

Alternative Pillar 1 Formulas for International Fairness

by Jeff Ferry and David Morse

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In this article, Ferry and Morse examine the advantages and disadvantages of pillar 1 of the OECD inclusive framework's proposed tax reforms for the digital economy.

In October the OECD announced the support of 136 nations (137 as of November 4) for a new global structure for corporate income tax known as the OECD/G-20 inclusive framework on base erosion and profit shifting. The structure also has the support and agreement of G-20 finance ministers and leaders. The OECD plan contains two pillars. Pillar 1 addresses the problem of companies generating revenue in jurisdictions in which they pay little or no corporate tax. Pillar 2 addresses the problem of companies shifting profits to low-tax tax havens. In this article, we focus on pillar 1.

Pillar 1 addresses tax challenges arising from the growing internationalization of the world economy and growing digitalization. Online retailer Amazon.com epitomizes the problem in the digital industry sector. Amazon sells online in dozens of markets around the world, with a minimal presence in many of those markets. Current corporate taxation is based on residence and arm's-length transfer pricing principles. This means that corporations pay tax based on attributing profit to its source or origin. Online retailers like Amazon can do business in many markets without booking any corporate profits in those markets because the incorporated entity booking the revenue can be located in the United States or virtually anywhere else. Even if corporate revenue is booked in the local market, modern tech companies are often structured in a way to pay royalties for the intellectual property

used in their businesses to subsidiaries in low-tax tax havens. An online retailer in a major consumer market, such as a European nation, could book billions of dollars of revenue in that market but then, by paying royalties to the IP-owning sister company in a tax haven, show no profits in the relevant consumer market. Brick-and-mortar retailers, and even many smaller, local online retailers, pay corporate taxes in each national market at or close to the headline tax rate, typically between 19 and 33 percent. They are at a considerable disadvantage competing against an international online retailer paying little or no tax in that national market or worldwide.

However, the problem is not limited to technology companies. Many nontech companies can use tax strategies to minimize taxes in a national market. For example, in 2012 an investigation of Starbucks by the U.K. House of Commons found that the company paid close to zero corporate tax in the United Kingdom despite reporting to investors that the U.K. market was highly profitable. Starbucks used a set of tax maneuvers, all legal, to shift profits away from the United Kingdom to lower-tax jurisdictions. The tactics involved the creation of Starbucks subsidiaries in other countries owning Starbucks's unique recipes and charging royalties to Starbucks U.K. for the use of them, thereby reducing Starbucks U.K.'s reported profits. Starbucks U.K. bought Starbucks coffee beans, purchased around the world by Starbucks Trading, headquartered in a low-tax Swiss canton. The beans never had to physically go through the canton, just the paper ownership. Then, Starbucks Manufacturing received the beans and roasted them in the Netherlands. Each step looked to apply a 20 percent markup.¹ But the coffee beans are not the

¹ Edward D. Kleinbard, "Through a Latte Darkly: Starbucks's Stateless Income Planning," *Tax Notes*, June 24, 2013, p. 1515.

only objects in the sale of a cup of coffee. Napkins and cups and other ancillary costs could be similarly accounted for in manipulating the cost of goods sold.

Multinational pharmaceutical companies are another notable beneficiary of the current taxation methods. The OECD BEPS inclusive framework is expected to recapture hundreds of millions of dollars per year with the pillar 1 and 2 reforms. But Pfizer and Johnson & Johnson are using the goodwill earned from vaccination manufacturing to pressure Congress to protect them.² Pfizer's participation is notable because previous reports indicated that Pfizer had been shifting profits generated by drugs developed in the United States and sold worldwide to tax havens in Ireland and elsewhere for over a decade.³ In 2020 Pfizer made a profit of \$7.5 billion on \$41.9 billion in revenue, on which it paid a global tax provision of just \$736 million, or 10 percent. Its cash tax payment to the U.S. federal government was just \$371 million, equivalent to just 4.9 percent of its profits.

The pillar 1 plan developed by the OECD in consultation with corporate and public sector representatives from many countries involves authorizing the collection of a portion of the profits linked to revenue generated in national markets. These profits are then reallocated to the market jurisdictions. The portion of profits that may be taxed this way is limited by multiple guidelines, including the size and profitability of the company, and a 25 percent apportioning to be allocated to this new tax base.

