ISI INTERNATIONAL STRATEGY & INVESTMENT

Accounting & Tax Research
Cash & Earnings Parked Overseas

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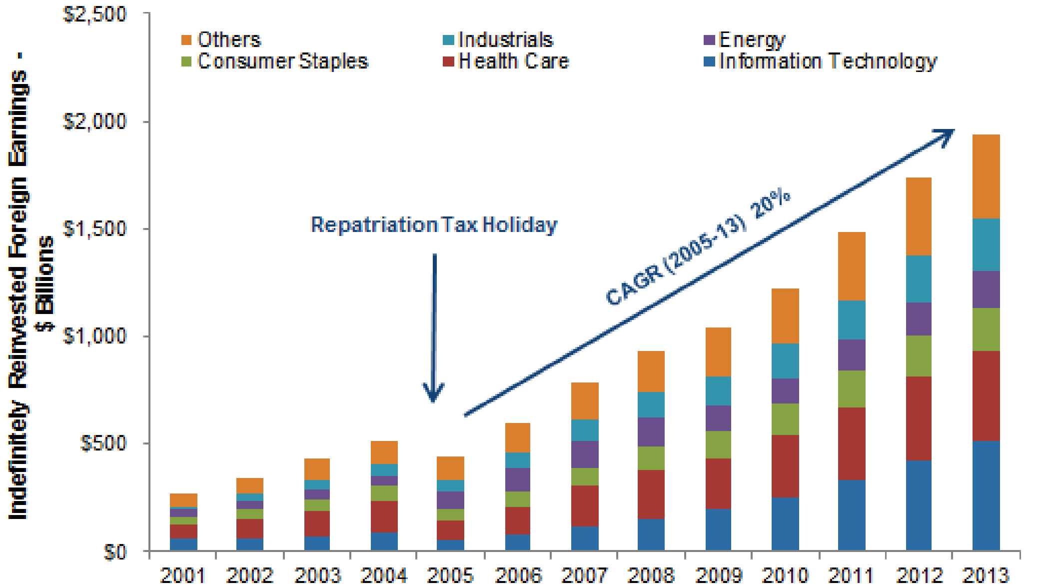
Nearly $2 Trillion in Earnings and At Least $650 Billion in Cash

Exhibit 1: Earnings Continue to Pile Up Overseas, 2001-2013, S&P 500



Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Calcbench and ISI Group estimates

- **Earnings parked overseas continue to grow, though the pace slowed in 2013.** The earnings parked overseas by the S&P 500 companies have grown at an 20% CAGR (since the last repatriation holiday in 2005) to $1.9 trillion and remain heavily concentrated with nearly half of the total parked in just two sectors (Tech and Health Care) and around 70% is held by just 45 companies.
- **The S&P 500 cash mountain is more like the Matterhorn than Mount Rushmore; all of the growth in cash (for some companies) is overseas.** Most companies don't tell you where their cash is located (they're not required to). For the companies that do, 64% of the cash is held by foreign subsidiaries and it represents 7% of market cap. For a smaller subset of companies (111) that provide the information quarterly, we find that *all* of the growth in their cash over the past couple of years is overseas. In fact, the increase in overseas cash for just these companies account for almost half the growth in the aggregate cash balance for the S&P 500 (ex-financials).
- **Mo Money, Mo Problems, $481 billion off-balance-sheet tax liability.** Parking earnings overseas and claiming that they're reinvested indefinitely (even if "reinvested" in cash) drive cash/book tax rates lower, pushing cash flows and earnings higher. But, there's a catch, a big tax bill to repatriate the earnings to the U.S., we estimate that tax hit would be more than 5% of market cap for 75 companies. As a result, you might want to consider applying a tax haircut to the overseas cash. Maybe balance sheets aren't as liquid / healthy as they initially appear.

*See the last page for an important disclosure regarding these stocks and this report.

Cash & Earnings Parked Overseas

As the corporate cash mountain continues to grow, it's passed $1.4 trillion for the S&P 500 and more than doubled over the past ten years. Investors (including an activist or two) want to know what companies plan on doing with all that cash. Will they reinvest it in the business, jack up dividends, buy back more stock, do some M&A, pay down debt, etc.? Or continue to build a cash cushion to save for a rainy day (that cash cushion may not be as big as you thought after factoring in a company's obligations).

But before you get too excited about the cash piling up on corporate balance sheets you might want to get a sense for where it's located. Because, if it's held by a foreign subsidiary, the company may have to take a big tax hit (cash taxes and earnings) if it wants to use the cash in the U.S. As a result it may stay parked overseas for quite some time; in that case the balance sheet may not be as liquid, flexible or strong as it initially appears since a portion of the cash is effectively trapped. Of course, some companies have tried to get around that by borrowing in the U.S., which works pretty well in a low interest rate environment. But they are still taking on more leverage and potentially incurring an opportunity cost if overseas profits are stuck in low yielding assets when you or the company could reinvest at a higher rate of return.

When there's a substantial amount of earnings parked overseas you may want to consider applying a haircut to the cash held by foreign subs (we estimate an off-balance-sheet tax liability of $481 billion for the S&P 500, that's a pretty big haircut) and scrutinize the sustainability of a low effective tax rate.

Now that Mercer, Harvard and Stanford have thrown a monkey wrench into your NCAA brackets, you should have some time for our version of March Madness, without the buzzer beaters, Cinderella stories, Nae Nae dance, or breakaway dunks. In this report we focus on the (at least) $650 billion of cash and $1.9 trillion of earnings parked overseas for the S&P 500 companies. Including where it's concentrated (Tech and Health Care) and how significant it is (versus market cap and assets) along with estimates of the off-balance-sheet tax liabilities (including the potential savings from a repatriation holiday), how much of the growth in cash is coming from overseas (all of it for some) and how much of the earnings parked overseas are "reinvested" in cash. In addition, we provide a summary of tax reform proposals that would change how the foreign profits of U.S. companies are taxed plus a quick run through on inversions (companies leaving the U.S. to redomicile elsewhere).

Earnings Parked Overseas

You can skip to page four if you don't need a quick refresher on how the U.S. taxes foreign profits. The U.S. is one of the few countries that still impose a worldwide tax system, where all of the profits of U.S. companies (and their foreign subsidiaries) no matter where they are generated (U.S., Ireland, Bermuda, Switzerland, Djibouti, etc.) are subject to U.S. taxation. Taxes paid overseas to other countries can be used as a foreign tax credit to reduce the amount of U.S. tax and avoid double taxation.

So, why do U.S. companies keep foreign profits parked overseas? Some companies might have investment opportunities outside the U.S. There's also a tax savings, the U.S. won't tax the profits generated by a foreign subsidiary of a U.S. company until they are repatriated back to the U.S. In other words U.S. companies can defer the U.S. tax on their foreign profits as long as they keep them parked overseas and away from the long arm of Uncle Sam and his 35% tax rate. That provides a temporary boost to cash flows and a real savings as putting off paying taxes is a present value positive assuming that the company is earning a return on the money that it hasn't yet paid to the IRS (which might be a stretch when the unremitted earnings are parked in cash) the lower the return, the smaller the savings.

In addition, if a company can claim (and most do) that it has both the intent and ability to reinvest the foreign profits indefinitely it avoids recognizing U.S. tax expense on the income statement (and a deferred tax liability on the balance sheet), reducing the effective tax rate and boosting earnings. In fact the single biggest driver of lower effective tax rates is having overseas profits taxed at low rates (see our November 7, 2013 report, *Tax Reform is Coming, Eventually, Guide to Potential Winners and Losers*, for more on the taxation of foreign profits and profit shifting).

For a simple example of how this all works check out *Exhibit 2,* it's the tax version of *Let's Make a Deal*. We discuss what's behind each door below, if you were making a deal with Monty Hall which door would you choose?

1. *Door #1* - A company repatriates all of its foreign profits as a result it ends up paying the full 35% U.S. corporate tax rate and recognizing a 35% tax rate on the income statement.
2. *Door #2* - The company decides not to repatriate any of the overseas earnings (reducing cash taxes temporarily since it only paid a 10% foreign tax rate) but it doesn't claim the earnings are indefinitely reinvested overseas so the book tax rate (35%) is higher than the cash tax rate (10%). For example, Apple has recognized a deferred tax liability of more than $18 billion on a portion of its unremitted foreign earnings that according to Apple are not indefinitely reinvested, $3.3 billion of which was recognized in 2013 and as a result the book tax rate was 6.6 percentage points higher than the cash tax rate.
3. *Door #3* - Where the company not only keeps the earnings parked overseas but also claims they are indefinitely reinvested driving the book and cash tax rates down to 10% (the tax rate in the imaginary foreign country) while driving up net income and cash flows.

Exhibit 2: Let's Make A Deal, The Tax Version

	Door 1	Door 2	Door 3
Repatriates Earnings	Yes	No	No
Foreign Earnings Indefinitely Reinvested	N/A	No	Yes
Foreign Pretax Income	$ 100	$ 100	$ 100
Tax Expense			
Current	35	10	10
Deferred	-	25	-
Total	$ 35	$ 35	$ 10
Cash Tax Rate	35%	**10%**	**10%**
Book Tax Rate	35%	**35%**	**10%**
Cash Flow From Operations	$ 65	**$ 90**	**$ 90**
Net Income	$ 65	**$ 65**	**$ 90**

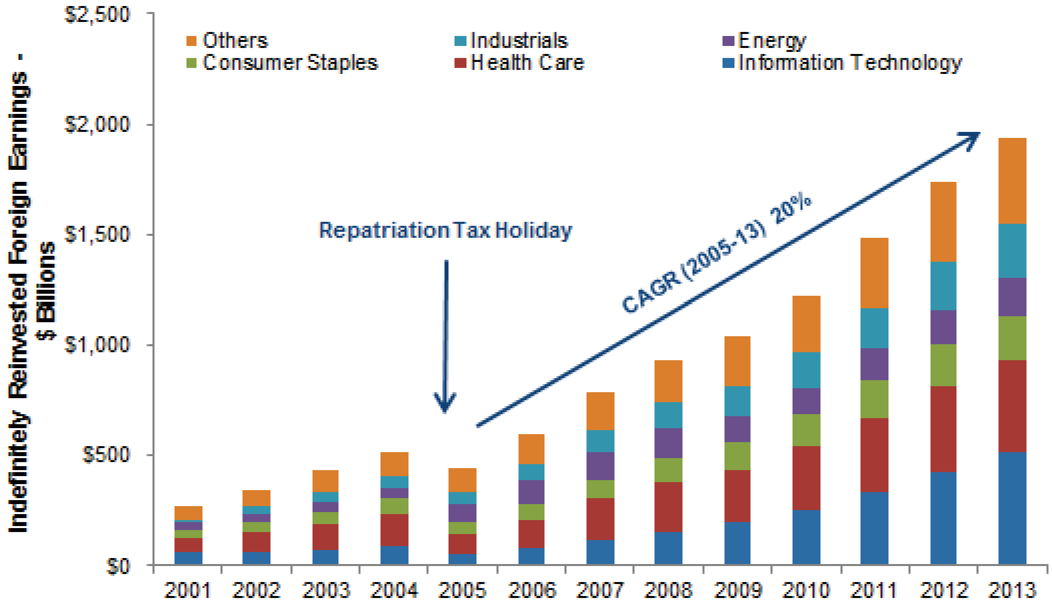
Note: Assumes the following: Pretax income is the same for GAAP and tax purposes; The only difference between earnings and cash flows is taxes; Current tax expense is same as cash taxes paid; Domestic tax rate is 35% and foreign tax rate is 10%.
Source: ISI Group estimates

Parking earnings overseas and claiming that they're indefinitely reinvested drive cash and book tax rates lower, pushing cash flow and earnings higher

Nearly $2 Trillion in Earnings Parked Overseas

Companies are required to disclose (on an annual basis) the amount of indefinitely reinvested foreign earnings (i.e., earnings parked overseas). You can usually find this disclosure in the tax footnotes. For this report, we pulled together thirteen (lucky) years of indefinitely reinvested foreign earnings data for each company in the S&P 500. As you can see in *Exhibit 3* the earnings parked overseas by the S&P 500 companies has continued to grow and now stands at nearly $2 trillion (we had expected it to crack the $2 trillion mark in our November 7, 2013 report, but the growth slowed a bit). For the first time we were able to use eXtensible Business Reporting Language (XBRL), which is like bar coding for financial data to gather the 2013 indefinitely reinvested foreign earnings (with the help of our friends at Calcbench).

