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Fairness and Tax Systems: A Rawlsian Approach to Addressing the Challenges Transfer Pricing  
Presents to the Fairness of Tax Systems

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## Abstract

### Fairness and Tax Systems: A Rawlsian Approach to Addressing the Challenges Transfer Pricing Presents to the Fairness of Tax Systems

By Luis Torres Jr.

This paper aims to provide unique insights when addressing the challenges that transfer pricing presents to the fairness of tax systems. The position taken in this paper is one predicated on John Rawls' principles of justice. It will be argued that the current tax system's reliance on the ambiguous definition of the "Arm's Length" standard and its use of market forces to allocate income are the reasons that transfer pricing practices undermine the fairness of tax systems, particularly by harming the least-advantaged in society. Through an application of the Rawls' principles of justice, it will be shown that Rawls' conception of a fair tax system would not rely solely on the "Arm's Length" standard but would employ the difference principle as a non-market criterion to specify permissible and impermissible transactions in the economy. But since the difference principle is a hypothetical tool that functions only in Rawls' just society, it will be argued that tax systems need to develop policy that functions as a non-market criterion if they are to adequately weigh the social consequences of market allocations. Ultimately, by deliberately working at the intersections of philosophy and economics, theory and practice, ethics and business, this thesis intends to provide meaningful insights for establishing fairer tax systems.

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“Malakalikumaya”

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## Preface

I would like to make a note on the direction that Rawls is taking us in our search for fairer tax systems. He is taking us on a path that many have criticized as unrealistic, unfeasible, impractical, and so on. Indeed, it is no easy task to advance a concept of justice as demanding and abstract as Rawls', and it is for this reason that it is rarely ever taken into serious consideration outside of academia. Freeman, the author of *Rawls*, says that the influence of Rawlsian theory in contemporary thinking outside of academia "is nil," and that "this is to be expected given the nature of his work" (*Rawls*, 457).

Does this, then, mean that Rawlsian theory has nothing to offer real-world business practices and tax systems? I don't think that this is the case. I believe that even abstract theories provide meaningful insights that can have application in the real world. For this reason, we should consider carefully justice as fairness and give to it the reflection it merits. Dismissing it as irrelevant, even for a business practice like transfer pricing, would surely be a disservice to Rawls' life's work and more generally to the philosophical tradition of seeking justice.

I'm often asked, why John Rawls? Rawls not only sought to establish a well-ordered society that was both liberal and democratic, but he sought to establish a just economic system that prioritized the least-advantaged in society. This last point was of particular importance for me. I've always thought the last, the least, and the lost of society should not be forgotten, for at times, my family and I were among these.

Rawls' definition of justice not only ensured that the least weren't forgotten, but it ensured that they were prioritized by raising the social minimum as high as it can go in society. When I first heard this, I thought it was a novel and brilliant way to establish fairness, and it

commanded my interest to learn more about Rawls' principles of justice. Then, I found that the more I became familiar with them, the more relevant they became for me.

Lastly, the purpose of this thesis is not to solve the problems that are found in tax systems, nor is it to advance my own conception of justice. Rather, it is to advance Rawls' conception of justice and to apply his principles of justice to tax systems. Perhaps, by gaining a better awareness of "the ideal," we can slowly make our way towards it.

### Justice as Fairness and its Three Principles

Before discussing the challenges that transfer pricing presents to establishing and maintaining the fairness of tax systems, we must first gain a sense of what fairness is. Surely, there is no one fixed definition for fairness. But for our purposes, it will serve us well to derive our definition from John Rawls' conception of justice as fairness. John Rawls was an ethicist of the 20<sup>th</sup> century whose work is considered deeply influential in contemporary moral and political theory. In his seminal work, *A Theory of Justice*, Rawls follows in the steps of Hobbes, Locke, and Rousseau in using social contract theory to advance his conception of a just society. In social contract theory, a person's moral and political obligations are dependent upon a contract or agreement they make with the society in which they live. Rawls believed that such a contract or agreement was capable of forming the well-ordered society he so eagerly sought, which is why he dedicated his life's work to it.

In Rawls' version of the social contract, an imaginary "veil of ignorance" comes over the individuals of a society so that they are ignorant of their personal circumstances, such as their race, class, age, gender, etc. Then, while under this veil, those same individuals agree upon the principles that are to govern their society. The beauty of reaching an agreement under the veil of ignorance is that individuals cannot reason from personal circumstance, allowing for fair principles to be chosen and a just, well-ordered society to be formed.

In his theory, Rawls argues that the following three principles would be agreed upon under the veil of ignorance: the liberty principle, the equal opportunity principle, and the difference principle, respectively. (The last two principles are derived from one single principle and form a part (a) and a part (b) of that principle, but for the sake of simplicity we will disregard this as a verbal difference and ignore it moving forward.) These principles are highly complex,

but I believe that wrestling with them and familiarizing ourselves with them will profit us greatly when seeking fairness in tax systems. As we make our way through each principle, I challenge you to think critically about what insights and implications they might offer for our discussion. Doing so will serve us well later when we attempt some application of Rawls' conception of justice.

The first, the liberty principle, maintains that "each person is to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others" (*A Theory of Justice*, 53 rev.). Rawls considers this to be the most important principle, which is why he gives it lexical priority. Lexical priority "is a special kind of moral importance that does not permit trade-offs" (Machin, 508). By giving liberty lexical priority over the other ideals, Rawls maintains the rights of citizens even over the general welfare of the state.

This last point is significant because when Rawls released *A Theory of Justice* in the early 70's, his liberal ideals came into stark contrast with the political philosophy that had dominated American politics up to that point—utilitarianism, which prioritizes the "greater good" over the conditions of the individual. Rawls' conception of justice and its emphasis on basic individual rights pushed back on utilitarianism and breathed life into a movement known as rights-oriented liberalism.<sup>1</sup> Rather than seeking to maximize the common good of society even at the cost of forgoing the rights of some, as is permissible in utilitarianism, rights-oriented liberalism maintains that "certain individual rights 'trump' or outweigh, considerations of the common good" (*Political Liberalism: A Review*, 1766). It can therefore be said that Rawls' first principle prioritizes *the right over the good* and that it serves as an important basis of his liberal conception of justice.

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<sup>1</sup> Sandel, Michael J. "Political Liberalism." *Harvard Law Review*, 1994.

As for the second principle, the equal opportunity principle, it states that “social and economic inequalities are to be arranged so that they are attached to.... positions and offices open to all” (*A Theory of Justice*, 53 rev.). To understand what this means, we must first clarify that Rawls is not strictly against inequality. In fact, he permits certain inequalities in his well-ordered society, but only if they follow from the principles agreed on. So, to establish equal opportunity while also allowing for certain inequalities, Rawls incorporates his concept of *fair opportunity of equality* (FEO) into the second principle. FEO requires that in “all parts of society there are to be roughly the same prospects of culture and achievement for those similarly motivated and endowed” (*Justice as Fairness*, 44). This way, as long as positions and offices are given on the basis of an individual’s motivation and endowment, the resulting inequalities are permissible.

But FEO functions beyond simply rewarding talent. It serves as a means of preventing inequalities that result from arbitrary criteria, like an individual’s sex, race, gender, social status, religion, and so on. Rawls acknowledges that arbitrary criteria are often used to determine who in society should have access to positions and offices, resulting in egregious, unjust inequalities. These inequalities are proof that “institutions.... favor certain starting places over others” and are “an affront to one’s dignity as an equal person and citizen” (*A Theory of Justice*, 7 rev. and *Rawls*, 91). By implementing FEO, Rawls ensures that this is not the case for his just society and that the prospect of equal opportunity can be realized by all.

