Trapped Cash: When Is a Dollar Not Worth a Dollar?

By Russell Engel and Bridget Lyons

The amount of cash held overseas by U.S. corporations has skyrocketed in the last five years. With that increase has come heightened awareness and coverage of "trapped cash," the cash and liquid investments that companies hold in subsidiaries located in jurisdictions outside the United States. Bringing those assets back to the U.S. would subject them to the corporate tax rate, less credit for foreign income taxes paid, so they remain "trapped" overseas.

The phenomenon of trapped cash essentially can be traced to U.S. corporate tax policy on earnings of global corporations and the related Financial Accounting Standards Board (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)." In other words, as long as a corporation states that its cash is staying overseas, that cash isn't subject to U.S. corporate taxes.

Firms don't have to disclose the level of foreign cash, but it's typically found in the discussion of liquidity and capital resources in the Management Discussion and Analysis (MD&A) section if they do.

So-called permanently reinvested earnings (PRE) and trapped cash can make it difficult for investors, analysts, and others to gain a clear financial picture of a corporation. And companies with trapped cash need to understand the landscape to be able to manage their finances effectively and anticipate any possible risks or opportunities.

Technology companies in particular have recently built up significant amounts of cash overseas, so the companies we use as examples come primarily from that sector. But keep in mind that trapped cash can impact other corporations with subsidiaries outside the U.S. At the end of 2013, for example, General Electric (GE) reported about $88 billion in cash with $57 billion held outside the U.S.; Johnson & Johnson held more than $20 billion, and foreign subsidiaries held more than $18 billion; and Coca Cola held about $20 billion in cash and equivalents, "the majority" of which was held outside the U.S.

Creating Confusion

Both the FASB and the U.S. Securities & Exchange Commission (SEC) are involved in disclosure requirements. The FASB has required the reporting of information on permanently reinvested earnings since 1993, and the SEC recently began encouraging increased transparency on the issue, questioning firms about the liquidity implications of their PRE. The result has been changes in what gets reported in annual reports and 10-Ks related to PRE and foreign-held cash balances.

A number of firms have changed their reporting of PRE and cash since 2009. As required, all firms report PRE. But some also report cash held outside the U.S., and some attempt to quantify the deferred tax liability associated with the PRE, though it's difficult to estimate. This has led to confusion, with published reports in print and online financial news sources mistaking undistributed earnings for cash.

Generally, the PRE disclosures can be found in the tax note, where the estimate of associated deferred tax liability may be included. Firms don't have to disclose the level of foreign cash, but it's typically found in the discussion of liquidity and capital resources in the Management Discussion and Analysis (MD&A) section if they do. Apple, for example, has been fairly transparent about foreign cash balances and estimates of the related deferred tax liability, reporting foreign cash even in 2007, while Microsoft began disclosing cash held by foreign subsidiaries in 2011. IBM still wasn't disclosing this information in 2011, leading the SEC to suggest that the company consider providing enhanced disclosure on this topic. Despite the request, IBM hasn't disclosed foreign cash in its annual reports or 10-K filings.

To show the range of disclosures on the topic, compare the financial notes from the 2013 10-K filings of IBM, Apple, and GE. The Management Discussion of liquidity in IBM's 10-K filing (p. 66) states: "The company does earn a significant amount of its pre-tax income outside the U.S. The company's policy is to indefinitely reinvest the undistributed earnings of its foreign subsidiaries, and accordingly, no provision for federal income taxes has been made on accumulated earnings of foreign subsidiaries. The company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability. Quantification of the deferred tax liability, if any, associated with indefinitely reinvested earnings is not practicable. While the company currently does not have a need to repatriate funds held by its foreign subsidiaries, if these funds are needed for operations and obligations in the U.S., the company could elect to repatriate these funds which could result in a reassessment of the company's policy and increased tax expense."

