The Deceptive Allure of Taxing "Residual Profits"

Stephen E. Shay[*]

This article outlines the traditional justifications for a residual profits business tax base and evaluates its role in the OECD/G20 Pillar One proposal to allocate income to market countries. The article concludes that basing the allocation of profits to market countries on multinationals' residual profits would be inferior to allocating a portion of total corporate profits.

1. Introduction

This article outlines traditional justifications for the use of a residual profits tax base. Practical limitations on the implementation of such proposals are inconsistent with the assumptions used in models that support claimed efficiency benefits. Few residual-profit-tax base proposals have made it beyond the blueprint stage, and the residual-profit-tax instruments currently in place are limited in scope.

Notwithstanding sparse experience with a residual profits tax base, a form of residual profits has been included as part of the OECD/G20 Inclusive Forum Pillar One proposal to reallocate taxing rights to market countries. This article evaluates restricting the reallocation of taxing rights to multinationals' residual profits. It concludes that under Pillar One there is no compelling reason to allocate the desired portion of residual profits instead of an equivalent portion of total corporate profits to market countries.

2. What Are Residual Profits?

For purposes of this article, the term residual profits refers to the portion of total profits that exceeds a threshold that, usually, is designed to isolate a minimum level of profit from taxation. As explained in section 3.1.2., thresholds include a "risk-free return", a "normal return" and "routine return." Although tax practitioners identify "routine return" as a transfer pricing concept, it is being used in the Pillar One context for a similar exclusion purpose. In the Pillar One context, the purpose of a threshold amount is not to exclude the amount from taxation, but is to exclude the threshold amount from allocation (which resembles but is not the same as a transfer pricing objective).

Whichever threshold is employed, a residual profits base is smaller than a traditional corporate tax base, though how much smaller depends critically on its design. For purposes of this article, the question is why has use of residual profit been imported into the Pillar One reallocation regime? It is submitted that there is no reason for the profits subject to reallocation under the current framework of the Pillar One proposal to be based on residual profits instead of total corporate profits.

3. Why Only Tax Residual Profits?

3.1. Justifications

3.1.1. The idea: A painless tax

There are a number of justifications for using residual profits, economic rents or excess returns as a base for taxation, but its attractiveness largely relates to a simple economic idea. The residual profits concepts are thought to be returns that are sufficiently high that they may be taxed without distorting pre-tax economic investment decisions.[1] That concept is attractive to economists because they believe such taxes are "efficient," meaning they do not distort pre-tax economic decisions.

---

1.   This somewhat overstates the actual efficiency claim, which is that taxing rents is more efficient than other taxes. The pure claim is overstated because taxing rents reduces the income of persons owning the rents (if uncompensated by the government, which is inconsistent with raising revenue for other purposes), which will have wealth effects that can change consumption decisions. The wealth effect is common to all taxes, though, whereas taxing rents will not change the decision to invest. *See* G. Schwerhoff, O. Edenhofer & M. Fleurbaey, *Taxation of Economic Rents*, 34 J. of Econ. Surveys 2, p. 412 (2020).

The efficiency justification is attractive to policymakers because the tax on businesses' residual profits may also have favourable distributive qualities if it is borne predominantly by owners of capital.[2] If so, it ticks both the optimal tax boxes of efficiency and equity.

Taxing businesses' residual profits may be attractive to politicians because the tax should be popular with those not taxed and may even be acceptable to (rational) taxpayers that are taxed.[3] Having to choose a profit level below which income is excluded from the tax base permits affected businesses to lobby for a high threshold. In the moneyed politics of the United States, political pressures push toward a higher threshold to minimize business complaints. Even assuming one can identify a meaningful exemption threshold, a tax on residual profits is nearly always more favourable to business than a tax on traditional corporate profits: the base is smaller and invariably the rate is not increased commensurately.