Exhibit 3: Earnings Continue to Pile Up Overseas, 2001-2013, S&P 500



Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Calcbench and ISI Group estimates

Since 2001 the earnings parked overseas for the S&P 500 companies have grown at an 18% compound annual rate in the aggregate and at a 20% CAGR since the last repatriation holiday in 2005 (see *Exhibit 4*). To put those growth rates into perspective, S&P 500 revenues have grown at a compound annual rate of 6.2% and 5.0% while book value has grown 8.6% and 7.5% over the same time frames. No surprise, a big chunk of the increase in earnings parked overseas has been driven by the Tech and Health Care sectors, which have accounted for more than half the growth in the aggregate since 2005.

Exhibit 4: Earnings Parked Overseas, Over Time by Sector, S&P 500

$ in billions	Indefinitely Reinvested Foreign Earnings													CAGR	
Sector	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2001-13**	**2005-13**
Consumer Discretionary	$14	$15	$18	$22	$24	$31	$39	$47	$54	$62	$88	$102	$110	19%	21%
Consumer Staples	31	44	57	73	54	73	89	106	129	147	173	189	203	17%	18%
Energy	33	33	44	50	80	104	121	134	112	122	140	151	170	15%	10%
Financials	20	23	30	37	44	59	82	85	109	128	150	169	184	20%	20%
Health Care	72	90	117	145	88	132	186	225	241	283	332	388	421	16%	22%
Industrials	14	34	47	55	57	75	105	125	140	159	184	225	246	27%	20%
Information Technology	57	65	72	85	56	76	116	154	194	256	337	426	511	20%	32%
Materials	27	33	38	43	35	41	49	53	57	63	71	79	85	10%	12%
Telecommunication Services	4	5	3	5	3	3	1	1	1	1	2	2	2	-5%	-4%
Utilities	2	2	3	3	2	3	2	3	3	4	6	7	9	12%	20%
S&P 500	**$274**	**$346**	**$430**	**$518**	**$443**	**$596**	**$790**	**$934**	**$1,040**	**$1,225**	**$1,482**	**$1,738**	**$1,941**	**18%**	**20%**
YoY Growth	**N/A**	**26%**	**24%**	**21%**	**-15%**	**35%**	**33%**	**18%**	**11%**	**18%**	**21%**	**17%**	**12%**		

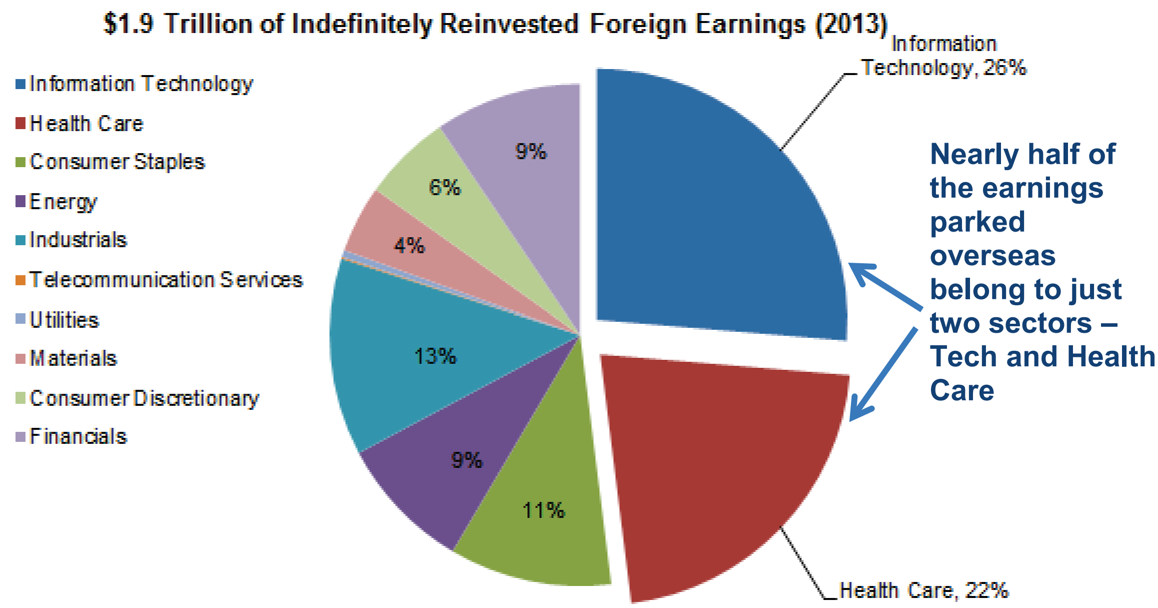
Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings,Calcbench and ISI Group estimates

Notice, however, that the growth rate slowed in 2013; in fact the 12% year-over-year growth in earnings parked overseas was among the slowest in the past 12 years (the only year-over-year decline was in 2005 as a result of the repatriation holiday). Besides the law of large numbers, one reason for the slowdown is that there were 47 companies where the amount of earnings parked overseas actually fell year-over-year, that's the highest number in the past four years. Keep in mind that all but ten of those companies actually generated foreign profits in 2013, guess they needed to get their hands on some of those overseas earnings back in the U.S.

A Tale of Two Sectors

As you can see in *Exhibit 5* nearly half of the earnings parked overseas for the entire S&P 500 sits in just two sectors, Tech and Health Care (to put that into perspective those two sectors combined make up 33% of the S&P 500 market cap).

Exhibit 5: $1.9 Trillion Earnings Parked Overseas Pie by Sector, S&P 500



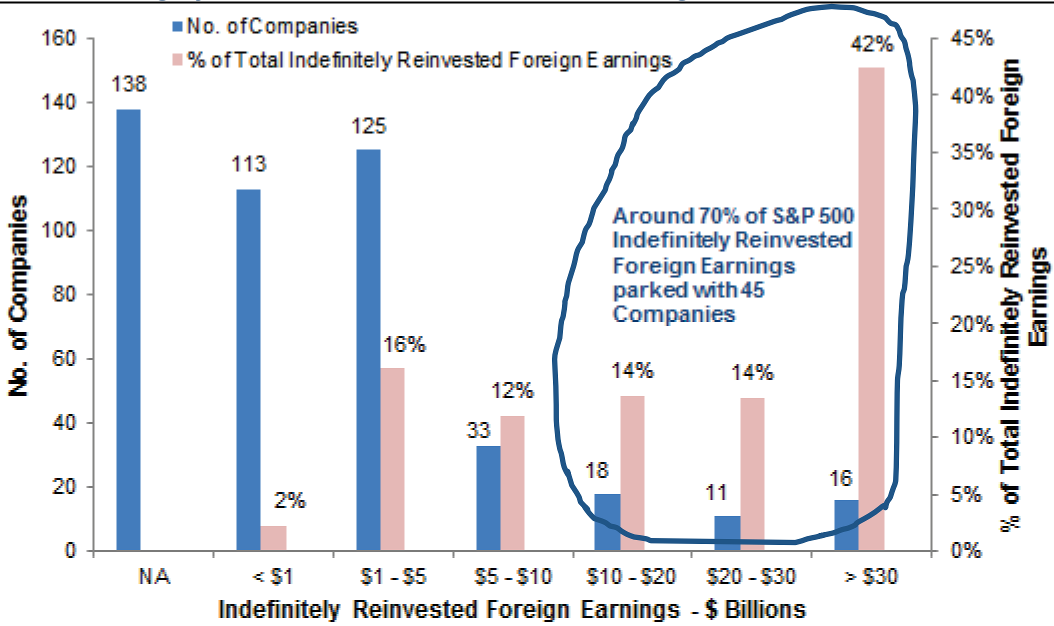
Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Calcbench and ISI Group estimates

You might be wondering, why there's such a heavy concentration. Maybe it's because the Tech and Health Care sectors have highly profitable foreign businesses that they want to keep investing in. Or that there is no need to repatriate the earnings since the U.S. businesses can satisfy the cash flow needs in the U.S. (supplemented here and there with some financing provided by creditors and the employees). Or it could have something to do with the fact that the main profit driver for those two sectors is highly mobile intellectual property that they can put in just the right place to shift profits to lower tax countries (it's easier to move a patent to Bermuda than to build a plant there). In addition some countries eager to attract jobs in these sectors might be providing companies with tax holidays, for example, Pfizer receives tax incentives from Singapore and Puerto Rico that are good for another 15 plus years. By keeping the profits stashed in the low tax countries, companies can put off paying U.S. taxes.

Heavy Concentration Among Companies Too

Not only are the earnings parked overseas concentrated among a couple of sectors, it's also concentrated among a handful of companies. In *Exhibit 6* you can see that there are 45 companies (each with over $10 billion of earnings parked overseas) that account for around 70% of the total for the S&P 500, those companies represent only 38% of the S&P 500 market cap.

Exhibit 6: Highly Concentrated, $1.9 Trillion of Earnings Parked Overseas, S&P 500



Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Calcbench and ISI Group estimates

So which companies have parked the most earnings overseas? We found 16 companies (see *Exhibit 7*) each with indefinitely reinvested foreign earnings over $30 billion. Combined, they have $824 billion in earnings parked overseas that's 42% of the total for the S&P 500.

