Combing Through the Cash Pile

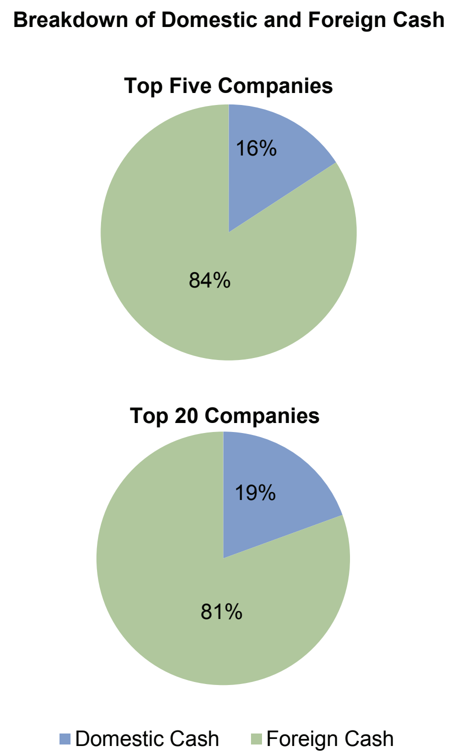
A string of headlines over the last few months has thrust the issue of cash held by the foreign subsidiaries of US companies back into the spotlight. First was Apple Inc.'s announcement that the company was increasing its dividend and buying back more stock while at the same time issuing $12 billion in debt to help pay for the return of capital—a curious decision given Apple's ~$150 billion in cash and investments. Then a handful of proposed mergers & acquisitions, including General Electric's attempt to purchase part of France's Alstom, Valeant's proposal to buy Allergan, and Medtronic's bid to buy Covidien, hit the wires. During the same stretch of announcements, eBay revealed that it would repatriate $9 billion of its foreign cash to buy back stock and pursue acquisitions at a cost to the company of nearly *$3 billion*. These stories highlight the very real challenges that companies face regarding what to do with cash held by their foreign subsidiaries. This brief discusses how and why so much cash ends up being held by foreign subsidiaries, how the structures that leave cash "stuck abroad" have benefitted investors, and what to watch going forward.

Why Is So Much Cash Overseas?

As companies expand abroad, they establish a complex network of interrelated foreign entities to facilitate international sales and operations. During this process, US parent companies can allocate certain costs, such as the rights to develop, manufacture, and sell products to foreign subsidiaries, in a tax-efficient manner. Highly valuable assets like intellectual property and licensing agreements often end up transferred to entities located in countries with low or zero corporate tax rates. With an increasing percentage of sales and profits coming from outside the United States, the foreign subsidiaries of many US-based multinational companies are generating substantial earnings for their US parent companies.

Top 20 Companies in the S&P 500 with the Highest Foreign Cash Balances
As of December 31, 2013

Company	Foreign Cash US$ (bn)	Total Cash US$ (bn)	Foreign as a % of Total
Apple Inc.	132.2	150.6	88.0
Microsoft Corp.	79.6	88.4	90.0
Cisco Systems, Inc.	43.8	47.1	93.0
Google Inc.	35.2	59.3	59.0
Oracle Corp.	31.4	37.2	84.0
Pfizer Inc.	25.9	32.4	80.0
Qualcomm Inc.	23.2	32.1	72.0
Johnson & Johnson	18.6	29.2	64.0
Amgen Inc.	17.1	19.8	86.0
Merck & Co. Inc.	14.9	17.5	85.0
Hewlett-Packard Co.	14.5	16.2	90.0
The Coca-Cola Co.	14.2	19.4	73.0
Medtronic, Inc.	13.5	13.7	99.0
Intel	11.3	25.1	45.0
PepsiCo	9.1	10.1	90.0
Bristol-Myers Squibb	7.8	10.6	74.0
Abott Laboratories	6.5	8.1	80.0
eBay Inc.	5.9	7.8	76.0
Wal-Mart Stores Inc.	5.8	7.3	79.0
Honeywell	5.3	8.2	65.0
Total	**515.8**	**640.1**	**81.0**



Once a US parent company designates the earnings of a foreign subsidiary to be permanently reinvested abroad, it generally does not need to recognize a US tax liability on those earnings. When those earnings are converted to cash, they could be managed as part of a global cash pool and at that point the US parent company can decide how to best put the cash to work. Should a foreign subsidiary wish to return cash it had previously deemed permanently reinvested outside the United States via an intercompany dividend payment to the US parent company, the parent company would owe the difference between the US corporate tax rate (35%) and what it has already recognized and paid in taxes overseas on those earnings. This predicament has in many cases constrained companies' willingness and ability to repatriate some of their foreign cash holdings.

