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GET READY: THE COMING CORPORATE TAX BATTLE

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Marquee policy initiatives – health care reform, cap-and-trade policy – dominate the headlines. But a less-prominent battle may end up being among the fiercest and most important – the desire of Barack Obama to extract $210 billion from American business to pay for his spendthrift ways.

Now, to date we do not know exactly what the Obama Administration is proposing – the details have been hidden while they cook up their formal budget submission (due out next week). But from the campaign forward, the President has been clear that a substantial chunk of the money will come from eliminating “deferral” of foreign source income in the corporate income tax.

Now readers are excused if their reaction is: yowzer, that is *really* third-degree geekiness. But hang on, it turns out to be really important. There are basically two ways to run a corporation income tax in the presence of globalization. You can tax a firm (regardless of its nationality) on what it earns in the United States (a “territorial” system), or tax a U.S. firm on its earnings each year regardless of where they are earned (a “worldwide system”).

At issue is how much to tax a U.S. multinational – say flag-waving Walmart – on its earnings from operations abroad (say, new stores in China). The territorialists say that the U.S. should tax only those profits earned in the U.S.. Notice that with territorial systems, all firms operating in, say, Iceland pay the same taxes (to Iceland) so they compete on a level playing field. Worldwideists want to tax the whole shebang, regardless of where it is earned or under what circumstances.

Currently, the U.S. is essentially a revenue junkie twitching in a halfway house. It taxes worldwide income, but it does not tax the overseas earnings until they are brought back to the U.S. – hence the term “deferral”. The Obama proposal is to get the high of a quick revenue fix, and fast, by getting rid of deferral and taxing everything it can locate on the globe. Is this a good idea?

The real world has decided this question definitively. As of 2008, there were only three (count ‘em three) countries that still clung to the worldwide system: the United States, Japan, and Britain. This year, Japan and Britain announced plans to shift to a territorial system. Eliminating deferral would make the United States a world “leader” in making sure that all its businesses pay the highest corporate rate – the United States at 35 percent – on the globe, regardless of competitive conditions.

The technical term for this is madness.

Or, as prominent tax expert (and former head of the Joint Committee on Taxation) Ken Kies puts it “What does the Obama Administration know that the rest of the world doesn’t?” That makes it sound like there is a secret plan for tax rationality, which makes me think Ken is an optimist.

Here is what we know. First, we have some data in addition to the fact that every (did I mention every) other country has moved away from a worldwide system. In a footnote to the 1986 tax reform, the U.S. eliminated deferral for the shipping industry. Faster than you can say “Somali pirates” there were NO U.S.-flagged carriers; instead all of the shipping industry was headquartered abroad. So, let us not kid ourselves. We ran the experiment and moving to a worldwide system will lead every firm to consider moving its headquarters.

Now, a fair question is whether headquarters matter, or whether firms will change. Let’s dispense with the latter. If the Obama Administration heads down this path, every global firm will be inundated with offers to move.

Moreover, we should care if they do. There is a well-documented “home country bias” in portfolios, so if our best industries move abroad, it is quite likely that their access to U.S. capital goes down along with the move. That spells bad news for the (soon-to-be American subsidiaries) operations in the U.S. It is also quite likely the case that more subtle connections to the United States: things like support for charitable causes, will wither as well (just ask St. Louis what it is like now that Anheuser-Busch is just a wing of InBev).

It is hard to rationalize this move as part of any competitive tax policy. The Obama crowd must really believe it is smarter than the rest of the world (combined). Hence, they are willing to ignore the evidence that eliminating deferral led to the demise of the U.S.-flagged shipping industry.

Moreover, they are willing to ignore the evidence that they are “solving” a problem that does not exist. If you listened to then-candidate Obama, the problem was a tax code that rewarded “off-shoring jobs.” That is, we did not tax heavily enough U.S. firms that closed plants in the United States, opened operations abroad, and sold the (supposedly cheaper) products in the U.S. It turns out that this is fiction. Few U.S. firms open operations abroad and ship back to the United States. Even fewer closed operations in the U.S.. But real Obamites don’t seem to believe they need to confront the facts. They are evidently too smart for that.

The reality is simple: if the U.S. wants to compete it has to allow its firms to compete. If we tax more then our competitors, our firms and their jobs will disappear. Our ability to tap the 95 percent of the world's consumers that are in other countries will be curtailed and our standard of living will suffer.

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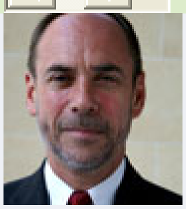

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