The fundamental principle of linking corporate taxation to the market jurisdiction in which customers pay revenue is accepted by more than 136 national governments, including the United States and virtually every other major economy. According to the October 8 OECD statement, for purposes of the new pillar 1

corporate tax, "Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed."⁴

As we have argued before, the only fair way to levy tax on corporate profits, especially in developed countries, is to base all corporate taxation on profits linked to the sales generated in each jurisdiction. The current system is far too easy to manipulate, and it is only becoming more so as IP is involved in more businesses. Each year more businesses become aware of the potential to minimize taxes by clever, entirely legal, tactics. Pillar 2 provides production-based tax carveouts that can drop the global minimum tax well below 15 percent, ensuring that tax competition between nations remains alive and well.

Even the relocation of intangible assets like IP ownership in low-tax jurisdictions will not be entirely negated. Implementing pillar 2 will set a global minimum corporate tax rate of 15 percent. Still, the savings involved in the difference between many national rates, such as the United States at 21 percent, and the 15 percent minimum will be significant enough to justify IP tax avoidance strategies for many multinational corporations.

Pillar 1 is a significant step toward a more rational global system of corporate taxation. However, one problem with the current version of the pillar 1 system is that it puts a considerable share of the burden on the United States because digital companies are the largest beneficiaries of the broken transfer pricing system. The current pillar 1 formula is packed with exclusions and deductions to ensure that only a handful of huge multinationals are hit with the new tax. These conditions end up protecting many non-U.S. corporations. This article looks at ways to modify those conditions to address concerns regarding the pillar 1 tax burden.

Pillar 1 includes only corporations with more than €20 billion (about \$23 billion) of revenue a year. That limits it to the largest companies worldwide. Next, it excludes all financial and extractive businesses. Then, it applies only to companies earning profit at a rate of more than 10

² Jenny Strasburg and Laura Cooper, "Big Pharma Quietly Pushes Back on Global Tax Deal, Citing Covid-19 Role," *The Wall Street Journal*, July 27, 2021.

³ Tom Bergin and Kevin Drawbaugh, "How Pfizer Has Shifted U.S. Profits Overseas for Years," *Reuters*, Nov. 16, 2015.

⁴ OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy," at 2 (Oct. 8, 2021).

percent of sales in the relevant year. That first 10 percent of profit is termed “routine profit” by the OECD. The pillar 1 tax is levied only on the profit above that 10 percent, which is termed “residual profit.” Finally, only a portion of that residual profit will be taxed. In the October OECD publication, that portion, known as the quantum, is fixed at 25 percent of the residual profit.

This multistage formula ensures that the pillar 1 tax begins by targeting the world’s largest and most profitable multinationals. The net will widen over time. According to the OECD, the revenue threshold should fall from €20 billion to €10 billion in year 8.⁵

To analyze the likely initial effect of pillar 1, we collected data on all companies in the *Fortune* Global 500 for 2020. We used actual data from financial statements to ensure we have accurate data for revenue, pretax profit, and other key variables. We found that a total of 76 companies met the October OECD pillar 1 requirements. The split was even, with 38 U.S.-headquartered companies and 38 qualifiers headquartered outside the United States.

But on a taxable-revenue basis, the split is far less balanced. Under the OECD standards, these 76 qualifying companies had \$399.8 billion of residual profit eligible for pillar 1 taxation. With an OECD-set quantum of 25 percent, that means \$99.95 billion of profit would be taxed under pillar 1. U.S. companies account for 73.8 percent of that total. That one-sidedness has raised specters of doubt toward the congressional agreement on pillar 1.⁶ The 73.8 percent figure appears excessive when compared with the U.S. share of global GDP, which is just 24 percent. Actual tax liabilities will depend on how much revenue each company books in each foreign jurisdiction and how those jurisdictions choose to apply their national corporate tax to profits linked to that revenue. But our estimates provide a good starting point.

The reason U.S. companies would be hit so hard by the current structure of pillar 1 can be seen in Table 1. The largest companies that meet the pillar 1 standard are big U.S. tech companies, and

they are highly profitable. The top five companies are the four largest U.S. tech giants plus Berkshire Hathaway, Warren Buffett’s huge conglomerate. Together these five account for \$163.9 billion of the \$399.8 billion in residual profit, or 41 percent of the \$99.95 billion total quanta that would be taxed under the OECD formula.

The OECD formula uses one measure of profit, the ratio between pretax profit and total revenue (sales), as a key factor in determining eligibility for pillar 1 tax. It has set a somewhat arbitrary threshold of 10 percent as routine profit, making only the excess over the 10 percent, labeled residual profit, eligible for the tax. The purpose of these artificial definitions and thresholds is to narrow down the number of eligible companies to make the pillar 1 tax more politically palatable to many companies and their lobbyists who opposed these taxes.