Establishing the equal opportunity principle alone is not satisfactory for Rawls if inequalities are to exist. His third and final principle, the difference principle, holds that social and economic inequalities “are to be to the greatest benefit of the least-advantaged members of society” (*Justice as Fairness*, 42). The difference principle, strictly speaking, is a maximizing

principle that raises the *expectations* of the *least-advantaged* as high as it can go in society. By expectations, Rawls means *expectations of primary goods*. Rawls uses the term primary goods throughout his work since “one’s share of income and wealth generally corresponds also with one’s share of the primary goods of powers, positions of authority, and bases of self-respect” (*Rawls*, 106). It logically follows, then, that the least-advantaged members of society are those who have the lowest share of primary goods. Moreover, we “we can regard the least advantaged to be the economically least advantaged people in a society—i.e., the poorest people” (*Rawls*, 106).

Rawls’ employment of the difference principle is unique in that he doesn’t seek to maximize the overall amount of expectation with it. Rather, his method of distribution is an attempt to achieve *democratic equality*—a special kind of societal equality that is achieved by employing both the equal opportunity principle and the difference principle. To understand what is meant by this, we should make use of figure 1—Rawls uses a similar graph in *A Theory of Justice* to give a thorough explanation of the difference principle and democratic equality. (I should note that I will be giving a “watered-down” version of Rawls’ original explanation of the difference principle. If you want to read the original, more extensive account, you can find it starting on page 65 of *A Theory of Justice*, revised.)

In figure 1, let  $x_1$  represent the most favored group in society—that is the group with the largest share of primary goods—and let  $x_2$  represent their less fortunate counterpart, the least advantaged group in society. Now, let the curve, OP, represent an efficient distribution of expectations, meaning that output is optimized given the shares held by both  $x_1$  and  $x_2$  at any point along the curve. The importance of the OP curve is that it theoretically illustrates the economic relationship between the most favored and the least-advantaged in society. (Note that

“it is against a background of market allocations of factors of production that Rawls assumes that the difference principle will work best to advance the position of the worst-off within a market economy” (Rawls, 100).

Notice on the OP curve that as  $x_1$ 's expectations rise so do  $x_2$ 's, all the way up to point b. Rawls tells us that the curve rises upwards initially because it is assumed that social cooperation between the most favored and the least-advantaged is mutually advantageous. Notice, too, that at every point after point O,  $x_1$ 's expectations are always greater than  $x_2$ 's—they are favorable for  $x_1$  in the sense that  $x_1$  always receives a larger contribution of expectations than  $x_2$ . This makes sense since  $x_1$  represents the most favored group in society. As for point O, we can interpret it as a starting place where there is a perfectly equal distribution of expectations between the two groups. It is not to be confused with a point 0 where no one has anything.<sup>2</sup>

Rawls believed that the difference principle is satisfied at point b for the following reasons: at point b, any further contribution to  $x_1$ 's expectations would result in a negative contribution to  $x_2$ 's expectations; and similarly, any reduction to  $x_1$ 's expectations would also result in a negative contribution to  $x_2$ 's expectations. Point b, effectively, maximizes the expectation of  $x_2$ . Therefore, it can be said that it is the only point along the OP curve where

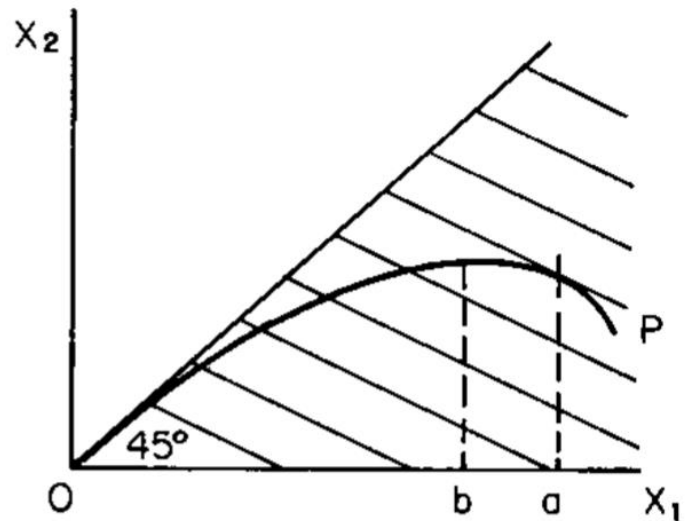


Figure 1

A recreation of the OP curve from *A Theory of Justice—Revised Edition* by John Rawls, p. 67, Cambridge, Mass. Belknap Press of Harvard University Press, 1971.

<sup>2</sup> Freeman. *Rawls*. Taylor & Francis Group, 2007.

inequalities in expectation are to the greatest benefit of the least-advantaged, as mandated by the difference principle. And assuming that point b is reached under the requirements of FEO, it can also be said to fully satisfy democratic equality.

As you may have noticed, Rawls uses concepts and methods that are similar but not identical with those seen in economics. The most important difference is that economists use concepts such as Pareto efficiency to talk about a distribution of *goods* while Rawls uses the difference principle to talk about a distribution of *expectations*. That isn't to say Rawls is wrong in his methods or that he disregards the importance of economic principles; just that his usage is a little different from what you might be familiar with. But this should come as no surprise since Rawls was more concerned with establishing a just distribution of primary goods than he was with maximizing efficiency and/or utility.<sup>3</sup>

The difference between seeking justice and maximizing utility is worth expanding on since utilitarianism was the dominant ideology in American politics when Rawls first published his work on the difference principle. To begin, if figure 1 were shown to a classic utilitarian, then they would surely tell you that the optimal point on the OP curve is point a. The shares of expectations at point a are greater than the shares given at any other point, including point b. Point a is “the point at which overall wealth and income (and economic utility too) in society are maximized; it is then ‘efficient,’ in the Kaldor–Hicks sense idealized by utilitarian economists” (*Rawls*, 110).

But point a, however “efficient” it is, allows for inequalities that Rawls considers impermissible. He argues that any contribution towards  $x_1$  that does not also increase the expectations of  $x_2$  is unjust since it does not express priority for the least-advantaged. Rawls

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<sup>3</sup> Brown, Eleanor P. Green, Michael. “Rawls’s Difference Principle.” *Pomona College*, 2010.



seems to be pointing this out as a flaw in utilitarianism when he says, “since the difference principle selects the point b and b is always to the left of a, utilitarianism allows, other things equal, larger inequalities” (*A Theory of Justice*, 67 rev.). It is clear that Rawls judges his scheme superior by considering the *social consequences* that follow from both schemes, with one having larger inequalities and less of a priority for the poor in society than the other. This will be important for our discussion in tax systems since we will encounter situations where taking into consideration the social consequences, particularly consequences faced by the least-advantaged, will help us to determine what fairness might look like.

I hope you are beginning to understand why the difference principle is, strictly speaking, a maximizing principle—its purpose is satisfied in raising the social minimum as high as it can go. It is a way of ensuring that all citizens consider their standard of living acceptable, regardless of their income and wealth. Assuming that the other two principles are also maintained, the difference principle allows for a liberal and democratic system to establish and secure the more attractive prospects of those better off while also protecting the prospects of those less fortunate—this is, for Rawls, justice as fairness. There is much more to be said on Rawls’ three principles of justice, but for the sake of time and space, we must move forward and begin developing our understanding of transfer pricing. Only after doing so will we be positioned to implement the rich insights provided in this section when seeking fairness in tax systems.