An income tax on residual profits may be politically second best to a tax that taxpayers do not notice, but low-salience taxes can cause taxpayers to misallocate budgets and tend to be regressive.[4] Other efforts to achieve a painless tax include taxes imposed on unsuspecting persons other than the taxpayer; however, these taxes will distort the behaviour of the person that bears the tax.[5] Taxing a residual profits base has the appearance of being a "Goldilocks" tax; not too hot and not too cold, but "just right."

3.1.2. The mechanism

What is the mechanism to identify the level of return on equity investment so that, once achieved, an excess over that return can be taxed without distortions? An initial problem is that economists do not agree on that threshold: is the right threshold the "risk-free return" or the "normal return," which is the return that is sufficient to compensate for the risk of the investment? Some economists have, for practical rather than theoretical reasons, accepted the transfer pricing concept of a "routine return" as a surrogate.[6]

The terms "risk-free return", "normal return" and "routine return" are sometimes conflated in usage;[7] however, they have different meanings. Each reflects the specific contexts in which they were developed and are used. Clarifying their meaning also elucidates their attributes for purposes of identifying returns that can be taxed without distorting investment decisions.

3.1.2.1. Risk-free return

A risk-free return is the return that can be earned independently of investment or market risk, e.g. the risks of the obligor's business. The investment is assured of being repaid. Stiglitz refers to the US Treasury bill return as a risk-free return.[8] Stiglitz argues that "at most, it is [risk-free interest] that should not be taxed on standard efficiency grounds that differential taxation distorts the economy".[9]

---

2.   Estimates of the extent to which the tax is borne by capital versus labour vary greatly. For a review of many studies and a delicate statement of the difficulties in theory and empirical work in this area, *see* K. Clausing, *In Search of Corporate Tax Incidence*, 65 Tax L. Rev. 3, pp. 434-445 (2012): "Yet one has empathy for the researchers in this area. The theory does not provide a crystalline roadmap for investigation, exogenous changes in tax policy are difficult to identify, and the true consequences of variations in corporate tax policies likely occur over time, with substantial lags from the policy changes." The most recent published review of the incidence of the US corporate tax by Staff of the Joint Committee on Taxation of the US Congress concluded that owners of capital bear 100% of the corporate income tax burden in the short run, and 75% of the corporate income tax burden in the long run, with the remainder (not distributed to domestic and foreign owners of capital) being borne by labour. *See* Staff of the Joint Committee on Taxation andhe year in the parenthesis. hesis. ions, i he same probelms napshot, but it may be helpful to mention a Plan C, or to explai, JCX-14–13, *Modeling The Distribution of Taxes on Business Income* 30 (2013). Between 1995 and 2013, the Joint Committee on Taxation did not distribute the corporate income tax because of uncertainty concerning the incidence of the tax. *See* J-A. Cronin et al., *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, 66 Nat. Tax J. 1, p. 242 (2013).
3.   Unlike most economists and policymakers, attentive politicians are aware from their practice of actually talking to voters that loss aversion dominates equally probable gain.
4.   J. Goldin, *Optimal Tax Salience*, 131 J. Pub. Econ., pp. 115-123 (2015). Low-salience taxes may be contrasted with high-salience (and unpopular) taxes, such as property tax and estate tax.
5.   For example, in the United States, half of the social security tax on wages is in form paid to the government by the employer. If, as is generally thought, the employer's share of the tax is shifted to the worker through lower wages, the worker may respond by preferring more leisure.
6.   In transfer pricing, a routine return is the amount necessary to compensate an unrelated person for performing routine functions as a means to separate and identify "residual" returns from non-routine functions and valuable intangibles. Transfer pricing is a creature of tax law and suffers from similar (if not greater) weaknesses as economics in differentiating between returns to tangible, intangible and human capital. For example, in practice, transfer pricing has difficulty accounting for returns from a blend of tangible, intangible and human capital. Recent work has recognized the importance for innovation of non-intellectual-property knowledge-based capital, which is difficult to classify. *See* A. Modica & T. Neubig, *Taxation of Knowledge-Based Capital: Non-R&D Investments, Average Effective Tax Rates, Internal vs. External KBC Development And Tax Limitations* (OECD 2016).
7.   *See* L.V. Faulhaber, *Lost in Translation: Excess Returns and the Search for Substantial Activities* p. 22 (18 Aug. 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3907496 (accessed 26 Aug. 2021).
8.   J.E. Stiglitz, *The Origins Of Inequality, and Policies To Contain It*, 68 Nat. Tax. J. 2, p. 442 (2015). Even this clearest of benchmarks is a concept that involves uncertainty in its determination. The use of treasuries as a risk-free benchmark might be questioned since Standard & Poor's downgraded US sovereign debt from AAA to AA+ in 2011. The bond rating agencies differ, but Standard & Poor's still rates the US Treasury as an AA+ credit risk. *See* https://tradingeconomics.com/united-states/rating (accessed 26 Aug. 2021).
9.   Stiglitz, id., at p. 442. Stiglitz pointed out that in recent years (even as of 2015), risk-free returns have been very, very low. They have been even lower since, and often negative in real terms. Stiglitz justifies including the returns to risk in the tax base (so long as there are loss offsets) on grounds that efficiency would be increased as "well-designed" higher taxation provides better risk-sharing, which is especially important in the context of improved risk markets.

