitable companies can increasingly divert their profits to favorable tax jurisdictions instead of to the places where their value is created, governments are constantly working on ways to protect their tax bases. Most of the member countries of the OECD have devised increasingly sophisticated base protecting rules and regimes to reallocate income when it has been inappropriately assigned away. But lower-income countries have struggled to claim an appropriate share of global profits despite making key value contributions. This Article proposed an approach that is innovative yet abides by accepted legal foundations.

The core argument is that when workers are compelled to trade their labor for less than a living wage, resulting market prices may not reflect fair market value, giving rise to the need to make transfer pricing adjustments. This leads to a proposed application of living wage methodology that would more accurately identify fair market value of transactions in markets where labor is systematically exploited. Using the case of Unilever, a company that has expressly articulated its commitment to paying taxes where value is created, the proposal is demonstrated to be conceptually coherent, viable in practical terms, and appropriate in both legal and normative terms.

What remains is to implement the appropriate adjustment and continue to explore other sources of inaccurate assessments and assignments of value. If accepted in principle, the proposed approach could be expanded beyond wages to consider other areas in which prices do not align with value creation. Ultimately this could provide a more detailed template to allocate multinational revenues for tax purposes in a way that does not inappropriately benefit richer countries at the expense of poorer ones. This should be a global project, in line with the principle that income should be taxed where value is created.