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When Is A Dollar Not Worth A Dollar?

The “Trapped” Cash Controversy

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The “Trapped” Cash / Corporate Tax Base Erosion Controversy

During 2013 the concept of “trapped cash” garnered heightened attention as reports of Dell, Apple and other firms holding massive cash levels outside the US surfaced. So called “trapped cash” refers to cash and liquid investments held by subsidiaries located outside the United States. Firms with overseas subsidiaries located in jurisdictions where the tax rate is lower than the rates in the US can reduce taxes by attributing profits to foreign locales. But bringing the cash back to the US subjects the funds to the US corporate tax rate, less credit for foreign income taxes paid.

The House Ways and Means Committee held hearings in June 2013 to examine corporate profit shifting by multinationals. This followed hearings held by The Senate Permanent Subcommittee on Investigations in May 2013 which focused on tax strategies at Apple and earlier hearings in September 2012 which focused on Microsoft and Hewlett Packard. Some have accused global firms of acting to avoid taxes leading to perhaps several billions of dollars of lost tax revenues. Others note that the real culprit is a US tax code with the highest corporate tax rates in the developed world. As the debate has raged, the Internal Revenue Service has sought to prohibit strategies related to intangible assets that the IRS claims firms have exploited to repatriate profits without tax implications. While the topic impacts all firms with liquid investments held outside of the US, this issue has been particularly important recently in the technology sector since over the past few years tech firms have amassed high cash levels from overseas operations as earnings strengthened and shrinking growth rates provided fewer investment opportunities.

Here we use the technology sector as a case study to: examine the magnitude of the issue, consider firm options for “trapped” cash and assess the valuation investors should place on trapped cash.

* We owe special thanks to our research assistant, Anthony Pasarella.

Magnitude of Trapped Cash

The magnitude of US corporations' overseas cash has skyrocketed during the past 5 years. In 2012 Bloomberg reported that 70 US companies had \$1.2 trillion in untaxed profits around the world, up 18.4 percent from a 2011. The recent rise is especially pronounced in the technology sector. At the end of 2012, ten of the top US technology firms had combined cash stockpiles totaling over \$385 billion. Over 60 percent of this cash is held outside the United States. Table 1 reports the cash holdings of the ten US technology companies holding the most cash and the substantial increase in size of the overseas holdings over the past three years. The phrase "trapped cash" has entered the parlance as a way of describing overseas cash.

Table 1 – USD millions

	2010		2012	
	Total Cash	Non US Cash %	Total Cash	Non US Cash %
Apple	51,011	60.4%	121,251	68.1%
Cisco	38,610	86.0%	47,096	90.2%
Dell*	14,365	80.0%	15,342	100.0%
Ebay	6,623	<i>na</i>	9,408	<i>na</i>
Google	35,000	47.7%	48,088	65.3%
HP	10,934	<i>na</i>	11,301	<i>na</i>
IBM	11,651	<i>na</i>	11,129	<i>na</i>
Intel	16,792	<i>na</i>	12,477	<i>na</i>
Microsoft	52,800	85.2%	77,000	90.4%
Oracle	28,848	<i>na</i>	32,216	87.5%

Dell, Microsoft and Oracle have non December year ends so 2011/2013 used

na = not disclosed in the 10K; nm = not meaningful

**Dell cash outside US is an estimate as firm reports in 2010 normally 10-20% of cash is held domestically.*

By 2012 Dell reports "substantially all" is held outside US.

Why is the Cash Trapped?

The cash is "trapped" overseas because repatriation of the cash would subject it to US Corporate tax rate of 35%. Susan M. Cosper, Technical Director at FASB testified at the September, 2012

Subcommittee hearing to explain US GAAP for deferred U.S. Income taxes attributable to unremitted earnings of a foreign subsidiary. In essence, she was in Washington to explain why companies are not paying taxes on overseas cash. The answer is found in FASB Accounting Standards Codification (ASC) Topic 740, Income taxes. *It shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity (740-30-25-3) unless sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely (740-30-25-17).* So as long as a corporation states that their cash is staying overseas, it is not subject to US Corporate Tax.

