Lost in Translation: Excess Returns and the Search for Substantial Activities

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Lost in Translation: Excess Returns and the Search for Substantial Activities

Lilian V. Faulhaber*

Starting in 2010, one international tax reform proposal moved from being a one-page idea in the Obama Treasury's proposed budget to being one of the OECD's options for CFC reform to becoming the basis for one of the major international tax reform provisions in the 2017 U.S. tax reform to being considered as part of Pillar Two of the OECD's current digital tax project. This proposal, for a minimum tax on foreign excess returns, has changed shape with every iteration, and its proponents have justified each version of this differently and defined its various elements differently.

This Article tells the story of the many recent proposals for minimum taxes on foreign excess returns, starting with the Obama Treasury's brief proposal and ending with the OECD's current negotiations over digital taxation. This Article highlights the common threads that links all of these rules, and it also shows how differently the drafters of each rule have understood the purpose and design of a minimum tax on foreign excess returns.

This Article argues that these are all effectively minimum taxes (or "top-up taxes") on foreign excess returns that are attempting to exclude income from "substantial activities" from taxation while imposing taxation on income from intangibles that have been shifted outside the jurisdiction. These are therefore yet another chapter in the story of the search for substantial activities.

But this Article also argues that, although policymakers are all using the same terminology of excess returns and normal returns, they are using these terms to mean different things. This in turn means that all of these measures define normal returns – and therefore substantial activities – very differently from each other, thereby creating confusion and masking the policy choices being made when calculating excess returns.

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Introduction

This Article charts the evolution of one tax reform proposal across administrations, political parties, and jurisdictions. Starting in 2010, one international tax reform proposal moved from being a one-page idea in the Obama Treasury's proposed budget to being one of the OECD's options for CFC reform to becoming the basis for one of the major international tax reform provisions in the 2017 tax reform to being considered as part of Pillar Two of the OECD's current digital tax project. With every iteration, this proposal changed shape in terms of how it was described, how its elements were calculated, and how its proponents justified it. At each stage of its development, it was understood to mean something different from what it meant in the previous stage.

The proposal in question is one for a minimum tax on foreign excess returns. The general concept of such a tax is that it separates excess returns from so-called normal returns and then imposes a minimum rate of taxation on the excess returns while excluding the normal returns from taxation. This minimum rate may be the same rate as the domestic rate in the country applying the tax or a lower rate. This Article highlights that this description can apply to several different Obama Treasury proposals, Camp's Option A, the international tax provisions in the Tax Cuts and Jobs Act[1] that was passed under the Trump Administration, Action 3 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, and Pillar Two of the OECD/G20 project on digital taxation.

At the same time that this Article points out the common thread that links all these rules, this Article also shows how differently the drafters of each rule have understood the purpose and design of a minimum tax on foreign excess returns. This Article argues that there is not one shared understanding about how to design taxes on excess returns or why to impose taxes on excess returns. Instead, although policymakers are all using the same terminology and referring to the concepts of excess returns and normal returns, they all mean different things and they are all using these terms for the purpose of addressing seemingly different problems.

This Article therefore considers what explains the different ways that these different provisions are all defining normal returns and excess returns. This Article first turns to economic theory to consider whether the theory of exempting normal returns from taxation explains the different definitions. After highlighting the many ways these proposals and provisions deviate from the economic theory of exempting normal returns, this Article then argues that these proposals are effectively all trying to impose taxation on shifted income, particularly shifted income from intangible assets. In other words, they are all designed to address the concern that a taxpayer earned income in one jurisdiction but was able to shift it to a second jurisdiction, thereby avoiding paying taxes in the first jurisdiction and paying taxes in the second jurisdiction. Implicit in this concern is the assumption that the second jurisdiction imposes lower tax rates than the first jurisdiction.

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[1] Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115–97 (2017).

This Article argues that these minimum taxes on foreign excess returns therefore represent a new phase in the search for substantial activities. For many years, policymakers have been searching for a solution to the problem of how to tax income that has been shifted to a low-tax jurisdiction from the jurisdiction that contributed to the creation of that income. This problem has many guises, but the general concept is that policymakers want to impose taxation on income that does not arise from so-called "substantial activities" (or "economic substance") in the low-tax jurisdiction. How to identify substantial activities and economic substance, however, has vexed policymakers for decades. These minimum taxes on foreign excess returns represent a new phase in the search for substantial activities. After many efforts to define substantial activities for themselves, policymakers turned to economic theory for a solution. And they found the theory of excess returns, under which normal returns should be exempted from taxation and the remaining excess returns should be taxed. But, when they translated this theory into practice, policymakers did so in a variety of ways, creating measures that differed both from each other and from the theory that inspired the measures.

To illustrate this interplay between theory and policy in the context of minimum taxes on foreign excess returns, this Article proceeds in five parts. Section I tells the story of the many proposals for such taxes over the last decade, following the Obama Administration's excess returns proposal from its first brief appearance in 2010 through its evolution into much more detailed proposals in subsequent budgets. This proposal then made an appearance in the OECD's Action 3 Report as one of the options for reforming controlled foreign company rules, and it ended up being enacted into U.S. law as the Global Intangible Low-Taxed Income (GILTI) provision in the 2017 tax reform bill. Since 2017, this proposal has also been considered as a possible version of Pillar Two of the OECD's digital tax project.

Section II then discusses the economic literature on taxing excess return, focusing on discussions of cash flow taxes and allowances for corporate equity. Section II does not intend to be a rich discussion of the debates over these tax reforms but instead aims to provide a general overview of how excess returns have traditionally appeared in the economic literature. Section II also briefly discusses excess profits or windfall taxes, which, despite their very similar name, are different from the theory of excess returns. However, as Section III will illustrate, some of the provisions outlined in Section I seem to have conflated the logic of excess returns and excess profits taxes.

Section III then discusses the many differences between all of the provisions outlined in Section I that consider themselves to be focused on excess returns. These differences exist in terms of the rates used to define normal returns, the costs or assets used to define normal returns, and the scope of the excess returns calculation. Section III then considers what these differences tell us about what these measures are targeting. Section III concludes that these taxes are not targeting excess returns as envisioned by economic theory, nor are they targeting the excess profits traditionally targeted by windfall taxes. Instead, Section III concludes by pointing out that the provisions all overlap in the sense that they are all trying to impose some degree of taxation on income that policymakers consider to have been shifted away from the jurisdiction that contributed to the earning of that income.

This insight about shifted income brings readers to Section IV, which considers how the recent excess returns provisions all contribute to an ongoing debate in the

international tax policy space about how to identify "substantial activities" or "economic substance." For some policymakers, tax preferences should only be granted to income arising from substantial activities in a jurisdiction and taxes should focus on income that does not arise from those same substantial activities. How to determine whether or not income arises from substantial activities, however, is an ongoing challenge for policymakers. For decades, have designed tax rules that define substantial activities in a variety of ways, and these minimum taxes on foreign excess returns are a new phase in the search for substantial activities. In effect, policymakers have been searching for a solution to the problem of substantial activities, and they turned to excess returns taxation to solve this problem. In translating the theory of excess returns into practice, however, policymakers transformed it into rules that defined normal and excess returns in ways consistent with policymakers' visions of substantial activities and not with the theory of excess returns.

Section V then discusses three concerns raised by the translation of the theory of excess returns into widely diverging definitions of substantial activities. First, the language of excess returns suggests that these taxes are defining substantial activities in a formulaic and objective way, which hides the discretion that policymakers are exercising when defining normal returns and excess returns. Second, the language of excess returns also masks the many differences between these provisions. Finally, the reliance on the concept of excess returns and normal returns may even disguise the degree to which policymakers are exercising discretion from the policymakers themselves.

I. How the Obama Administration's Excessive Returns Proposal Became the Trump Administration's GILTI and the OECD's Pillar Two

This Section describes the evolution that took place from 2010 to the present day as the Obama Administration's initial proposal changed shape and moved from one administration to the next and from the United States to the international stage. This Section begins in 2010 and introduces readers to the Obama Treasury's various proposals, Camp Option A, the OECD Action 3 Final Report, the GILTI provision from the 2017 U.S. tax reform bill, and the OECD's current work on Pillar Two. Although these developments are not often discussed together, this Section highlights that they are all effectively minimum taxes on foreign excess returns. This Section ends with an overview of the similarities and differences between all of these provisions.

A. The Evolution of Excess Returns Proposals in the United States from 2010 to 2017

The Obama Administration's first reference to excess returns appeared in the context of controlled foreign company (CFC) rules. CFC rules, which exist in dozens of countries,[2] tax income earned by foreign subsidiaries on a current basis. These rules subject certain categories of income ("CFC income") to taxation in the parent company's jurisdiction even though the income was earned abroad. Since the parent company can

[2] *See* OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Paris) [hereinafter "Action 3 Final Report"].

generally qualify for foreign tax credits on taxes paid to the subsidiary's jurisdiction on the same income, the effect of CFC rules is to require taxpayers to make up the difference between the parent company's tax rate and the foreign subsidiary's tax rate on any CFC income.[3]

In February 2010, the Obama Administration proposed an international tax reform as part of its Fiscal Year 2011 budget. This proposal would apply to "excess returns" from the transfer of an intangible asset abroad,[4] and it would achieve this by subjecting a new category of income to CFC taxation: the "excessive return" earned by the foreign subsidiary because a U.S. corporation had transferred an intangible asset to the subsidiary.[5] The Obama Treasury Department explained this proposal by stating that the transfer of intangible assets from U.S. corporations to controlled subsidiaries in low-tax jurisdictions "has resulted in a significant erosion of the U.S. tax base."[6] The brief proposal did not provide information on how taxpayers should calculate excess returns.[7] It instead stated that, if the transfer of intangible assets occurred "in circumstances that evidence excessive income shifting, then an amount equal to the excessive return" would be subject to CFC taxation.[8]

This concept then evolved over the Obama Administration's following six proposed budgets. In 2011, as part of the Fiscal Year 2012 budget, the Obama Administration included a very similar excess returns proposal with much of the same wording as the Fiscal Year 2011 version,[9] but the Fiscal Year 2012 version defined the excess returns that would be subject to CFC taxation in the following way: "excess intangible income would be defined as the excess of gross income from transactions

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[3] To illustrate the general concept, imagine that Parent Co. is a U.S. headquartered multinational with subsidiaries around the world. Because it is a U.S. taxpayer, Parent Co. is subject to taxation on its worldwide income,[3] but its separately incorporated subsidiaries are generally only subject to tax on their income at the rate imposed by the country in which they were located. CFC rules are the exception to this, and they subject the shareholders of controlled foreign corporations (i.e., foreign subsidiaries with significant U.S. ownership) to current taxation on their pro rata share of certain types of income ("CFC income," or, in the United States, "Subpart F income"). Therefore, if Parent Co. owns 90% of Sub1, which is tax resident of Country1, and Sub1 earns $1 million of CFC income, then Parent Co. will be taxed on $900,000 of income at U.S. rates in that year. Parent Co. would generally qualify for a foreign tax credit for any foreign taxes paid to Country1. The effect of the foreign tax credit is that CFC rules subject income that has not been taxed at the U.S. rate to taxation on the difference between the tax owed at the U.S. rate and tax owed at the Country1 rate.

[4] U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (February 2010), *available at* http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf, 43 [hereinafter "Fiscal Year 2011 Greenbook"] (proposing that the U.S. "tax currently excess returns associated with transfers of intangibles offshore" (capitalization removed)).

[5] Fiscal Year 2011 Greenbook, 43.

[6] Fiscal Year 2011 Greenbook, 43.

[7] A Treasury official is reported to have suggested that these returns would be those in excess of a 30% return on the intangible. *See* Martin A. Sullivan, *Economic Analysis: Designing Anti-Base-Erosion Rules*, Tax Analysts (April 22, 2013), *available at* http://www.taxhistory.org/www/features.nsf/Articles/499620F25830720185257B550046CC6F?OpenDocument.

[8] Fiscal Year 2011 Greenbook, 43.

[9] U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals (February 2011), *available at* http://www.treas.gov/offices/tax-policy/library/greenbk12.pdf, 43 [hereinafter "Fiscal Year 2012 Greenbook"] (again proposing that the U.S. "tax currently excess returns associated with transfers of intangibles offshore" (capitalization removed)).

connected with or benefiting from [the transferred] intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up."[10] In other words, excess returns would be limited to excess intangible returns, and they would be the difference between the income arising from the transferred intangible and a fixed return on the costs associated with the transferred intangible.

A few months later, very similar wording appeared in Option A of House Ways and Means Chairman Dave Camp's tax reform proposal, but this also did not end up being implemented.[11] In October 2011, Representative Camp proposed a comprehensive tax reform bill that set out three different options for rules to prevent base erosion.[12] Although this bill was never passed, and only Option C made it into Camp's final 2014 proposal,[13] Option A set out an excess returns proposal similar to that included in the Obama Administration's early budgets. Option A included excess returns (referred to in the proposal as "excess income") from transfers of intangibles to related parties in low-taxed jurisdictions in a corporation's Subpart F income (i.e., the U.S. version of CFC income).[14] These excess returns were calculated by subtracting 150% of the costs associated with an intangible asset that was transferred to a foreign related party from the income earned from the sale, lease, license, or other disposition of that intangible, as well as from the provision of services of that intangible.[15] In other words, excess returns were only calculated in the context of intangibles that were transferred to a foreign related party. They were calculated by treating 150% of the costs associated with said intangibles as a normal return and treating any income greater than that as excess returns. Camp Option A also only included these excess returns if they were taxed in a foreign country at a rate less than or equal to 10%.