### What Is Transfer Pricing?

Understanding transfer pricing requires that we first learn about multinational corporations (MNCs) and their trade structures. MNCs operate on a global scale and must constantly facilitate cross-border trade between their subsidiaries (these are related companies

working under the same MNC). So, unlike inter-company trade between unrelated parties, MNCs engage in intra-company trade between their related subsidiaries. MNCs have scaled the economy so effectively that 60% of all trade in the world is intra-company trade.<sup>4</sup>

Transfer pricing is the accounting practice that determines the transfer price at which goods and services are traded between subsidiaries of an MNC.<sup>5</sup> Although useful for various purposes, transfer pricing is best known in the business world for its tax benefits. This is because the transfer price determines to which subsidiaries taxable income is allocated, with some subsidiaries being subject to lower tax rates than others. Using transfer pricing tactics, MNCs can lower tax liability by allocating their taxable income into subsidiaries with lower tax rates.

But MNCs cannot freely choose the transfer price as they wish. Countries have tax and transfer pricing regulations that they must adhere to, which constrains their behavior. The methods and procedures for arriving at the transfer price are largely dictated by the arm's length standard.<sup>6</sup> For example, in the U.S. tax law, section 482 of the Internal Revenue Code indicates that the "Arm's Length" standard works in the following way:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled

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<sup>4</sup> OECD. "OECD/G20 Inclusive Framework on BEPS." *OECD Publishing*, 2018.

<sup>5</sup> For an overview of transfer pricing, please see Part B1, UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries* UN, New York, 2017.

<sup>6</sup> Most developed nations utilize the OECD Transfer Pricing Guidelines as the basis for their transfer pricing regulations. OECD. "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017." *OECD Publishing*, 2017.

taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

Simply stated, transactions that occur between related parties (controlled taxpayers) must be comparable to transactions that occur between unrelated parties (uncontrolled taxpayers). In economics, market transactions that occur between unrelated parties are governed by market forces. So, if determined at arm's length, the transfer price should be comparable to the *market price*—a price that results from market forces and not incentives to reduce tax liability.

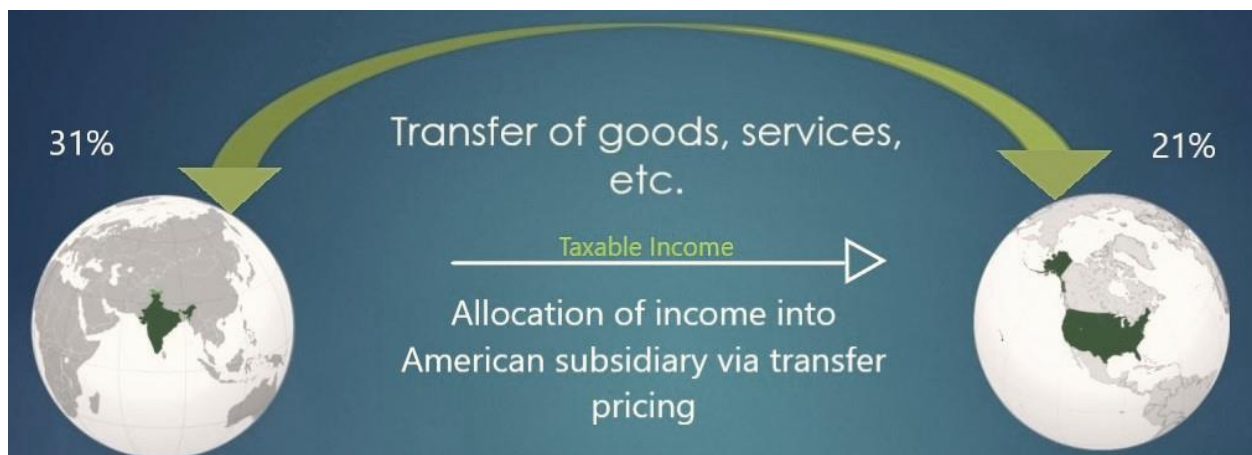


Figure 2

A recreation of a transfer pricing graphic given by Harish Ojha in his web series “What is Transfer Pricing?” on *YouTube.com*, published November 21, 2016 and accessed January 10, 2020.

To gain an appreciation for the arm's length standard, let us imagine a world without it. In such a world, MNCs would be allowed to determine the transfer price as they freely wished. It is likely that they would choose the transfer price that allocates the largest portion of income into low-tax regions. We can demonstrate this visually using figure 2. Imagine that an MNC has a subsidiary in India that is taxed at a rate of 31% and another subsidiary in the U.S. that is taxed at a rate of 21%. Now assume that the MNC's subsidiaries trade goods and services with each other. Without the arm's length standard, there would be nothing preventing the MNC from behaving opportunistically. That is, the MNC would deliberately set on a transfer price that

allocates the largest portion of income possible into the U.S. subsidiary where tax rates are 10% lower. This behavior reduces the MNC's overall tax liability. One should be aware that figure 2 is a very simple example of income allocation via transfer pricing; much more elaborate structures are common in real-world business practices.

The reason that the behavior of the subsidiaries in figure 2 is not permissible by tax policy (and the underlying tax and transfer pricing regulations) is that it undermines the purpose of tax systems, which is to raise government revenue by taxing income *where value is created*. If the MNC generates most of their value in India, then it follows that most of their income should be taxed there at 31%. In theory, the arm's length standard would ensure proper taxation by preventing the MNC from shifting income earned in India into the U.S. subsidiary. But in practice, the arm's length standard cannot guarantee that the transfer price reflects economic reality more than tax incentives. This is because it is inherently difficult to observe the conditions that would allow two related parties to behave as if they were unrelated. In fact, "various elements of an MNC 'are not subject to the same market forces shaping relations between two independent companies,' but, legally, these entities often get treated like they are completely separate and independent, despite their behavior to the contrary" (Iyer, 22). This means that even with the arm's length standard in place, MNCs are not prevented from deliberately coordinating the behavior of their subsidiaries for tax benefits, ultimately preventing governments from receiving the appropriate amount of tax revenues. This is indeed a problem. But what are the consequences? In the next section, we will explore the impact of corporate transfer pricing practices on governments and the citizens they are to govern.

## BEPS and its Impact on Governments

The consequences of transfer pricing begin at the institutional level where we find that governments are doubting “the adequacy of existing tax regimes to continue to raise sufficient revenue” (PwC. “Economic and Policy Aspects of Digital Services Turnover Taxes: A Literature Review,” 2). This is largely owed to tax avoidance strategies, many of which employ transfer pricing schemes to dent government taxing rights. While this is certainly a concern for all governments, the situation is especially concerning for governments of developing nations since they rely more heavily on corporate tax revenue than their developed counterparts. Rawls’ conception of justice maintains that the least-advantaged in society be prioritized, which commands that we not ignore the social consequences that transfer pricing has on developing nations.

But first, we must familiarize ourselves with the Organisation for Economic Co-operation and Development (OECD), an international organization set in place to regulate international tax policy, among other things. Their goal is to build better policies for better lives—policies that foster prosperity, equality, opportunity and well-being for all.<sup>7</sup> The OECD is important for our discussion because they have been working to stop transfer pricing practices that engage in base erosion and profit shifting (BEPS) for decades now. In the following statement, they explain what BEPS practices are, how they impact developing nations, and what their relevance is for our discussion on the fairness of tax systems.

BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic

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<sup>7</sup> OECD. “Who we are.” <https://www.oecd.org/about/>. Accessed Mar 11, 2020.

activity or to erode tax bases through deductible payments such as interest or royalties. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs and can effectively participate in the process of standard-setting on international tax.<sup>8</sup>

This statement offers a lot for us to unpack. First, notice the language used by the OECD. By using the terms “artificially” and “erode,” the OECD is expressing the same concern that we saw expressed earlier, which is that MNCs are engaging in practices that are meant to reduce tax liability rather than reflect market outcomes. This suggests that an MNC is engaging in BEPS if their subsidiaries are behaving as related, dependent parties with the aim of reducing tax liability.

The statement also provides clarification for a common misconception of BEPS practices, which is that they largely consist of illegal schemes. The OECD affirms that they are in fact mostly legal. This means that regardless of legal compliance any business practice engaging in BEPS “undermines the fairness and integrity of tax systems.” Put another way, legality does not guarantee fairness and/or integrity.

But how exactly is fairness compromised? The OECD tells us that BEPS gives a competitive advantage to MNCs over domestic enterprises. Using transfer pricing practices,

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<sup>8</sup> OECD. “What is BEPS?” <https://www.oecd.org/tax/beps/about/>. Accessed Jan 20, 2020.

MNCs have the option to shift their profits across borders to lower their tax burden. This is not true for enterprises at the domestic level that must bear the entirety of the tax burden. They are at a competitive disadvantage as a result of international tax policies. This is but one of the ways that transfer pricing presents challenges to the fairness in tax systems.

The OECD opens the discussion to the idea of fairness in another way. They highlight the moral dimensions of BEPS by acknowledging the crucial role that tax revenues, particularly those from multinational enterprises (referred to as MNCs in this paper), serve for the economic prosperity and general welfare of developing nations. The OECD does not go into detail about why tax revenue from MNCs is of significance for developing nations in this statement, but in another report by them, they clarify that “in developing countries, the lack of tax revenue leads to critical under-funding of public investment that could help promote economic growth” (OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 8). The conversation therefore spans into moral territory since BEPS can stunt economic progress for developing nations and hinder access to a higher quality of life for their citizens, who are likely to be among the most economically disadvantaged in our societies today.

#### Ghana: A case study

If you find yourself confused right now because you still haven't fully grasped what transfer pricing is or how it engages in base erosion and profit shifting, don't worry. It's a complicated practice. But as you continue reading about it, I promise that you'll begin to gain an awareness of it—it just takes time. Fortunately, this process will be made much easier now that we are going to conduct a case study of transfer pricing strategies used by a corporation to avoid

taxes in a developing nation. This will give us a break from the abstract language that we have been working with and finally give us a glance at how the practice looks in the real-world.

Our case study will take place in Ghana, the first African state to declare independence from colonial rule in 1957. Since then, Ghana has made great strides in development, including reducing the number of Ghanaians going hungry by 75% from 1990 to 2010. Ghana is also known for having a relatively stable economy and higher standard of living than most of their neighboring countries, making them a leading example for African states that strive to advance on the development index.

But according to ActionAid—an intergovernmental federation that is working for a world free from poverty<sup>9</sup>—Ghana still has a long way to go when it comes to advancing on the development index. Much like most African states, and surely all developing nations, Ghana has historically struggled with poverty. Even today, poverty remains pervasive in its northern regions where there is lower school enrollment, higher illiteracy, and fewer opportunities for women.<sup>10</sup> To improve the living conditions of their citizens, the Ghanaian government relies heavily on tax revenues, including those derived from corporations.

Tax revenues also serve on a more fundamental level. They are necessary for the Ghanaian government to run a functioning society that can facilitate its institutions and attract foreign investment. One member of ActionAid, Emmanuel Budu Addo, wrote a report explaining how MNCs register in Ghana to operate in various industries, such as banking, breweries, textiles, oil and gas, and mining. “The government has the responsibility for providing an enabling environment including security, infrastructure, and human capital to facilitate the

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<sup>9</sup> ActionAid. “About.” <https://actionaid.org/about>. Accessed Jan 20, 2020.

<sup>10</sup> Central Intelligence Agency. “Africa: Ghana.” [https://www.cia.gov/library/publications/the-world-factbook/geos/print\\_gh.html](https://www.cia.gov/library/publications/the-world-factbook/geos/print_gh.html). Accessed Jan 20, 2020.



smooth operations of these businesses,” Addo said. In return, MNCs are obliged to pay income tax, which goes back into maintaining a healthy society. “Unfortunately,” Addo wrote, “most MNEs use various schemes to aggressively avoid paying taxes. One of the commonest schemes used is to shift profits from Ghana to other countries through transfer mispricing of goods and services.”<sup>11</sup> If Addo’s allegations are true, many MNCs are not only hindering the provision of public goods and services, they are also, ironically, taking away from the very same social structures that allow them to operate across international borders.

Were the tax avoidance strategies that Addo referred to contributing to BEPS? And more importantly, what were the consequences for Ghana? To answer this, our case study will include a look into a report published by ActionAid in 2010 which reveals strategies used by the MNC SABMiller to protect its profits from Ghana’s taxing rights. At the time of their investigation, SABMiller was one of four massive conglomerates which, together, controlled roughly half of the world’s beer consumption and earned 75% of the industry’s total profits. Today, SABMiller is a business division of Anheuser-Busch InBev SA/NV, which acquired SABMiller in 2016.<sup>12</sup>

Although the report covers transfer pricing strategies that are over a decade old, it remains relevant since similar strategies, or some variation of them, remain in use today. In fact, it is well documented that many of today’s most recognized MNCs have employed or currently employ similar transfer pricing tactics—MNCs like Google, Facebook, Yahoo, Apple, and Amazon.<sup>13</sup> We will be covering some of the more novel transfer pricing strategies used by these

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<sup>11</sup> Addo, Emmanuel B. “Multinational enterprises must stop profit shifting and pay their corporate income taxes.” *ActionAid*, 2010.

<sup>12</sup> Brown, Lisa. “A-B InBev finalizes \$100B billion acquisition of SABMiller, creating world's largest beer company.” *Chicago Tribune*. <https://www.chicagotribune.com/business/ct-megabrew-ab-inbev-sabmiller-merger-20161010-story.html>. Accessed March 3, 2020.

<sup>13</sup> Barker, Joel. Asare, Kwadwo. Brickman, Sharon. Borough. “Transfer Pricing As A Vehicle In Corporate Tax Avoidance.” *The Journal of Applied Business Research*. V. 33, No. 1, 2017.

“tech giants” later. But since their strategies are highly complex, understanding them requires that we first establish our knowledge of the more basic examples found with SABMiller.

In the first transfer pricing tactic identified by ActionAid, SABMiller reduced their tax liability by allocating their taxable income into low-tax regions using management fees. Typically, firms pay management fees to another entity as compensation for professional management, like asset management for example. But within an MNC, professional management can be handled by one of their subsidiaries, which would provide the service for every other subsidiary within the same company. In such a case, professional management would be considered a service that is being traded between related subsidiaries and the amount of the management fee would be considered the transfer price.

In SABMiller’s case, its African subsidiary paid management fees to a related subsidiary found in a low-tax region in Europe. The European subsidiary provided professional management which justified the payments made to them. But by paying the management fees, the African subsidiary effectively transferred a portion of the income gained in Ghana to a subsidiary in a low-tax region. In doing so, the subsidiaries protected a portion of SABMiller’s income from Ghana’s 25% tax rate.