Unfortunately for investors, few companies disclose what they have done with earnings converted to cash and held by foreign subsidiaries. While the cumulative amount of permanently reinvested earnings is disclosed once a year in annual reports, investors have relatively few ways to gain insights into how companies are using their cash abroad. A


May 2014 working paper estimated that up to 55% of permanently reinvested earnings of foreign subsidiaries are held in non-financial assets and 38% of these earnings have been invested in high-growth subsidiaries.[1] While these numbers are simply estimates, they help shed some light on the myth that companies' only motivation for designating assets abroad is to avoid taxes. A majority of the aggregate permanently reinvested earnings and cash held by foreign subsidiaries appears to have been invested to grow the businesses overseas. A few notable exceptions exist, however, where outsized cash and investment balances held by foreign subsidiaries have given investors (and regulators) pause, as discussed below.

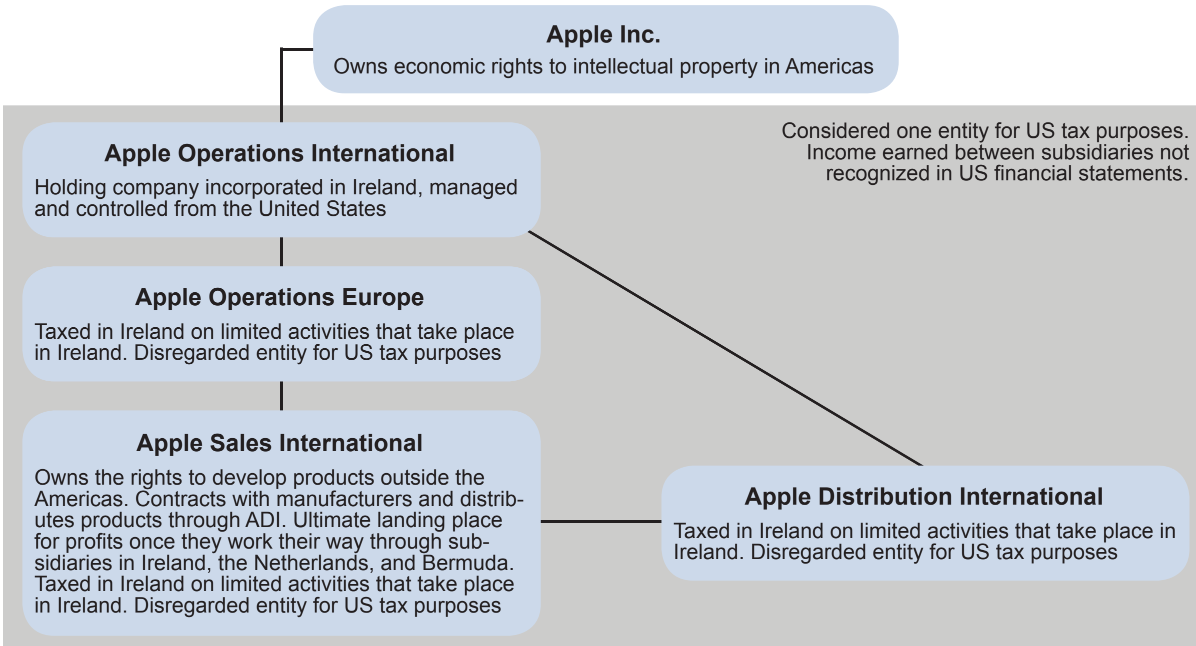
Apple of the Tax Man's Eye

At over $150 billion, Apple alone accounts for 11% of the total cash held by companies in the S&P 500 Index (ex financials), and its foreign cash and investments account for around 7.5% of the same. Apple's large and growing cash pile and the corporate structures that allow it to minimize the amount of taxes it owes on its foreign operations have come under increasing scrutiny. In 2011, Apple Sales International (ASI)—an Irish subsidiary of Apple Inc.— paid $13 million in taxes on $22 billion of income, a number that gained the attention of lawmakers. In the fall of 2013, the US Senate Subcommittee on Permanent Investigations held hearings that focused exclusively on the corporate structures and tax arrangement employed by Apple. According to testimony by Villanova University Tax Professor Richard Harvey, Jr., from 2009 to 2012 ASI earned $74 billion in pre-tax income, or 64% of Apple's total global pre-tax income over that time period.

How can Apple pay such a low rate of taxes on its foreign income? In Apple's case, due to a longstanding cost-sharing agreement with ASI, Apple Inc. transferred to ASI the development rights to sell Apple products outside of the Americas. ASI in turn works with other Apple subsidiaries and contractors to manufacture and distribute Apple products and services outside the United States, paying royalties to and collecting income from these other subsidiaries. US tax laws allow companies to treat their various subsidiaries, such as ASI, as "disregarded" for tax purposes—meaning inter-entity transactions are ignored and companies simply report the combined financial data from all their foreign subsidiaries for tax purposes. By not having to disclose financial information of each subsidiary and recognize the inter-company transfers between foreign subsidiaries (each with its own country residency and tax status), companies can take advantage of different definitions of tax residence. Companies can thus avoid recognizing sales and income between foreign entities for US tax purposes that they otherwise would have had to recognize had they not elected to treat the entities as disregarded for US tax purposes.