The tax note (p. 123) states: "The company has not provided deferred taxes on $52.3 billion of undistributed

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earnings of non-U.S. subsidiaries at December 31, 2013, as it is the company's policy to indefinitely reinvest these earnings in non-U.S. operations. However, the company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability. Quantification of the deferred tax liability, if any, associated with indefinitely reinvested earnings is not practicable."

In comparison, Apple reports cash held outside the U.S. in the Management Discussion in its 2013 10-K (p. 35): "As of September 28, 2013 and September 29, 2012, $111.3 billion and $82.6 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."

Note 5, its tax note (p. 64), states: "The foreign provision for income taxes is based on foreign pre-tax earnings of $30.5 billion, $36.8 billion and $24.0 billion in 2013, 2012 and 2011, respectively. The Company's consolidated financial statements provide for any related tax liability on undistributed earnings that the Company does not intend to be indefinitely reinvested outside the U.S. Substantially all of the Company's undistributed international earnings intended to be indefinitely reinvested in operations outside the U.S. were generated by subsidiaries organized in Ireland, which has a statutory tax rate of 12.5%. As of September 28, 2013, U.S. income taxes have not been provided on a cumulative total of $54.4 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be approximately $18.4 billion."

Finally, in the Management Discussion of its 2013 10-K, GE presents information on its cash balances and provides an unusual detail—"cash indefinitely reinvested": "Cash and equivalents of $57.0 billion at December 31, 2013, were held by non-U.S. subsidiaries. Of this amount at December 31, 2013, $8.1 billion was indefinitely reinvested. Indefinitely reinvested cash held outside of the U.S. is available to fund operations and other growth of non-U.S. subsidiaries; it is also available to fund our needs in the U.S. on a short-term basis through short-term loans, without being subject to U.S. tax. Under the Internal Revenue Code, these loans are permitted to be outstanding for 30 days or less and the total of all such loans is required to be outstanding for less than 60 days during the year."

The current situation leads to several key questions regarding trapped cash:

1. Is the treatment of trapped cash likely to change in future tax regulations?
2. How can firms maximize the value of trapped cash?
3. How should investors value trapped cash?

Future Tax Treatment of Trapped Cash

The expectations game going on between the federal government and companies accumulating trapped cash is muddying the waters further. As part of the American Jobs Creation Act of 2004, companies were allowed to repatriate overseas cash at a reduced rate of 5.25%. The Internal Revenue Service (IRS) reported that 843 companies took advantage of this and that $312 billion was repatriated. That resulted in a tax savings of $265 billion for the companies.

Should we expect another tax holiday? It's unlikely. Companies wouldn't want to repatriate their cash today only to miss a tax holiday tomorrow, but the Obama administration has shown no indication it's considering another tax holiday. The tax holiday had little noticeable impact on the broad economy. Some estimates show that more than 60% percent of the repatriated funds went to share repurchases. That may be good for investors, but it does little for economic stimulus.

Should we expect lower corporate tax rates then? That's what Apple CEO Tim Cook called for during testimony before the Senate's Permanent Subcommittee on

Key Dates Regarding Trapped Cash

May 10, 2011
Microsoft buys Skype with overseas cash.

October 11, 2011
Permanent Subcommittee on Investigations releases *Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals*. The report recommends against enacting a second corporate repatriation tax break due to the harm associated with a substantial revenue loss, failed jobs stimulus, and added incentive for U.S. corporations to move jobs and investment offshore.

October 26, 2011
Rep. David Camp (R.-Mich., chair of the House Committee on Ways and Means) releases *International Tax Reform* discussion draft, which proposes a shift from a worldwide system of taxation to a territorial-based system:

- Exempts 95% of overseas earnings from U.S. taxation when profits are brought back to the United States from a foreign subsidiary.
- Includes anti-abuse rules to ensure companies don't avoid paying their fair share of U.S. taxes.
- Frees up existing overseas earnings to be reinvested in the U.S. after they are taxed at a low rate in line with current repatriation proposals.
- Aims to make U.S. companies more competitive on the global stage with little or no impact on the federal deficit.