Exhibit 7: Companies with Over $30 Billion in Earnings Parked Overseas

$ in millions			Indefinitely Reinvested Foreign Earnings		
Ticker	**Company**	**Sector**	**2012**	**2013**	**Y/Y Growth**
GE [1]	GENERAL ELECTRIC CO	Industrials	$108,000	$110,000	2%
MSFT	MICROSOFT CORP	Information Technology	60,800	76,400	26%
PFE	PFIZER INC	Health Care	73,000	69,000	-5%
MRK	MERCK & CO	Health Care	53,400	57,100	7%
AAPL	APPLE INC	Information Technology	40,400	54,400	35%
IBM [2]	INTL BUSINESS MACHINES CORP	Information Technology	44,400	52,300	18%
JNJ	JOHNSON & JOHNSON	Health Care	49,000	50,900	4%
CSCO	CISCO SYSTEMS INC	Information Technology	41,300	48,000	16%
XOM [3]	EXXON MOBIL CORP	Energy	43,000	47,000	9%
C	CITIGROUP INC	Financials	42,600	43,800	3%
PG	PROCTER & GAMBLE CO	Consumer Staples	39,000	42,000	8%
GOOG	GOOGLE INC	Information Technology	33,300	38,900	17%
HPQ	HEWLETT-PACKARD CO	Information Technology	33,400	38,200	14%
PEP	PEPSICO INC	Consumer Staples	32,200	34,100	6%
CVX	CHEVRON CORP	Energy	26,527	31,300	18%
KO	COCA-COLA CO	Consumer Staples	26,900	30,600	14%

1: The lower tax rates on the indefinitely reinvested foreign earnings in 2013 provided a tax benefit of $2.5 billion, which includes the impact of eligible earnings from the sale of a portion of Cembra.
2: Per the company, it periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability.
3: Per the company, unrecognized deferred taxes on remittance of these funds are not expected to be material.
Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings,Calcbench and ISI Group estimates

During 2013 we found 47 companies that reduced the amount of indefinitely reinvested foreign earnings. Including Pfizer, which had $69 billion of earnings parked overseas at the end of 2013 that's down from the $73 billion at the end of 2012. That's in spite of the company generating roughly $17 billion in foreign profits during 2013. In the past Pfizer had kept about half of its foreign profits parked outside the U.S.

Earnings Parked Overseas Vs. Assets

The nearly $2 trillion of earnings parked overseas by the S&P 500 companies would span nearly 988 billion feet (if stretched from end to end as $1 bills) or the length of 10.5 billion basketball courts, now that's some serious March Madness. Another way to get a sense for the significance of the indefinitely reinvested earnings is to compare them against the total assets for each company. Why compare against assets? Because the indefinitely reinvested foreign earnings are probably buried amongst the assets either as cash or invested back into PP&E, inventory, etc.

You can see in *Exhibit 8* that the earnings parked overseas have become a larger and larger part of the asset base for the S&P 500, now 7% in the aggregate (15% ex-financials) and 4% for the median company. Those percentages would increase to 8% and 14% respectively if we were to include only those companies that disclose earnings parked overseas.

Exhibit 8: Earnings Parked Overseas, A Larger Part of the Asset Base, S&P 500

	Indefinitely Reinvested Foreign Earnings/Total Assets												
Sector	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Consumer Discretionary	1%	1%	1%	1%	1%	2%	3%	4%	4%	5%	6%	7%	7%
Consumer Staples	6%	8%	9%	11%	8%	9%	10%	12%	14%	14%	16%	17%	18%
Energy	7%	6%	8%	8%	10%	11%	11%	12%	10%	9%	10%	10%	10%
Financials	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	1%	1%
Health Care	15%	17%	18%	20%	12%	16%	21%	26%	22%	25%	27%	29%	31%
Industrials	1%	3%	4%	4%	4%	5%	6%	7%	8%	9%	10%	12%	13%
Information Technology	11%	12%	12%	13%	8%	10%	13%	16%	19%	22%	25%	29%	32%
Materials	11%	13%	14%	15%	12%	13%	13%	14%	14%	15%	15%	16%	16%
Telecommunication Services	1%	2%	1%	2%	1%	1%	0%	0%	0%	0%	0%	0%	0%
Utilities	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%
S&P 500	**2%**	**3%**	**3%**	**3%**	**2%**	**3%**	**3%**	**4%**	**4%**	**5%**	**6%**	**6%**	**7%**
S&P 500 (ex-Financials)	**5%**	**5%**	**6%**	**7%**	**5%**	**7%**	**8%**	**10%**	**10%**	**11%**	**13%**	**14%**	**15%**

Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Compustat, Calcbench and ISI Group estimates

Once again, no surprise, Tech and Health Care stand out with earnings parked overseas nearly one-third of their total assets (notice we have highlighted each year where the earnings parked overseas were more than 10% of total assets). A bit more surprising is Consumer Staples with earnings parked overseas at 18% of total assets, but keep in mind there are a few companies in this sector with a bunch of earnings parked overseas like Procter & Gamble, Coca Cola and Mondelez, also it's more than half of the total assets for Philip Morris and Kimberly Clark.

When we drill down to individual companies we find 75 where the earnings parked overseas are more than one-third of total assets, including the six companies in *Exhibit 9* where it's more than two-thirds.

Exhibit 9: Companies Where Earnings Parked Overseas is More Than Two-Thirds of Total Assets, S&P 500

$ in millions

Ticker	Company	Sector	Indefinitely Reinvested Foreign Earnings	Total Assets	Indefinitely Reinvested Foreign Earnings/Total Assets
MAT	MATTEL INC	Consumer Discretionary	$5,900	$6,440	92% [1]
WAT	WATERS CORP	Health Care	3,000	3,583	84%
FRX	FOREST LABORATORIES -CL A	Health Care	6,300	7,630	83%
ABBV	ABBVIE INC	Health Care	21,000	29,198	72%
BSX	BOSTON SCIENTIFIC CORP	Health Care	11,902	16,571	72% [1]
LLY	LILLY (ELI) & CO	Health Care	23,740	35,249	67%

1: The ratio is more than 100% if goodwill is excluded from total assets.
Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Compustat, Calcbench and ISI Group estimates

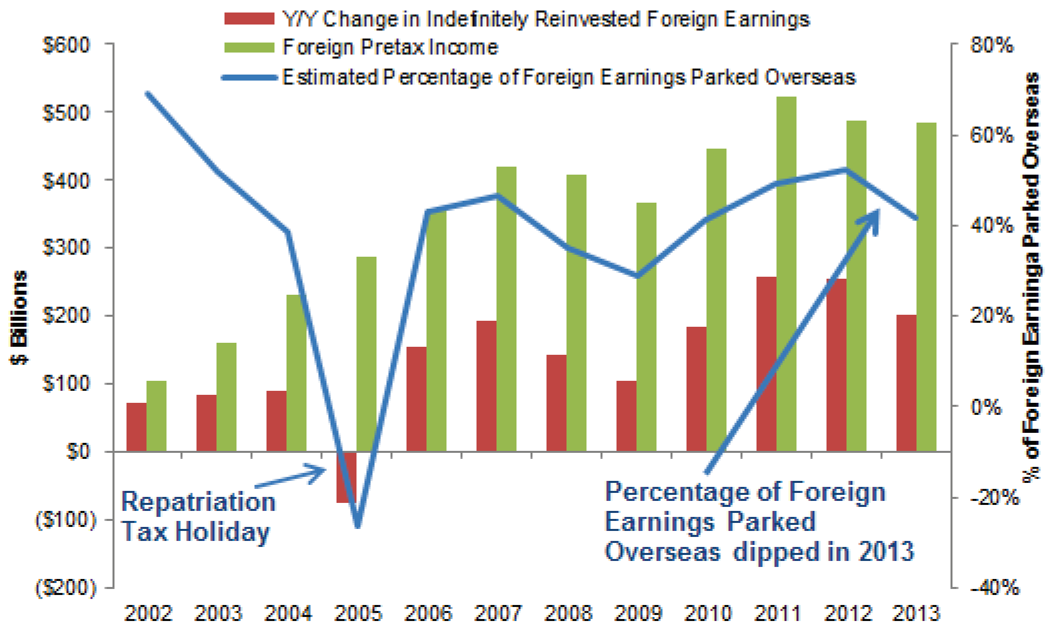
Having a large chunk of the balance sheet tied up in assets outside the U.S. is not really a problem for companies with growth opportunities overseas or where they need to reinvest in the foreign business. But if the foreign business is a cash cow and the company needs to get some of the overseas cash back to the U.S. it might have to take a big tax hit to do so, making the balance sheet less flexible than it appears. Of course one way around that (which happens to provide a tax shield) is for companies to borrow money in the U.S. For example, Microsoft has $23 billion of debt despite having $84 billion of cash (cash, cash equivalents and short-term investments) on the balance sheet, Apple has $17 billion of debt and $41 billion of cash and Cisco despite a cash pile of $47 billion has $17 billion of debt.

A Little Over 40% of Foreign Profits Parked Overseas During 2013

Not all foreign profits are kept parked overseas, some companies might not have incremental investment opportunities overseas and don’t want to bear the opportunity costs of having the earnings stuck in low yielding cash (clearly there are plenty of companies that don’t seem to have a problem taking on that opportunity cost). Keep in mind that repatriating earnings from some countries is less painful than others, due to differences in tax rates; the higher the tax rate paid overseas the less taxes owed when the earnings are brought back to the U.S. since the company would get the benefit of a larger foreign tax credit.

So, how much of the foreign profits is being parked overseas? To get a rough idea we compared the amount of foreign pretax income each year from 2002-2013 to the year-over-year change in the earnings parked overseas for each company in the S&P 500. In the aggregate, it appears as if 42% of the foreign profits in 2013 were kept stashed overseas (see *Exhibit 10*). That’s down from the 52% in 2012 and the lowest level since 2010.

Exhibit 10: Estimated Percentage of Foreign Earnings Parked Overseas Each Year, S&P 500



Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Compustat, Calcbench and ISI Group estimates

As for individual companies, we found 137 companies where it appears as if more than half of the cumulative foreign profits since 2002 have been kept overseas. Including 28 companies where the profits parked overseas are actually greater than the foreign profits generated over the same time frame including the 10 companies at the top of the list in *Exhibit 11*. When we examine the data by year we found that in about 20% of the cases companies appeared to park more earnings overseas than the amount of foreign profits that they generated. That might be due to a mix of profitable and unprofitable foreign subs throwing this ratio out of whack or it might signal some serious profit shifting.