Key Questions

1. Is the treatment of trapped cash likely to change in future tax regulations?
2. What options do firms have for trapped cash?
3. How should investors value trapped cash?

Future Tax Treatment of Trapped Cash

Further muddying the waters is the expectations game going on between the federal government and companies accumulating trapped cash. As part of the *American Jobs Creation Act of 2004*, companies were allowed to repatriate overseas cash at the reduced rate of 5.25%. The IRS reported 843 companies took advantage of this and that \$312 billion was repatriated leading to a \$265 billion in savings. Companies would not want to repatriate their cash today only to miss a tax holiday tomorrow.

Should we expect another tax holiday? Despite urges from some firms and politicians for another such act, we don't think so. The last tax holiday seemed to be a non-event in terms of its impact on the broad economy. The Obama administration has shown no indication it is considering another tax holiday.

Should we expect lower corporate tax rates? Apple CEO Tim Cook called for such a reduction and many would agree that lowering the corporate tax rate is sound economic policy. Companies would welcome it and US Tax coffers could increase as less cash would be "trapped" overseas and more would be repatriated. However cutting corporate tax rates is not popular. When asked by Gallup (April 4-7, 2013) "As I read off some different groups, please tell me if you think they are paying their fair share in federal taxes, paying too much, or paying too little. How about: Corporations?" 66% of respondents said too

little. So while lowering the corporate tax on repatriated earnings would likely increase the amount of taxes paid, this argument may be a little too nuanced for most politicians to embrace.

Despite the hearings and proposals for legislative reform, change is unlikely to occur quickly since it would involve significant change to US international tax law.

Firm Options for Trapped Cash

Firms can of course repatriate the cash and pay the resulting tax. Firms opting not to repatriate the cash have options including:

- Invest the cash in the countries where it is located
- Use the cash for an acquisition
- Borrow against the cash and use the debt proceeds for dividends or share repurchases

Many firms do indeed use offshore cash to fund growth outside the U.S. As many sectors in the U.S. have matured, investing outside of the U.S. is a primary strategy for growth. Acquiring non U.S. firms can contribute to growth and prove tax advantageous. In September 2013, Microsoft announced the \$5 billion purchase of Nokia Corp.'s cellphone business would be financed with cash held outside the U.S. Two years ago the firm acquired Skype, again using offshore cash. In 2012 Cisco used \$5 billion of trapped cash to acquire U.K. based NDS Group. An interesting result is that the treatment of offshore cash increases the attractiveness of non U.S. firms (versus domestic firms) as acquisition targets if the deal is funded with cash since the offshore cash can be used to acquire the foreign firms without first repatriating the cash and paying associated taxes.

The last strategy has been famously implemented by Apple. In April 2013, Apple issued \$17 billion of debt while holding over \$100 billion in overseas cash. Apple is joining in on a game that Microsoft and Oracle (among others) have been playing. Since January 2012, Apple, Microsoft and Oracle have borrowed \$26.9 billion while sitting on \$197.5 billion in overseas cash (see Table 2). The companies are borrowing at historically low rates, then using the interest payments as tax deductions and using the cash from creditors to issue dividends and repurchase shares.

In this scenario, the firm issues additional debt at low cost due to the current interest rate environment and high levels of cash at the firm. The additional debt lowers the firm's weighted average cost of

capital (WACC), increasing firm and equity values. If, as expected, interest rates rise over the next few years, this strategy will become less attractive.

Focusing on the firms in Table 1 that reported cash held outside the US, Table 2 shows the level of debt and three year dividend and share repurchase information. This information records dividend and share repurchase activity through 2012 so Apple had not yet borrowed, paid dividends and initiated its share repurchase plan.