S. Shay, The Deceptive Allure of Taxing "Residual Profits", 75 Bull. Intl. Taxn. 11/12 (2021), Journal Articles & Opinion Pieces IBFD (accessed 13 October 2021).

2

The risk-free return is the most easily identified of the three thresholds and, therefore, the easiest to implement in practice. It is too low to achieve the claimed efficiency objective of no effect on an investment decision since the returns on risk would be left in the tax base.[10] Nonetheless, the use of a risk-free return may be justified as being good enough for the purpose.[11]

The use of a single risk-free return metric as a rough surrogate highlights a central implementation problem with identifying a residual profits tax base to achieve the asserted efficiency benefits. As a matter of administration, the mechanism to identify the residual profits threshold will be designed to apply to all taxpayers subject to the tax. It is not practical to have a bespoke target return for each taxpayer.

Relying on a single return threshold to identify a firm's residual profits instead of determining the threshold return for each firm at the time of investment means that the threshold will be "wrong" for most firms and investments. The dispersion of correct thresholds will determine the extent of the problem across firms.

This leads to a second problem: one of political economy. In picking the return threshold to identify residual profits, politicians will be affected by those with political power. In the context of a general domestic tax base, the political bias will be to make the threshold too low to avoid excessive revenue loss. In the context of an OECD-designed system to shift taxing rights to income of multinational enterprises to source countries, the bias of capital-rich countries will be to make the threshold too high.

We will consider the viability of expensing investment as a means to overcome the single threshold problem in the discussion of a "normal" return in section 3.1.2.2.

3.1.2.2. The normal return

The "normal" return is used in economics to describe the return above which the investor will earn economic rents. Economic rent refers to the return on an investment that is above the minimum necessary to cause an investor to make the investment.[12] As a practical matter, the normal return will include both the risk-free return and the return necessary to compensate the investor for the risk of the investment. If the tax on residual profits is going to be applied on a firm-by-firm basis, the objective is to identify a normal return for a firm in order to tax profits in excess of the normal return.