[1] Jennifer Blouin (University of Pennsylvania), Linda Krull (University of Oregon), and Leslie Robinson (Dartmouth College), "The Location, Composition, and Investment Implications of Permanently Reinvested Earnings" (May 2014). http://public-prod-acquia.gsb.stanford.edu/sites/default/files/documents/acct_05_14_robinson.pdf

Stylized Snapshot of Apple Inc. Corporate Structure



Note: Exhibit only shows a select group of operating subsidiaries.

What Has Been the Effect of These Corporate Structures?

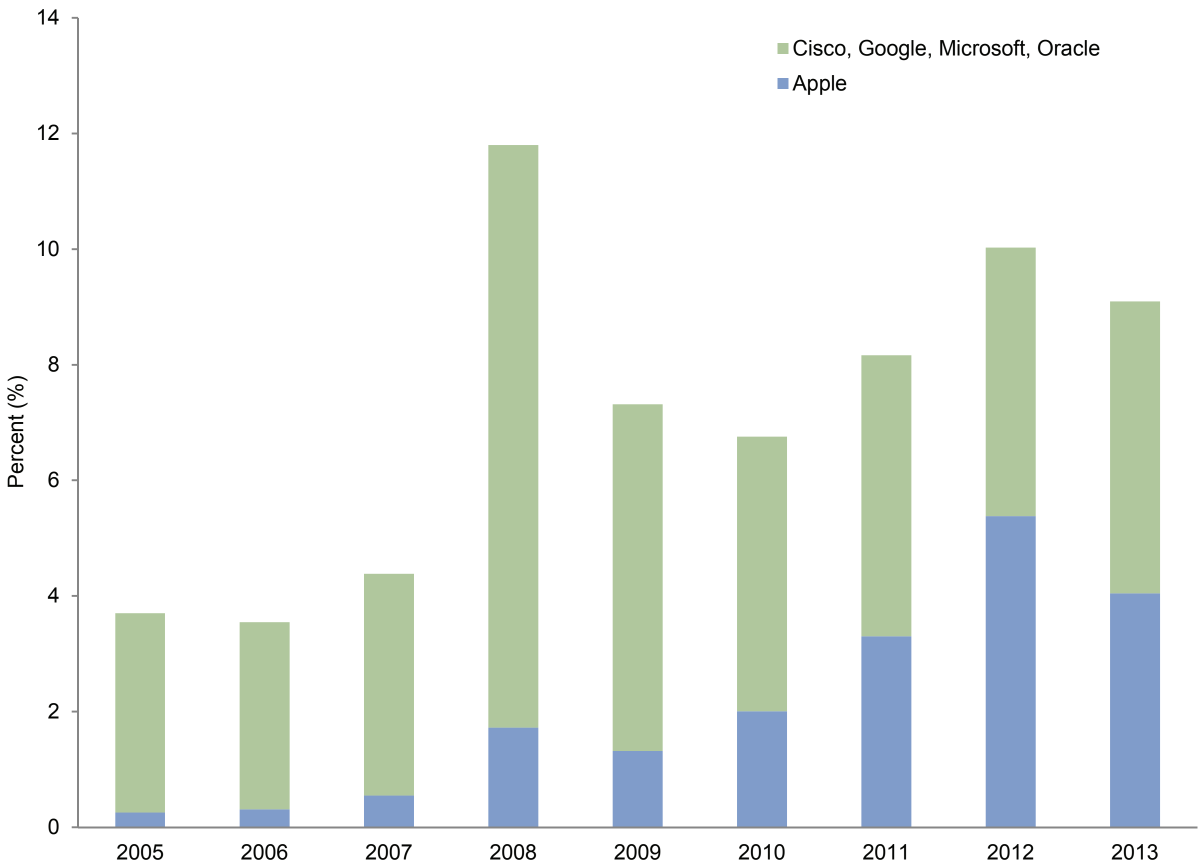
If a company can allocate its highest-value assets into structures that give it control over how and where it recognizes taxes, other elements of the company's income statement and balance sheet will also be affected, as the Apple example shows. Taxes represent a cost of doing business, and few would argue that higher taxes benefit investors. International sales are a significant percentage of overall S&P 500 sales, and as those sales are increasingly recognized through structures that minimize the effect of overall taxes, financial reporting is affected.