Table 2

	2010			2012			2010-2012: 3 Year Total	
	Total Cash	Non US Cash %	Debt	Total Cash	Non US Cash %	Debt	Dividends	Share repurchases
Apple	51,011	60.4%	0	121,251	68.1%	0	2,488	0
Cisco	38,610	86.0%	15,284	47,096	90.2%	16,328	2,159	19,520
Dell*	14,365	80.0%	5,997	15,342	100.0%	9,085	278	4,241
Google	35,000	47.7%	0	48,088	65.3%	5,537	0	0
Microsoft	52,800	85.2%	11,921	77,000	90.4%	15,600	14,226	32,177
Oracle	28,848	na	15,922	32,216	87.5%	18,494	3,699	18,037

Valuation of Trapped Cash

When valuing a firm, for acquisition or investment purposes, most valuation techniques focus on the value of core operations and then equity value is adjusted to account for any excess cash, debt, preference shares, and more complex items like investments in affiliates, noncontrolling interest and non-operating assets. While some of these adjustments can be difficult to value, cash has generally been straightforward. **Equity values increase with the value of excess cash held by the firm.**

Equity value = Enterprise value of core operations + Excess Cash – Debt

– Preference shares +/- Other Adjustments

Recently increasing numbers of analysts and investors are reconsidering the value of cash when it is “trapped”. Assuming no change in regulations it seems that the value of the trapped cash is, at a minimum, equal to the after tax value of cash.

$$\text{Onshore cash} + \text{Offshore cash} * (1 - \text{marginal tax rate}) \leq \textit{Intrinsic Cash value} \leq \text{Onshore} + \text{Offshore cash}$$

If the firm can use the cash for future growth, acquisition activity or to secure debt then it may be more appropriate to apply a smaller, or no discount.

Most research analysts and portfolio managers we have spoken to value cash at balance sheet levels, noting that excess cash is typically insignificant in the overall firm valuation. However, if there is a sizeable cash position, the realizable value of the offshore cash probably lies somewhere between the after tax value, assuming repatriation and the actual stated value. In these situations, analysts may apply a discount to the value of the trapped cash if it cannot be readily used to fund growth or acquisition.

Sidebar: How Firms Report Trapped Cash & Undistributed Earnings

Under US GAAP, firms need not report the cash held outside of the US and a number of firms instead provide information on accumulated undistributed earnings from non US subsidiaries. This has led to confusion and some published reports in print and online financial news sources have confused undistributed earnings and cash. Three typical financial notes from published 10Ks on the issue follow. Apple reports the cash held outside the US, while HP reports undistributed earnings. Under Armour reports both.

From Note 5 of the Apple 2012 10K:

As of September 29, 2012 and September 24, 2011, \$82.6 billion and \$54.3 billion, respectively, of the Company’s cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.

From Note 14 of the HP 2012 10K:

HP has not provided for U.S. federal income and foreign withholding taxes on \$33.4 billion of undistributed earnings from non-U.S. operations as of October 31, 2012 because HP intends to reinvest such earnings indefinitely outside of the United States. If HP were to distribute these earnings, foreign tax credits may become available under current law to reduce the resulting U.S. income tax liability.

Determination of the amount of unrecognized deferred tax liability related to these earnings is not practicable. HP will remit non-indefinitely reinvested earnings of its non-US subsidiaries for which deferred U.S. federal and withholding taxes have been provided where excess cash has accumulated and it determines that it is advantageous for business operations, tax or cash management reasons.

From Note 10 of the Under Armour 2012 10k

As of December 31, 2012, approximately \$57.2 million of cash and cash equivalents was held by the Company's non-U.S. subsidiaries whose cumulative undistributed earnings total \$100.8 million . Withholding and U.S. taxes have not been provided on the undistributed earnings as the Company takes the position that the earnings are permanently reinvested in its non-U.S. subsidiaries. Determining the tax liability that would arise if these earnings were repatriated is not practical.