There are two ways to exempt the normal return: (i) allow an annual deduction for an amount equal to the normal return; or (ii) it is argued, allow expensing. The issue in allowing a deduction is how to identify the normal return amount, which involves identifying the portion of a firm's return required to compensate for risk in addition to the risk-free return. There are various proxies for measuring returns to risk, but they do not lend themselves to incorporation in a tax system.[13]

The approach used in most residual-profit-tax proposals, such as an allowance for corporate equity (ACE), is to use a deduction amount measured in relation to equity. Countries that have adopted an ACE in practice generally have applied it only to new equity investment.[14] These countries largely break into two groups in determining the allowance rate to use to calculate the ACE. The first are developed countries that use a low rate sometimes based on a government borrowing rate,[15] and the second are investment hubs that use higher deduction rates to compete for investment (that generally does not stay in the country) to generate income for local service providers.[16] It is fair to say that the ACE regimes put in place have been limited to "toes in the water" to attract investment without risking revenue.

The alternative to using a deduction to offset the normal return is to allow expensing of investment. The claim made for expensing is that the value of an immediate deduction for investment reinvested in the business at the firm's normal return

---

10. Kleinbard points out that "what the tax law literature calls risky returns in many cases actually are [ex ante] risk-adjusted normal returns." E.D. Kleinbard, Capital Taxation in An Age of Inequality, 90 S. Cal. L. Rev. 3, p. 669 (2017). It is beyond the scope of this article to consider the Domar-Musgrave theory that investors can respond to taxation by adjusting portfolios to higher-risk assets in order to maintain a pre-tax return. In its simple version, this theory also relies on strong assumptions, including that transactions costs may be disregarded.
11. *See*, for example, J. Mirrlees et al., *Tax by Design: The Mirrlees Review*, ch. 17 (Oxford University Press 2011), available at http://www.ifs.org.uk/publications/5353 (accessed 26 Aug. 2021) (under strong assumptions an allowance for corporate equity may be based on a risk-free return).
12. Schwerhoff, Edenhofer & Fleurbaey, *supra* n. 1, at p. 400, citing H.R. Varian, *Intermediate Microeconomics: A Modern Approach* p. 412 (WW Norton 2006) refers to "those payments to a factor of production that are in excess of the minimum payment necessary to have it supplied". Schwerhoff, Edenhofer & Fleurbaey generalize the concept beyond production factors. They also acknowledge that the precise meaning of "economic rent" is subject to debate in the literature.
13. In theory, using a capital asset pricing model (CAPM), it would be possible to identify a firm's market risk premium. Identifying a market risk premium is not administratively feasible due to, inter alia, a lack of ready information for non-public firms and the need to rely on data for comparable public firms. Moreover, this risk premium is not a good fit as it takes account of risks for infra-marginal returns.
14. Countries with an ACE include Belgium, Cyprus, Italy, Malta, Poland, Portugal and Turkey. (Brazil allows a deduction for a portion of dividends based on a long-term government bond rate but imposes a 15% withholding tax.) Only Poland applies the deduction to old equity, but Poland limits the deduction to EUR 60,000. These regimes, which do not replace the existing corporate tax, function less as a tax base than as a tax incentive for equity investment.
15. Belgium's allowance rate is 0.726% (1.226% for small and medium-sized enterprises), Italy's is 1.30% and Poland's is 2.50%. Portugal's allowance rate is 7.00%, but it is capped at EUR 2 million or 25% of a firm's EBITDA. These regimes have been frequently changed.
16. Cyprus's allowance rate is 5.30%, Malta's is 6.27% and Turkey's is 27.04% (as of 2018). Turkey is not an investment hub but has been under economic stress and seeks to attract investment.

offsets the net present value of future taxes on the normal return from the investment.[17] This claim of a deduction exempting the normal return requires that:

- tax rates remain the same over the life of the investment;

- tax savings from losses be refundable immediately in the year of loss (irrespective of whether there has been prior income); and

- the original investment and the investment of the amount saved by reason of expensing earn the same return.[18]

The assumptions needed for the normal return to be exempted are strong assumptions that are not often seen in the real world. The requirement of a constant tax rate with respect to future returns for expensed amounts involves a government commitment that rarely is found in democratic systems and, if adopted, would hobble fiscal policy as an economic management tool.[19] Uncertainty regarding government commitment to constant tax rates affects taxpayer expectations and reinvestment plans.[20] Countries do not provide immediate tax refunds for start-up losses.[21] The design elements of expensing necessary to have the effect of exempting the normal return are not found in existing corporate income taxes.[22]

Notwithstanding these problems, expensing is consistently referred to as exempting the normal return, which overstates or understates the position, depending on the facts. There is not sufficient actual experience with basing a corporate tax on residual profits to conclude that the theoretical efficiency gains exist in practice.