Some experts have argued that pillar 1 unfairly burdens U.S. companies because they tend to have higher profitability ratios than many non-U.S. companies.⁷ They believe the United States suffers because it will not gain additional revenue in exchange for this potential agreement, and pillar 1 cannot be salvaged as a result.

However, other experts focus on the revenue-based allocation key as the culprit that denies developing nations their share of the tax. They argue that large market countries are the true beneficiaries of the agreement and developing nations gain the crumbs.⁸ Experts in this camp have no love for the monopolistic tendencies of the greatest tax avoiders, even if they are U.S. companies in name.

The dissonance between these two arguments can be resolved by refocusing on the political construction of pillar 1. The 10 percent routine profit threshold creates an imbalanced application and should be reconsidered.

One way to broaden the net to resolve both complaints is to lower the routine profit threshold. In Table 2, we compare how the tax would work with various levels of routine profit thresholds.

⁵ Stephanie Soong Johnston, “Countries Advance Historic Global Tax Plan With New Details,” *Tax Notes Federal*, July 12, 2021, p. 295.

⁶ Frederic Lee, “GOP Senators Warn Against Skipping Treaty Process on Pillar 1,” *Tax Notes Federal*, Oct. 18, 2021, p. 383.

⁷ Mindy Herzfeld, “Is the OECD Deal Good or Bad for the United States?” *Tax Notes Federal*, Oct. 25, 2021, p. 440.

⁸ Joseph Stiglitz, “Making the International Corporate Tax System Work for All,” *The Progressive Post*, Nov. 3, 2021.

Table 1. Top Pillar 1 Taxpayers With 10 Percent Routine Profit Threshold

Ranking	Company	Nationality	Revenue 2020 (\$M)	Pretax Profit 2020 (\$M)	Profit Rate (%)	Routine Profit (\$M)	Residual Profit	Quantum	Share of Total Quantum
1	Apple	USA	\$274,515	\$67,091	24.4%	\$27,452	\$39,640	\$9,910	9.9%
2	Microsoft	USA	\$143,015	\$53,036	37.1%	\$14,302	\$38,735	\$9,684	9.7%
3	Berkshire Hathaway	USA	\$245,510	\$143,015	22.7%	\$24,551	\$31,142	\$7,786	7.8%
4	Google	USA	\$182,527	\$245,510	26.3%	\$18,253	\$29,829	\$7,457	7.5%
5	Facebook	USA	\$85,965	\$182,527	38.6%	\$8,597	\$24,584	\$6,146	6.1%
6	Tencent	China	\$69,822	\$85,965	37.3%	\$6,982	\$19,092	\$4,773	4.8%
7	Intel	USA	\$77,867	\$25,078	32.2%	\$7,787	\$17,291	\$4,323	4.3%
8	Sanofi	France	\$41,123	\$15,750	38.3%	\$4,112	\$11,638	\$2,910	2.9%
9	Samsung Electronics	Korea	\$200,589	\$30,786	15.3%	\$20,059	\$10,728	\$2,682	2.7%
10	China Mobile	China	\$111,247	\$20,619	18.5%	\$11,125	\$9,495	\$2,374	2.4%
	<i>Top 10</i>		\$1,432,180	\$375,390	26.2%	\$143,218	\$232,172	\$58,043	58.1%
	Total (76 companies)					\$399,766	\$399,815	\$99,954	100.0%

Source: Company filings, CPA calculations.

Lowering the threshold has three advantages: It increases the number of companies liable to pay pillar 1 tax; it increases the dollar value of the quantum of profit liable for the tax; and it increases the concentration of non-U.S. companies liable for the tax.

Table 2. U.S./International Split With Varying Routine Profit Thresholds

Routine Profit Threshold	Number of Pillar 1 Taxpayers	Total Quantum (pillar 1 taxable profit, in billions)	U.S. Companies Share of Total Quantum
10%	76	\$100	73.8%
5%	115	\$160.8	68.0%
3%	130	\$228.3	56.5%
0%	144	\$302.9	54.5%

Note: Based on 2020 financial reports.
Source: Company filings, CPA calculations.

It also eliminates some of the randomness that comes from an artificially chosen threshold. For example, Amazon is probably the company that has done the most to drive the 137 nations to press for a new form of corporate taxation. Amazon's large online sales in many nations, often accompanied by small payments of corporate tax in those nations, was a big contributor to the pressure for new forms of corporate taxation. Yet under the OECD-proposed formula, Amazon would not be liable for pillar 1 tax. The reason is that Amazon's profit rate in 2020 was just 6.3 percent, well below the 10 percent threshold set by the OECD.