November 17, 2011
House Committee on Ways and Means holds a hearing on Camp's discussion draft.

September 20, 2012
The Permanent Subcommittee on Investigations holds a hearing, "Offshore Profit Shifting and the U.S. Tax Code." Part 1 includes Microsoft and Hewlett-Packard.

February 7, 2013
David Einhorn, president of Greenlight Capital, files suit against Apple Inc.

March 1, 2013
Einhorn drops suit against Apple.

April 30, 2013
Apple issues a bond offering ($17 billion).

May 21, 2013
The Permanent Subcommittee on Investigations holds Part 2 of "Offshore Profit Shifting and the U.S. Tax Code," this time including Apple.

June 13, 2013
Ways and Means Committee hearing on tax reform: "Tax Havens, Base Erosion and Profit-Shifting."

September 3, 2013
Microsoft buys Nokia with overseas cash.

September 19, 2013
Sen. Carl Levin (D.-Mich.) introduces the Stop Tax Haven Abuse Act.

February 26, 2014
Rep. Camp releases tax reform plan to "strengthen the economy and make the tax code simpler, fairer, and flatter."

Table 1: 2010-2013 Trapped Cash in Tech Companies

	2010		2013	
	TOTAL CASH	NON-U.S. CASH (%)	TOTAL CASH	NON-U.S. CASH (%)
Apple	$51,011	60%	$146,761	76%
Cisco	39,861	86%	50,610	80%
Dell*	15,069	80%	15,342	100%
eBay	7,800	65%	12,000	81%
Google	35,000	48%	58,717	57%
Hewlett-Packard	10,900	not disclosed	12,500	not disclosed
IBM	11,651	not disclosed	11,000	not disclosed
Intel	21,500	not disclosed	20,100	56%
Microsoft	36,800	not disclosed	77,002	90%
Oracle	18,469	not disclosed	32,216	88%

*Dell cash outside the U.S. is an estimate; in 2010, it reported that 10%-20% of cash is normally held domestically. By 2012, Dell reported "substantially all" is held outside the U.S.

Investigations in hearings regarding offshore tax practices. And if you were to consider why he was testifying, it's reasonable to conclude that there was political motivation somewhere to provide a popular and reasonable face for corporate tax cuts.

Lowering the corporate tax rate seems to be sound policy. Companies would welcome it, and the U.S. tax coffers could grow as more cash gets repatriated. But cutting corporate tax rates isn't popular with the general public. In an April 2013 Gallup poll, 66% of respondents felt that corporations were paying too little in taxes. While it could be argued that 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—and voters—to embrace.

As you'll see in the next section, corporations appear to be getting better at leveraging their overseas cash so it becomes less "trapped" over time. While this goes on, there will be less tax revenue from overseas earnings. This seems to swing the pendulum toward a permanent tax code change in the long run rather than another repatriation holiday. Congress continually flirts with making this change to the corporate tax code. As recently as February 26, 2014, Representative David Camp (R.-Mich.), the chair of the House Committee on Ways and Means, released a tax plan that would exempt 95% of repatriated earnings from taxation. The legislation is unlikely to succeed in its current form, but the proposal—as well as the wide coverage it received in the mainstream press—shows that lowering taxes on repatriated cash is gaining momentum.

Maximizing the Value of Trapped Cash

Companies choosing not to repatriate the cash have several options. They can invest the cash in the countries where it's located, use the cash for a foreign acquisition, or borrow against it and use the debt proceeds for dividends or share repurchases in the U.S.

That last strategy was famously implemented by Apple. In April 2013, Apple issued $17 billion of debt in the U.S. while holding more than $100 billion in overseas cash. This strategy is effective because the company issuing the debt has high levels of cash and current interest rates are low. The additional debt lowers the firm's weighted average cost of capital (WACC), increasing firm and equity values. If interest rates rise over the next few years, as expected, this strategy will become less attractive. Companies won't be able to borrow as freely and would need to take the tax hit on repatriation or get more aggressive with their accounting practices.