3.1.2.3. Routine Return

Taxation operates in a world of the second best. The use of an amorphous transfer pricing "routine return" to identify residual profits that may be allocated draws on such second-best precedent. "Transfer pricing" is the term used for pricing transactions between members of a group of companies or businesses that are related by ownership or that operate under common control such that there is a lack of adversity between the parties to the transaction. Tax transfer pricing rules are designed to restrict the opportunity to avoid taxation through manipulation of transfer prices in related-party transactions by requiring prices to be within a range of what would be charged between persons that are not related or under common control. The residual profits method is used when the functions performed by the related parties involve hard-to-value elements, whether intangibles, services or both. The method calls for applying a return to routine functions that reflects their lack of market risk in order to isolate the residual profits earned from the hard-to-value elements of the business.

The routine return is a middle ground between a risk-free return and a normal return that reflects all of the risks in a firm's business. It is thought of as the risk that an independent contractor takes in performing the function at modest or no market risk (in the latter case because, for example, the purchaser agrees to buy the vendor's output).[23] Even these routine returns vary by function, and such returns should be based on comparable market transactions.[24] In transfer pricing, the resulting residual profits are allocated between the parties based on some metric that reflects their contributions.

As will be discussed in section 4., the use of residual profits has been proposed as a base from which profits would be reallocated in part to "market" countries where sales are made. Note that this form of proposal does not take routine profits out of the tax base, but leaves them in the country where the activity is physically performed (i.e. where the income is earned).

---

17.   *See* A.J. Auerbach, *A Modern Corporate Tax*, p. 2 (Hamilton Project 2010).
18.   For a more complete description of the relationships that underlie the result in theory, *see* A.C. Warren, Jr, *How Much Capital Income Taxed under an Income Tax Is Exempt under a Cash Flow Tax*, 52 Tax L. Rev. 1 (1996). Note that in the standard model, the amount saved by reason of expensing is not just the tax rate times the deducted amount but also the tax saved by immediately deducting the reinvestment of that tax saving. In other words, if the investment is 100 and the tax rate is 30%, the amount saved is 43 (0.3/(1-0.3) = 0.42587). Id., at p. 3. Tax refunds generally are not immediate. Kleinbard highlights that the assumption of constant tax rates in the standard model implies a flat rather than a graduated rate structure. *See* Kleinbard, *supra* n. 10, at p. 669.
19.   Following the US 2017 tax rate reductions, expecting constant tax rates was a risky expectation, given that the tax legislation was estimated to expand deficits by over USD 1.4 trillion and was passed with no support from the other (now majority) party. President Biden's fiscal year 2022 budget proposals would raise the corporate rate from 21% to 28%.
20.   Mirrlees et al., *supra* n. 11, at p. 874: "[T]he neutrality of the tax with respect to investment depends crucially on the tax rate being constant over time: indeed, it requires that investors believe that the tax rate will not change in the future."
21.   Id., at p. 875: "Governments are typically reluctant to provide such subsidies, especially through a general tax system – and with some reason, since they would enhance the possibility of fraud."
22.   Schwerhoff, Edenhofer & Fleurbaey, *supra* n. 1, at p. 399: "This paper aims to bridge the gap between the conceptual appeal and the practical irrelevance of rent taxation." Estonia, Georgia and Latvia do not impose corporate taxes on corporate earnings until they are distributed, which is quite different from taxing corporate residual profits.
23.   Thus, under one formulation, a routine return would be determined for "all business functions and activities within a multinational business – research and development (R&D) activities, manufacturing, general and administrative activities (G&A), sales and marketing activities, and others". *See* M. Devereux et al., *Taxing Profit in a Global Economy* p. 189 (Oxford University Press 2021). Devereux et al. observe that, in this approach, the routine profit will often (but not necessarily always) be lower than its normal return, and in such case, the residual profit will exceed the economic rent. *See* id., at p. 202.
24.   This article does not discuss safe harbours used to determine routine returns. *See* OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* pp. 124-125 (OECD 2020).