In 2012, 2013, and 2014, as part of the Fiscal Year 2013, Fiscal Year 2014, and Fiscal Year 2015 budgets, respectively, the Obama Administration again included a very similar excess returns proposal with almost identical wording to the Fiscal Year 2012 version.[16]

In 2015, as part of the Fiscal Year 2016 budget, the Obama Administration's excess returns proposal changed significantly. No longer was this a proposal for subjecting excess returns from transferred intangibles to CFC taxation. Instead, the new

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[10] Fiscal Year 2012 Greenbook, 44.

[11] U.S. House of Representatives, Ways and Means Discussion Draft: Tax Reform Act of 2011 (Oct. 26, 2011).

[12] The other two options were Option B (an active business exemption in the home country) and Option C (a reduced rate for foreign intangible income).

[13] *See* Tax Reform Act of 2014, https://www.congress.gov/bill/113th-congress/house-bill/1/text.

[14] Tax Reform Act of 2011, Sec. 331A.

[15] Tax Reform Act of 2011, Sec. 331A.

[16] U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (February 2012), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf, 88-89 [hereinafter "Fiscal Year 2013 Greenbook"]; U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf, 49-50 [hereinafter "Fiscal Year 2014 Greenbook"]; U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (March 2014), *available at* http://www.treasury.gov/resource-center/tax-policy/Pages/general explanation.aspx, 45-46 [hereinafter "Fiscal Year 2015 Greenbook"].

proposal was described as one that would "impose a 19-percent minimum tax on foreign income."[17] A minimum tax differs facially from CFC rules in that a minimum tax imposes current taxation on foreign income that is taxed at a significantly lower rate than the home country rate. Th effect of a minimum tax is to make up the difference between the foreign rate and the minimum tax rate, which may be the same rate that applies in the country imposing the tax or which may be a lower minimum tax rate.[18] This proposal envisioned a significant change to the existing CFC rules, pursuant to which the foreign earnings of U.S. corporations and their CFCs would be subject to a minimum tax rate of 19%, reduced by 85% of the foreign rate that applied to the earnings.[19]

Minimum taxes do not by definition require any excess returns calculation, but the Fiscal Year 2016 budget proposal incorporated such a calculation into its minimum tax proposal. In other words, the proposal first subtracted normal returns from the income earned in the foreign country and then only applied the minimum tax to the income, if any, that remained. The Fiscal Year 2016 proposal did not, however, explicitly describe this calculation as one that focused on excess returns. Instead, it presented it as a formula whereby the foreign earnings were "reduced by an allowance for corporate equity (ACE)."[20] Although the Fiscal Year 2016 proposal did not provide a specific equation for the ACE, it explained that carving out an ACE allowance was the same as "provid[ing] a risk free return on equity invested in active assets," which in turn meant that "the ACE allowance is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country."[21] Very similar language appeared again in February

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[17] U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (February 2015), *available at* http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx, 19-22 [hereinafter "Fiscal Year 2016 Greenbook"] (capitalization removed).

[18] To illustrate the general idea of a minimum tax, imagine that a U.S. corporation earns $1 million in Country A, and its wholly owned CFC earns $1 million in Country B and another $1 million in Country C. Country A imposes a 30% tax rate on income earned in Country A, Country B imposes a 20% tax rate on income earn in Country B, and Country C imposes a 10% tax rate on income earned in Country C. If the U.S. imposes a minimum tax with a 20% rate, the U.S. would impose no extra tax on the $1 million earned in Country A or the $1 million earned in Country B, but it would impose an extra tax of 10% on the $1 million earned in Country C because Country C's tax rate is 10 percentage points less than 20%. A minimum tax, in other words, would ensure that all foreign income would be subject to at least a 20% rate. This example ignores the complexities of actual minimum tax proposals such as cross-crediting, but this provides the general outline.

[19] Fiscal Year 2016 Greenbook, 20. For illustration, imagine again that a U.S. corporation earns $1 million in Country A, and its wholly owned CFC earns $1 million in Country B and another $1 million in Country C. Country A imposes a 30% tax rate on income earned in Country A, Country B imposes a 20% tax rate on income earn in Country B, and Country C imposes a 10% tax rate on income earned in Country C. Under a minimum tax such as the one proposed in the Fiscal Year 2016 budget, the U.S. would impose no extra tax on the $1 million earned in Country A because 85% of 30% is 25.5%, which is greater than 19%. The U.S. would impose an extra tax of 2% on the $1 million earned in Country B because 85% of 20% is 17%, which is 2 percentage points less than 19%. And the U.S. would impose an extra tax of 10.5% on the $1 million earned in Country C because 85% of 10% is 8.5%, which is 10.5 percentage points less than 19%. A minimum tax, in other words, would ensure that all foreign income would be subject to at least a 19% rate. If the foreign country's tax rate was greater than or equal to 22.35%, then the U.S. would impose no extra tax. If the foreign country's tax rate was lower, then the U.S. would impose a tax equal to the difference between the minimum tax and 85% of the foreign tax rate.

[20] Fiscal Year 2016 Greenbook, 21.

[21] Fiscal Year 2016 Greenbook, 21.

2016 in the Obama Administration's final budget proposal for Fiscal Year 2017,[22] and a similar version of this minimum tax with an ACE appeared in April 2016 in the 2016 Update to The President's Framework for Business Tax Reform.[23]

From 2010 to 2016, therefore, the Obama Administration's excess returns proposals evolved from a very general idea about taxing the excess returns on transferred intangibles to a much more detailed proposal for first calculating these excess returns by subtracting the costs associated with the transferred intangible plus a mark-up from the overall intangible income to finally calculating them by subtracting an allowance for corporate equity from all foreign earnings.

The justifications for these proposals also changed. For the first few years of the Obama Treasury's proposals, they argued that an excess returns provision was a way to address erosion of the U.S. tax base caused by U.S. companies transferring intangible assets to related parties in low-tax jurisdictions. These early U.S. proposals presented excess returns provisions as backstops or supports to the existing transfer pricing rules. In the Fiscal Year 2011 proposal, for example, the Obama Treasury explained its reasoning by stating that transfers of intangibles between related parties "pu[t] significant pressure on the enforcement and effective application of transfer pricing rules" and that evidence indicates "that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base."[24] In the Fiscal Year 2012, Fiscal Year 2013, Fiscal Year 2014, and Fiscal Year 2015 proposals, the Obama Treasury echoed these justifications and explicitly stated that including "excess income from intangibles transferred to low-taxed affiliates [in income subject to CFC taxation] will reduce the incentive for taxpayers to engage in these transactions."[25] Therefore, one reason alleged for focusing on excess returns is to accurately tax income earned from intangibles, both by ensuring that this income is allocated to the right jurisdiction and by ensuring that the correct amount of income is taxed. A second and related reason for focusing on excess returns is to fill the gaps created by transfer pricing rules that cannot correctly tax income from intangibles.

The reasons for taxing excess returns shifted significantly by the time of the Obama Treasury's Fiscal Year 2016 and Fiscal Year 2017 proposals. No longer was the focus just on the transfer of intangibles to related parties. Although that was implicitly a part of the justification,[26] the reasons provided by the Obama Administration in these last two proposals were much broader, and they focused on reducing incentives to "locate production overseas and shift profits abroad, eroding the tax base."[27] The reason for targeting just excess returns and not targeting normal returns was that exempting the

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[22] U.S. Dept. of the Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals (February 2016), *available at* http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx, 9-12 [hereinafter "Fiscal Year 2017 Greenbook"].

[23] The White House and U.S. Dept. of the Treasury, The President's Frameowrk for Business Tax Reform: An Update (April 2016), *available at* the-presidents-framework-for-business-tax-reform-an-update-04-04-2016.pdf, 24.

[24] Fiscal Year 2011 Greenbook, 43.

[25] Fiscal Year 2012 Greenbook, 43; Fiscal Year 2013 Greenbook, 88; Fiscal Year 2014 Greenbook, 49; Fiscal Year 2015 Greenbook, 45.

[26] *See, e.g.,* Fiscal Year 2017 Greenbook, 10 (referring the ability of U.S. multinationals to "shift profits abroad").

[27] Fiscal Year 2016 Greenbook, 20; Fiscal Year 2017 Greenbook, 10.

normal return was "intended to exempt…a return on the actual activities undertaken in a foreign country."[28] In other words, the reason for imposing a minimum tax just on excess returns were that excess returns were income that had been shifted abroad but that did not arise from actual activities in the foreign jurisdiction.

In the midst of this evolution, Republican Representative Camp proposed his own version of an excess returns rule. This rule included excess returns from transfers of intangibles to related parties in low-taxed jurisdictions in a corporation's Subpart F income.[29] The justification for this rule was the general prevention of base erosion.

B. Action 3 of the OECD's BEPS Project

At the same time that the Obama Administration was shifting its view of excess returns from something focused purely on intangible transfers to something broader, the Organisation for Economic Co-operation and Development (OECD) also proposed an excess returns rule that was a combination of the earlier proposals for Fiscal Years 2012-2015 and the later ones for Fiscal Years 2016-2017. This occurred as part of the OECD/G-20 Base Erosion and Profit Shifting (BEPS) Project, which took place from 2013 to 2015 and which involved 44 countries working on 15 action items that were designed to limit corporate tax avoidance and aggressive tax planning.[30] As part of its final report for Action 3, which focused on designing effective CFC rules, the OECD listed a variety of methods countries could use to define the types of income that were subject to taxation.[31] Among several methods that countries were already using in their existing CFC rules, the Action 3 final report also mentioned that "[a]nother approach to defining income is an 'excess profits' analysis, which is not a feature of any existing CFC rules."[32] The report went on to describe that an excess profits analysis would subtract a normal return from the CFC's income to determine the excess profit, and it stated that the normal return was "the return that a normal investor would expect to make with respect to an equity investment."[33] The report stated that this normal return was calculated by multiplying the risk-inclusive rate of return by eligible equity, and it highlighted that significant questions remained as to how to calculate either the return or the equity.[34] As envisioned as part of a CFC rule, the excess profits approach would apply only to excess returns earned in a low-tax jurisdiction, so it would effectively be a minimum tax (although it was not referred to as such in the Action 3 Final Report).[35]

The OECD's inclusion of an excess returns approach in its report on CFCs was controversial because no country had such a rule at the time. In May 2015, about five months before the Action 3 final report was issued, the OECD issued a discussion draft

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[28] Fiscal Year 2016 Greenbook, 21; Fiscal Year 2017 Greenbook, 11.

[29] Tax Reform Act of 2011, Sec. 331A.

[30] *See, e.g.*, OECD (2015), *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, *available at* www.oecd.org/tax/beps-explanatory-statement-2015.pdf [hereinafter "BEPS Explanatory Statement"].

[31] Action 3 Final Report, 43-55.

[32] Action 3 Final Report, 49. Note that this uses "excess profits" to mean "excess returns." Briefly distinguish excess profits taxes.

[33] Action 3 Final Report, 49.

[34] Action 3 Final Report, 49-50.

[35] Action 3 Final Report, 49.

for Action 3.[36] This discussion draft clarified that the countries discussing Action 3 had not yet reached consensus,[37] and it included the following caveat at the start of the chapter in which the excess profits approach was introduced:

> "In line with the general comments setting out the non-consensus status of the discussion draft as a whole, it should be emphasised that the approaches to defining CFC income do not reflect a consensus view. In particular, there are different views on the excess profits approach set out at Part III B. The differences arise because some countries believe that an excess profits approach will include income irrespective of whether it arises from genuine economic activity of the CFC and where there is appropriate substance. Other countries believe that excluding a normal return on eligible equity is an effective method for identifying CFC income."[38]

Despite the controversy, by October 2015, the excess profits approach was included in the consensus-supported Action 3 Final Report. Some of the wording surrounding its description had changed, and the OECD was explicit in the final report that none of the listed options for defining CFC income, including the excess profits approach, were viewed as best practices or minimum standards.[39] The inclusion of an excess returns approach that appeared very similar to the Obama Administration's Fiscal Year 2016 and Fiscal Year 2017 budget proposals in an OECD/G-20 document setting out recommendations for CFC rules, however, brought international attention to the concept.[40]

Along with setting out a description of this excess returns approach, the Action 3 final report provided a variety of reasons that countries might implement such a rule, although it also acknowledged that some countries might not find these reasons compelling.[41] The first reason for implementing an excess returns rule was to subject "income from intangibles and risk shifting" to taxation.[42] Linked to this, a second reason for implementing an excess returns rule was to address weaknesses in transfer pricing rules since, according to the Action 3 final report, the existence of excess returns suggested that "intangibles and risk-shifting transactions among related parties could be susceptible to systematic mispricing."[43] A third reason for implementing an excess returns rule was that it should target "income raising BEPS concerns" – i.e., shifted

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[36] OECD, *Public Discussion Draft: BEPS Action 3: Strengthening CFC* Rules, OECD/G20 Base Erosion and Profit Shifting Project (May 12, 2015), *available at* http://www.oecd.org/ctp/aggressive/discussion-draft-beps-action-3-strengthening-CFC-rules.pdf [hereinafter "Action 3 Discussion Draft"].

[37] Action 3 Discussion Draft, 3.

[38] Action 3 Discussion Draft, 34.

[39] BEPS Explanatory Statement, 13.

[40] Lilian V. Faulhaber, *Diverse Interests and International Legitimation: Public Choice Theory and the Politics of International Tax*, 114 Am. J. Int'l L. (Unbound) 265 (2020).

[41] Action 3 Final Report, 50 (stating that "there is no consensus on whether the excess profits approach should be combined with a mandatory substance-based exclusion").

[42] Action 3 Final Report, 49.