SABMiller held the position that the payments were compliant with the arm’s length standard since the management fees were comparable to transactions that occur between unrelated entities. But the Ghanaian government did not necessarily agree with SABMiller’s methods for arriving at the transfer price (the amount of the management fees). The head of the Ghana Revenue Authority (GRA) expressed frustration saying, “management fees is an area that we know is being used widely [to avoid tax], and it’s mainly because it’s difficult to verify the reasonableness of the management fee.” In other words, Ghanaian tax authorities often suspect

that the amount of the management fees is determined for tax saving purposes more so than as compensation for the professional management services. If this were the case with SABMiller, then they were artificially shifting profits. The GRA's frustration lay in the fact that this was difficult to argue since it is difficult to verify the reasonableness of the management fees—no doubt that this difficulty was owed to the loopholes in tax law and the ambiguity of the arm's length standard.

In the second transfer pricing practice, SABMiller protected up to millions of dollars from high tax rates by taking advantage of a unique set of tax rules that allowed them to pay next to nothing on royalties they earned. To exploit these tax rules, an MNC must first set up a subsidiary in a country that offers them. Then, they transfer ownership of intangible assets, like company brands or intellectual property, to the strategically placed subsidiary so that it receives the royalties paid on behalf of the intellectual property. Once the royalties hit the subsidiary's account, the tax rules protect them from what could have otherwise been high tax rates.

SABMiller took this tax planning approach by establishing a subsidiary in the Netherlands, one of the countries that offered the unique set of tax savings on royalties. Then SABMiller transferred the ownership rights of various brands over to the subsidiary. These brands included local African brands like Castle, Stone, and Chibuku, which were developed, brewed, and consumed in Africa. Having negotiated a tax ruling with the Dutch revenue authorities, SABMiller's subsidiary in the Netherlands received the royalties for these brands and paid little to no tax on them, reducing the MNC's tax liability significantly over the years.

Much like the first transfer pricing practice, the second was too difficult for the GRA to dispute since SABMiller could provide evidence that it adhered to the arm's length standard. This is a good example of the complexities that come with trying to determine whether a practice

is fair or not. Although it is obvious that SABMiller was making choices to protect their income from Ghana's tax rates, their practices were considered fair in the sense that they stayed within their legal rights and did not technically engage in BEPS. Either way, the consequences were the same. In total, the management fees and royalties paid by SABMiller's Ghanaian subsidiary to tax havens in Europe reduced Ghana's annual tax revenue by roughly £212,000. When also considering the operations SABMiller had in Zambia, Tanzania, and Mozambique, ActionAid estimated that SABMiller's transfer pricing strategies withheld a total of £3.4 million in annual tax revenues from Africa. And when taking into account not just SABMiller's but all of the corporate world's practices which funneled capital gains into tax havens during the time of the report, the OECD estimated that Africa lost several times more tax revenue than it received in aid.<sup>14</sup>

These numbers are staggering. Hundreds of billions of dollars were kept from being properly taxed every year, affecting not only developing nations but virtually every nation that had an MNC operating in their territories. It is difficult to imagine that all the aid going into African nations for the purposes of helping them advance on the development index was indirectly siphoned out in the form of royalties, management fees, and the like. When considering the losses, one begins to understand why it is that organizations like the OECD and ActionAid invest so much of their time and resources to stopping BEPS. They understand the importance of weighing the social consequences that result from these practices, as well as the moral implications that follow. It is owed to their work and the work of their supporters that the situation has improved significantly since 2013. It was then that the OECD's efforts to stop

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<sup>14</sup> This figure is reiterated in several different ways, but the same message holds for every iteration—Africa, and the developing generally, suffers massive monetary losses from practices, legal and illegal, which siphon money into tax havens. Brooks, Richard. Hearson, Martin. "CallingTime." *ActionAid*, 2010.

BEPS manifested in 15 action items that were implemented to “strengthen the international tax system by removing egregious tax loopholes and ensuring that profits were taxed where economic activities occurred and value was created” (Insight: Taxing the Digital Economy—Pillar One Is Not BEPS 2 (Part 1), 1). Furthermore, the action items required that MNCs comply with the arm’s length standard for them not to be considered as engaging in base erosion and profit shifting, and served as a hopeful sign for better tax systems ahead.<sup>15</sup>

But not everything was solved. The ambiguity of the arm’s length standard persists today and has become more elusive than ever. Recall that arm’s length prices don’t always allocate income in a way that accurately reflects value creation. While this was addressed in the 15 BEPS action items, the rapidly changing digital economy and the ever-evolving world of business practices have made it impossible to lay the problem to rest. Currently, the international tax community is eagerly awaiting the finalization of the OECD’s *Unified Approach* and its “Pillar One” proposals, which are a continuation of the first 15 action items aimed at finding ways to properly tax highly-digitalized multinational corporations where value is created. I promised that we would look at examples of practices used by these “tech giants.” Doing so will strengthen our awareness of more novel corporate transfer pricing practices and, more importantly, will show the unique challenges facing tax policy today.

### Challenges Presented by the Digital Economy

The digital economy is the result of the implementation of information and communication technology (ICT) into economic and social structures. The influence of ICT has

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<sup>15</sup> AU/ECA Conference of Ministers of Finance, Planning and Economic Development. “Illicit Financial Flow (IFF): Report of the High Level Panel on Illicit Financial Flows from Africa.” 2011.

been so substantial that the digital economy is increasingly becoming the economy itself.<sup>16</sup> As noted by the OECD, the digital economy is characterized by “unparalleled reliance on intangibles, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs” (Addressing the Tax Challenges of the Digital Economy, Action 1 2015 Final Report, 16). What this is effectively saying is that MNCs are making an unprecedented shift towards digital methods and procedures, and that existing tax policies are having a hard time keeping up with the changes. This last point is evident in the OECD’s acknowledgement that there is difficulty when “determining the jurisdiction in which value creation occurs”—we have already seen this to be a fundamental step in taxation without which government efforts to collect tax inevitably collapse.

The reason that the digital economy is problematic for existing tax regimes is that the general basis for taxing corporations has remained virtually unaltered for almost a century—since the 1920s to be exact. The problem with using tax regimes from the 1920s is that their method of determining where value creation occurs largely relies on the physical establishment of the parties involved. While it used to be that economic activities primarily consisted of the exchange of tangible goods and typically required the physical establishment of the corporations, the implementation of ICT into business models has allowed for corporations to create value around the world without a physical presence. Companies that exploit intangible assets in such a way are typically highly-digitalized multinational corporations—enterprises that have a heavy reliance on intangibles and data, are highly mobile, and can scale without mass. The digital nature of these MNCs make them perceptibly more difficult to tax than “brick and mortar” firms,

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<sup>16</sup> OECD. “Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project.” *OECD Publishing*, 2015.

stirring up controversy as to how the apparent disjuncture between tax policy and business practices should be resolved.<sup>17</sup>

While the digital economy does not contribute any unique BEPS issues, it exacerbates them.<sup>18</sup> Many of the practices used by tech companies today have similar rationale to those used by SABMiller, but since they deal with digital methods and procedures, like the implementation of hard-to-value intangibles, the problem is far more complex in nature. An excellent example of a tech giant using transfer pricing practices to reduce tax liability on income earned from intangible assets can be found in the currently ongoing \$9 billion tax dispute between Facebook and the Internal Revenue Service (IRS). This is the latest dispute between a highly-digitalized MNC and the IRS, following the victory Amazon had over the IRS in August 2019.<sup>19</sup>

At the heart of the dispute between Facebook and the IRS is a transfer pricing disagreement as to how intangible assets should be valued. Back in 2010, when Facebook was far from the tech giant that it is today, the company decided to restructure their operations to reduce their tax liability.<sup>20</sup> They transferred intellectual assets, like trademarks and platform technologies, into Ireland where they could take advantage of a unique scheme known as the “Double Irish.” Like SABMiller’s situation where they transferred intellectual property into a European subsidiary and paid little to no tax on royalties earned, the “Double Irish” reduced tax liability by allocating royalties into low-tax jurisdictions. It allowed corporations to “move intangible assets to low-tax jurisdictions such as Ireland and then channel the income through countries like Bermuda, the British Virgin Islands and the Cayman Islands,” where tax rates were

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<sup>17</sup> Eden, Lorraine. Treidler, Oliver. “Insight: Taxing the Digital Economy—Pillar One Is Not BEPS 2.” *Bloomberg Tax*, 2019.