Residual profits only are used as the base for reallocating profits to countries where sales are made and customers are located. The allocation will be based on sales.[25]

At this stage, it is only necessary to observe that the usual efficiency claims made for using residual profits as a tax base do not apply, because the risk-free, routine or normal returns remain subject to tax in the location where they would traditionally be taxed. Accordingly, the potential for distortion in the amount of investment remains.

3.2. Should different sources of residual profits be taxed differently?

It is worth pausing for a moment to consider what gives rise to residual profits. Schwerhoff et al. provide a classification of economic rents that illustrates their multiple sources, including (i) political interventions (familiar to lobbyists and their clients); (ii) investments (in innovation and often manifest in patents and brands, whether trademarked or not); (iii) natural monopolies; (iv) market power (e.g. from network effects or anti-competitive behaviour); and (v) scarcity (demand for limited supply exceeds marginal costs from natural limits or regulation).[26] For our purposes, the point is that rents are found throughout the modern economy.[27]

Assuming that a normal return is capable of being sufficiently identified, a question for policymakers is whether resulting residual profits (here, economic rents) should be treated in the same manner for tax purposes if one makes the further strong assumption that distinct sub-species of economic rents can be sufficiently identified. Schwerhoff et al. observe, for example, that optimal policy would differentiate between reasons for the rents. The efficiency rationale for taxing natural monopoly rents may not be the same as taxing rents from regulation.[28]

For purposes of this article, it is sufficient to observe that the reasons for realizing economic rents (or residual profits) will differ between industries and firms within industries. In addition to the question of whether rents can be sufficiently identified to single them out on efficiency grounds for taxation separate from a normal or routine return, it may be questioned whether some subset(s) of rents should be excluded from such a tax base on efficiency grounds.

3.3. Residual profits as an efficient tax base: Trouble with the curve[29]

There is a gap between (i) the theory that residual profits or economic rents are an efficient tax base; and (ii) the ability to identify rents and implement the tax. There is little empirical evidence as to the size of the gap, but there is reason to believe it is material given the centrality of assumptions underlying the theory that are not (and perhaps cannot) be satisfied. It is also not feasible to differentiate between rents that should and should not be taxed on efficiency grounds.

There is a further issue to be considered. If the normal return is small, as Stiglitz suggests, at least in recent years in relation to a risk-free measure, then the question is whether excluding the risk-free return is worthwhile in relation to the benefit. If the risk-free return is large, or is expected to become large, then the tax rate would have to increase in order for a change in the base to raise the same or greater revenue. A higher tax rate has its own efficiency effects.[30]

A further issue is transition and how it applies to existing investment. In order to avoid the revenue loss (or need for a higher tax rate) from allowing both pre-effective date depreciation and a deduction for the normal return, countries often apply the new regime only to new investment. Transition can be politically challenging because of the implicit tax on pre-effective date capital.[31]