[43] Action 3 Final Report, 49.

income.[44] A fourth and final reason for implementing an excess returns rule was its simplicity, which the Action 3 final report referred to as "the mechanical nature of this approach."[45]

C. GILTI

On December 22, 2017, the U.S. tax reform bill (often referred to as the Tax Cuts and Jobs Act, or TCJA) was signed into law. On the international tax side, the TCJA included three new provisions: the Global Intangible Low Taxed Income (GILTI) provision, the Foreign Derived Intangibles Income (FDII) deduction, and the Base Erosion and Anti-Avoidance Tax (BEAT). The GILTI provision builds directly on the earlier Obama Administration and OECD excess return proposals. Although the provision itself does not explicitly refer to excess returns, it provides calculations for subtracting normal returns and therefore subjects only excess returns to taxation.[46] Furthermore, in later regulations, the Treasury Department repeatedly refers to the calculation for determining GILTI as one in which a "normal return" is subtracted in order to arrive at the amount that is subject to taxation.[47]

The GILTI provision is codified in Section 951A of the Internal Revenue Code.[48] This provision, when combined with Section 250, imposes a minimum tax of 10.5% on certain income earned by foreign subsidiaries of U.S. taxpayers that qualify as CFCs.[49] The income that is subject to this minimum tax is the amount of the net income of the subsidiary that exceeds 10% of the subsidiary's investment in tangible depreciable property.[50] In other words, the GILTI provision treats a CFC's normal return as 10% of the CFC's investment in tangible depreciable property. Any income above that amount is subject to the 10.5% tax. If the income has already been subject to at least 10.5% in foreign taxes, then the foreign tax credit means that the CFC's U.S. shareholders will not owe any extra taxes. If it has not, then the CFC's U.S. shareholders will owe the difference between the taxes paid and the 10.5% rate of the GILTI provision.[51]

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[44] Action 3 Final Report, 50.

[45] Action 3 Final Report, 50.

[46] FDII refers back to GILTI and uses the same normal returns calculation, but FDII is not discussed here because it is a deduction rather than a minimum tax.

[47] Internal Revenue Service, Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits, Doc. 2019-12437 (*available at* https://federalregister.gov/d/2019-12437), 29323, 29327, 29329 (all referring to the calculation as one in which a "normal return" is subtracted).

[48] 26 U.S.C. §951A.

[49] 26 U.S.C. §951A(a) (including all "global intangible low-taxed income" in the U.S. shareholder's income); 26 U.S.C. §250 (a)(1) (allowing a 50% deduction for the "global intangible low-taxed income," thereby only subjecting the remaining 50% to taxation). Assuming the U.S. taxpayer is a corporation subject to the 21% rate, the effect of these two provisions is to impose a tax of 10.5% on the global intangible low-taxed income. Note that the minimum tax rate will increase after December 31, 2026, when there will only be a 37.5% deduction instead of a 50% deduction. Note that, in situations where there is some foreign corporate income tax that applies and that gives rise to U.S. foreign tax credits, U.S. taxpayers will end up paying a combined effective rate of 13.125%. *See* TFDE Interim Report 2018, pg. 123 n.17.

[50] 26 U.S.C. §951A.

[51] Note that, while the Obama Administration's budget proposals for Fiscal Year 2016 and Fiscal Year 2017 calculated the foreign tax credit on a per-country basis, averaging the rates imposed by each

When the GILTI provision was passed in 2017 as part of U.S. tax reform, the Senate Committee on the Budget's explanation of the final bill stated that the GILTI provision was designed to tax "income derived from intangible property, or intangible income," which the Senate Finance Committee "believe[d] [to be] the type of income that is most readily allocated to low- or zero-tax jurisdictions."[52] The Committee then stated that "the most difficult problem with identifying GILTI [was] identifying intangible income," so "the provision adopts a formulaic approach to calculating intangible income to make the determination simpler and more administrable."[53] The Committee explained that the formulaic approach "is based on the premise that directly calculating tangible income is simpler than calculating intangible income."[54] According to this explanation, therefore, Congress's reason for taxing the excess returns in GILTI were threefold. First, excess returns represented intangible income. Second, taxing excess returns was a way to tax income that was shifted outside of the U.S. Third, designing a tax provision that focused on excess returns was simpler and more administrable, since, according to the committee, "calculating intangible income based on facts and circumstances may be both complicated and administratively difficult."[55]

D. Pillar Two of the OECD's Digital Economy Project

Therefore, from 2010 to 2017, a minimum tax focused on excess returns jumped from being a proposal in a Democratic administration's budget that was never passed to being one of the major international tax provisions in the tax reform bill of a Republican-majority Congress. At the same time, this concept was also gaining acceptance on the international stage. In 2015, when the OECD issued the Action 3 Final Report, a minimum tax on excess returns was seen as a controversial idea that had difficulty gaining support of the 44 countries involved in the BEPS Project. By 2019, a very similar idea was being seriously considered by the 137 countries involved in the OECD's digital tax project.

The discussions leading up to this digital tax project had started earlier, when the OECD/G-20 BEPS Project included amongst its fifteen action items Action 1, which focused on Addressing the Tax Challenges of the Digital Economy.[56] Over the course of

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country over five years to determine whether they equaled or exceeded the minimum tax, the GILTI provision pools all income potentially subject to GILTI and allows foreign tax credits associated with any of that income to be used against all of the income. This is therefore an "overall" minimum tax, which only subjects income in a low-tax jurisdiction to the minimum tax if there is not sufficient income subject to tax in a high-tax jurisdiction to provide sufficient excess credits to offset the low taxation, as opposed to a per-country minimum tax, which subjects all income in a low-tax jurisdiction to the minimum tax regardless of whether any other income earned by the U.S. taxpayer was subject to higher tax rates.

[52] Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 370 (Comm. Print 2017).

[53] Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 370-371 (Comm. Print 2017).

[54] Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 371 (Comm. Print 2017).

[55] Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 370 (Comm. Print 2017).

[56] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, *available at* http://dx.doi.org/10.1787/9789264202719-en [hereinafter "BEPS Action Plan"].

the BEPS Project, the OECD and G-20 created a Task Force on the Digital Economy (TFDE), which was responsible for working on Action 1. In 2014, the TFDE issued an interim report,[57] which was followed by a final report in 2015.[58] These two reports stated that the digital economy could not be ring-fenced from the rest of the economy.[59] In other words, the digital economy was not separate from the rest of the economy, nor could it be separated from the rest of the economy. They then went on to consider possible rules that could be implemented to address the particular challenges raised by the digital economy, including modifications to the permanent establishment rules to make it harder for taxpayers to fall within the exceptions, new definitions of what constitutes a permanent establishment, withholding taxes on certain digital transactions, and a so-called equalization levy, which would be designed to equalize the treatment of digital companies and brick-and-mortar companies by subjecting the former to a tax based on digital revenues, advertising income, or the like.[60] None of these possible rules were presented as recommendations. Instead, the reports issued under Action 1 stated that the countries involved in the BEPS Project could not agree to recommend any one option on a multilateral basis, but countries could implement them on a unilateral basis – as long as such implementation did not conflict with any international commitments.[61]

Although the BEPS Project did not issue any recommendations in the area of digital taxation, many individual countries and the European Union proposed and implemented their own rules designed to target the digital economy in 2014 and after.[62] In response to these growing demands for an international solution to the problems created by digitalization, the TFDE continued to meet and issued an interim report in 2018.[63] The TFDE then issued a public consultation document on the digital economy in early 2019,[64] and it then issued a work program outlining its plans for reaching consensus on a digital tax solution by the end of 2020.[65]

Over the course of these documents, the TFDE's vision of possible solutions to the tax challenges raised by digitalization changed. As mentioned above, early BEPS-era

[57] OECD (2014), Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264218789-en [hereinafter "Action 1 2104 Interim Report"].

[58] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241046-en [hereinafter "Action 1 2015 Final Report"].

[59] *See* Action 1 2014 Interim Report, 12; Action 1 2015 Final Report, 11.

[60] See Action 1 2015 Final Report, para 274.

[61] *See* Action 1 2014 Interim Report; Action 1 2015 Final Report.

[62] *See* Lilian V. Faulhaber, *Taxing Tech: The Future of Digital Taxation*, 39 VA. TAX REV. 145 (2019).

[63] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, *available at* https://doi.org/10.1787/9789264293083-en [hereinafter "TFDE 2018 Interim Report"].

[64] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Public Consultation Document*, OECD/G20 Base Erosion and Profit Shifting Project (2019), *available at* https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf [hereinafter "TFDE Public Consultation Document 2019"].

[65] OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on BEPS (May 2019), *available at* www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm [hereinafter "TFDE Programme of Work"].

publications focused on withholding taxes, changes to permanent establishment and allocation rules, and special equalization levies. By 2019, although the TFDE was still considering some of those ideas, it had also added the concept of a minimum tax. Although the TFDE briefly mentioned the U.S. GILTI in its 2018 interim report, this was merely a reference to a development in international tax, and it was not considered as a model for any future digital measures.[66] (It was, however, explicitly linked to the Action 3 report and described as a "tax on excess returns."[67])

By early 2019, however, when the TFDE issued its public consultation document, a minimum tax was one of the primary solutions it was considering. The public consultation document floated the idea of an "income inclusion rule," which it described as a "minimum tax" that "would build on the Action 3 recommendations and draw on aspects of the US regime for taxing Global Intangible Low-Taxed Income ('GILTI')."[68] This minimum tax was referred to as the Global Anti-Base Erosion rule,[69] which was eventually shortened to GloBE. The document did not provide many details, and there was no mention of a deduction for normal returns, but it did raise the possibility that there could be "thresholds or safe harbours to facilitate administration and compliance with the rule."[70] Only a few months later, the TFDE's programme of work included more details on the inclusion rule, which it stated would "impose a minimum tax rate."[71] Along with a variety of design considerations, the programme of work considered the "possible use and effect of carve-outs, including for…[a] return on tangible assets."[72]

Then, in August 2020, the OECD circulated a draft proposal to the delegates of the Inclusive Framework that included a longer discussion of a "formulaic substance-based carve-out."[73] This proposal was then included in the public report on Pillar Two that the OECD published in October 2020. This public report explained that this substance-based carve-out was an optional design feature of the recommended minimum tax and that it was "intended to exclude a fixed return for substantive activities within a jurisdiction from the scope of the [minimum tax.] Excluding a fixed return from substantive activities focuses the minimum tax on 'excess income', such as intangible-related income, which is most susceptible to BEPS risks."[74] The October 2020 report stated that the fixed return would be calculated by multiplying a fixed percentage by payroll costs plus depreciation expenses for tangible assets.[75] Although the fixed percentage had not yet been determined by October 2020, the report suggested that it

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66 TFDE 2018 Interim Report, 2018, 100-101.

67 TFDE Interim Report 2018, 101.

68 TFDE Public Consultation Document 2019, 25-26.

69 TFDE Public Consultation Document 2019.

70 TFDE Public Consultation Document 2019, 26.

71 Programme of Work, 27.

72 Programme of Work, 29.

73 This was a confidential document that was leaked to the press and published alongside the following article: Alex M. Parker, OECD Favoring Adding Exemption To Corp. Min. Tax, Law360 (August 17, 2020), *available at* https://www-law360-com/tax/articles/1301998/oecd-favoring-adding-exemption-to-corp-min-tax.

74 OECD, Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, *available at* https://doi.org/10.1787/abb4c3d1-en.October 2020, 81 (Oct. 2020) [hereinafter "October 2020 Pillar Two Blueprint Report"].

75 October 2020 Pillar Two Blueprint Report, 91-92.

would be "limited to a modest return (sometimes colloquially referred to as a 'routine return')"[76] and kept open the possibility that the fixed percentage could differ for different items.[77] The report also stated:

> "The policy rationale behind a formulaic carve-out based on expenditures for payroll and tangible assets is to exclude a fixed return for substantive activities within a jurisdiction from the scope of the GloBE rules. The use of payroll and tangible assets as indicators of substantive activities is justified because these factors are generally expected to be less mobile and less likely to lead to tax induced distortions. Conceptually, excluding a fixed return from substantive activities focuses GloBE on "excess income", such as intangible-related income, which is most susceptible to BEPS risks. Furthermore, a carve-out based on expenditures for payroll and tangible assets should help to shield low-margin businesses from what would otherwise be disproportionately negative outcomes under the GloBE as a result of expenditure based tax credits and other forms of government subsidy based on expenditure, such as government grants."[78]

Thus, while the OECD's original work on digital taxation during the BEPS Project had said nothing about the possibility of a minimum tax that applied only to excess returns, by 2019, in the wake of the U.S. passage of the GILTI regime, one of the primary digital tax solutions proposed by the OECD's Task Force on the Digital Economy was a minimum tax that could apply only to excess returns, and this proposal remains a key part of the digital tax project. From 2010 to 2020, therefore, excess returns provisions went from a vaguely described proposal in the U.S. president's budget that would apply only to intangibles and that was never passed to a major element of the U.S.'s 2017 tax reform bill and one of the primary solutions currently being discussed at the OECD to address the challenges raised by the digital economy.

E. A Map of the Changing Definitions and Explanations of Excess Returns

How, then, do these various proposals relate to each other? First, they are all effectively minimum taxes. Although CFC rules are not always discussed as minimum taxes, the effect of a CFC rule is to impose taxation on the difference between the source country's tax rate and the parent country's tax rate. This is also what a minimum tax does, although minimum taxes may apply a lower minimum tax rate than the parent country's tax rate and they may apply to a broader category of income than CFC rules.[79] (These could alternatively all be referred to as "top-up taxes" since the effect of both CFC rules and minimum taxes is to impose tax in such a way to bring the overall tax paid up to the rate imposed by the CFC rule or minimum tax.) This linkage between CFC rules

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[76] October 2020 Pillar Two Blueprint Report, 92.

[77] October 2020 Pillar Two Blueprint Report, 101, n. 6.

[78] October 2020 Pillar Two Blueprint Report, 92.