Exhibit 11: Disconnect Between Earnings Parked Overseas and Reported Pretax Foreign Income, S&P 500

$ in millions

Ticker	Company	Sector	Cumulative change in Indefinitely Reinvested Foreign Earnings (2002 - 2013)	Cumulative Pretax Foreign Income (2002 - 2013)	Change in Indefinitely Reinvested Earnings as a % of Pretax Foreign Income
CLF [1]	CLIFFS NATURAL RESOURCES INC	Materials	$1,184	$164 [4]	720%
CSC [2]	COMPUTER SCIENCES CORP	Information Technology	2,701	441 [4]	613%
BSX	BOSTON SCIENTIFIC CORP	Health Care	10,996	4,955 [4]	222%
YHOO [3]	YAHOO INC	Information Technology	2,555	1,345	190%
TMO	THERMO FISHER SCIENTIFIC INC	Health Care	5,456	3,084	177%
AMZN [3]	AMAZON.COM INC	Consumer Discretionary	2,480	1,556	159%
MHK [3]	MOHAWK INDUSTRIES INC	Consumer Discretionary	1,152	723	159%
HOT	STARWOOD HOTELS&RESORTS WRLD	Consumer Discretionary	3,183	2,075	153%
SWK	STANLEY BLACK & DECKER INC	Industrials	4,376	2,869	153%
TRV	TRAVELERS COS INC	Financials	642	429	150%

1: Analysis done for 2006 -2013.
2: Analysis done for 2003 -2013.
3: Analysis done for 2005 -2013.
4: Each of the companies had significant pretax foreign losses in 2012 which may be affecting this analysis, Cliff Resources($1340 loss), Computer Sciences Corp ($2646 loss), and Boston Scientific ($2842 loss).

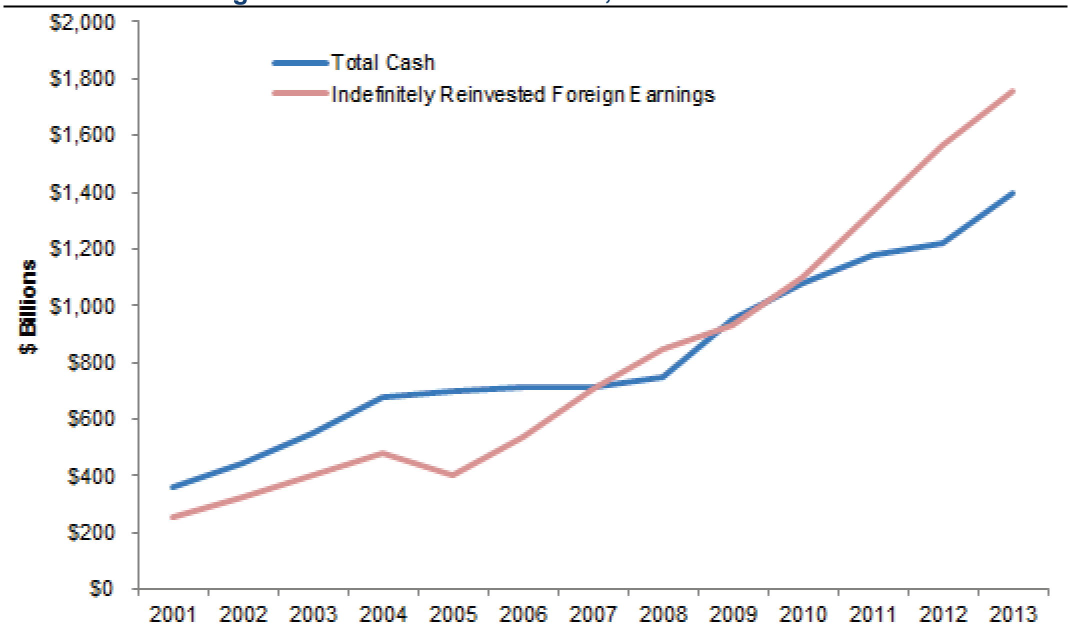
Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Calcbench and ISI Group estimates

When you see companies keeping so much of their foreign profits outside the U.S., there are a number of questions to consider, including: is the company generating profits in the same place that economic activity (e.g., sales) takes place? If not, you might want to question the sustainability of the tax rate (especially under tax reform) and how much credit you give the company for it in your valuation. Are the profits being parked outside the U.S. because the company is reinvesting/growing its foreign business or because it doesn't want to get hit with a U.S. tax bill? What are its cash flow needs in the U.S.? Will the company need to bring back some of its overseas earnings and take a tax hit to fund capex, dividends, etc. or does the company have the capacity to borrow instead? Sure, putting off paying taxes is a present value positive, but when does that get swamped by the opportunity cost if the profits are stuck in low yielding assets when you or the company could reinvest at a higher rate of return?

Cash Parked Overseas

Cash continues to pile up on corporate balance sheets, hitting $1.4 trillion for the S&P 500 companies (ex-Financials) at the end of 2013 (see *Exhibit 12*), and it has increased at a 12% CAGR over the past 12 years. It's no wonder that investors are interested in figuring out what companies will do with all that cash. Will they reinvest it in the business, jack up dividends, buy back more stock, do some M&A, pay down debt? Or continue to build a cash cushion to save for a rainy day or keep parking it overseas with hopes of another repatriation holiday.

Exhibit 12: Earnings Parked Overseas vs. Cash, S&P 500 ex-Financials



Note: Analysis excludes Financials and companies domiciled outside U.S. Total Cash is defined as the sum of cash, cash equivalents and short-term investments.
Source: Company filings, Compustat, Calcbench and ISI Group estimates

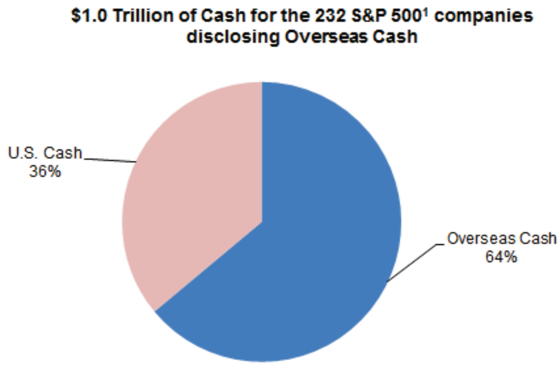
Before you get too excited about all that cash piled up on the balance sheet, you might want to find out where it's located. Because if it's held by a foreign subsidiary and it's the result of unremitted foreign earnings, the company may have to take a big tax hit (cash taxes and earnings) to get its hands on the cash in the U.S. to fund a buyback or pay you a dividend.

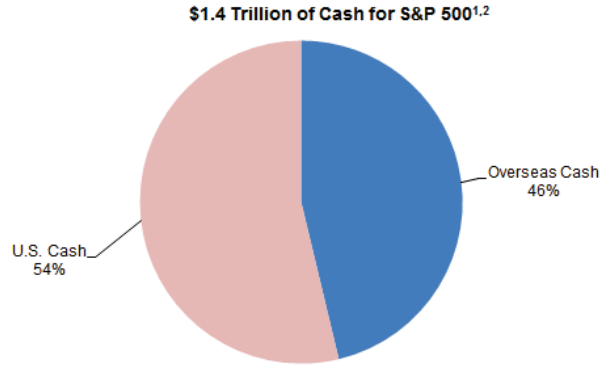
If that's the case the balance sheet may not be as liquid or strong as it initially appears since some portion of the cash is trapped in foreign subsidiaries. So, you may want to consider applying a haircut to the cash held by foreign subs. (Keep in mind that in some cases the cash of foreign subs may actually be held in the U.S., in U.S. bank accounts or invested in U.S. treasury bonds, mutual funds or unrelated corporate bonds and stocks as found in the December 14, 2011 Permanent Subcommittee on Investigations majority staff study, *Offshore Funds Located Onshore*).

The problem is that most companies don't tell you where their cash is located (it's not a required disclosure, though the SEC has been asking for it), we found only

232 companies in the S&P 500 that give you some sense for where their cash is located. Those companies hold $1 trillion in cash (72% of the S&P 500 total) and $650 billion or 64% of it is in overseas subsidiaries (see pie on the left in *Exhibit 13*). If we assume (be careful) that the overseas cash is immaterial for the other S&P 500 companies (pretty big assumption) we find that overseas cash is still 46% of the $1.4 trillion in total cash for the S&P 500 (pie on the right in *Exhibit 13*).

Exhibit 13 : Where's the Money? Two Perspectives





Total Cash is defined as the sum of cash, cash equivalents and short-term investments.
1: Excludes Financials and companies domiciled outside U.S.
2: Analysis assumes overseas cash is zero for companies that do not disclose it.
Source: Company filings, Compustat and ISI Group estimates

Since 2010, more and more companies have been disclosing the amount of cash held by their overseas subsidiaries (see *Exhibit 14*). However, the disclosure is spotty (we typically find it in the Management Discussion and Analysis section under Liquidity and Capital Resources), some companies disclose it on a quarterly basis (160 companies disclosed it each quarter during 2013); while there were 33 companies that only provided it at year-end and 39 companies that provided it sporadically. Most include only cash, cash equivalents and short term investments, but some (27 companies) include other investments.

As a result, to avoid comparing apples and oranges we adjusted the amounts provided by the companies to exclude long-term investments, for example Apple reported that $124.4 billion (78%) of its $146.7 billion of cash, cash equivalents and marketable securities were overseas as of December 31, 2013. Excluding the long-term marketable securities of $118.1 billion, leaves $40.7 billion of cash, cash equivalents and short-term investments, if we assume the same 78% of which is overseas we arrive at an estimated $31.9 billion in overseas cash. Many companies give you dollar amounts or percentages of cash held overseas, but some only provide a qualitative description such as approximately half, majority, substantial majority and substantially all, etc. we turned those into percentages, 50%, 67%, 85% and 100% respectively.

Exhibit 14: Overseas Cash Over Time, S&P 500

$ in billions		2010	2011				2012				2013			
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
A	**Total Cash (S&P 500)**	$1,091	$1,107	$1,132	$1,158	$1,169	$1,170	$1,163	$1,206	$1,230	$1,251	$1,269	$1,366	$1,405
B	**Number of Companies disclosing Overseas Cash in that Quarter**	32	7	11	24	157	139	164	163	206	173	177	197	222
C	**Total Cash of Companies disclosing Overseas Cash**	$337	$345	$416	$442	$703	$721	$741	$792	$851	$889	$919	$976	$1,016
D = A / B	**Total Cash of Companies disclosing Overseas Cash as a % of Total Cash of S&P 500**	31%	31%	37%	38%	60%	62%	64%	66%	69%	71%	72%	71%	72%
E	**Last Reported Overseas Cash Balance[1]**	$172	$175	$223	$244	$449	$466	$487	$520	$552	$579	$604	$631	$650
F = E / C	**Overseas Cash as a % of Total Cash**	51%	51%	54%	55%	64%	65%	66%	66%	65%	65%	66%	65%	64%

Note: S&P 500 excludes Financials and companies domiciled outside the U.S. Total Cash is defined as the sum of cash, cash equivalents and short-term investments.
1: Some companies report Overseas Cash annually, so we assume the overseas cash amount remains same until it is updated.
Source: Compustat, Company filings and ISI Group estimates

Here are a few examples of overseas cash disclosures from recent 10-Ks:

Apple (12/31/2013)

As of December 28, 2013 and September 28, 2013, $124.4 billion and $111.3 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.

