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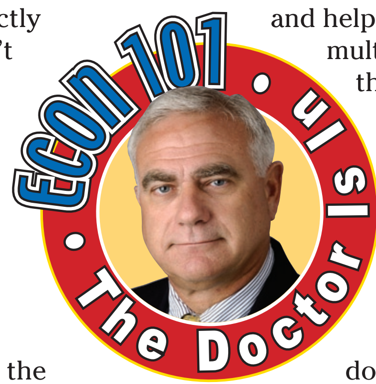
Dr. Martin Regalia: ECON 101

Deferral Is Not a Dirty Word

Throughout his campaign, candidate Barack Obama threatened to raise taxes on "companies that ship jobs overseas" without ever specifying what exactly he meant. Recently, President Obama released some of the details of his proposed tax increases, and we are beginning to see exactly what he had in mind—and the details aren't good news.



The president's proposal would significantly change the way U.S. multinationals are taxed on their foreign profits, and it is estimated that the change would increase taxes on these companies by more than $200 billion over the next 10 years!

A big piece of this proposal, estimated to be worth $60 billion, is designed to limit the ability of multinational companies to defer the income tax on profits earned abroad. This proposal, a variation of one offered by House Ways and Means Committee Chairman Charlie Rangel (D-NY) in 2007, changes the timing of when companies can deduct expenses on foreign income, forcing them to delay the deduction until the foreign income is repatriated, or brought back, to the United States. While on its face this proposal may seem to have some commonsense appeal, it must be evaluated in the historical context of what deferral is designed to do, why it exists in the code, and what impact on economic and job growth this limitation may cause.

What Is Deferral?

The United States employs a universal or worldwide tax system. This means that our multinational corporations are taxed here on their U.S. profits (just like domestic companies), taxed abroad on their foreign profits, and then taxed again when those foreign profits are brought back home.

By contrast, virtually all foreign multinationals are taxed under a territorial system in which they pay taxes on their home country profits in their home country and on their foreign profits in the foreign country, but foreign profits are not taxed a second time when they are brought home. Thus, the double taxation of foreign profits is avoided.

To offset the advantage of a territorial tax system and help level the playing field between U.S. multinationals and their foreign competitors, the U.S. government employs a system of tax credits and tax deferral. Deferral, which has been in the code in various forms since the 1960s, allows U.S. companies to delay paying tax on foreign earnings until that income is repatriated.

Debunking the Deferral Myths

Why is deferral controversial, and why does this administration want to get rid of it?

Deferral is a complicated concept that is easy to demagogue and misrepresent. As a result, a number of myths, mistruths, and misunderstandings surround it. Let's take a closer look at a few of these.

One prevalent half-truth is that deferral creates a tax advantage for investing and reinvesting overseas and that restrictions on deferral are needed. The reality is that deferral is a vital mechanism needed to offset the advantage of a territorial tax system used by the rest of the industrialized world. The president's plan takes the United States in the wrong direction. Without deferral, U.S. companies would be subject to double taxation and wouldn't have a fighting chance of competing against foreign companies. Limiting or ending deferral would hinder the global competitiveness of U.S. companies, impede U.S. economic growth, and result in the loss of jobs—both at the companies directly impacted and at the companies in their supply chains. Moreover, as businesses struggle to stay afloat in a severe recession, common sense suggests that raising taxes is not a good idea. Rather, we should adopt pro-growth policies.

A common misconception is that deferral is a tax break that encourages U.S. multinational companies to

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ship jobs overseas. Again, the reality is much different.

According to data from the Bureau of Economic Analysis (BEA), in 2006, U.S. multinational companies employed a total of 31.2 million employees. Of these, 21.7 million, or almost 70%, were employed by the U.S. parent, compared with 9.5 million employed by foreign affiliates. Essentially, for every one employee at a foreign affiliate, a U.S. parent company employs 2.28 employees. These figures don't include jobs provided by the suppliers of U.S. multinational companies. In short, U.S. multinationals maintain a large presence in America relative to the size of foreign affiliates.

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In addition, U.S. multinationals impact employment in other parts of the U.S. economy. For example, 2006 BEA data indicate that 87% of R&D, a whopping $187.8 billion, is performed by the U.S. parents of U.S. multinationals. Further, U.S. multinationals purchase goods and services from U.S. suppliers and use U.S. companies in their distribution chains. And the presence of foreign affiliates stimulates domestic production, creating jobs for U.S. workers.

In 2004, BEA data indicate that 18.9% of exports by multinationals were shipped to foreign affiliates, and 13.5% of imports were from foreign affiliates of U.S. parents.

Finally, there is the myth that U.S. companies invest abroad to reduce the cost of providing goods to U.S. consumers. In actuality, in 2006, according to BEA data, 89.5% of sales by foreign affiliates of U.S. companies were to foreign countries. Of those sales, 67.6% were to persons located in the same foreign country where the foreign affiliates were located.

So legislation (S. 260) introduced by Sen. Byron Dorgan (D-ND) to address these purported "runaway plants" is based on a flawed premise—that U.S. companies invest overseas to export goods back to the U.S. market. The truth is that U.S. companies are investing overseas to more efficiently serve foreign markets—where 95% of the world's population resides—provide goods locally, and reduce transportation costs.

What Would Happen if We Repealed Deferral?

Congress has already given us a case study of what happens when you repeal deferral—in 1986, it eliminated deferral for U.S.-flagged carriers. As a result, U.S. shippers saw a dramatic erosion of their market share, as many became acquisition targets for foreign-owned carriers. U.S. shippers moved their operations abroad, including jobs and capital investment.

In 2004, Congress reinstated deferral for U.S. shippers. The Joint Committee on Taxation (JCT) explained that because other countries did not tax foreign shipping income and because the United States had denied deferral, a "steady and substantial decline" of the U.S. shipping industry had occurred. The JCT said that reinstating deferral allowed U.S. shippers to "be competitive with their tax-advantaged foreign competitors."

The Bottom Line

If the United States is trying to disadvantage the competitiveness of U.S. companies in worldwide markets, impede U.S. economic growth, and cause domestic job loss, then proposals limiting or repealing deferral are the way to go—just ask U.S. shippers. But if we are working to keep U.S. companies competitive worldwide and spur economic growth, limiting or repealing deferral is not the answer.

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