[79] Note that this Article focuses primarily on the exemption for excess returns and not on the decision by policymakers to design these measures as minimum taxes or top-up taxes. For further discussion on minimum taxes, see Daniel Shaviro, What are Minimum Taxes, and Why Might One Favor or Disfavor Them?, ______ (2020).

and minimum taxes can be seen in GILTI, which imposes minimum taxation by way of CFC taxation, and the Pillar Two minimum tax proposal, which uses a similar mechanism. This linkage can also be seen in the evolution of the Obama Administration proposals. These proposals initially added a new category of CFC income, which had the effect of subjecting more income to CFC taxation, and then shifted to impose minimum taxation on that new category of income. A similar evolution took place in the OECD, where Action 3 focused on adding income to CFC rules, while Pillar Two focuses on subjecting income to minimum taxation.

Second, they are minimum taxes or top-up taxes that apply only to foreign income. All of the provisions discussed above are designed implicitly or explicitly to apply only to income that would otherwise be taxed in a jurisdiction different from the country imposing the tax. This occurs automatically with CFC rules, which by definition apply only to income earned by foreign subsidiaries. This also occurs with minimum taxes of the sort described above in that they are designed to apply only to income earned in another jurisdiction because they are imposing taxation at a rate above the rate applied by that other jurisdiction. These are all therefore exercises of taxation by one country on the income earned in another country. By imposing a minimum rate, they are all essentially claiming that the other jurisdiction has not taxed the income in question enough.

Third, they are minimum taxes or top-up taxes that allow a deduction or exemption for normal returns. Even those that do not explicitly refer to normal returns or excess returns in their statutory language use one or both of these terms in their administrative guidance or legislative history, and all of them focus on income greater than normal returns. All of them calculate normal returns by multiplying a fixed rate by some amount of cost or investment.

Putting all these similarities together, all of the provisions listed above can be seen as effectively minimum taxes on foreign excess returns. Despite these overarching similarities, these provisions and proposals differ in two important ways. First, they differ in the details of how they calculate normal returns. Second, they differ in the reasons they state for imposing minimum taxation on excess returns.

In 2010, when the Obama Administration first proposed an excess returns provision, it provided no means of calculating excess returns. It merely stated that "an amount equal to the excessive return" would be included in CFC income.[80] For the following four years, the Obama Treasury clarified that the provision would apply to "excess intangible income," which would be defined as the difference between the gross income from a transferred intangible and the costs allocated and apportioned to the income from the intangible increased by a percentage mark-up.[81] In other words, the normal return would be equal to the costs associated with the transferred intangible multiplied by a given percentage. The excess return would be the income from the transferred intangible minus that normal return.

The Obama Treasury's last two excess returns proposals set out very different ways of calculating excess returns compared to its first four proposals. In 2015, for its Fiscal Year 2016 budget, the Obama Administration shifted its excess returns proposal

[80] Fiscal Year 2011 Greenbook, 43.

[81] Fiscal Year 2012 Greenbook, 44; Fiscal Year 2013 Greenbook, 89; Fiscal Year 2014 Greenbook, 50; Fiscal Year 2015 Greenbook, 46.

from a proposal that focused on excess intangibles income to a proposal that focused on all income earned abroad that exceeded an allowance for corporate equity. Excess returns were therefore calculated in the Fiscal Year 2016 and Fiscal Year 2017 proposals by calculating the difference between the foreign income earned by a U.S. corporation or its CFC and an ACE.[82] The ACE represented the normal return, although neither the Fiscal Year 2016 nor the Fiscal Year 2017 proposal provided greater guidance on how to calculate the ACE.

Unlike the Obama Administration's proposals, the OECD's discussion of excess returns provisions in the Action 3 final report went into much greater detail about how to calculate excess returns, as well as some of the difficulties of making such a calculation. The Action 3 final report stated that the excess return would be the difference between income and a normal return, and a "normal return could be calculated using the following formula: normal return = (rate of return) x (eligible equity)."[83] It then stated that the rate of return should generally be the risk-inclusive rate of return, which includes the risk-free rate of return plus a risk premium.[84] According to the Action 3 final report, which did not cite any studies for this proposition, "economic studies often estimate this risk-inclusive rate as being approximately 8% to 10%, although this varies by industry, leverage, and jurisdiction."[85] The eligible equity that would be multiplied by this rate of return would be "only equity invested in assets used in the active conduct of a trade or business, including IP assets."[86]

The U.S. GILTI provides detailed information on how to calculate the normal returns that will be subtracted from income to arrive at the excess returns. GILTI calculates normal returns by multiplying 10% by qualified business asset investment ("QBAI").[87] The Senate committee explained that the formula for calculating excess returns in the context of GILTI was "based on the premise that directly calculating tangible income is simpler than calculating intangible income."[88] It then went on to explain that the GILTI "provision approximates a U.S. corporation's tangible income…as a 10-percent return on…the adjusted basis in tangible depreciable property."[89] This tangible income, which Treasury regulations later refer to as the "normal return,"[90] is then subtracted from the total amount of certain income to leave the amount subject to

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82 Fiscal Year 2016 Greenbook, 21; Fiscal Year 2017 Greenbook, 11.

83 Action 3 Final Report, 49.

84 Action 3 Final Report, 49.

85 Action 3 Final Report, 49.

86 Action 3 Final Report, 50. (Note that the Action 3 final report also suggested that the eligible equity could exclude equity invested in assets that produced CFC income, but this was because total income would not include CFC income.)

87 26 U.S.C. §951A(b)(2).

88 Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 371 (Comm. Print 2017).

89 Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 371 (Comm. Print 2017) (details about how this normal return is calculated by CFC omitted).

90 Internal Revenue Service, Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits, Doc. 2019-12437 (*available at* https://federalregister.gov/d/2019-12437), 29323.

GILTI taxation.[91] The Committee explanation then stated that, because of this subtraction of 10% of QBAI, "[t]herefore, the provision exempts tangible income from U.S. tax."[92]

Finally, the OECD's current proposal for a minimum tax as part of its digital tax project would allow the exclusion (or carve-out, in the words of the OECD) for a normal return calculated by multiplying a fixed percentage by payroll costs plus depreciation expenses for tangible assets. According to the OECD, this would be a way to exempt income from "substantive activities" from taxation.

The various methods for calculating excess returns are listed in the table below. Note that, although the very first Obama Administration proposal from Fiscal Year 2011 seemed to take a positive approach where it calculated the excess returns without regard to normal returns, all other proposals take a negative approach where excess returns are whatever remains after normal returns are subtracted, and the focus of the provision is on how to define normal returns.

The table below also lists the justifications for excess returns taxes. As discussed above, each of the proposals and provisions was justified slightly differently from the others. The original Obama Administration proposal was focused on addressing "income shifting through transfers of intangibles to low-taxed affiliates [which] has resulted in a significant erosion of the U.S. tax base."[93] The four Obama Administration proposals that followed explained that the purpose of the excess returns provision was to "reduce the incentive for taxpayers to engage in…income shifting through transfers of intangibles to low-taxed affiliates."[94] Camp Option A justified the excess returns proposal as a way to prevent base erosion.[95] The Obama Administration proposals for Fiscal Years 2016 and 2017 were explained in part by the need to eliminate "the incentive to locate production overseas and shift profits abroad, eroding the U.S. tax base."[96] The Action 3 Final Report listed several reasons for its excess returns proposal, including subjecting "income from intangibles and risk shifting" to taxation, particularly that income raising from transactions with related parties, and targeting shifted income.[97] GILTI was explained as a means to target intangible income that was likely to have been "allocated to low- or zero-tax jurisdictions."[98] Finally, the purpose of focusing Pillar Two of the OECD digital tax project on excess returns was to focus on income "such as intangible income, which is most susceptible to BEPS risks."[99] In previous work, the OECD has used "BEPS risks" to refer to the risks of income being shifted to low-tax jurisdictions, often by way of transfers to related parties.[100] Alongside these specific justifications, another justification cited by many of the proposals, including the Action 3 Final Report, GILTI, and Pillar

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91 Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 371 (Comm. Print 2017).

92 Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 371 (Comm. Print 2017).

93 Fiscal Year 2011 Greenbook, 43.

94 Fiscal Year 2012 Greenbook, 43.

95 Tax Reform Act of 2011.

96 Fiscal Year 2016 Greenbook, 20.

97 Action 3 Final Report, 49.

98 Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 370 (Comm. Print 2017).

99 OECD Pillar Two Blueprint Report, 81.

100 *See, e.g.*, BEPS Explanatory Statement, 6-7 (referring to both "BEPS risks" and "BEPS concerns").

Two of the OECD digital tax project, was the mechanical or formulaic nature of a tax on excess returns.

Provision or Proposal	Method for Calculation	Justifications
Obama Treasury Dept. proposal, Fiscal Year 2011	Excess returns = “excessive returns” No method for calculation	In order to address “income shifting through transfers of intangibles to low-taxed affiliates [which] has resulted in a significant erosion of the U.S. tax base”
Obama Treasury Dept. proposals, Fiscal Year 2012, Fiscal Year 2013, Fiscal Year 2014, Fiscal Year 2015	Excess returns = “excess intangible income” = (gross income from a transferred intangible) – (normal return) Normal return = (undefined percentage mark-up) x (costs allocated and apportioned to the income from the intangible)	In order to “reduce the incentive for taxpayers to engage in…income shifting through transfers of intangibles to low-taxed affiliates”
Camp Option A (2011)	Excess returns = “excess income” = (income from an intangible transferred to a foreign related party) – normal return Normal return = 150% of costs associated with the relevant intangible	In order to prevent base erosion
Obama Treasury Dept. proposals, Fiscal Year 2016, Fiscal Year 2017	Excess returns = (foreign income) – ((risk-free rate of return) x (equity invested in active assets))	In order to eliminate “the incentive to locate production overseas and shift profits abroad, eroding the U.S. tax base”
BEPS Action 3 Final Report	Excess returns = (all income earned by the CFC and not otherwise taxed) – (normal return) Normal return = (risk-inclusive rate of return, possibly between 8% and 10%) x (equity invested in assets used in the active conduct of a trade or	In order to subject “income from intangibles and risk shifting” to taxation (particularly income arising from transactions with related parties), and to target shifted income The “mechanical nature” of the excess returns

	business, including IP assets)	calculation
GILTI provision	Excess returns = income – (normal return) Normal return = 10% x adjusted basis in tangible depreciable property	In order to target intangible income that was likely to have been "allocated to low- or zero-tax jurisdictions" The "formulaic approach…make[s] the determination simpler and more administrable"
OECD digital tax proposal	Excess returns = income – (normal return), where normal return is "fixed return for substantive activities" Normal return = (fixed percentage) x (payroll costs + depreciation expenses for tangible assets)	In order to target income "such as intangible income, which is most susceptible to" shifting The "formulaic" approach would "facilitate administration and compliance with the rule"

II. What Do Excess Returns Represent?

Over the past decade, there have therefore been multiple proposals in the United States and on the international stage for minimum taxes on foreign excess returns. Although these proposals share overarching similarities in terms of their general design, they differ significantly in terms of their details. What, then, are policymakers using excess returns to represent? This Section considers one possible answer, which is that policymakers are building on the economic theory of excess returns.

Readers should note that excess returns are different from residual profits, the latter of which are a transfer pricing concept.[101] Despite their similar names, they are also

[101] Residual profits are a transfer pricing concept. The general concept of residual profits is that they are the profits that are greater than a routine return calculated based on the functions and activities undertaken by a corporate taxpayer during a specific period in a specific jurisdiction. Michael Devereux et al., Oxford International Tax Group Working Paper: Residual profit allocation by income WP 19/01 (March 2019), 22 ("The concepts of routine and residual profits are broadly related to – but are not equivalent to – the economic concepts of 'normal' returns and 'excess' returns or 'economic rents'….[W]hile there is some overlap between [these concepts] [routine vs. residual profits and normal vs. excess returns], they should not be thought of as equivalent."). *See also* Michael Devereux et al., Oxford International Tax Group Working Paper: Residual profit allocation by income WP 19/01 (March 2019), 22. "[r]outine profit is defined as the return for the functions and activities undertaken by the business in a particular period, taking into account only the risks that would be faced by an independent contractor," while residual profit is any amount greater than routine profit. Michael Devereux and his co-authors have distinguished residual profits from economic rent in that routine profit (which is subtracted to arrive at

different from excess profits, but, as will be outlined later in this Section, the theories of excess returns and excess profits are often conflated.[102] This Section will therefore first discuss the theory of excess returns and then briefly introduce excess profits taxes to illustrate how they are often understood together.

A. The Theory of Excess Returns

The return on capital can be divided into normal returns and excess returns, where normal returns are the minimum return required for an investment and excess returns are all returns above that minimum required amount.[103] Excess returns are also known as supernormal returns or economic rents.[104] Most existing tax systems tax both the normal return and the excess return and do not distinguish between the two, but the idea of designing a corporate income tax so that it exempts normal returns and thus targets excess returns has existed for decades. The theory of exempting normal returns is thus a proposal for reforming the income tax to apply to less income, not a proposal for a supplemental "excess returns tax" on top of existing taxes.