Hewlett Packard (10/31/2013)

Our cash balances are held in numerous locations throughout the world, with substantially all of those amounts held outside of the United States.

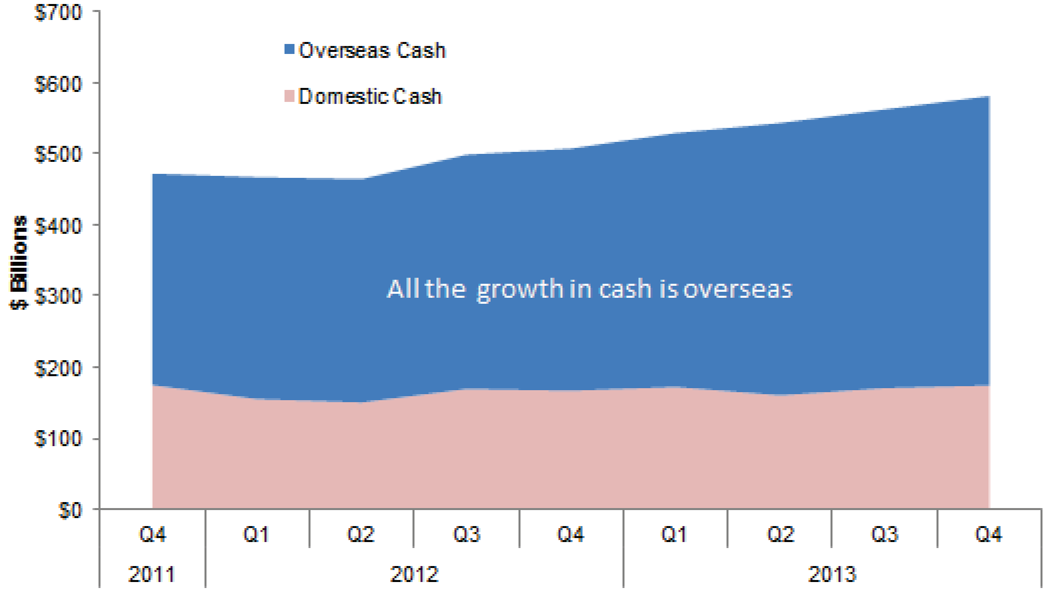
Verizon (12/31/2013)

Our cash and cash equivalents are primarily held domestically in diversified accounts and are invested to maintain principal and liquidity. Accordingly, we do not have significant exposure to foreign currency fluctuations.

Growth in Cash Driven by Foreign Subs

Corporate cash has surged to record levels, but how much of the overall growth in cash is coming from outside the U.S.? The lack of disclosure doesn't allow us to answer this question in the aggregate, but we can try to answer it for the companies that provide the info. We found 111 S&P 500 companies that have consistently provided quarterly disclosures about where their cash is located over the past couple of years. The cash pile for those companies has grown 23% from $473 billion at the end of 2011 to $582 billion at the end of 2013 the overseas piece has grown from $298 billion to $407 billion accounting for *all* of the growth in cash for these companies over this time frame (see *Exhibit 15*).

Exhibit 15: Corporate Cash Mountain is Growing Outside the U.S.



Note: Analysis includes only 111 companies that have disclosed overseas cash every quarter since 2011 Q4.
Total Cash is defined as the sum of cash, cash equivalents and short-term investments.
Source: Company filings and ISI Group estimates

Clearly there might be a bias in this analysis, companies that provide overseas cash information on a quarterly basis are more likely to have significant overseas cash balances, however the increase in overseas cash for just these 111 companies would account for 46% of the growth in the aggregate cash balance for the entire S&P 500 over the past two years (that assumes the remaining companies have not had any growth in cash held by their foreign subs). In other words it looks like a significant chunk of the growth in corporate cash over the past few years may be coming from overseas.

Cash Vs Market Cap Don't Forget About the Overseas Tax Haircut

We'll see cash getting compared against market cap to support a valuation (see how much cash there is, the stock looks cheap) or to set a valuation floor (it shouldn't trade below this because of all that cash). However, if a good chunk of the cash is overseas that throws a monkey wrench into the analysis, you'd need to factor in the taxes that the company would pay to get its hands (or your hands) on the cash, the lack of liquidity as the cash may stay parked outside the U.S. for quite some time (kind of like restricted cash, you don't give companies full credit for that, do you?) and don't forget the opportunity cost if companies pass up on higher returning investment opportunities to avoid paying taxes. In other words be careful giving companies full credit for the cash on the balance sheet it may not be worth as much as stated.

In the aggregate cash is now 10% of the market cap for the S&P 500 and there are 128 companies where cash is more than 10% of market cap (49% of those are in the Tech and Health Care sectors). Focusing on the 232 companies that disclose how much cash they have overseas, we can split cash as a percentage of market cap into the overseas and domestic pieces, in total cash is 12% of market cap for those companies and overseas cash is 7% of market cap leaving domestic at 5%.

At the top of the list among those 232 companies are the five companies in *Exhibit 16* where cash is more than 30% of market cap. Notice how all five of the companies have a larger percentage of overseas cash to market cap than domestic cash to market cap. Have you adjusted your valuation to reflect some of the issues surrounding the overseas cash, the potential tax hit, lack of liquidity, etc.?

Exhibit 16: Splitting Cash to Market Cap Between Overseas and Domestic

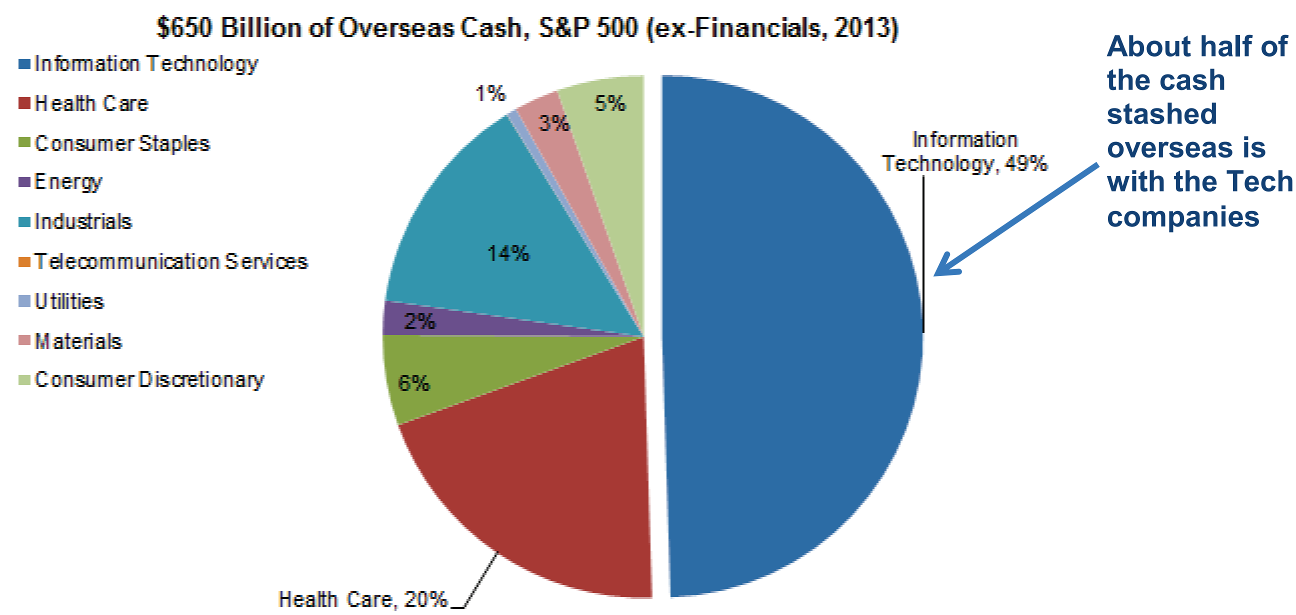
$ in millions			Cash			Cash as a % of Market Cap[2]		
Ticker	**Company**	**Sector**	**Overseas**	**Domestic**	**Total[1]**	**Overseas**	**Domestic**	**Total**
GT	GOODYEAR TIRE & RUBBER CO	Consumer Discretionary	$1,633	$1,363	$2,996	24%	20%	45%
CSCO	CISCO SYSTEMS INC	Information Technology	42,000	6,201	48,201	37%	6%	43%
NTAP	NETAPP INC	Information Technology	3,900	1,380	5,280	29%	10%	39%
GE	GENERAL ELECTRIC CO	Industrials	57,000	34,052	91,052	22%	13%	36%
FSLR	FIRST SOLAR INC	Information Technology	1,173	592	1,764	21%	10%	31%

1: Total Cash includes cash, cash equivalents and short-term investments.
2: Market Cap as of 02/28/2014.
Note: Analysis excludes Financials and companies domiciled outside U.S.
Source: Company filings, Compustat and ISI Group estimates

Overseas Cash Even More Concentrated Than Earnings Parked Overseas

We highlighted above that the Tech and Health Care sectors have comparable amounts of earnings parked overseas (26% and 22% of the S&P 500 total respectively). However, a different picture emerges when you look at the cash held by foreign subsidiaries in *Exhibit 17*. Tech holds a whopping 49% of the aggregate overseas cash compared to just 20% for Health Care.

Exhibit 17: Cash Stashed Overseas by Sector, S&P 500



Note: Analysis excludes Financials and companies domiciled outside U.S.
Source: Company filings, Compustat and ISI Group estimates

When we drill down to individual companies we find 96 with more than $1 billion of overseas cash, the top ten listed on the left side of *Exhibit 18* have a combined $352 billion of overseas cash (that's 54% of the total). When we analyze the portion of cash that's overseas there are 140 companies where it's more than half the cash balance and at the top of the list are the ten companies on the right side of *Exhibit 18* where more than 97% of their cash is held by foreign subs. Notice that while the left side of *Exhibit 18* is Tech, Health Care and General Electric the right is a little more mixed.