---

25.   The proposal by Devereux et al., *supra* n. 23 would allocate based on gross income from sales.
26.   *See* Schwerhoff, Edenhofer & Fleurbaey, *supra* n. 1, pp. 401-405 (2020).
27.   This is buttressed by the high estimates for the portion of corporate profits that constitute rents (though the methodology for making such estimates includes a number of strong assumptions, including those already described in connection with the definition of a "normal" return). *See* L. Power & A. Frerick, *Have Excess Returns to Corporations Been Increasing Over Time?*, 69 Nat. Tax J., 4, p. 831 (2016) (estimating that 75% of US C corporation profits are attributable to economic rents). Under the methodology used by Power and Frerick, rents are concentrated in multinationals and in a subset of industries (pharma, tech, chemical and non-durable manufacturing). Most C corporations do not earn rents.
28.   When regulation is implemented in the form of taxes or other government charges, the government presumably captures the rent so further taxation may be unnecessary. Schwerhoff, Edenhofer & Fleurbaey, *supra* n. 1, at p. 402.
29.   *Trouble with the Curve* is a US film involving an aging baseball scout (played by Clint Eastwood). The scout sees that a prospect who statistically is rated highly as a hitter cannot hit curve balls and recommends against signing the prospect. (Once such a weakness is observed by opposing teams, the batter would be unproductive, making the statistical choice unreliable.) Spoiler alert: Eastwood is shown to be right, and the data-driven youngsters wrong. The movie is a drama, not a documentary.
30.   J. Gruber, Public Finance and Public Policy 625 (6th ed., 2019). (The efficiency loss from taxation increases as the tax rate increases, more specifically, "the deadweight loss rises with the square of the tax rate".)
31.   A substantial portion of the asserted efficiency gains from switching from an income tax base to a consumption tax base come from taxing consumption with pre-effective-date investments and savings. *See* D. Altig at al., *Simulating FundamentalTax Reform in the United States*, 91 Am. Econ. Rev. 3, pp. 575-76 (2001).

S. Shay, The Deceptive Allure of Taxing "Residual Profits", 75 Bull. Intl. Taxn. 11/12 (2021), Journal Articles & Opinion Pieces IBFD (accessed 13 October 2021).

5

The allure fades when the prospect of taxing residual profits is examined closely. This is one explanation why the implementation of ACE regimes has been limited and often second-guessed after a few years of experience or when there is an economic downturn. The theory of taxing residual profits has trouble with the curves thrown in the real world.

4. Mission Creep: Residual Profits as a Base for Market Country Allocation

The use of residual profits as a base for allocating income to market countries is a component of the Pillar One proposal. Very briefly, Amount A under Pillar One will be a "reallocation percentage" (25%) of a multinational's "residual profit."[32] The residual profit is the amount of the multinational's profit that exceeds a 10% profit percentage (pre-tax profit to revenue).[33] The Amount A resulting from applying the reallocation percentage to residual profits would be apportioned among market countries according to revenues that are taken into account in identifying that a country is eligible for an allocation of Amount A. An additional step re-assigns Amount A taxed by market countries back to the individual members of the multinational group from which the residual profit is deemed to derive (so-called "paying entities") in order to avoid double taxation of the income.[34]

As noted previously, under Pillar One, all routine returns are taxed. In other words, the 10% profit that is deemed to be a routine return is taxed by the country having traditional jurisdiction to tax. Even if the efficiency benefits claimed from excluding normal returns do, in fact, exist, the Pillar One proposal does not exclude routine returns from taxation; it only excludes them from the base on which to determine the amount of profits reallocated to a market country. The aggregate income base subject to tax does not change under Pillar One; the right to tax the income is allocated to different countries, which may or may not result in different amounts of aggregate tax depending on country tax rates and whether and how double taxation is addressed.[35]

The limitation of Amount A to residual profits has no efficiency effect in and of itself. The purpose of Amount A is to identify a number that is the portion of the firm's profit to be allocated to market countries. The amount allocated to market countries depends on the allocation percentage (i.e. the portion of Amount A allocable to market countries), which can be mathematically adjusted to give the same result, whether multiplied by residual profits or total profits.