There are two ways to exempt normal returns from taxation: up-front expensing and allowing an annual deduction for the normal return.[105] The first option – expensing – allows an immediate deduction for business investments. This is also known as a cash flow tax and does not allow deductions for interest and depreciation.[106] Economists have advocated for cash flow taxes since at least the 1940s and have argued that the effect of allowing an immediate deduction for business expenditures was to exempt the normal

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residual profits) takes into account only the risks faced by an independent contractor but not all the risks taken into account by the multinational entity employing the independent contractor, whereas "economic rent…is defined as a return over and above that required to compensate for all risk." Michael Devereux et al., Oxford International Tax Group Working Paper: Residual profit allocation by income WP 19/01 (March 2019), 23. They have pointed out that "it is possible that the residual profit may be greater than, or smaller than, economic rent of the overall enterprise." Michael Devereux et al., Oxford International Tax Group Working Paper: Residual profit allocation by income WP 19/01 (March 2019), 22. Note that, despite this seeming agreement on the difference between residual profits and excess returns, even economists who share this understanding sometimes use the terms interchangeably. The Mirrlees Review, for example, refers to a personal income tax equivalent of an ACE as applying to the "residual business income" rather than the excess return. J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles, and J. Poterba (eds), Dimensions of Tax Design: The Mirrlees Review, Oxford: Oxford University Press for Institute for Fiscal Studies, 917 [hereinafter "Mirrlees Review"].

[102] It is worth noting that the similarity of the terms residual returns, excess returns, and excess profits itself highlights some of the complexities and confusion facing policymakers as they try to design an effective tax provision. Economists also occasionally conflate these terms. The Mirrlees Review, for example, refers to a personal-income-tax equivalent of an ACE as applying to the "residual business income" rather than the excess return. Mirrlees Review, 917.

[103] *See, e.g.*, Martin A. Sullivan, *Economic Analysis: Designing Anti-Base-Erosion Rules*, Tax Analysts (April 22, 2013), *available at* http://www.taxhistory.org/www/features.nsf/Articles/499620F25830720185257B550046CC6F?OpenDocument.

[104] *See, e.g.*, Mirrlees Review, 427 (referring to a personal tax that does not tax the normal return on savings, and only taxes excess returns or economic rents); Mirrlees Review, 413-14 ("Profits in excess of the required rate of return are referred to as 'supernormal' profits or 'economic rents').

[105] See, e.g., Mirrlees Review. Note that some of the reforms considered in the Mirrlees Review, such as the Comprehensive Business Income Tax (CBIT) do not exempt the normal return.

[106] Mirrlees Review, 419.

return to capital from taxation.[107] The second option – a deduction for the normal return – requires a calculation of the normal return and is also known as an allowance for corporate equity (ACE), where the deduction is the equity equivalent of an interest deduction.[108] The concept of an ACE has existed for decades, many economists have proposed this as a way exclude the normal return,[109] and several countries have implemented versions of an ACE.[110]

There are several reasons that economists advocate reforming the income tax system to exempt the normal return on capital. These reasons all turn on the idea that the normal return is the minimum return that investors demand in exchange for providing capital (or another factor of production) rather than consuming it currently[111] and that any return greater than that return on an investment would be eliminated by competition unless there were some hidden asset or resource that created that greater return.[112] This in turn means that the excess return is a sign that the party earning such returns "possess[es] some scarce resource, knowledge, or ability that is not easily replicated by other" parties.[113] A prime example of a scarce resource that creates excess returns is a natural resource, but economists also consider that excess returns on investments in tangible assets are the product of intangible assets.[114]

Building on these concepts that the normal return is the minimum return that investors would demand and that anything beyond this amount would be eliminated by competition in the absence of a resource that competitors do not have, the two main reasons for exempting normal returns are to eliminate distortions from taxpayers' investment decisions and to encourage taxpayers to invest the efficient amount.[115] The explanation for why exempting the normal return would eliminate distortions is that not exempting the normal return (i.e., taxing all corporate income as most corporate income taxes currently do) both favors consumption today relative to consumption tomorrow and

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[107] Edward Fox and Zachary Liscow, A Case for Higher Corporate Tax Rates, Tax Notes International 1369, 1372 (June 22, 2020) (citing E. Cary Brown, Business-Income Taxation and Investment Incentives, and Alvin C. Warren, Jr., How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?).

[108] Mirrlees Review, 421.

[109] Michael P. Devereux, Issues in the Design of Taxes on Corporate Profit, Oxford University Centre for Business Taxation (April 2012), 3 (citing Boadway and Bruce in 1984, Devereux and Freeman in 1991, Bond and Devereux in both 1995 and 2003, and Kleinbard in 2007).

[110] Michael P. Devereux, Issues in the Design of Taxes on Corporate Profit, Oxford University Centre for Business Taxation (April 2012), 3.

[111] Edward Fox and Zachary Liscow, A Case for Higher Corporate Tax Rates, Tax Notes International 1369, 1372 (June 22, 2020).

[112] *See, e.g.*, Martin A. Sullivan, *Economic Analysis: Designing Anti-Base-Erosion Rules*, Tax Analysts (April 22, 2013), *available at* http://www.taxhistory.org/www/features.nsf/Articles/499620F25830720185257B550046CC6F?OpenDocument.

[113] Mirrlees Review, 414.

[114] Martin A. Sullivan, *Economic Analysis: Designing Anti-Base-Erosion Rules*, Tax Analysts (April 22, 2013), *available at* http://www.taxhistory.org/www/features.nsf/Articles/499620F25830720185257B550046CC6F?OpenDocument.

[115] Edward Fox and Zachary Liscow, A Case for Higher Corporate Tax Rates, Tax Notes International 1369, 1372 (June 22, 2020). It should be noted that the Mirrlees Review also mentions that there are reasons *not* to exempt the normal return, and the authors acknowledge this option by considering reforms that would tax the normal return.

creates a bias in favor of debt over equity.[116] Changing the tax system to exempt the normal return would create neutrality in terms of timing because it would allow the risk-free rate of return to escape taxation, thereby allowing an investment to earn the amount necessary so that its present value was equal to its future value. Any return above that would then be taxed. The reason that exempting the normal return would create neutrality between debt and equity investments is that, currently, most corporate income taxes provide an interest deduction. This means that debt investments have a way to offset their normal return (since the interest rate is presumed to equal the normal return), but equity investments do not.[117] The explanation for why exempting the normal return would lead companies to invest the efficient amount builds off the debt bias that currently exists in most tax systems and highlights that taxing the normal return without providing any tax reduction similar to the deductibility of interest increases the cost of capital and reduces investment since investors require higher returns than they would if the normal return were exempted from taxation.[118]

In order to achieve these goals, therefore, a tax system could exempt the normal return either by allowing for expensing or by allowing for a deduction for the normal return on equity. In theory, these two options are economically equivalent because allowing an immediate deduction of business expenditures leads to the exemption of the normal return when overall returns are taxed, as does the deduction of the normal return by way of an ACE. In reality, however, expensing does not require a calculation of the normal return, since the normal return is automatically excluded by way of the interaction between the immediate deduction and the future value of the investment, while an ACE or similar annual deduction for the normal return requires the tax system to provide a determination of how to calculate that normal return. The rate of return for a deduction for normal returns must thus be calculated correctly for the effect of this deduction to be equivalent to expensing. Economists have acknowledged that setting the correct rate is difficult and that it could differ by industry or investment.[119]

If a jurisdiction does choose to implement a deduction for normal returns, this forces the jurisdiction to determine the appropriate rate of return to use. The normal return for these purposes equals the risk-free rate of return.[120] This is the minimum rate of return required for an investor to make an investment,[121] and it is generally equal to the interest rate on medium-maturity government bonds.[122]

B. Excess Profits Taxes

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[116] *See, e.g.*, Edward Fox and Zachary Liscow, A Case for Higher Corporate Tax Rates, Tax Notes International 1369 (June 22, 2020).

[117] Michael P. Devereux, Issues in the Design of Taxes on Corporate Profit, Oxford University Centre for Business Taxation (April 2012), 3.

[118] Mirrlees Review, 419.

[119] Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 675 (September 2013). *See also* Action 3 Final Report.

[120] Mirrlees Review, 422-23.

[121] Mirrlees Review, 438-39.

[122] Stephen R. Bond and Michael P. Devereux, Generalised R-based and S-based taxes under uncertainty, 87 J. of Public Economics 1291-1311 (2003).

Taxation of excess returns is thus taxation of all income that exceeds the risk-free rate of return on investments. This is a different concept than the concept underlying excess profits taxes, which have existed since the early days of the income tax in the United States. This Part briefly outlines excess profits taxes because, as will be discussed later, some of the proposals for excess returns taxes seem to partly conflate excess returns and excess profits. Also, the similarity of the phrases means that proposals such as the one in the BEPS Action 3 Final Report refer to "excess profits" when they seem to intend to focus on excess returns instead.

Taxes on excess profits are designed to "syphon off" profits from exogenous shocks such as wartime or pandemics, when certain companies or industries would otherwise profit significantly.[123] They subject all income above normal profits to a supplemental tax, often at a higher rate than the normal tax rate. The United States has implemented excess profits taxes during World War I, World War II, and the Korean War, as well as other periods in between.[124] Several economists and academics have recently proposed excess profits taxes as a response to the economic disruption caused by COVID-19.[125]

The World War I excess profits tax applied to all profits above an 8% return on invested capital, and it applied rates up to 80%.[126] The World War II excess profits tax

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[123] Reuven Avi-Yonah, Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?, U. of Michigan Public Law Research Paper No. 671, U. of Michigan Law & Econ Research Paper No. 20-008 (May 19, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806

[124] Reuven Avi-Yonah, Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?, U. of Michigan Public Law Research Paper No. 671, U. of Michigan Law & Econ Research Paper No. 20-008 (May 19, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806. The United States is not the only country that has historically had such taxes, and they are sufficiently common that Section 901(b)(1) has included "income, war profits, and excess profits taxes" in the definition of taxes that qualify for the foreign tax credit since 1918. 26 U.S.C. § 901(b)(1); PPL v. Commissioner, 569 U.S. 329 (2013).The United Kingdom has had similar taxes, often referred to as windfall taxes. In a U.S. Supreme Court case debating whether one such U.K. tax was a creditable excess profits tax the Supreme Court stated that a "classic excess profits tax" was one that imposed a "tax on all profits above a threshold." PPL v. Commissioner, 569 U.S. 329 (2013). Note that whether the tax in PPL was itself an excess profits question was a contested question, so this Article does not treat that tax as an example of an excess profits tax, partly because it was a one-time levy. That said, that tax does share many characteristics with the excess profits taxes described above, including the fact that it was designed to target income above some normal level of income, which in this case was the amount the UK government retrospectively thought companies should have earned.

[125] Reuven Avi-Yonah floated this idea in March 2020. *See* Reuven Avi-Yonah, Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?, U. of Michigan Public Law Research Paper No. 671, U. of Michigan Law & Econ Research Paper No. 20-008 (May 19, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806, *also available at* https://sites.law.duke.edu/thefinregblog/2020/03/30/taxes-in-the-time-of-coronavirus-is-it-time-to-revive-the-excess-profits-tax/ and https://prospect.org/coronavirus/its-time-to-revive-the-excess-profits-tax/. Emmanuel Saez and Gabriel Zucman also proposed this around the same time. Emmanuel Saez and Gabriel Zucman, *Jobs Aren't Being Destroyed This Fast Elsewhere. Why Is That?*, The NY Times (March 30, 2020), *available at* https://www.nytimes.com/2020/03/30/opinion/coronavirus-economy-saez-zucman.html. Allison Christians and Tarcísio Diniz Magalhães proposed a similar concept in May 2020. Allison Christians and Tarcísio Diniz Magalhães, *It's Time for Pillar 3: A Global Excess Profits Tax For COVID-19 and Beyond*, Tax Notes International, 507 (May 4, 2020).

[126] Emmanuel Saez and Gabriel Zucman also proposed this around the same time. Emmanuel Saez and Gabriel Zucman, *Jobs Aren't Being Destroyed This Fast Elsewhere. Why Is That?*, The NY Times (March 30, 2020), *available at* https://www.nytimes.com/2020/03/30/opinion/coronavirus-economy-saez-

applied rates up to 95%,[127] although it capped the total tax rate that applied to all income at 72%.[128] It calculated normal profits in one of two ways. The average earnings method averaged the income earned by the corporation in 1936, 1937, 1938, and 1939, and it treated that average as normal profits.[129] The invested capital method treated a rate of return ranging from 5% to 8% on invested capital as normal profits.[130] The Korean War excess profits tax applied a 30% rate to excess profits, with a 62% overall cap on total taxes paid by any one corporation.[131] It calculated excess profits similarly to the World War II excess profits tax. To determine normal profits based on average earnings, a taxpayer would determine its average net income for the years 1946, 1947, 1948, and 1949, and it would then multiply that average by 85%.[132] To determine normal profits based on invested capital, a taxpayer would treat between 8% and 12% of invested capital as a normal return.[133] This amount would then be subtracted from excess profits net income to determine the excess profits that would be subject to the 30% tax on top of other corporate income taxes.[134]

These excess profits taxes therefore differ from the theory of excess returns in a number of important ways. First, they are designed to prevent companies from getting the full windfall from exogenous shocks such as wartime, not to focus the income tax on income that arises from intangible assets or other resources that competitors may not be able to access.[135] Second, they have defined excess profits either as the excess over a normal return on invested capital or as the excess over average income from the pre-war (or other shock) period. Third, at least during wartime, they all had very high tax rates on the excess profits. Fourth, they were referred to as excess profits taxes, but they were often called windfall taxes as well. Fifth, they were all designed to apply on top of

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zucman.html. Despite this tax being implemented in order to target windfalls from wartime, several legislators pushed to have it become permanent, and it was briefly followed by a non-wartime excess profits tax in the mid-1930s.

[127] Reuven Avi-Yonah, Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?, U. of Michigan Public Law Research Paper No. 671, U. of Michigan Law & Econ Research Paper No. 20-008 (May 19, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806.

[128] Schroeder Boulton, *The Excess Profits Tax of 1950: A Layman's Outline from the Viewpoint of the Corporate Analyst*, The Analysts Journal, 2nd Qtr., 1951, Vol. 7, No. 2, 153, 153. The World War II cap was an over-all rate of 80%, but this was applied after applying a 10% "postwar refund," which means that the effective over-all cap was 72%. Boulton, 153.