<sup>18</sup> OECD. “Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy.” *OECD Publishing*, 2020.

<sup>19</sup> United States Court Of Appeals for the Ninth Court. “AMAZON.COM V. CIR.” *United States Tax Court*, 2019.

<sup>20</sup> Jason, Aten. “Facebook Is Preparing for a \$9 Billion Showdown With the IRS.” *Inc.* <https://www.inc.com/jason-aten/facebook-is-preparing-for-a-9-billion-showdown-with-irs.html>. Accessed Mar 10, 2020.

extremely low, if not 0% (White, Josh. “The IRS takes Facebook to court over its Irish tax structure.” *International Tax Review*).<sup>21</sup> In 2016 alone, Facebook used the “Double Irish” structure to shift €12.6 billion (\$13.6 billion) in European revenue through Ireland and only paid €29.5 million in tax for it—that’s less than a 0.25% tax rate on their European revenue!<sup>22</sup>

Closure on the “Double-Irish” began in 2015 and will officially be completed by the end of this year, and was the result of international pressure, particularly from the OECD, to stop BEPS. Over the course of its existence, it saved American MNCs hundreds of billions of dollars.<sup>23</sup> The IRS, in an effort to tax income that has been stashed away in tax havens across the world, has been closely investigating the transfer pricing practices used by companies engaging in the loophole. They naturally took interest in Facebook’s practices and discovered a potential discrepancy in Facebook’s initial valuation of their intangible assets from 2010.

As example of the ambiguous nature of the arm’s length standard, Facebook’s transfer pricing methods valued the worth of the assets at \$6.5 billion (this amount is also the transfer price) before transferring them to their Irish subsidiary, but the IRS’s methods valued them at \$13.8 billion—more than twice as much. If the IRS wins the case, Facebook will be forced to pay a \$1.73 million tax bill for 2010. And when taking into account the subsequent tax years, which are also subject to examination, Facebook’s tax bill can be as much as \$9 billion in total.<sup>24</sup> The dispute will boil down to whose transfer pricing methods give the correct valuation of intangible assets.

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<sup>21</sup> Gravelle, Jane. “Tax Havens: International Tax Avoidance and Evasion.” *Congressional Research Service*, 2015.

<sup>22</sup> White, Josh. “The IRS takes Facebook to court over its Irish tax structure.” *International Tax Review*. <https://www.internationaltaxreview.com/article/b1kdw0nx8h3jz1/the-irs-takes-facebook-to-court-over-its-irish-tax-structure>. Accessed Mar 10, 2020.

<sup>23</sup> Waters, Richard. “Google to end use of ‘double Irish’ as tax loophole set to close.” *Financial Times*. <https://www.ft.com/content/991f11ae-2c51-11ea-bc77-65e4aa615551>. Accessed Mar 10, 2020.

<sup>24</sup> Leon, Jeffery. “Facebook Heads to Trial in Tax Dispute That Could Cost \$9 Billion.” *Bloomberg Tax*. <https://news.bloombergtax.com/daily-tax-report/facebook-heads-to-trial-in-tax-dispute-that-could-cost-9-billion>. Accessed Mar 15, 2020.



### Arm's Length and Ambiguity

The difficulty with valuing intangible assets boils down to, not surprisingly, the ambiguity of the arm's length standard. The intangibles being traded among Facebook's subsidiaries lead to highly complex transactions that are rarely replicated in third-party market transactions, making it impossibly difficult to determine what is considered arm's length. To further complicate the process, there are multiple approaches to arriving at a transfer price that is arm's length, and no one approach is right. That is why it is possible for a \$9 billion tax dispute to exist in the first place. In light of these discrepancies, many have posed the question as to whether the arm's length standard is enough to dictate transfer pricing practices or if more policy is needed to facilitate taxation in the digital economy.

The OECD's *Unified Approach*, issued in 2019, advanced proposals to improve the process of taxing highly-digitalized MNCs.<sup>25</sup> But according to an analysis by Bloomberg Tax, “proposals in the *Unified Approach* suffer from several defects, the most important of which is their apparent abandonment of the arm's length standard” (Eden and Treidler, 1). If the analysis is correct, then the OECD's approach to better taxation suggests that no, the arm's length standard is not enough, and more policy is needed.

As part of their report, ActionAid offered recommendations for improving tax systems. They too placed an emphasis on the failure of the arm's length standard, specifically when dictating transfer pricing practices in developing nations. They claim, “there are reasons to doubt that a system based on the ambiguous definition of an ‘arm's length price’—a system that results in multi-billion-pound legal disputes even in more developed countries—can be made to work for countries like Ghana” (Richard and Martin, 29).

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<sup>25</sup> OECD. “Public consultation document, Secretariat Proposal for a “Unified Approach” under Pillar One.” *OECD Publishing*, 2019.

The subjective nature of transfer pricing is so substantial that one could even say there is an art to finding the transfer price. This has unintended consequences. In practice, the side which devotes more time and resources to building the strongest argument for a transfer pricing outcome usually wins. Unfortunately, poorer nations do not always have the capacity to build strong arguments when disputing the transfer price since it is so costly. And the task is made especially difficult when going up against a corporate giant like SABMiller, which has the resources to hire the best transfer pricing accountants there are. Even the IRS, the taxing authority of one of the most powerful nations today, has been struggling for funding when going up against Facebook, explaining why the court case has been stalled at times.<sup>26</sup> It is becoming increasingly clear that the arm's length standard unintentionally benefits those with more power.

After speaking with Michael Durst, a former Director of the department of the IRS that reaches advanced transfer pricing agreements with multinational companies, ActionAid learned that by sticking to the arm's length approach, "tax officials are shooting themselves in the foot," especially when it comes to intangible assets. "Transfer pricing takes corporate structures, even those motivated entirely by tax avoidance, for granted, only examining the prices charged rather than the structures themselves" (Richard and Martin, 29). In response to this, ActionAid urged corporations like SABMiller to reconsider the validity of their transfer pricing practices and offered alternatives to the arm's length standard, much like those proposed by the OECD.

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<sup>26</sup> Leon, Jeffery. "Facebook Heads to Trial in Tax Dispute That Could Cost \$9 Billion." *Bloomberg Tax*. <https://news.bloombergtax.com/daily-tax-report/facebook-heads-to-trial-in-tax-dispute-that-could-cost-9-billion>. Accessed Mar 15, 2020.

## Justice as Fairness for Tax Systems

In their recommendations, both the OECD and ActionAid have hinted that the tax system's dependence on the arm's length standard is to blame for most of the problems posed by transfer pricing practices, including the undermining of fairness. Their efforts to find better taxing alternatives demonstrate that they are as concerned with establishing the fairness of tax systems as we are. Moreover, the special concern they have for the way tax systems impact developing nations and their citizens show their devotion to helping those among the least-advantaged in society, as Rawls thinks society should do.