While the percentage of revenues coming from abroad for the largest companies in the S&P 500 is significant, investors are ultimately interested in *profits*. The top five companies with the largest foreign cash balances (Apple, Microsoft, Cisco, Google, and Oracle) accounted for over *20%* of the entire increase in earnings for the S&P 500 over the 2006–13 period. Other factors are at play here of course, including the declining contribution of the financial sector to overall index earnings, but these results are striking and speak to the substantial impact that high-margin, low (effective) tax businesses can have even at an index level.

Top 20 Companies with the Highest Foreign Cash Balances: Sales Outside the United States
As of December 31, 2013

Company	% Sales ex US % Total	Company	% Sales ex US % Total
Apple Inc.	63.0	Hewlett-Packard Co.	64.0
Microsoft Corp.	47.0	The Coca-Cola Co.	54.0
Cisco Systems, Inc.	41.0	Medtronic, Inc.	45.0
Google Inc.	55.0	Intel	83.0
Oracle Corp.	57.0	PepsiCo	49.0
Pfizer Inc.	61.0	Bristol-Myers Squibb	49.0
Qualcomm Inc.	97.0	Abbott Laboratories	71.0
Johnson & Johnson	55.0	eBay Inc.	52.0
Amgen Inc.	23.0	Wal-Mart Stores Inc.	29.0
Merck & Co. Inc.	59.0	Honeywell	41.0

Contribution to S&P 500 Earnings for the Five Companies With the Largest Foreign Cash Balances
2005–13



What to Watch

Avoiding income taxes on foreign sales has clearly had a significant effect on US-based multinational companies' reported financial statements, financial performance, and overall capital allocation decisions. Going forward, what happens in global tax policy will be worth watching. Both President Obama's 2015 budget and the Tax Reform Act of 2014 brought forth by Republicans in the House are seeking tax revenue from un-repatriated earnings. Additional tax proposals that have been floated include limiting certain cross-border mergers, takeovers, and "inversions,"[2] in addition to proposals lowering the overall corporate tax rate to the 25% to 28% range.

Yet even if the United States passes some sort of tax reform (an unlikely outcome), most of the benefits from structures related to foreign subsidiaries in low-tax jurisdictions are so significant that changing US corporate tax rates may have little effect. Companies do face a risk that governments across the globe could act in coordination to restrict certain elements of international tax rules that multinational companies have used to their advantage. The Organisation for Economic Co-operation and Development has placed global tax policy near the top of its priority list and will be specifically focused on overhauling the international tax policies to increase the taxing powers of countries where consumers are actually based. However, historically, globally coordinated overhauls of tax policies are rare.

Should policy changes force US-based companies to alter their current reporting structures, the outlook for those companies that benefit the most from current structures may be diminished. At that point, the amount of cash held by such companies' foreign subsidiaries would be the least of their investors' concerns.

The Bottom Line

Assets like cash that appear "stuck abroad" are a reflection of international growth and tax rules that have not kept up with the changing landscape of global business. Although a handful of companies with large influence at the index level have benefitted the most from strategies that leave them with outsized foreign cash piles, large-scale changes to international tax rules could have a significant impact on the future earnings of these same companies (and their relevant indexes). ■

[2] Inversions are designed to reduce a US company's tax burden and can include strategies such as re-incorporating in a foreign jurisdiction to recognize lower taxes on foreign sources of income.


Contributors

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Exhibit Notes

Top 20 Companies in the S&P 500 with the Highest Foreign Cash Balances
Sources: Goldman, Sachs & Co. and the US Securities and Exchange Commission.
Notes: List of companies represents the top 20 companies in the S&P 500 with the largest overseas cash holdings excluding financials and General Electric. Financials were excluded due to presence of large short-term cash-like assets. Failure to incorporate the amount of short-term liabilities distorts the assessment of cash holdings. GE was excluded due to the presence of GE Capital, which operates similar to a financial institution.

Stylized Snapshot of Apple Inc. Corporate Structure
Sources: "Testimony of J. Richard (Dick) Harvey, Jr. Before the US Senate Permanent Subcommittee on Investigations" (May 21, 2013) and *Financial Times*.

Top 20 Companies with the Highest Foreign Cash Balances: Sales Outside the United States
Source: Barclays.
Notes: List of companies represents the top 20 companies in the S&P 500 Index with the largest overseas cash holdings excluding financials and General Electric. Financials were excluded due to presence of large short-term cash-like assets. Failure to incorporate the amount of short-term liabilities distorts the assessment of cash holdings. GE was excluded due to the presence of GE Capital, which operates similar to a financial institution.

Contribution to S&P 500 Earnings for the Five Companies With the Largest Foreign Cash Balances
Source: FactSet Research Systems.
Note: Top five companies determined based on the S&P 500 ex financials and General Electric universe.