[129] Reuven Avi-Yonah, Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?, U. of Michigan Public Law Research Paper No. 671, U. of Michigan Law & Econ Research Paper No. 20-008 (May 19, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806.

[130] Reuven Avi-Yonah, Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?, U. of Michigan Public Law Research Paper No. 671, U. of Michigan Law & Econ Research Paper No. 20-008 (May 19, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806.

[131] Schroeder Boulton, *The Excess Profits Tax of 1950: A Layman's Outline from the Viewpoint of the Corporate Analyst*, The Analysts Journal, 2nd Qtr., 1951, Vol. 7, No. 2, 153, 153.

[132] Schroeder Boulton, *The Excess Profits Tax of 1950: A Layman's Outline from the Viewpoint of the Corporate Analyst*, The Analysts Journal, 2nd Qtr., 1951, Vol. 7, No. 2, 153, 154.

[133] Schroeder Boulton, *The Excess Profits Tax of 1950: A Layman's Outline from the Viewpoint of the Corporate Analyst*, The Analysts Journal, 2nd Qtr., 1951, Vol. 7, No. 2, 153, 154.

[134] Schroeder Boulton, *The Excess Profits Tax of 1950: A Layman's Outline from the Viewpoint of the Corporate Analyst*, The Analysts Journal, 2nd Qtr., 1951, Vol. 7, No. 2, 153, 154.

[135] That said, it is worth noting that many lawmakers lobbied for these taxes to remain and become permanent after each war was over, suggesting that at least some lawmakers saw a broader justification underlying them.

existing corporate income taxes rather than being reforms to existing income taxes. The 1950 excess profits tax, for example, applied a separate 30% rate to excess profits, while overall corporate income (which included excess profits) was subject to a top marginal tax rate of 47%.[136] Finally, for those that defined normal profits to be the normal return on invested capital, they calculated this return using rates ranging from 5% to 12%. These rates were not intended to represent the risk-free rate of return as used in the excess returns literature but instead the return that a company would have expected in the absence of the windfall arising from war or, in the case of the excess profits taxes that applied outside of wartime, some other extenuating circumstance.

C. Summary of the Theory of Excess Returns and the Practice of Excess Profits

Excess returns, therefore, are the amount that remain when the risk-free rate of return is exempted from taxation, either by immediately deducting business expenditures or by taking a deduction for the normal return on capital. The risk-free rate is the minimum required rate of return, and it is equal to the interest rate on medium-maturity government bonds.[137] Excess returns (or supernormal returns or economic rents) represent profits from some "resource, knowledge, or ability" that other parties do not have and cannot replicate, and the primary reasons for exempting the normal return and therefore subjecting only the excess return to taxation are to eliminate distortions and to lead to an efficient amount of investment by reducing the cost of capital.

In contrast, excess profits taxes are not a concept that exists in the economic literature but are instead a fairly common set of taxes that exist to tax windfalls arising from exogenous shocks such as war, privatization, global pandemic, or the like. For these taxes, the normal profits that are not subject to taxation are not the risk-free returns on investment but rather the higher rate of return that policymakers think a taxpayer could have expected to earn in the absence of the economic disruption caused by the extreme circumstances motivating the tax. This higher rate of return has historically ranged between 5% and 12%. Alternatively, normal profits can also be calculated as an average of the taxpayer's earnings over several years prior to the economic disruption in question.

III. Practice versus Theory: How Do Minimum Taxes on Foreign Excess Returns Compare to the Theory of Excess Returns?

The minimum taxes on foreign excess returns discussed in Section I are all theoretically designed to focus on excess returns, not on excess profits. But this Section will show the many ways in which the taxes described in Section I diverge from the theory of excess returns – and how they differ from each other. This Section will also

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[136] Schroeder Boulton, *The Excess Profits Tax of 1950: A Layman's Outline from the Viewpoint of the Corporate Analyst*, The Analysts Journal, 2nd Qtr., 1951, Vol. 7, No. 2, 153, 153. This corporate income tax rate was presented as a normal tax of 25% on earnings up to $25,000 and a surtax of 22% on earnings above that amount, but that is the same as a tax with two brackets of 25% and 47%. Boulton, 153. Note that the 1950 excess profits tax did not apply to taxpayers with excess profits less than or equal to $25,000. Once a taxpayer had excess profits greater than $25,000, however, the tax applied to all of those excess profits. Boulton, 154.

[137] William Griffiths, Paul H. Jensen, and Elizabeth Webster, *What Creates Abnormal Profits?*, 58 Scottish Journal of Political Economy 323 (2011).

highlight how at least some of the taxes in Section I seem to be borrowing elements from excess profits taxes while claiming to target excess returns. This Section concludes that these taxes are not in fact trying to do what the theory of excess returns was designed to achieve but that they are instead a new step towards an entirely different goal.

The first distinction to note is that all of the minimum taxes discussed in Section I require a definition of the normal return because they provide an annual deduction for the normal return on investments rather than allowing up-front expensing. This means that each of the proposals must come up with its own definition of normal returns by establishing the relevant rate of return and the investments to which that rate of return is to be applied. This design choice differs significantly from the minimum tax on foreign excess returns that provides the inspiration for at least some of the taxes discussed in Section I. This minimum tax was proposed in a 2013 article in which Harry Grubert and Rosanne Altshuler exported the concepts of normal returns and excess returns to the international tax space.[138] They contemplated a minimum tax that would apply only to the return greater than a "company's normal return abroad, the rate with which it discounts cash flows from real investments."[139] They suggested that exempting this normal return was an alternative to providing an exemption for income from active businesses.[140] Grubert and Altshuler argued that the reason for focusing on excess returns was that these were "cases in which the company probably has less intense foreign competition"[141] or where the investments in question "probably do not have very close foreign competitors, so imposing a minimum tax is not likely to put [the companies] at a competitive disadvantage."[142] In other words, companies that only earned a normal return "probably have more intense foreign competition" and imposing a U.S. tax on these companies "could put them at a competitive disadvantage."[143] Grubert and Altshuler also suggested that the returns that would be taxed after normal returns were subtracted were "excess returns attributable to U.S. developed intellectual property."[144] This envisioned minimum tax has many of the same goals as the ones mentioned in Section I, but Grubert and Altshuler proposed achieving the exemption of normal returns not by way of a deduction but by way of expensing, which eliminated the need for them to calculate the normal return.

All of the taxes discussed in Section I, however, define normal returns as an amount to be subtracted annually to determine excess profits, and this amount is equal to a fixed rate multiplied by a certain category of investments. Each minimum tax discussed in Section I defines normal returns differently from all the others, and these taxes also

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138 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671 (September 2013).

139 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 677 (September 2013).

140 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 672 (September 2013).

141 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 673 (September 2013).

142 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 675 (September 2013).

143 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 675 (September 2013).

144 Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 675 (September 2013).

differ in their definition of normal returns when compared to how the theory of excess returns defines normal returns. This Section will first outline the ways that these taxes differ from each other and will then discuss the ways that they all differ from the theory of excess returns and the practice of excess profits taxes.

A. Differences Between the Various Proposals

The minimum taxes discussed in Section I vary from each other in at least three ways: (i) whether or not they calculate normal returns using investment or costs, (ii) the rates they use to calculate normal returns, and (iii) the degree to which normal returns are limited to a category of returns.

On the first point, the taxes discussed in Section I can be broken into two categories in terms of how they define normal returns. There are those that define normal returns by multiplying a set rate by the equity invested in various assets and there are those that define normal returns by multiplying a set rate by the costs associated with a given set of assets. The latter approach appears to involve annual costs such as R&D and depreciation rather than the full cost of any asset, but this is not clear in many of the proposals.

The taxes that define normal returns by multiplying a set rate by the equity invested in various assets hew most closely to the concept of an ACE. Examples of taxes that do this are the final Obama Treasury proposals, the Action 3 Final Report and the GILTI. These all differ, however, in terms of what investments qualify. The Obama Treasury proposals use equity invested in active assets as their qualifying investments. The Action 3 Final Report proposes multiplying the rate by equity invested in assets that are used in the active conduct of a trade or business, but it makes clear that these assets include intangible assets. GILTI, on the other hand, uses the investment in tangible depreciable property as its qualifying investments.

The taxes that instead use costs associated with the asset are in some ways closer to an expensing system, but they still differ from each other in what costs qualify for the deduction. The earlier Obama Treasury proposals focus on costs allocated and apportioned to income from a transferred intangible. Similarly, Camp Option A focuses on costs associated with an intangible that has been transferred to a foreign related party. But the Pillar Two proposal focuses on an entirely different set of costs, defining normal returns by way of payroll costs plus depreciation costs for tangible assets.

Once these proposals and provisions have determined what assets or costs qualify, those that list rates all vary in terms of the rate of return used to calculate normal returns. The BEPS Action 3 Final Report explicitly states that it is using the risk-inclusive rate of return, which it suggests could be between 8% and 10%. GILTI uses a 10% rate. But the later Obama Treasury proposals explicitly state that they will use the risk-free rate of return, although they do not provide an actual number for this rate. For those taxes that uses costs, although the earlier Obama Treasury proposals say nothing about what rate will be used, Treasury officials apparently planned to use a 30% rate. Camp Option A, in contrast, uses a 150% rate. And the Pillar Two proposal does not supply a rate, but it suggests that the rate to be used should be similar to the rates used under cost-plus transfer pricing analyses, which would require the 137 countries involved in the digital

tax work to agree on a gross profit mark-up that would be appropriate across industries and jurisdictions.[145]

Finally, it should be noted that some of the taxes discussed in Section I narrow the scope of the tax so it applies only to certain excess returns. The early Obama Treasury proposals and Camp Option A only subtract normal returns from intangible income, while the other proposals subtract normal returns from all foreign income (or all income earned by the CFC).

B. Are These Taxing Excess Returns?

Given all the differences outlined above, is it possible to see these minimum taxes on foreign excess returns as taxing excess returns as defined in economic theory? Recall that, under the economic theory of excess returns, normal returns are equal to the risk-free rate of return on capital, generally estimated to be the interest rate on medium-maturity U.S. Treasury bonds. In 2019, the interest rate on medium-maturity U.S. Treasury bonds was between 1.6% and 2.8%.[146] In 2015, this rate never exceeded 3% and never fell below 1.5%.[147] In 2010, this rate was slightly higher, hovering between 2.5% and just over 4%.[148] In a cash flow tax, this return on capital should automatically be exempted. In an ACE or similar deduction, however, the rate must be determined and then multiplied by qualifying investments. (Note that, if an ACE were designed to be equivalent to a cash flow tax, the amount deducted immediately under a cash flow tax should be the same amount that represents the investment base in an ACE.)

All the provisions discussed above seem to use much higher rates of return multiplied by investments, and some of them explicitly focus on the risk-inclusive rate of return. For those that use costs as a base, they use different rates from one another, and some of them focus on investments in tangible assets, while others focus on investments in active assets including intangible assets. So it seems that these provisions are doing something different than just exempting the risk-free rate of return on real investment.

C. Are These Taxing Excess Profits?

Are they, perhaps, trying to tax excess profits? In some ways, these taxes do align more with excess profits taxes than with taxation of excess returns. First, the rates that provisions such as the Action 3 Final Report’s proposed CFC rule or the GILTI rule use to calculate normal returns are closer to normal profits rates of 8% and 10%. At least of these provisions therefore seem less focused on the risk-free rate of return and more focused on the return that the taxpayer would have been able to earn without the ability to

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[145] Note also that the OECD’s reference to cost-plus and its claim in the Blueprint that a normal return is also known as a routine return suggests that the OECD is conflating excess returns with the transfer pricing concept of residual returns.

[146] U.S. Dept. of the Treasury, Daily Treasury Yield Curve Rates, *available at* https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2019

[147] https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2015

[148] https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2010

shift income or intangible assets. Second, these rules are focused less on excluding normal returns than they are on subjecting taxpayers who earn excess returns to more taxation. Third, although they are not focused on specific windfalls, they are focused on imposing taxation on taxpayers who are able to benefit from the use of intangibles or the digital economy where other taxpayers are not. Finally, at least one of them – from the BEPS Action 3 Final Report – refers to "excess profits" instead of "excess returns."

That said, these measures also differ from excess profits taxes in important ways. First, many of the measures discussed in Section I use expenditures instead of investment to calculate normal returns. Second, some of the measures discussed in Section I refer specifically to the risk-free rate of return, suggesting that, even if they are in fact using a higher rate than the minimum required rate, they intend to be using the minimum required rate. Third, all of these measures claim not to be taxing a specific exogenous shock but rather reacting to the overall international business environment that allows certain taxpayers to earn income greater than some normal return.

These measures may thus represent more a conflation of normal returns and normal profits (and therefore of excess returns and excess profits) than a desire by policymakers to impose windfall taxes similar to those that were imposed in previous eras. They do, however, highlight that policymakers are not actually trying to exempt just the risk-free return on investment from minimum taxation. Instead, by using higher rates and borrowing at least in part from excess profits taxes, they are doing something different than just reducing distortions in terms of the timing and form of investment. As the Part below will illustrate, they are trying to achieve something very different than either a tax exempting a normal return or an excess profits tax was designed to achieve.

D. What Are These Taxing?

The discussion above has highlighted the many differences amongst these various excess returns proposals as well as the many differences between these proposals and economic theory. In many ways, it appears that the only similarity between these proposals is the terminology they use: normal returns are whatever policymakers want them to be, and excess returns are whatever exceed those normal returns.