Exhibit 18: Top Ten Overseas Cash by Dollar Amount & as a % of Total Cash, S&P 500

$ in millions

Ticker	Company	Overseas Cash	Total Cash[1]	Overseas Cash as a % of Total Cash	Ticker	Company	Overseas Cash	Total Cash[1]	Overseas Cash as a % of Total Cash
MSFT	MICROSOFT CORP	$75,700	$83,944	90%	ITW [6]	ILLINOIS TOOL WORKS	$3,618	$3,618	100%
GE	GENERAL ELECTRIC CO	57,000	91,052	63%	HPQ [6]	HEWLETT-PACKARD CO	12,163	12,163	100%
CSCO	CISCO SYSTEMS INC	42,000	48,201	87%	BHI [6]	BAKER HUGHES INC	1,399	1,399	100%
GOOG	GOOGLE INC	33,600	58,717	57%	FTI [6]	FMC TECHNOLOGIES INC	399	399	100%
AAPL [2]	APPLE INC	31,884	40,711	78%	BWA	BORGWARNER INC	937	940	100%
ORCL	ORACLE CORP	31,200	36,974	84%	MCHP [7]	MICROCHIP TECHNOLOGY INC	1,302	1,307	100%
PFE [3]	PFIZER INC	25,926	32,408	80%	MDT	MEDTRONIC INC	12,504	12,584	99%
JNJ	JOHNSON & JOHNSON	18,600	29,206	64%	AME	AMETEK INC	291	295	99%
KO [4]	COCA-COLA CO	18,300	20,268	90%	PLL [8]	PALL CORP	948	968	98%
AMGN [5]	AMGEN INC	17,784	19,401	92%	STJ [9]	ST JUDE MEDICAL INC	1,373	1,408	98%

1: Total Cash includes cash, cash equivalents and short-term investments.
2: Company disclosed that it had $118,131 overseas as of its last year fiscal end, but the amount included long-term marketable securities in addition to cash, cash equivalents and short-term investments. In this analysis, we include only cash, cash equivalents and short-term investments as part of total cash, so the amount was prorated.
3: Company disclosed that 10%-30% of cash, cash equivalents and short-term investments are in the U.S. tax jurisdiction. We are using midpoint of the range to determine overseas cash.
4: Company's subsidiaries in Argentina and Venezuela held $353 million and $324 million, respectively, of cash, cash equivalents, short-term investments and marketable securities. According to the company, the absence of a government-approved mechanism to convert local currency into U.S. dollars in Argentina and Venezuela restricts the Company's ability to pay dividends from these locations.
5:The number ($20,900) disclosed by the company was prorated to account for the fact that the number includes restricted investment balances.
6: The company disclosed that primarily all of its cash and equivalents were held by its international subsidiaries. We assume "primarily all" to be 100%.
7: The number ($2,022) disclosed by the company was prorated to account for the fact that the number includes long term investments.
8: Per the company, repatriation of overseas cash could be subject to restrictions in the host countries as well as both local and U.S. taxes. However, the company does not expect these to have a material effect on its overall liquidity.
9: The company disclosed that substantially all of its cash and equivalents were held by its international subsidiaries. We assume "substantially all" to be 100%.
Note: Analysis excludes Financials and companies domiciled outside U.S.
Source: Company filings, Compustat and ISI Group estimates

At least 36% of Earnings Parked Overseas Are "Reinvested" in Cash

Not all of the earnings parked overseas are sitting in a bank account, for some companies it really is reinvested in the business (inventory, PP&E etc.). The problem (as highlighted above) with trying to split the earnings parked overseas into its cash and non-cash components is that most companies don't talk about their overseas cash. For the 214 companies that disclose both overseas cash and indefinitely reinvested earnings we find that 46% of the earnings parked overseas are stashed in cash (left hand side of *Exhibit 19*). If we were to include overseas investments in long-term marketable securities (for the 27 companies that provide this information) the number would jump to 55%. On the other hand if we assume (watch out) that the overseas cash is immaterial for the companies that don't disclose it then 36% of the aggregate earnings parked overseas for the S&P 500 appears to be in cash (right hand side of *Exhibit 19*) and 43% if we include investments in long-term marketable securities. We assume the rest of the earnings parked overseas have been reinvested in the business.

Exhibit 19: Earnings Parked Overseas Stashed in Cash, S&P 500 (ex-Financials)

$ in billions

	S&P 500 (ex - Financials) companies reporting Overseas Cash				S&P 500 (ex - Financials)			
Sector	Earnings Parked Overseas	Overseas Cash[1]	Estimated Earnings Reinvested	Estimated % of Earnings Parked in Cash	Earnings Parked Overseas	Overseas Cash[1]	Estimated Earnings Reinvested	Estimated % of Earnings Parked in Cash
Consumer Discretionary	$74	$35	$38	48%	$110	$35	$75	32%
Consumer Staples	118	36	82	30%	203	36	168	18%
Energy	72	14	59	19%	170	14	156	8%
Health Care	373	127	245	34%	421	127	294	30%
Industrials	205	91	114	44%	246	91	156	37%
Information Technology	450	305	145	68%	511	305	206	60%
Materials	70	18	52	26%	85	18	66	21%
Telecommunication Services	-	0	(0)	-	2	0	2	5%
Utilities	9	4	5	47%	9	4	5	47%
Total	**$1,370**	**$630**	**$740**	**46%**	**$1,757**	**$630**	**$1,127**	**36%**

1: Overseas cash as of the end of the last fiscal year ending before 12/31/2013.
Note: Analysis excludes Financials and companies domiciled outside U.S.
Source: Company filings, Compustat, Calcbench and ISI Group estimates

At least 60% of the earnings parked overseas for the Tech sector appears to be held in cash compared to 30% for Health Care. What does this mean? Do Health Care companies have more opportunities to reinvest their earnings overseas? Are Tech companies more aggressive at shifting profits abroad? Or is it that Health Care companies do a better job of accessing their overseas cash, resulting in smaller overseas cash balances, sometimes in creative ways? For example, Boston Scientific has legacy intercompany loans that allow it to bring home the cash generated outside the U.S. without paying residual taxes (they're not alone, Hewlett Packard uses intercompany loans to access overseas cash too). Here is what Jeff Capello Boston Scientific's CFO, said in February 2013 at the Citi Global Healthcare Conference in response to a question on tax rates and their ability to repatriate cash:

> *Sure. A lot of large companies are constrained in the sense that they produce more cash offshore than they do onshore and because of the tax reasons if they were to bring that cash back they would have to increase their tax rate. By virtue of the way that we did the Guidant acquisition we have significant intercompany notes that exist between the foreign entities and the domestic entities, which allows us to bring back cash without any impact to our tax rates. And those notes should last for at least the next couple years…We also look at our tax structure going forward. So we have got at least a two-year window where we can bring cash back without any impact to the tax rate, and we're working on solutions to be able to further that going forward.*

In *Exhibit* 20, we compare and contrast the cash and earnings parked overseas for the Health Care and Tech sectors along with the rest of the S&P 500.

Exhibit 20: Tech vs Health Care – A Tale of Two Sectors

$ in billions **Metrics**	**Information Technology**	**Health Care**	**Rest of S&P 500 (ex-Financials)**	**S&P 500 (ex-Financials)**
Overseas Cash as a % of Indefinitely Reinvested Foreign Earnings	60%	30%	24%	36%
Overseas Cash[1]	$305	$127	$198	$630
Indefinitely Reinvested Foreign Earnings	511	421	825	1,757
Total Assets	$1,621	$1,378	$8,559	$11,557
Indefinitely Reinvested Foreign Earnings/Total Assets	32%	31%	10%	15%
Number of Companies disclosing Overseas Cash	50	35	145	230
Total Cash	$466	$244	$686	$1,396
Overseas Cash as a % of Total Cash	65%	52%	29%	45%
Foreign Pretax Income (2001 - 2013)	$805	$578	$2,485	$3,867
Total Pretax Income (2001 - 2013)	1,496	1,139	6,387	9,021
Foreign Income as % of Pretax Income	54%	51%	39%	43%
Estimated Effective Tax Rate 2003-2012[2]	25%	25%	32%	30%
Estimated Cash Tax Rate 2003-2012[2]	19%	25%	27%	25%

1: Overseas cash as of the end of the last fiscal year ending before 12/31/2013.
2: Excludes years in which companies had pretax losses
Note: Analysis excludes Financials and companies domiciled outside U.S.
Source: Company filings, Calcbench, Compustat and ISI Group estimates

There are 90 companies where we estimate more than half of the earnings parked overseas is kept in cash, including 26 companies where the overseas cash is actually greater than the indefinitely reinvested earnings. Such a large percentage of the earnings parked overseas in cash should call into question whether the earnings are truly "reinvested indefinitely." When making this claim companies are supposed to take into account, cash flow forecasts, liquidity needs and the amount of cash parked overseas relative to the cash held in the U.S. Basically that the U.S. parent doesn't need the overseas cash and the company has a plan to reinvest the earnings overseas. But, how many companies reinvest their earnings in cash indefinitely? A more accurate description might be reinvested indefinitely until the next repatriation holiday comes along.

Another open question is whether a higher proportion of earnings parked overseas in cash indicate a higher level of profit shifting. For the 26 companies where the overseas cash is greater than the earnings parked overseas some of these companies (like Apple) may have additional unremitted earnings that are not considered "reinvested indefinitely" which can throw the analysis out of whack.

On the other hand we find 86 companies with earnings parked overseas that don't disclose overseas cash, including seven companies (IBM, Exxon Mobil, Procter & Gamble, Chevron, United Technologies, Eli Lilly and Philip Morris) with more than $20 billion of earnings parked overseas. Do these companies really have $0 overseas cash, maybe it's immaterial or they've simply decided not to disclose it. As overseas cash continues to build on corporate balance sheets the FASB and or the SEC should *require* companies to disclose it.

Mo Money, Mo Problems

By claiming that their foreign earnings are invested overseas "indefinitely" companies also avoid recognizing a deferred tax liability for the U.S. tax that would be due if the earnings of their foreign subs were repatriated to the U.S. As a result there's an off-balance-sheet tax liability.

$481 Billion Off-Balance-Sheet Tax Liability

Of the 313 companies in the S&P 500 that disclose earnings parked overseas, there are only 72 that provide an estimate of the related deferred tax liability (covering only one-quarter of the total earnings parked overseas). Even though it's a required disclosure, companies can get around providing an estimate of the deferred tax liability if it's too difficult (impractical) to estimate. For example, Procter and Gamble had $42 billion of earnings parked overseas as of June 30, 2013, if those earnings were repatriated they would have to pay U.S. taxes however, the company claims that the "calculation of the amount of deferred U.S. income tax on these earnings is not practicable because of the large number of assumptions necessary to compute the tax."

Funny, if it's too tough to estimate the U.S. tax bill from repatriating how do companies know whether it makes sense to keep the earnings parked overseas or not (especially when those earnings are sitting in low yielding cash). As the earnings parked overseas continue to grow this is another area where the FASB and SEC might want to improve disclosures going forward.

For the companies that do provide this disclosure, the median additional tax liability is 25% of the undistributed earnings (it ranged from 0% to 40%), that would imply a median foreign effective tax rate on those earnings of 10%.

To estimate the off-balance-sheet deferred tax liability on the earnings parked overseas for the S&P 500 we start with the amounts provided by the 72 companies ($128 billion) and for the remaining companies we simply multiply the earnings parked overseas by the median tax rate of 25%. Put that all together and we come up with a $481 billion estimated off-balance-sheet tax liability. In other words, if the companies decided to repatriate all of the earnings parked overseas back to the U.S., we estimate they'd have to pay $481 billion in taxes to Uncle Sam.