To pull Amazon into the pillar 1 net, some national governments pressed to tax Amazon's two major divisions separately under a specialized rule known as segmentation. The Amazon retail business showed an operating profit of \$9.4 billion with a profit rate of 2.7 percent in 2020, while the technology business, Amazon Web Services, booked an operating profit of \$13.5 billion, for a profit rate of 29.7

Table 3. Top Pillar 1 Taxpayers With 0 Percent Routine Profit Threshold

Ranking	Company	Nationality	Revenue 2020 (\$M)	Pretax Profit 2020 (\$M)	Profit Rate (%)	Routine Profit (\$M)	Residual Profit	Quantum	Share of Total Quantum
1	Apple	USA	\$274,515	\$67,091	24.4%	0	\$67,091	\$16,773	5.5%
2	Berkshire Hathaway	USA	\$245,510	\$55,693	22.7%	0	\$55,693	\$13,923	4.6%
3	Microsoft	USA	\$143,015	\$53,036	37.1%	0	\$53,036	\$13,259	4.4%
4	Google	USA	\$182,527	\$48,082	26.3%	0	\$48,082	\$12,021	4.0%
5	Facebook	USA	\$85,965	\$33,180	38.6%	0	\$33,180	\$8,295	2.7%
6	Samsung Electronics	Korea	\$200,589	\$30,786	15.3%	0	\$30,786	\$7,697	2.5%
7	Toyota	Japan	\$254,877	\$27,463	10.8%	0	\$27,463	\$6,866	2.3%
8	Tencent	China	\$69,822	\$26,074	37.3%	0	\$26,074	\$6,519	2.2%
9	Intel	USA	\$77,867	\$25,078	32.2%	0	\$25,078	\$6,270	2.1%
10	Amazon	USA	\$386,064	\$24,178	6.3%	0	\$24,178	\$6,045	2.0%
	<i>Top 10</i>		\$1,920,751	\$390,662	20.3%	—	\$390,662	\$97,665	32.2%
	Total (144 companies)						\$1,211,406	\$302,851	100.0%

Source: Company filings, CPA calculations.

percent. Ironically, pillar 1 could lead to the web services business paying tax in many jurisdictions, even though it is Amazon's retail business that has caused the most grievances in foreign markets.

Another example of the strange effects of a 10 percent threshold is that it excludes supermarket businesses. For example, U.S. supermarket chain Trader Joe's, with more than 500 locations, is owned by a German company, while Aldi, with more than 2,000 U.S. locations, is owned by another German company. Both are multibillion-dollar businesses. Yet neither one would be liable for pillar 1 tax because supermarkets typically show a profit rate well under 10 percent — usually under 5 percent. (As privately owned businesses, neither of these supermarket chains publishes profitability figures.)

Table 2 shows that as the rate of routine profit excluded from pillar 1 tax liability declines, the tax net widens. With a 5 percent threshold for routine profit, based on our 2020 data, 115 companies would become liable for the tax (including Amazon), with a taxable quantum of

\$160.8 billion. That's 60 percent more taxable profit than in the 10 percent routine profit case. With a 3 percent routine profit threshold, 130 companies would be liable for the tax, with a taxable quantum of \$228.3 billion. Finally, a routine profit threshold of zero would make 144 companies liable for the tax, with a quantum of \$302.9 billion.

In the case of a zero routine profit threshold, U.S. companies would pay only 54.5 percent of the total tax. While recognizing the weight of the current U.S. digital footprint in the world economy, this more balanced approach resolves both sets of complaints. Also, because the OECD and many observers would like the system to broaden over time, a move now to a zero routine profit threshold would be a good early step in that direction.

Table 3 shows the top pillar 1 taxpayers with a zero routine profit threshold; that is, when all pretax profit is included but then reduced by 75 percent to generate the 25 percent quantum. Amazon now just makes it into the top 10 because although its rate of profit is low, the absolute

value of its profit, \$24.2 billion in 2020, is very high. U.S. companies still dominate the list, but by bringing in more foreign companies, foreign taxpayers at 82 now outnumber U.S. taxpayers at 62.

A broader net means a fairer distribution of the tax burden. It is also a bigger step toward universalizing a system of corporate tax based on the location of revenue and customers rather than the increasingly untenable origin of profit. ■

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