But a closer look suggests that, even if there are not direct equivalencies between the proposals, one place where there is overlap is in the justifications for these provisions. Although the calculation of normal returns varies by provision, and although individual provisions are justified in different ways, the justifications all share a larger vision of why a tax on excess returns is necessary. As discussed above, some provisions focus on the need to tax intangibles, particularly those that have been shifted outside the jurisdiction. Some provisions instead focus on the need to provide a backstop to transfer pricing, a concern that often arises because the ease with which intangible income and intangible assets can be shifted between jurisdictions makes it difficult to correctly allocate income from intangible assets. Finally, some provisions focus on the need to tax income that has been separated from the underlying economic substance.

Although these justifications all sound different from each other, they share a general vision of the problems that can be addressed by a tax on excess returns. All of them are explicitly or implicitly designed to address the concern that, under the current international tax regime, taxpayers are able to shift income from the high-tax jurisdictions

that contributed most to that income to low-tax jurisdictions that contributed very little to the income. This shifting is easiest when the income in question arises out of underlying intangible assets that can be shifted to related parties in the low-tax jurisdiction.

Therefore, although the excess returns proposals in Section I may not have much in common with the theory of excess returns in Section II, they are all attempting to target the same shifted income in low-tax jurisdictions. They are all minimum taxes or CFC rules that are designed to impose taxation on income that would otherwise not have been taxed sufficiently in its home jurisdiction, and they are all attempting to define normal returns to represent income that has not been shifted and excess returns to represent income that has been shifted away from the jurisdiction that contributed to it.

These minimum taxes on foreign excess returns thus represent a new phase in the ongoing tax policy debate over "substantial activities," "economic substance," "real activity," "substance," and the like. All of these phrases arise in a policy discussion over how to determine whether income has been shifted away from the jurisdiction that contributed to its production and what it means for income to be shifted. The concept underlying all of these phrases is that income has not been shifted if it arises out of substantial activities in the jurisdiction that taxes it, but that it has been shifted if it cannot be linked to substantial activities in that jurisdiction. In attempting to tax income from shifted intangibles by taxing excess returns, all of the measures discussed in Section I have added a new phase to the search for substantial activities: they have implicitly determined that normal returns are a proxy for substantial activities.

IV. The Difficulties of Defining Substantial Activities

Although the minimum taxes on excess returns discussed above vary in their stated justifications, they all fundamentally share a focus on exempting the return on substantial activities or income that has not been shifted. This Section sets out a brief history of efforts to identify substantial activities for tax purposes. This policy discussion has gone on for decades, but it reached particular international salience during the OECD/BEPS Project, where many of the Actions were focused on ensuring that income was not permitted to be separated from real economic activity for tax purposes. This Section then illustrates how the minimum taxes on foreign excess returns fit into this ongoing search for a definition of substantial activities. This Section concludes by outlining the criticisms that have been leveled against earlier efforts to identify and define substantial activities and considers whether using normal returns as a proxy for substantial activities addresses these critiques.

A. The Search for Substantial Activities

The concept of real economic activity or substance initially arose in the context of domestic tax avoidance. In 1935, the U.S. Supreme Court agreed with the Commissioner of the Internal Revenue Service that a transaction was "without substance" and therefore must be disregarded.[149] In the following years, courts developed a variety of doctrines to determine when a transaction did not represent real economic activity and instead lacked

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[149] Gregory v. Helvering, 293 U.S. 465, 467 (1935).

substance.[150] The concept of requiring substantial activities in order to grant a tax benefit was not limited to the United States, and courts outside the U.S. often addressed this same concern by referring to "abuse of law," pursuant to which a taxpayer was engaged in a transaction that met the requirements of the law but was motivated by an intend to avoid taxation.[151] By the early 2000s, these concepts had become intertwined, and the European Court of Justice required Member States to require "genuine economic activities" in order to grant certain tax benefits.[152]

As courts created various doctrines to address the lack of substance underlying transactions, legislatures were also designing their own rules requiring substantial activities for tax benefits (or imposing taxation on income that did not arise from substantial activities). In 2010, the U.S. Congress codified the economic substance doctrine in Section 7701(o) of the Internal Revenue Code.[153] At the same time, several European countries were imposing their own substance requirements.[154]

On the international stage, the OECD was also designing rules and guidelines intended to require substantial activities. In 1998, as part of its work on international tax competition, the OECD stated that a lack of a "substantial activities" requirement was one of the key factors identifying tax havens.[155] In other words, if a country did not require a taxpayer to have substantial activities in the jurisdiction in order to benefit from a tax preference, the absence of that requirements was itself a sign that the jurisdiction was a tax haven.[156] This focus on substantial activities then became even more striking during the BEPS Project. In the Action Plan setting out the goals of the project, the OECD called for "a realignment of taxation and relevant substance," stating that one of the fundamental issues for international taxation was the activity of "shell companies that have little or no substance in terms of office space, tangible assets and employees."[157]

Several of the fifteen Actions that made up the BEPS Project ended up proposing ways to determine whether a taxpayer had sufficient substance in a jurisdiction. Two of the main Actions that did this were Action 3 and Action 5. Action 5 was the one Action out of the fifteen that explicitly referred to substantial activities. In the Action Plan, the OECD charged the delegates working on Action 5 to "revamp the work on harmful tax practices with a priority on…requiring substantial activity for any preferential regime."[158] This mandate required the Action 5 delegates to update the work that the Forum on Harmful Tax Practices (FHTP) had been doing since the 1998 report on tax competition was published, and this resulted in what is known as the nexus approach. The nexus approach, which was described in the Action 5 Final Report that was published in 2015, only allows jurisdictions to provide preferential tax rates for income from IP (i.e., to grant

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[150] *See* Lilian V. Faulhaber, Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance, 48 Colum. J. Transnat'l L. 177, 201 n. 82 (2010).

[151] *See* Lilian V. Faulhaber, Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance, 48 Colum. J. Transnat'l L. 177, 203-206 (2010).

[152] *See* Lilian V. Faulhaber, Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance, 48 Colum. J. Transnat'l L. 177, 198 (2010).

[153] 26 U.S.C. §7701(o).

[154] *E.g.*, U.K. Finance Bill 2012.

[155] OECD, Harmful Tax Competition: An Emerging Global Issue, 23 (1998) [hereinafter "OECD 1998 Report"].

[156] OECD 1998 Report, 23.

[157] BEPS Action Plan, 13.

[158] BEPS Action Plan, 18.

benefits under a so-called "patent box") if the income bears a nexus to R&D undertaken in the jurisdiction granting the preferential rate.[159] In order to determine this nexus, the OECD required jurisdictions to limit their tax benefits to the proportion of relevant R&D that was undertaken in the jurisdiction.[160] In other words, if a taxpayer had done all the necessary R&D for the IP asset generating the income in the jurisdiction providing the preferential rate, then that taxpayer could apply the preferential rate to all of their income from the IP asset. But if a taxpayer had only done a portion of the necessary R&D in that jurisdiction, then they could only apply the preferential rate to the equivalent portion of their income from the IP asset.[161]

After 2015, the nexus approach was then expanded to apply to preferential regimes that granted reduced rates to income other than IP income.[162] In 2017, the FHTP issued a report where they introduced an "approach to implementing the substantial activities requirement in the context of non-IP regimes."[163] This approach required all regimes other than IP regimes to grant benefits "only when the core income generating activities are undertaken…in the jurisdiction providing benefits."[164] The FHTP then clarified that "[c]ore income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities."[165]

Action 5 (and thus the FHTP) therefore has a very particular view of what constitutes substantial activities: a direct link between the jurisdiction providing tax benefits, the expenditures incurred to generate the income, and the income receiving tax benefits.

Unlike Action 5, which explicitly mandated a focus on substantial activities, Action 3 ended up including a substance analysis as one of the options it recommended even though this was not mandated in the 2013 Action Plan. As discussed earlier, Action 3 focused on reforming CFC rules and included a chapter about possible ways to define the income to be subject to CFC rules. This chapter proposed three possible approaches

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159 The jurisdictional limitation is more complicated than is stated here due to limits imposed by European Union law. For a more detailed explanation, see Lilian V. Faulhaber, The Luxembourg Effect: Patent Boxes and the Limits of International Cooperation, 101 Minn. L. Rev. 1641 (2017).

160 OECD, Countering Harmful Tax Practices More Effectively Taking Into Account Transparency and Substance: Action 5: 2015 Final Report, 24-25 [hereinafter "Action 5 Final Report"].

161 The nexus approach is again more complicated than this description makes it sound, with a possible 30% "uplift," the possibility of a rebuttable presumption, limits on qualifying expenditures and qualifying IP assets, and other limitations, but this description sets out the necessary elements. For a more detailed description of how the nexus approach actually works, see Lilian V. Faulhaber, The Luxembourg Effect: Patent Boxes and the Limits of International Cooperation, 101 Minn. L. Rev. 1641 (2017).

162 This was mandated in the Action Plan and predicted in the Action 5 Final Report. *See* BEPS Action Plan; Action 5 Final Report.

163 OECD, Harmful Tax Practices – 2017 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5, OECD/G20 Base Erosion and Profit Shifting Project, 39, *available at* http://dx.doi.org/10.1787/9789264283954-en [hereinafter "Action 5 2017 Progress Report"].

164 As with the nexus approach, the jurisdictional limitation does not apply within the European Union. See Action 5 2017 Progress Report, 40, 44 n.3; Lilian V. Faulhaber, The Luxembourg Effect: Patent Boxes and the Limits of International Cooperation, 101 Minn. L. Rev. 1641 (2017).

165 Action 5 2017 Progress Report, 40. This description was followed by examples of core income generating activities for a variety of preferential regimes. Action 5 2017 Progress Report, 40-41.

to defining CFC income:[166] a categorical analysis, a "substance analysis," and the excess profits analysis described in Section I. The Action 3 Final Report described substance analyses in the following way:

> A substance analysis looks to whether the CFC engaged in substantial activities in determining what income is CFC income. Many existing CFC rules apply a substance analysis of some sort, and many Member States of the European Union combine a categorical approach with a carve-out for genuine economic activities. Substance analyses can use a variety of proxies to determine whether the CFC's income was separated from the underlying substance, including people, premises, assets, and risks. Regardless of which proxies they consider, substance analyses are generally asking the same fundamental question, which is whether the CFC had the ability to earn the income itself.[167]

The Action 3 Final Report then considered four different substance analyses that could apply in the context of CFC rules. The first would apply "a facts and circumstances analysis to determine whether the employees of the CFC have made a substantial contribution to the income earned by the CFC."[168] The second would focus on the significant functions performed by related companies "to determine whether the CFC is the entity which would be most likely to own particular assets, or undertake particular risks, if the entities were unrelated."[169] The third would assess whether the CFC had the "necessary business premises and establishment" and "the necessary number of employees with the requisite skill" in the CFC jurisdiction "to actually earn the income."[170] The fourth and final option was to "use the nexus approach that was developed in the context of Action Item 5."[171] This option would therefore essentially allow income that benefited from a preferential regime to escape CFC taxation if the preferential regime met the requirements of the nexus approach.

By 2017, therefore, the OECD had identified a variety of approaches for requiring substantial activities. The reason for such a requirement was either because policymakers in OECD/G20 countries believed that preferential regimes should only grant tax preferences to income arising from substantial activities or, in the inverse, because they believed that income that did not arise from substantial activities should be subject to supplemental taxation. The chart below lists the different ways that the OECD had considered defining or identifying substance or substantial activities, many of which were based on rules that already existed in various jurisdictions. Note that, in 2015, the excess profits analysis was presented as an alternative to a substance analysis. In other words, the Action 3 excess profits analysis was not presented as a way of taxing income that did not reflect substantial activities.

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166 Note that it appears to also propose a fourth approach ("4.2.4 Transactional and entity approaches"), but the fourth approach makes clear that this is a determination that applies to the previous three approaches and is not an alternative to the others. Action 3 Final Report, 50.

167 Action 3 Final Report, 47.

168 Action 3 Final Report, 48.

169 Action 3 Final Report, 48.

170 Action 3 Final Report, 48.

171 Action 3 Final Report, 48.

Action 3 options for identifying substantial activities	• Facts and circumstances based on whether employees made a substantial contribution to the income. • Significant functions analysis to determine whether the CFC is the appropriate entity for owning the assets or undertaking the risks associated with the income. • Analysis of whether the CFC had the necessary business premises, establishment, and employees necessary to earn the income. • Nexus approach, which identifies substantial activities based on R&D expenditures incurred in the jurisdiction (or by the taxpayer)
Action 5 requirements for identifying substantial activities	• For IP regimes: nexus approach, which identifies substantial activities based on R&D expenditures incurred in the jurisdiction (or by the taxpayer) • For other preferential regimes: substantial activities analysis, which identifies substantial activities based on "core income generating activities," including operating expenditures incurred and number of employees hired in the jurisdiction (or by the taxpayer)

All of these approaches focus to a varying degree on whether the taxpayer in question has incurred the necessary expenditures in the jurisdiction to produce the income in question. Some, such as the nexus approach, focus on the expenditures themselves. Others focus on what the expenditures purchased, including sufficiently qualified employees or appropriate business premises.

In 2020, this list of possible approaches to defining substantial activities was expanded to include a carve-out for normal returns. In the Pillar Two work, one reason that the OECD explained the inclusion of a carve-out for normal returns was that this would allow income arising from economic substance to escape taxation under the minimum tax. The normal return calculation in the Pillar Two work is therefore a proxy for substantial activities. And, as detailed in Section I, the Pillar Two normal returns

carve-out was explicitly modeled on several of the other minimum taxes on foreign excess returns discussed above. Furthermore, as detailed in Section III, the Pillar Two normal returns carve-out shares the overall goal of the other minimum taxes on foreign excess returns, which is to subject income from shifted intangibles to taxation. This overall goal is similar to the goals underlying the various substantial activities tests in Action 3 and Action 5. The measures outlined in Section I can thus all be seen as new additions to the ongoing search for substantial activities.