To put those off-balance-sheet U.S. tax liabilities into perspective we compare them to market cap. We found 75 companies where the off-balance-sheet tax liability is more than 5% of market cap and it's more than 10% for the 17 companies in *Exhibit 21*. Are these off-balance-sheet tax liabilities priced in by the market? Academic studies have come to conflicting conclusions, even when it's disclosed. Our guess is that it's probably not priced in (especially since most companies don't disclose it).

Exhibit 21: Highest Off-Balance-Sheet Tax Liability as a % of Market Cap

$ in millions

Ticker		Company	Sector	Indefinitely Reinvested Foreign Earnings	Estimated Off-Balance-Sheet Tax Liability related to Foreign Earnings[1]		Market Cap[2]	Estimated Off-Balance-Sheet Tax Liability as % of Market Cap
BSX		BOSTON SCIENTIFIC CORP	Health Care	$11,902	$2,976		$17,347	17%
HPQ		HEWLETT-PACKARD CO	Information Technology	38,200	9,550		56,626	17%
XRX		XEROX CORP	Information Technology	8,000	2,000		13,023	15%
FSLR		FIRST SOLAR INC	Information Technology	2,100	848	3	5,679	15%
OI		OWENS-ILLINOIS INC	Materials	3,200	800		5,589	14%
GT	4	GOODYEAR TIRE & RUBBER CO	Consumer Discretionary	3,800	950		6,670	14%
WU		WESTERN UNION CO	Information Technology	5,000	1,250		9,167	14%
APA	5	APACHE CORP	Energy	17,000	4,250		31,298	14%
JBL		JABIL CIRCUIT INC	Information Technology	2,000	500		3,817	13%
MAT		MATTEL INC	Consumer Discretionary	5,900	1,475		12,699	12%
GLW	6	CORNING INC	Information Technology	12,400	3,100		26,802	12%
WDC		WESTERN DIGITAL CORP	Information Technology	6,800	2,300	3	20,552	11%
AVY		AVERY DENNISON CORP	Materials	2,100	525		4,781	11%
GE	7	GENERAL ELECTRIC CO	Industrials	110,000	27,500		255,337	11%
CSCO		CISCO SYSTEMS INC	Information Technology	48,000	12,000		112,298	11%
AA		ALCOA INC	Materials	5,200	1,300		12,701	10%
BAX		BAXTER INTERNATIONAL INC	Health Care	12,200	3,800	3	37,752	10%

1: Off-balance-sheet liability estimated by applying a rate of 25% (which is the median for the companies that disclose the liability) on the indefinitely reinvested foreign earnings.
2: Market Cap as of 02/28/2014
3: Off-balance-sheet tax liability disclosed by the company
4: Company states a signficant portion of the indefinitely reinvested earnings has already been subjected to Federal taxation, so the off-balance sheet liability might be lower than estimated.
5: Company states currently limited foreign tax credits are available to reduce the U.S. taxes and we assume foreign tax credit of 10% when estimating off-balance-sheet liability, so the liability might be higher than estimated.
6: Company states as of December 31, 2013 income and remittance taxes have not been recorded on $748.2 of undistributed earnings of foreign subsidiaries, as the Company intends to reinvest those earnings indefinitely. If the Company did not intend to reinvest those earnings indefinitely, the Company would have a deferred tax liability of $17.5 (~2% of earnings). This indicates company may have much higher foreign tax credits than 10% which can lead to a lower off-balance-sheet liability than estimated.
7: The lower tax rates on the indefinitely reinvested foreign earnings in 2013 provided a tax benefit of $2.5 billion, which includes the impact of eligible earnings from the sale of a portion of Cembra.
Source: Company filings, Calcbench and ISI Group estimates

Whether or not it's priced in you might want to think twice about giving these companies full credit for the cash they hold offshore in a valuation analysis. Our estimate of the off-balance-sheet tax liability is one way of getting at the haircut that should be applied to their overseas cash if you're expecting the company to use it in the U.S. or for it to land in your hands. Keep in mind that these are back-of-the-envelope estimates (it's the best that we can do with the information provided), the companies may owe more or less taxes to the U.S. upon repatriation and we are not taking into account time value (the longer the company puts off paying taxes the smaller the liability today, i.e., it's a smaller liability if the company has truly reinvested overseas).

Repatriation Holiday Would Shrink Off-Balance-Sheet Tax Liability

The estimates of the off-balance-sheet tax liability above are based on U.S. tax rates today, what if instead there was some type of repatriation holiday that would lighten the tax load of bringing back cash to the U.S. For example, last month the Chairman of the House Ways & Means Committee Dave Camp (R-Mi.) released the *Tax Reform Act of 2014* proposing comprehensive tax reform (see our February 28, 2014 report, *Another Step Toward Tax Reform, Proposal Cuts the Tax Rate to 25% but Eliminates Lots of Goodies*). Among a number of other things, the discussion draft proposes that all unremitted foreign earnings would be taxed at a reduced tax rate (8.75% for the portion that's held in cash or other liquid assets, 3.5% for everything else) whether or not the earnings are repatriated and the tax could be paid over eight years. Companies would be allowed to use foreign tax credits (partially) to reduce the tax bill in the U.S. Keep in mind the Camp proposal might be a best case, the international tax reform proposals issued last November by former Senate Finance Committee Chairman, Max Baucus, proposed that all unremitted earnings be taxed at a 20% rate.

So, how much might those off-balance-sheet liabilities drop if the Camp plan were put in place? In order to figure that out we relied upon the estimates above where we split the earnings parked overseas into its cash and non-cash components. We assume the cash piece is taxed at an 8.75% tax rate and everything else is 3.5% and estimate that the off-balance-sheet tax liability would fall by 85% in the aggregate to $71 billion. We found 62 companies where we estimate the potential savings is more than 5% of market cap including the top ten in *Exhibit 22* where it's more than 10% of market cap. No surprise, all of these companies show up on *Exhibit 21* where we highlighted the companies with the largest off-balance-sheet tax liabilities as a percent of market cap.

Exhibit 22 : Estimated Tax Savings from Camp's Proposal as a % of Market Cap

$ in millions

Ticker	Company	Sector	Overseas Cash[1]	Indefinitely Reinvested Foreign Earnings	Estimated Off-Balance-Sheet Tax Liability related to Foreign Earnings[2]	Estimated Repatriation Tax Expense under Camp's Proposal[3]	Estimated Benefit under Camp's Proposal	Estimated Benefit as a % of Market Cap[4]
BSX	BOSTON SCIENTIFIC CORP	Health Care	$0	$11,902	$2,976	$298	$2,678	15%
HPQ	HEWLETT-PACKARD CO	Information Technology	12,163	38,200	9,550	1,411	8,139	14%
XRX	XEROX CORP	Information Technology	600	8,000	2,000	223	1,778	14%
OI	OWENS-ILLINOIS INC	Materials	356	3,200	800	93	707	13%
FSLR	FIRST SOLAR INC	Information Technology	1,173	2,100	848 [7]	156	692	12%
APA [5]	APACHE CORP	Energy	1,700	17,000	4,250	489	3,761	12%
GT [6]	GOODYEAR TIRE & RUBBER CO	Consumer Discretionary	1,633	3,800	950	156	794	12%
WU	WESTERN UNION CO	Information Technology	1,100	5,000	1,250	166	1,084	12%
JBL	JABIL CIRCUIT INC	Information Technology	743	2,000	500	78	422	11%
MAT	MATTEL INC	Consumer Discretionary	894	5,900	1,475	181	1,294	10%

1: Overseas cash as of the end of the last fiscal year ending before 12/31/2013.
2: Off-balance-sheet liability estimated by applying a rate of 25% (which is the median for the companies that disclose the liability) on the indefinitely reinvested foreign earnings.
3: Estimated repatriation tax expense under Camp's proposal takes into account partial foreign tax credits.
4: Market Cap as of 02/28/2014
5: Off-balance-sheet tax liability disclosed by the company
6: Company states currently limited foreign tax credits are available to reduce the U.S. taxes and we assume foreign tax credit of 10% when estimating off-balance-sheet liability, so the liability might be higher than estimated.
7: Company states a signficant portion of the indefinitely reinvested earnings has already been subjected to Federal taxation, so the off-balance sheet liability might be lower than estimated
Note: Analysis excludes Financials and companies domiciled outside U.S.
Source: Company filings, Compustat and ISI Group estimates

Tax Reform

It seems like the only chance of getting another repatriation holiday is if it's part of a larger tax reform effort. Boy do we need tax reform; the U.S. tax code is a broken complex mess, especially when it comes to how overseas profits are taxed. It incentivizes companies to shift profits to low-tax (or no tax) countries (or no countries) and then keep the earnings parked outside the U.S. until the next repatriation holiday comes around. It has also resulted in a number of companies leaving the U.S. in search of greener tax pastures abroad (e.g., Eaton, Omnicom, Perrigo, Actavis, Endo Health Solutions, etc.).

There are a number of proposals floating around to try and fix the tax code including how foreign profits are taxed, the four most prominent are as follows:

(1) The *Tax Reform Act of 2014*, a nearly 1,000 page comprehensive tax reform proposal released last month by Dave Camp (R-Mi.) the Chairman of the House Ways and Means Committee (see our February 28, 2014 report).

(2) The current Chairman of the Senate Finance Committee, Ron Wyden (D-Ore.) has also proposed comprehensive tax reforms in the past, most

recently with Senator Dan Coats (R-Ind.) in the *Bipartisan Tax Fairness and Simplification Act of 2011*.

(3) President Obama's 2015 Budget Proposal included a number of proposals to reform the U.S. international tax system (some old and some new).

(4) The staff discussion papers released last November by former Chairman of the Senate Finance Committee Max Baucus (see our November 20, 2013 report, *Tax Reform Gets Rolling, Tackling International Business Tax Reform*).

In *Exhibit 23* we summarize the international tax reforms from each of these proposals. Keep in mind that it's unlikely that any of these proposals will turn into legislation this year instead it looks like Congress is getting ready to tackle tax extenders next month (the 60 or so "temporary" tax provisions, like the R&D tax credit, that expired at the end of 2013). For a full list of the tax extenders check out our February 14, 2014 (Valentine's Day) report, *Bonus Depreciation Boomerang, Potential Drag on Cash Flows If Bonus Depreciation is Not Extended*.