For example, assume that an in-scope firm has total profit percentage of 25%, of which 10% is deemed under the IF Statement to be a routine profit and 15% is residual profit. Assume that the allocation percentage (again the portion of residual profits allocated to market countries) is 25%. Amount A would be the same if it were 25% of the 15% residual profits or 3.75% of total profits (25% × 15% = 3.75%) or if it were 15% of the 25% rate of total profits or 3.0% of total profits (12% × 25% = 3.75%) (*see* Table 1).[36]

Table 1 – Equivalence of allocation of residual profits and total profits

	Total return	Normal	Residual
Allocation %	25%	10%	15%
25%	-	-	3.75%
15%	3.75%	-	-

The market countries to which the amount is allocated will be unaffected, regardless of whether Amount A is based on residual profits or total profits.

Using total corporate profits as a base for reallocation likely would increase the number of countries from which allocations are derived and the extent to which a lower-profit country in which the multinational group operates may include a payee entity whose income is deemed taxed in part by a market country (and, therefore, exempted or eligible for a foreign tax credit). That is

---

32. OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, p. 2 (OECD 2021), available at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf (accessed 13 Oct. 2021) [hereinafter IF Statement].
33. Id., at p. 2.
34. OECD, *supra* n. 24, at p. 123. There are additional details, such as how to address market countries that already tax a share of the residual profit, that do not have to be addressed for purposes of this article. Id., at chs. 6 and 7.
35. The only element of the Pillar One design identified in the economic impact assessment as having an efficiency consequence (albeit a very small one) is the limitation of in-scope multinationals to those with 10% or higher profitability. OECD, *Tax Challenges Arising from Digitalisation – Economic Impact Assessment*, p. 142 (OECD 2020) ("Higher-profit companies are found to be less sensitive to the effects of tax on investment."); and IF Statement, *supra* n. 32, at p. 1.
36. Algebraically, if the residual profit allocation percentage (x) is 25% and the routine profit percentage (y) is 10%, then for any in-scope return (r) the total profit allocation percentage (z) would be determined as $z = xr – xy$. In the example in the text, z = 6.25% (20% × 25%) – 2.5% (25% × 10%), or 3.75%.

---

unlikely to have a measurable effect on the amount or location of investment.[37] Moreover, there likely would be little additional burden on the payee entity whether it reduces double taxation by exemption or credit.

There is no discernible efficiency benefit from using residual profits in determining Amount A. If Amount A is determined by applying the reallocation percentage to total corporate profits, implementation will be more appropriately integrated with Pillar Two, which should take account of the taxation map after application of Pillar One. Using residual profits adds complexity and yields little or no net benefit.

A cynic might take the view that the reason the OECD looked to residual profits was to make the allocation to market countries look like more than it is and to make it harder to expand the proposal to a broader group of companies. Irrespective of the allocation method, the small ambition of Pillar One is striking. Assuming that the average profitability of firms within the scope of Pillar One is 25%, a 25% reallocation percentage would reallocate no more than 3.75% of corporate profits to market countries. For these modest amounts, Pillar One should be drafted to be as straightforward as possible in implementation.

5. Conclusion

Taxing residual profits garners enthusiasm on the drawing board, but it has yet to deliver on the promise held out by economic theory. The allure is deceptive in relation to the reality. The allure is even further removed in relation to Pillar One. There does not appear to be a compelling reason to import residual-profit taxation into the Pillar One regime.

---

37. Pillar One is estimated to have an extremely modest effect on firms' overall effective tax rates (ETRs), at a 10% profitability threshold. *See* T. Hanappi & A.C.G. Cabral, *The impact of the Pillar One and Pillar Two proposals on MNE's investment costs: An analysis using forward-looking effective tax rates*, OECD Taxation Working Paper No. 50, pp. 30-31 (2020): "The results show that Pillar One would have relatively limited impacts on group-level ETRs. The global GDP-weighted EATR is expected to increase on average 0.01 percentage points following the introduction of Pillar One, with the EMTR increasing roughly by the same amount."

Exported / Printed on 16 Nov. 2021 by IBFD.