B. Criticisms of Efforts to Define Substantial Activities

Both domestically and internationally, efforts to define substantial activities have faced two broad categories of criticism: (i) the lack of objective guidance on what does or does not constitute substantial activity and (ii) the flexibility and unpredictability of many of these tests. Together, these criticisms suggest that there has historically been disagreement over what constitutes substantial activities and that commentators have had concerns about policymakers exercising unacceptable discretion in defining substantial activities to achieve their own purposes.

The first category of criticism historically focused on the fact that many of the initial economic substance tests were ex post judicial tests that found a lack of substantial activity only after a transaction had occurred.[172] But, even after jurisdictions started to implement their own ex ante substantial activities tests, commentators and taxpayers challenged these tests as not being based on a consistent theory.[173] This is at least partly because the concepts of substantial activities and economic substance are not rigorously defined in the economic literature, so commentators have argued that policymakers were essentially defining substantial activities to be whatever they wanted them to be.[174]

The second category of criticism built on the first and argued that substantial activity tests provided too much flexibility for policymakers, courts, and tax administrations. This again applied initially to the judicial tests that were the initial efforts to define substantial activities, but these criticisms continued to apply to ex ante tests implemented by legislatures and international organizations. Even tests such as the Action 5 core income generating activities test can be subjected to such criticisms in that legislators can arguably define the concept of a "core income generating activity" in any way they see fit.

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[172] *See, e.g.*, Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax,* 54 SMU L. Rev. 149 (2001); David P. Hariton, *Sorting Out the Tangle of Economic Substance,* 52 Tax Law 235 (1999); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?,* 1 N.Y.U. J. L. & Bus. 371, 373 (2005); Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 Va. Tax Rev. 783, 787 (2007); Sandra Favelukes O'Neill, *Let's Try Again: Reformulating the Economic Substance Doctrine*, 121 Tax Notes 1053, 1053-54 (2008).

[173] *See, e.g.*, public comments on BEPS public consultations.

[174] Susan Morse, Value Creation: A Standard in Search of a Process, 72 Bull. Int'l. Tax'n. 196 (2018); António Carlos dos Santos, What Is Substantial Economic Activity for Tax Purposes in the Context of the European Union and the OECD Initiatives against Harmful Tax Competition?, 24 EC Tax Rev. 166 (2015).

C. Normal Returns as a Proxy for Substantial Activities

In response to these criticisms and in the face of continued income shifting, policymakers thus found a new way of defining substantial activities that they lauded for its formulaic and mechanical nature. This new approach was to exempt normal returns from taxation, thereby treating normal returns as a proxy for substantial activities. This in turn treated excess returns as all income separated from substantial activities.

As shown above, many of the minimum taxes on foreign excess returns were advertised by their designers as formulaic and mechanical. As also illustrated above, however, all of these taxes defined normal returns differently from each other. So, as this Part will illustrate, the formulaic nature of these taxes does not in fact eliminate the concerns that were leveled at previous substantial activities tests. Instead, by defining normal returns in a way that diverges from the theory of excess returns, policymakers are still exercising discretion in their definition of normal returns and are still defining this amount in whatever way they see fit.

How, then, do all of these minimum taxes on foreign excess returns define substantial activities if we understand them to be using normal returns as a proxy for substantial activities? Early Obama Treasury proposals define these to be a fixed, perhaps 30%, mark-up of costs allocated and apportioned to income from a transferred intangible. Therefore, the more money that a taxpayer spends on a transferred intangible, the more substance will be seen to exist. Camp Option A uses the same concept, but its mark-up is five times as large, suggesting that fewer costs will lead to more substance. Later Obama Treasury proposals instead focus on equity invested in a jurisdiction, but they only calculate the normal return based on equity invested in active assets instead of passive assets, and they only use the risk-free rate of return. Therefore, substantial activity requires active assets, but any income greater than the risk-free return is treated as shifted income. The BEPS Action 3 proposal again focuses on equity invested in active assets (explicitly including intangible assets), but it uses a risk-inclusive rate of return, thereby leading to a larger amount of income being treated as income from substantial activities. GILTI focuses on tangible depreciable property and uses a rate closer to the risk-inclusive rate of return. This means that any income arising from intangible assets is presumed not to arise from substantial activities for GILTI purposes. And the Pillar Two proposal focuses on payroll costs and depreciation expenses for tangible assets, meaning that substance relies on tangible assets and employees, whereas employees did not factor at all into the normal return definitions that relied on investments.

These views of substantial activities all overlap to a certain extent, but they also all vary significantly from each other. This highlights that, while policymakers focus on the formulaic nature inherent in exempting normal returns from taxation, this does not in turn mean that the formula used to calculate normal returns is based on any inherent definition of normal returns. In fact, policymakers are able to define these in whatever way aligns with their view of substantial activities. For some policymakers, intangible income is automatically inconsistent with substantial activities, so they define normal returns based on tangible assets. For others, substantial activities depend on the number of employees, so they define normal returns based on payroll costs.[175] For others,

[175] Note that payroll costs depend on both the number of employees and the costs of those employees, so reliance on these suggests that more costly employees represent more substantial activities.

anything greater than the minimum required rate of return on assets in a jurisdiction is considered to arise from something other than substantial activities. For still others, a larger return on those same assets arises from substantial activities, so a smaller amount represents shifted income.

The addition of excess returns to the collection of tools that policymakers are using to define economic substance and substantial activities therefore at first appears to be formulaic and based on economic theory. But, in reality, policymakers are using normal returns to define substantial activities very differently from each other in each of these minimum taxes. This is both because the concept of excess returns was not designed to target income arising from shifted assets or insubstantial activities and because policymakers have moved far enough away from the actual theory of normal returns to define them in a variety of ways.

As can be seen by the evolution of the original 2010 excess returns proposal from a short proposal focusing on shifted IP income that originated in a Democratic administration to a key design feature in an international minimum tax that was adopted by a Republican administration and is now being considered by 137 countries, excess returns rules appeal across the political spectrum and across national borders. But, as shown in earlier sections, this is not because everyone supports the same proposal. It is rather because policymakers can design excess returns rules in a variety of ways. They can define normal returns in a way that is consistent with their goals, and they can justify an excess returns rule in multiple ways.

V. Excess Returns, the Search for Substance, and Problems of Translation

Normal returns therefore represent a new chapter in the search for substantial activities. But turning to excess returns still does not answer the question of what substantial activities are because policymakers have defined excess returns and normal returns very differently. This Section discusses three concerns raised by the use of normal returns as a proxy for substantial activities. This Section then concludes by considering why normal returns raise these concerns and whether this is inherent in any definition of normal returns or whether it is a result of the particular ways that economic theory was translated into policy.

A. The Problems with Using Normal Returns as a Proxy for Substantial Activities

Using normal returns as a proxy for substantial activities raises at least three significant concerns. First, using the formulaic terminology of excess returns hides the fact that policymakers are exercising discretion when designing these rules. Second, this hidden discretion in turn disguises the fact that each policy defines normal returns differently from the other, seemingly similar, policies. Finally, relying on the economic theory of excess returns may even prevent policymakers themselves from realizing that they are defining excess returns in a way that is inconsistent with their own understandings of substantial activities. This Part goes through these three concerns in order.

i. Unacknowledged discretion

One of the criticisms of earlier substantial activities tests was that they were not grounded in theory but instead gave policymakers too much leeway to define substantial activities however they saw fit. To some observers, identifying substantial activities by way of the more formulaic calculation of normal returns may seem to eliminate some of this discretion. But, as shown above, policymakers have as much latitude in defining normal returns as they have in defining substantial activities because all of the minimum taxes on excess returns have diverged from the economic theory of exempting normal returns.

The normal returns that policymakers are using as a proxy for substantial activities thus vary significantly. Some of them use higher or lower rates of returns. Some of them these rates by costs while others multiply them by investments in assets. Some of them exempt income from intangible assets while others consider any income from intangible assets to be excess returns that will be subject to tax. All of these differences are the result of exercises of discretion by policymakers, just as differences among previous substantial activities tests were exercises of discretion.

But for at least some observers, exempting a so-called normal return from taxation rather than defining substantial activities by way of a facts-and-circumstances test or a similar rule may seem to have more legitimacy because this approach uses the same terminology as economic theory. The use of normal returns as a proxy for substantial activities may thus hide some of the discretion that observers previously criticized in other measures designed to tax shifted income.

ii. Unacknowledged differences

Furthermore, not only are policymakers exercising discretion relative to the pure theory of excess returns taxation, but they are all exercising discretion in different ways. As pointed out above, some of the provisions and proposals discussed in Section I use expenditures as a base, some of them use investments as a base, and all of them use a different amount of expenditures or costs from all the others. In terms of rates, the provisions that use expenditures vary from an unknown rate likely to be close to 10% all the way to 150%, while the provisions that use investments use either the unstated risk-free rate of return (which should be less than 2% in the current economic climate) or a rate closer to 10%, which is nearer to the rate of return used in excess profits taxes than the risk-free rate of return used in excess returns calculations. All of these are therefore carving out a “normal return,” but each of them defines a normal return extremely differently, which may not be clear from the terminology used in each provision.

iii. Unacknowledged inconsistencies

The three concerns above imply that at least some policymakers may be aware that their use of normal returns allows them to define substantial activities in the ways they see fit regardless of economic theory. But this Article is not arguing that all or even most policymakers are aware of this. Instead, a fourth concern with the use of excess returns taxation is that it also disguises the effects of using normal returns to represent substantial activities from policymakers themselves. This can be seen in the fact that at least some of the provisions described in Section I define normal returns in a way that is not entirely consistent with the stated goals of policymakers. This criticism was

highlighted in the controversy surrounding the Action 3 Final Report, where at least some delegates to the BEPS Project raised concerns that normal returns could be too narrow and could allow income to be treated as excess returns even if they arose out of substantial activities.[176] For example, both the BEPS Action 3 excess returns provision and the GILTI are supposed to be targeting income from shifted intangible assets. Yet one of them calculates the normal return to be 8-10% of the equity invested in assets used in the active conduct of a trade or business, including IP assets, while the other calculates the normal return to be 10% of the equity invested in tangible depreciable property. Do either of these numbers represent all the income and only the income from everything other than shifted intangible assets? And does the excess above these either of these numbers represent all the income and only the income from shifted intangible assets? In another example, the Pillar Two carve-out for substantial activities was originally envisioned as a deduction for the "return on tangible assets," but by October 2020 it was instead an unidentified percentage of payroll costs and depreciation expenses. Are those two economically equivalent? Are they equally good proxies for substantial activities? Little in the economic literature can answer the questions in either of these examples since discussions of excess returns and excess profits taxes do not focus on substantial activities. Policymakers are therefore left filling in the blanks with their own rates and bases without much guidance as to whether these amounts are actually representative of the substance they are trying to exempt.

Furthermore, many of the amounts used to calculate normal returns are subject to negotiation with other jurisdictions or with domestic stakeholders. This is most obvious in the context of the current OECD digital tax project, where the rate to be used is put in brackets, suggesting that it will depend on what rate of return will be acceptable to all the countries involved. A rate of return determined by consensus is likely to be different from an actual risk-free rate of return or the accurate average rate of return for different industries.

B. Problems of Translation

If the use of normal returns as a proxy for substantial activities raises all the concerns above, is this result inherent in the design of any tax that exempts normal returns? In their 2013 paper, Harry Grubert and Rosanne Altshuler contemplated a minimum tax that exempted the normal return on "real investment" by way of expensing as a solution to several international tax problems, including income shifting. They acknowledged that one of the primary causes of income shifting was "intangible assets that create large excess returns,"[177] and they showed that their minimum tax could be effective at creating a disincentive to engage in such income shifting. This paper was the inspiration for at least some of the measures discussed in this Article. But, as has been highlighted above, all of the excess returns provisions proposed starting in 2010 differ significantly from a provision that allows an immediate deduction for investment in a jurisdiction. All of these measures opted not to allow an up-front deduction for business investment but instead opted to provide an annual deduction for normal returns, which in

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[176] Action 3 Discussion Draft, 34.

[177] Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 National Tax Journal, 671, 704 (September 2013).

turn required policymakers to set a rate and to determine qualifying investments or expenditures. These determinations that were necessary for calculating normal returns in the absence of up-front expensing are where all of these measures moved away from the model that Grubert and Altshuler proposed – and where they all diverged from each other as well.

The story of minimum taxes on foreign excess returns is therefore a story of translation. All of the measures described in Section I differ significantly from each other, and they differ significantly from the theory of excess returns as well. This is because, in translating economic theory into policy, policymakers chose to implement the version of a tax exempting normal returns that required them to define normal returns. They likely chose this version for several reasons, including pressure from taxpayers to impose a higher rate, administrative ease, political expediency, and many others. But the consequence of translating the theory of excess returns into policy in this way is that each one of these measures varies significantly from the others, thereby defining significant activities differently from the others and disguising the discretion that policymakers exercised in designing these calculations.

Conclusion

Although there is an economic theory of excess returns, the recent spate of minimum taxes on foreign excess returns are designed in ways that diverge significantly from that theory. They also differ significantly from each other in terms of details, but all of them share a focus on substantial activities. This Article therefore argues that these minimum taxes on foreign excess returns all represent a new phase in the ongoing search for substantial activities. This new phase, however, hides what policymakers are actually doing by seeming to rely on the theory of excess returns. In reality, policymakers are defining normal returns differently from each other and using the concept of normal returns to represent whatever they want substantial activities to be. They are therefore using an existing economic theory to solve a problem that is not recognized in economics – and they are applying the theory in ways that are both inconsistent with the theory itself and in ways that differ from policy to policy.