Does this mean that seeking fairness from a Rawlsian point of view should take the same approaches as those taken by the OECD and ActionAid? The answer is no. To understand why, let's make an important distinction. In taking a Rawlsian approach to establishing fairness for tax systems we are effectively saying that we are seeking *justice as fairness* for them. Fairness in this regard is not the same conception of fairness that the OECD and ActionAid advance, for their conception is not ultimately realized in a well-ordered society as Rawls' is. This forces us to depart from the OECD's and ActionAid's approach and to develop a uniquely Rawlsian one.

Bear in mind that justice as fairness cannot, for Rawls, be realized apart from his three principles of justice. If tax systems are to be fair, then they must satisfy the requirements placed forth by the liberty principle, the equal opportunity principle, and the difference principle. But these cannot be satisfied by making changes to the methods and procedures of tax systems alone, like, for example, implementing an alternative for the arm's length standard. Rawls would have us think on a more fundamental level. If we are to establish a fair tax system, then we must first establish a fair economic system. To accomplish this, we will make use of Rawls' difference principle.

Many have interpreted Rawls' difference principle as a rule that guides the decisions of the consumers and the suppliers in a market economy. This would mean that corporations would have to carefully consider the consequences their decisions have on the least-advantaged. The same would go for citizens. But this is a gross misunderstanding of the difference principle. Rawls never makes it a duty "that we must express concern for the well-being of the less advantaged in our daily economic choices" (*Rawls*, 122). Rather, he sees the difference principle's greatest value in functioning as a criterion while deciding which economic system to institute in society. In Rawls' words, "other things being equal, the difference principle directs that society aim at the highest point on the OP curve of the most effectively designed scheme of cooperation" (*Justice as Fairness*, 63).

The difference principle is therefore meant to be used in the following way: first to establish an economy "that consistently makes the poorest class better off than they would be in any other economy (compatible with basic liberties and fair equal opportunities)," and then to "maximize the poor's position within that 'most effective' system" (*Rawls*, 121). This means that if we are to arrive at a just economic system, it must be one that prioritizes the least-advantaged *from the outset* and that is also compatible with the first two principles of justice. Only then will we be any closer to a fair tax system as Rawls would have it.

Now that we have learned the function of the difference principle as a criterion, we can make use of it. Freeman tells us to do so in the following way:

Imagine a continuum of economic systems.... starting from libertarian laissez-faire capitalism on the right (where all property is privately owned and all allocations and distributions are decided by unregulated market exchange, or by gift, bequest, gambling,

or some other free choice), through classical liberalism, then a variety of mixed economies, all the way to Soviet-style command economy on the left (where allocation and distribution is decided according to a central plan). The difference principle says the preferred economic system along this continuum is the one whose mix of economic and legal institutions makes the least advantaged class better off (in terms of its members' share of income and wealth and powers and positions of office) than all other systems along the continuum. (*Rawls*, 105)

Of all the economic systems along the continuum, Rawls, later in his works, favors either a property-owning democracy or a liberal socialist system, “both of which eliminate the wage-relationship with capitalist owners and provide workers with real opportunities to control their work environment and their means of production” (*Rawls*, 28). If we take Rawls for his word, it seems as if justice as fairness for tax systems requires an unprecedented shift towards either a property-owning democracy or a liberal socialist state. If so, then perhaps the only insight we can gain from our inquiry is that we need to change the system on a fundamental level to arrive at fairer tax systems.

But rather than allowing our conversation to conclude at that, it might be more profitable to step away from Rawls' recommendations and make the following two assumptions: (1) that the least-advantaged in society are maximally benefited under the market-oriented mixed economies that characterize our global economy today, and (2) that the liberty principle and the equal opportunity principle are compatible with these mixed economies.

By making these assumptions we can move past thinking on the fundamental level and begin thinking on the more particular level, which is where we find our tax systems. Only now

have we positioned ourselves to use Rawls' principles of justice as they were designed to be used. We can begin working in their requirements for tax systems and see for ourselves what we come upon. To limit the scope of this task and to make it more relevant for our discussion, I will highlight only what I consider are the most significant insights the principles offer, with a special view for their implications for transfer pricing practices.

We will begin with the first and most important principle, the liberty principle. Recall that it protects an individual's right to a basic scheme of liberties that is compatible with a similar scheme of liberties for others. Among these liberties is that which allows for individuals and firms to "act like ordinary economic agents, seeking to obtain as much 'bang for the buck' as they can and thereby maximize their economic utility" (*Rawls*, 100). Hence, the first principle protects the right for an MNC to make profit-maximizing economic choices. Moreover, Rawls expects the parties in his social contract to behave this way since he assumes that they "are not morally motivated, but aim only to choose terms of cooperation that best advance their own particular good and their fundamental interests" (*Rawls*, 16).

But an MNC cannot make choices which impede on another's right to an equal scheme of basic liberties. This raises the question as to whether efforts to avoid tax should be permissible under the first principle since they have the potential to hinder the basic liberties of the citizens that rely on government funded goods and services. I am not saying that tax avoidance generally does this, but that in certain cases it might have the potential to. Either way, answering this question is beyond the scope of this paper—I simply wanted to point out the possibility. For now, we will consider efforts to avoid tax, including those which use transfer pricing practices to lower tax liability, as rational economic choices protected by the first principle.

On the opposite end of tax avoidance is taxation itself. Egalitarian liberals like Rawls “argue that we cannot meaningfully exercise our civil and political liberties without the provision of basic social and economic needs: governments should therefore assure each person, as a matter of right, a decent level of such goods as education, income, housing, healthcare, and the like” (*Political Liberalism: A Review*, 1766). Rawls is therefore a strong proponent of governments and their taxing rights and of their duty to serve their citizens by providing for them basic rights. Furthermore, these rights are not an option for institutions to provide, they are paramount to the degree that they overshadow every other consideration, even that of the common good.

When incorporating the equal opportunity principle, we should keep in mind that we are to incorporate it along with the difference principle since Rawls intended for the two to be coupled together in their employment. Remember that FEO opens positions and offices equally to those similarly endowed. It has special importance for the difference principle since “it is only in a society where [fair equality of opportunity] to compete for open positions is satisfied that distribution designed to maximize the share of the worst-off will satisfy the requirements of distributive justice” (*Rawls*, 92). Assuming this generally holds true, we can finally begin thinking about the implications that come with raising the social minimum to its maximum.

Most obviously, all inequalities that result from legal institutions, including those governing taxation, must be to the greatest advantage of the poorest in society. Less obvious is the way that the difference principle functions to specify what transactions are permissible in the economic system. What is meant by this? Earlier, we used the difference principle as a criterion while deciding which economic system to implement into society. Indeed, the difference principle’s main point “is to provide a non-market criterion for deciding the proper division of

income and wealth resulting from market allocations of productive resources and the resulting social product” (*Rawls*, 104). In other words, the difference principle functions as an additional tool for arriving at fair distributions that is not subject to market forces but rather to social forces that aim to help the lesser in society. It is for that reason that Rawls recognizes it as a *non-market* criterion.

This is of particular significance for transfer pricing since its methods and procedures, strictly speaking, rely entirely on market criteria. This is evident in its dependence on the arm’s length principle, which is meant to ensure that the transfer price is comparable to the *market price*. That way, income earned by MNCs is, theoretically, allocated along market lines to their corresponding subsidiaries. But what should we make of an MNC’s desire to lower tax liability by arguing for an arm’s length price that allocates income for tax benefits rather than economic reality? I suppose that even this can be considered a product of market forces since lowering their tax burden is a function of a cost minimization/profit maximization for a firm. Allocation of income along these lines can, then, also be considered as the result of a market forces.