Exhibit 23 : Tax Reform Proposals - Taxation of Foreign Profits

	Dave Camp Tax Reform Act of 2014 (February-2014)	Ron Wyden, Dan Coats Bipartisan Tax Fairness and Simplification Act (April-2011)	President Obama 2015 Budget (March-2014)	Max Baucus Staff Discussion Papers - International Tax Reform (November-2013)
Tax Earnings Parked Overseas / Repatriation Holiday	Tax all unremitted foreign earnings at a reduced rate, 8.75% if it's in cash and 3.5% for everything else. Allowed to use foreign tax credits (partially) to reduce U.S. tax bill. Tax could be paid over eight years (back-end loaded).	Repatriation holiday, 5.25% tax rate for overseas earnings repatriated and reinvested in the U.S. only if it supplements otherwise scheduled U.S. investment (e.g., capex, R&D, M&A that creates/saves jobs, worker hiring/training, clean energy).	N/A	Tax all unremitted foreign earnings at a reduced rate of 20%. Allowed to use foreign tax credits (partially) to reduce the U.S. tax bill. Tax could be paid over eight years.
Taxing foreign profits going forward	Territorial system, where 95% of the dividends paid by a foreign subsidiary to its U.S. parent are exempt from U.S. taxes. In other words the foreign profits would be subject to a 1.25% U.S. tax rate (5% x 25%).	Keep worldwide system but eliminate deferral, where all foreign profits are subject to U.S. tax immediately at reduced corporate tax rate of 24%.	Keep worldwide system. Could have minimum tax on foreign profits. President favors long run revenue neutral tax reform that would cut corporate tax rate to 28%.	Tax foreign profits immediately or not at all, two proposals: (1) *Option Y*: Like a territorial tax system with a twist where foreign profits are exempt from U.S. tax unless the foreign country has a low tax rate. Effectively slaps a minimum tax rate on foreign profits equal to 80% of the U.S. corporate tax rate. (2) *Option Z*: 60% of active foreign income is subject to full U.S. taxation, the remaining 40% is U.S. tax-free.
Base Erosion and Profit Shifting	Expand Subpart F, making more of a foreign sub's profits subject to some amount of U.S. tax immediately. Three types of Subpart F income: (1) *Foreign personal holding company income* (e.g., dividends, interest, royalties, rent etc.) subject to a minimum tax rate of 25%. (2) *Foreign base company sales income* (e.g., related party sales) subject to a minimum tax rate of 12.5%. (3) New category of Subpart F - *Foreign base company intangible income* (the amount of foreign sub's taxable income that is greater than 10% of foreign sub's depreciable tangible assets) subject to a minimum tax rate of 15%. Limit interest expense deductions to the extent U.S. parent has excess domestic debt and net interest expense is greater than 40% of taxable income. Also harder to strip profits from the U.S. through intercompany interest expense for a foreign parent.	Discourage base erosion and profit shifting by reducing the corporate tax rate and eliminating deferral. Reinstitute per country foreign tax credit limit.	Expand Subpart F, making more of a foreign sub's profits subject to full U.S. tax immediately, including a new category - *foreign base company digital income* to include income from certain transactions involving digital goods and services. Defer interest expense deductions related to earnings parked overseas. Limit "excessive" interest expense deductions. Tax "excess" returns of intangible asset transferred offshore. Require pooling of foreign tax credits. Limit shifting of income through intellectual property transfers. Restrict the use of hybrids (e.g., entities, financial instruments that are treated differently under different tax jurisdictions) that create tax deductions in the U.S. and "stateless" income.	Expand Subpart F and make more of a foreign sub's profits subject to full U.S. tax immediately including passive income and income from selling products and providing services to U.S. customers (i.e., U.S. related income). Limit interest expense deductions to the extent the earnings of the foreign subs are exempt from U.S. tax and to the extent the U.S. companies are over-levered. Limit income shifting through transfers of intellectual property. Deny deductions for related party payments that erode the tax base. Get rid of check the box.
Inversion	Discourage inversion by lowering the corporate tax rate and limiting the ability of companies to shift profits around the world.	Discourage inversion by lowering the corporate tax rate.	Limit the ability of U.S. companies to leave the U.S. Replace the 80% and 60% tests in the current rules with a greater than 50% test. In other words if the former shareholders of the U.S. company retain a greater than 50% stake in the foreign acquiring company it would be treated as a U.S. company for tax purposes. In addition regardless of the stake held by the former U.S. shareholders, if the company has substantial business activities in the U.S. and is primarily managed and controlled from the U.S. the company would be treated as a U.S. company for tax purposes.	Discourage inversion by lowering the corporate tax rate and limiting the ability of companies to shift profits around the world.

Inversions Are All the Rage, For Now

Back in the late 90's and early 2000's a number of U.S. companies (e.g., Tyco, Transocean, Noble, Cooper Industries, Weatherford, Nabors Industries, Seagate Technology, Ingersoll Rand, Foster Wheeler, Accenture, PWC Consulting even Fruit of the Loom, etc.) packed their bags and redomiciled to Bermuda and the Cayman Islands, for a little tax fun in the sun. In response the U.S. tightened the rules around inversions with section 7874 of the American Jobs Creation Act of 2004.

Inversion/redomicile activity slowed down initially after the enactment of Section 7874. Then we starting seeing some inversions take place around 2009/2010, including Ensco leaving for the U.K., Tim Hortons moving back to Canada (yes Tim Hortons was a U.S. company) and Valeant going to Canada too. Around the same time a number of the former U.S. companies domiciled in the Caribbean departed for Ireland (e.g., Cooper Industries, Accenture, etc.) and Switzerland (e.g., Transocean, Weatherford, etc.) in search of tax treaty protection from the still threatened but not yet passed *Stop Tax Haven Abuse Act*.

In the past few years inversion/redomicile activity has really picked up pace. Nowadays it seems like companies can't wait to get the heck out of Dodge and redomicile outside the U.S. We included a few of the more significant inversions that have taken place (been announced) over the past few years, see *Exhibit 24*.

Exhibit 24: A Few Inversions

U.S. Company	Foreign Company	Foreign Company's Domicile	Domicile After Inversion	Effective Date	Percentage of the Combined Entity Owned by the Former Shareholders of the U.S. Company
Omnicom Group	Publicis Groupe	France	Netherlands	Expected in 3Q 2014	~50%
Applied Materials Inc.	Tokyo Electron Limited	Japan	Netherlands	Expected in 2Q 2014	68%
Endo Health Solutions	Paladin Labs	Canada	Ireland	February 28, 2014	77%
Perrigo Company	Elan Corporation	Ireland	Ireland	December 18, 2013	71%
Actavis Inc.	Warner Chilcott Plc	Ireland	Ireland	October 1, 2013	77%
Liberty Global	Virgin Media	U.K.	U.K.	June 7, 2013	64%
Eaton Company	Cooper Industries Plc	Ireland	Ireland	November 30, 2012	73%
Jazz Pharmaceuticals, Inc.	Azur Pharma Limited	Ireland	Ireland	January 18, 2012	< 80%
Alkermes, Inc.	Elan Drug Technologies	Ireland	Ireland	September 16, 2011	75%
Pride International	Ensco Plc	U.K.	U.K.	May 31, 2011	38%
Valeant Pharmaceuticals	Biovail	Canada	Canada	September 28, 2010	50%
Rowan Companies			U.K.	May 4, 2012	N/A
Aon Corporation			U.K.	April 2, 2012	N/A

Source: Company filings, press releases and presentations

With among the highest statutory corporate tax rates in the world it's no surprise that taxes are a major motivator behind U.S. companies looking to redomicile elsewhere. Leave the U.S. for the more tax friendly confines of Ireland, Switzerland, Netherlands, even the UK and a company can reduce its tax rate, driving up earnings and cash flows. The tax savings are typically a result of two things: (1) removing the foreign operations from U.S. taxation and (2) reducing the tax burden on the U.S. operations by stripping the profits out of the U.S. through tax deductible interest, royalties, rents, management fees, etc. paid to the new lower tax foreign parent or other foreign affiliates. Keep in mind that if tax reform makes it harder to shift profits around the world, it could result in higher tax rates even for those companies that have already departed the U.S.

Leaving on a Jet Plane

So how do companies leave the U.S., do they just pack some bags and jump on the next Aer Lingus flight to Ireland? It's a bit more complex than that. The companies are reincorporating in a foreign country replacing the U.S. parent with a new foreign parent. An inversion takes place when pursuant to a plan or a series of related transactions (yes an inversion can happen in multiple steps over time) a foreign company acquires substantially all of the assets held by a U.S. company. In most cases (stock inversions) a new foreign company is set up and the U.S. company shareholders exchange their shares for new foreign company shares with the U.S. company becoming a subsidiary of the foreign company.

Substantial Business Activities is a Tough Test to Meet

In order for a U.S. company to pull this off on its own (i.e., without a merger partner) it must have "substantial business activities" in whatever country it is moving to for the U.S. to respect that it's now a foreign corporation from a tax perspective (if not it will continue to be taxed like a U.S. company). The definition of substantial business activities was tightened significantly back in 2012 and is now a bright line test with three specific criteria all of which must be met: (1) at least 25% of the employees (headcount and compensation) must be in the foreign country during the testing period (one year period before the inversion) (2) at least 25% of the total assets (tangible and real property) must be in the foreign country and (3) at least 25% of the total sales must be made to customers in that country (during the testing period). Clearly this is a tough test to meet, as a result there are not many transactions that we are aware of that have met the new criteria, Alexion appears to be one example.

Most Companies Invert Through M&A, Key Is to Get the Ownership Right

The much more popular route for a company to depart the U.S. is through M&A, but they have to find the right foreign merger partner to combine with. The focus of Section 7874 is on the former shareholders of the U.S. company and how big of a stake they have in the new foreign company (by vote or value). The key to finding the "right" merger partner is to make sure that after combining the two companies the former shareholders of the U.S. company have a less than 80% stake in the new foreign company, see below:

- ______ *Has Left the United States* – If the former shareholders of the U.S. company own *less than 60%* of the new foreign company, then all's clear, you have escaped the U.S. tax system.
- *Surrogate Foreign Corporation* - If the former shareholders of the U.S. company own between 60% - 80% of the new foreign company, it's treated as a foreign company for tax purposes. But the company can't use NOL's or foreign tax credits to offset any inversion gains for 10 years. On top of that, Section 4985 slaps an excise tax (cap gains rate) on the value of insider's stock-based compensation.
- *Back in the U.S.A* - If the former shareholders of the U.S. company own 80% or more of the new foreign company then the company will be treated as a U.S. company for tax purposes regardless of where it calls home.

Cracking Down on Inversions?

As more and more companies pack up and leave the U.S. it shouldn't come as a surprise that the Obama administration 2015 Budget proposed making it much more difficult to do an inversion transaction. The 60% and 80% tests mentioned above would be replaced by a 50% ownership test. In other words for a U.S. company to redomicile and be taxed like a foreign company, its owners would have to give up control (i.e., own less than 50% of the new foreign company). We get one or two big brand name U.S. companies leaving the U.S. and this type of proposal could gain some real traction in Washington.

Here's the thinking behind the proposal "there is no policy reason to permit a domestic entity to engage in an inversion transaction when its owners retain a controlling interest in the resulting entity, only minimal operational changes are expected, and there is significant potential for substantial erosion of the U.S. tax base." Funny but that's not much different than the reasons laid out by Congress for enacting Section 7874 ten years ago "inversion transactions resulting in a minimal presence in a foreign country…were a means of avoiding U.S. tax and should be curtailed" and that "certain inversion transactions have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes."

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