In issuing debt, Apple merely joined in on a game that Microsoft, Oracle, and others have been playing. Since January 2012, Apple, Microsoft, and Oracle have borrowed a combined $26.9 billion while sitting on $197.5 billion in overseas cash. The companies borrow at historically low rates, use their interest payments as tax deductions, and use the cash from creditors to issue dividends or repurchase shares.

Aside from Apple's debt issuance, trapped cash also received significant attention in 2013 based on Dell's acquisition bids that involved trapped cash. To show the growing prevalence of trapped cash, Table 1 reports the cash hold-

Table 2: 2010-2013 Debt, Dividends, and Share Repurchases

	2010			2013			2010-2013: FOUR-YEAR TOTAL	
	TOTAL CASH	NON-U.S. CASH (%)	DEBT	TOTAL CASH	NON-U.S. CASH (%)	DEBT	DIVIDENDS	SHARE REPURCHASES
Apple	$51,011	60%	$ 0	$146,761	76%	$16,900	$13,052	$22,860
Cisco	39,861	86%	15,284	50,610	80%	16,211	5,469	22,293
Dell*	15,069	80%	5,997	15,342	100%	9,085	278	4,241
Google	35,000	48%	0	58,717	57%	5,245	0	0
Microsoft	36,800	not disclosed	11,921	77,002	90%	15,600	21,681	37,537
Oracle	18,469	not disclosed	15,922	32,216	88%	18,494	5,121	29,058

*Dell cash outside the U.S. is an estimate; in 2010, it reported that 10%-20% of cash is normally held domestically. By 2012, Dell reported "substantially all" is held outside the U.S.

ings of the U.S. technology companies holding the most cash and the substantial increase in size of the overseas holdings over the past three years. Table 2 shows the level of debt and three-year dividend and share repurchase information for the firms that best illustrate the change in strategy toward dividends and share repurchases.

Investor Valuation of Trapped Cash

Most valuation techniques focus on the value of core operations, and then equity value is adjusted to account for excess cash, debt, preference shares, and complexities including investments in affiliates, noncontrolling interest, and nonoperating 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

More and more analysts and investors are reconsidering the value of cash when it's trapped. Assuming no change in regulations, the value of the trapped cash is being treated, at a minimum, as equal to the after-tax value of cash if it were repatriated:

Onshore Cash + Offshore Cash * (1 – Marginal Tax Rate) ≤ Intrinsic Cash Value ≤ Onshore + Offshore Cash

If the firm can use the cash without repatriating—i.e., for future growth, acquisition activity, or to secure debt—then it may be more appropriate to apply a smaller discount or none at all. CEOs and CFOs may also consider acquisitions made with foreign cash as "deals." Microsoft's purchases of Skype and Nokia are case studies of this.

Most research analysts and portfolio managers we've spoken to value cash at balance sheet levels, noting that excess cash is typically insignificant in the overall firm valuation. If there's a sizeable cash position, however, 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 might apply a discount to the value of the trapped cash if it can't be used readily to fund growth or acquisition.

Staying Trapped for Now

As U.S. corporations increasingly maintain large amounts of cash in foreign locales to take advantage of favorable tax treatment, they're becoming more adept at using the trapped cash in tax-effective ways, such as through financial strategies and acquisitions. Until the future of the corporate tax code becomes more certain, it will remain challenging for firms to manage this cash and for investors to value it. Meanwhile, we expect CEOs and CFOs will continue to keep the cash offshore. Some of the cash will be used to fund foreign acquisitions. If the current low interest rates continue, more firms may employ Apple's strategy of issuing debt in the U.S. to fund share repurchases and/or dividends while avoiding the taxes that occur when the cash is repatriated directly. **SF**

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