Now, what are we to make of an arm’s length price which gives outcomes that consistently benefit the wealthy while simultaneously making the lesser advantaged poorer? It is in this predicament that the difference principle would serve as a non-market criterion which takes into account the social consequences of market transactions. Since the expectations of the poorer would be falling while those of the richer rise, the distribution would be deemed unjust and transaction impermissible. This is precisely how Rawls envisions the difference principle to function. He wants it to be used as a non-market criterion to determine not only the appropriate forms of ownership and property rights and responsibilities, but also to “specify... permissible and impermissible transactions in the economic system” (*Rawls*, 103).



Now, it is highly likely that Rawls' difference principle would interfere with the efficiency and utility of the market if employed as a non-market criterion for distribution. But recall that neither efficiency nor utility maximization mattered to Rawls as much as increasing the expectations of the least-advantaged to their maximum within the system. Additionally, doing otherwise for the sake of some other ideal could potentially violate the first principle. Say, for example, that to distribute healthcare packages in a more efficient manner, the government decides to stop providing free healthcare all together. The government would be prioritizing the good over the right; they would be violating the liberties of a few for the good of the majority. In turn, they would be violating the first principle and seeking unjust ends.

The significance of all this is that Rawls would require more than the arm's length standard when determining a fair allocation of income, for the market alone cannot govern a distribution that contributes prospects to the most favored while also securing those of the least-advantaged. And while Rawls did not take issue with using market prices for purposes of allocation, he did indicate that relying exclusively on markets for distribution was entirely different and capable of grave social consequences.

### Insights Arising

For some time now, we have devoted ourselves to exploring what the ideal might look like for Rawls when it comes to tax systems. In the process, we have come to understand that justice as fairness cannot be satisfied on any other level than the most fundamental. And although we focused heavily on the role that the difference principle plays in Rawls' well-ordered society, it is the least of the three principles. Before maximizing the minimum position, a

society has a duty to first secure an equal scheme of liberties for its citizens and to then refrain from opening positions to anything else other than an individual's endowment.

Moving forward, we can devote ourselves to the more fruitful question of our inquiry, which is, how can we move closer to the ideal? Only in asking this will meaningful insights finally arise. I want to start with making a few things clear. Methods for taxing MNCs rely heavily on the arm's length standard but I should clarify that this does not mean that tax systems rely exclusively on market prices. Recall that the OECD, being fully aware that the arm's length standard is far from perfect, implemented the 15 BEPS action items as additional policy to help push against unfair tax outcomes. We can interpret such policy as a tool that functions as a non-market criterion for specifying impermissible transactions in the economy. And its effectiveness can be supported empirically with the closure of the "Double Irish" loophole following its implementation.

While market forces permitted the loophole, social forces did not. This is a promising sign. It seems as if we are slowly making our way to striking a balance between market forces and social forces that brings us closer to the ideal Rawls has in mind for his well-ordered society. This brings us to the most significant insight that I believe Rawls' theory has to offer for establishing and maintaining the fairness of international tax systems today. While deciding on the best methods for taxing the digital economy and for ensuring sufficient government revenues, we should lean towards the method that promises a fairer balance between market forces and social forces.

Even though this so called "fairer balance" sounds like a measure too abstract to determine, I think it can be captured with a thorough analysis of the consequences that policies from each method would have on society, most importantly on its poorest. So, when deciding

whether to abandon the arm's length standard for better taxation as the OECD seems to recommend in the *Unified Approach*, or whether to simply improve the action items currently in place as others have recommended, we must refrain from solely relying on criteria like efficiency and utility. For if we consider the purpose of tax systems and the tremendous impact they have on society, it only makes sense that fairness cannot be achieved if economic rationality is the only vehicle for arriving at conclusions; more than that, we need methods of weighing more carefully and honestly the way that our societies are affected by market forces. Like Rawls, we have to recognize that governments have a responsibility to ensure that their citizens have a satisfactory standard of living. This means that, ultimately, the choice that should be made is the method which employs non-market criteria, and that in doing so, brings about the greatest amount of liberties, fair opportunities, and welfare, surely for all of society but especially for the poorest.

#### Final Remarks

There are a few remarks I would like to make regarding the application of Rawls' principles. First, it might have come off as unnecessary to go through all the trouble of first seeking justice as fairness for the economic structures of societies before moving to tax systems. But this was necessary if an appropriate application of Rawlsian theory were to take place. Doing otherwise would likely single out the importance of the difference principle alone, reducing Rawls' theory of justice to something lesser, as is common of mainstream economists.<sup>27</sup>

Second, even though Rawls' theory is ideally meant to be applied at the social level, I took the liberty of assuming that this means it can also be applied on the global level. This is of

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<sup>27</sup> Edgren, John A. "On the Relevance of John Rawls's Theory of Justice to Welfare Economics." *Review of Social Economy*, 1995.

course subject to disagreement, but I followed in the tradition of Thomas Pogge, a former student of Rawls, who believed that Rawls' principles could establish justice at the global level.<sup>28</sup>

Third, I would like to touch on my decision to make the assumptions which allowed us to apply his principles of justice to the market-oriented mixed economies that characterize our global economy today. Although Rawls might not think that the capitalistic nature of these economies can allow for his conception of justice to be realized, there is a very real possibility that it can. After all, there is no way of knowing for sure that a shift to another global economic system would contribute more to the poor's expectations than they already have. My assumption should not, however, be misinterpreted as a defense of capitalism. Rather, I make this assumption for the sake of extrapolating Rawls' conception of justice in a way that might provide unique insights for fairer tax systems in contemporary economies.

Fourth, by seeking justice as fairness in tax systems, I highlighted the importance of ensuring that the poorest of society were prioritized. Indeed, they are not only of importance for Rawls, but for me too—and they should be for everyone. This is because the least-advantaged are not a fixed group of people. Rather, they are anyone that has found themselves in the lowest position in society. The least-advantaged therefore “refers to a relative position in society that people can move into or out of,” a position that everyone is subject of falling into (*Rawls*, 108).

Furthermore, I hope that my application of the difference principle has not been interpreted as a way to simply provide more money for poorer people. This would be erroneous. Freeman insightfully tells us the true purpose of the difference principle in the following excerpt:

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<sup>28</sup> Pogge, Thomas. “Rawls and Global Justice.” *Canadian Journal of Philosophy*, 1998.

It is not simply a duty to provide “welfare payments” or public assistance to those straitened by unfortunate circumstance. The difference principle goes deeper than that and functions on a different plane. Legal institutions specifying rights of property and contract, and economic institutions that make production, trade, and consumption possible are to be designed from the outset focusing on the prospects of the economically least advantaged. Rather than setting up the economic system so that it optimally promotes some other value (efficiency, aggregate utility, freedom to choose, etc.) and then allowing its benefits to “trickle down” to the poor – as if their well-being were an afterthought, the last thing to be taken care of by the social system – the difference principle focuses first on the prospects of the least advantaged in determining the system of ownership and control, production and exchange. (*Rawls, 99*)

This brings me to my final remark. If we are to take Rawls seriously and pursue justice as fairness, it requires patience. Establishing liberty, fair opportunity, and ultimately fairness on the systemic plane is no overnight task. It requires the marginal contributions made by those who also, like Rawls, believe in the possibility of a well-ordered society. It takes generations of advancing thought for the moral sentiments of a society to begin to take on a finer form. And while the ideal may be impossible to fully achieve, this does not mean that the ideal cannot be worked towards. If nothing else, I hope that this thesis does just that—help us move closer to the ideal.

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