SHOULD APPLE REPATRIATE ITS INTERNATIONAL EARNINGS?

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CASE DESCRIPTION

The primary subject matter of this case involves international taxation of U.S. multinational corporations. Secondary issues include tax policy, corporate responsibility, macroeconomics, and public policy. The case has a difficulty level of two or higher. Business students at the sophomore, junior, or senior level can successfully complete this case. The case is appropriate for undergraduate courses in macroeconomics, microeconomics, international economics, tax, corporate tax, or corporate finance. The case is designed to be taught in 1-2 class hours and is expected to require up to 2 hours of outside preparation by students.

CASE SYNOPSIS

The case focuses on the strategic decision made by Apple and many other U.S.-based multinational firms to hold large cash balances offshore. In April 2017, Apple held approximately $230 billion cash offshore (90% of its $256 billion cash balance). Many other large, U.S.-based multinational firms also held tens of billions of dollars offshore, with some estimates putting the total cash held internationally by U.S. firms at approximately $2.5 trillion. The case explores the potential reasons for this strategic decision, focusing on the worldwide tax system used by the U.S., wherein corporations are taxed on income wherever it occurs in the world. This tax, however, is not triggered until U.S. firms bring foreign earnings back home, thus creating a perverse incentive not to repatriate foreign earnings.

The case presents the idea that Apple (and other firms pursuing similar strategies) are "unpatriotic" for taking advantage of the legal tax strategy of avoiding U.S. income taxes on foreign earnings by leaving those earnings overseas. The case also presents the idea that Apple is making prudent business decisions, consistent with its fiduciary responsibility to its shareholders, by delaying repatriation until tax rates are more favorable. Students are left to assess the arguments and form a conclusion.

INTRODUCTION

In April 2017, Apple, Inc. reported an astonishing $256 billion in cash on its balance sheet. More than 90% of that cash was held outside the United States, outside the reach of the

U.S. tax system ("Apple's Case for Tax Reform," 2017). To show the enormity of the Apple cash holdings, one writer calculated what Apple could purchase with its stash:

> *With the $250 billion sitting in its bank account, Apple could comfortably go out and buy Chevron, the second-largest U.S. oil company, at today's market price without borrowing a penny. The technology giant would still have $50 billion left to buy more than 700,000 Tesla model S electric cars or about four Gerald R. Ford class aircraft carriers (Heath, 2017).*

Apple sells iPhones, iPads, Macs, wearables and software services like the Apple app store, iTunes, and Apple Music. About 65% of its 2017 revenue were earned outside the United States (Apple, 2017a). Table 1 shows selected financial information about Apple for fiscal years 2016 and 2017. The total cash and marketable securities decreased from $268.9 billion to $237.6 billion for 2017.

Table 1
APPLE SELECTED FINANCIAL INFORMATION
In Millions
(Apple, 2017c)

	September 2016	September 2017
Net sales	$ 215,639	$ 229,234
Cost of sales	131,376	141,048
Gross margin	84,263	88,186
Net operating expenses	22,891	26,842
Earnings before income tax	61,372	64,089
Income tax expense	15,685	15,738
Net Income	$ 45,687	$ 48,351
Total cash and marketable securities	$ 268,895	$ 237,585

Table 2 shows the cash and marketable securities as of April 2017. This was Apple's second quarter in 2017. This is where the Apple reported the $256.8 billion in cash and marketable securities.

Table 2
CASH AND MARKETABLE SECURITIES APRIL 2017
In Millions
(Apple, 2017b)

Cash and cash equivalents	$ 15,157
Short-term marketable securities	$ 51,944
Long-term marketable securities	$ 189,740
Total cash and marketable securities	$ 256,841

Apple pays income tax in countries where it earns revenue. So, if Apple has sales in Germany, it pays income tax to Germany based on those sales. Since Apple is headquartered in the United States, transferring cash from foreign accounts to domestic accounts triggers a taxable event under U.S. tax law. This process of bringing foreign earnings into the United States is

called “repatriation.” For Apple, repatriating any foreign earnings would cause an additional U.S. tax of about 40% ("Apple's Case for Tax Reform," 2017).

This tax on repatriated earnings is the primary reason Apple holds large cash balances outside the U.S. While Apple has had the largest foreign holdings of cash in recent years, many other U.S.-based, multinational firms have substantial holdings as well. See Table 3 for the companies with the largest foreign cash. Some estimates put the total cash held by U.S. corporations overseas at $2.5 trillion (Apple's Case for Tax Reform, 2017).

Apple’s tax strategy has been criticized as “not paying its fair share” in articles such as, “How Apple Sidesteps Billions in Taxes,” from the *New York Times.* The article illustrates Apple’s strategy of locating subsidiaries in lower tax states such as Nevada, instead of its home state of California, for the purpose of lowering its corporate taxes. To extend this internationally, Apple uses lower tax rates in Ireland, Luxembourg, the Netherlands, and Singapore to shift income away from the United States and its higher taxes. Apple famously started two subsidiaries and a factory in Ireland in the 1980’s because of the tax benefits offered in that country (Duhigg & Kocieniewski, 2012).

Table 3
FOREIGN CASH HOLDINGS OF U.S. COMPANIES, APRIL 2017
(Linnane, 2017)

COMPANY	TOTAL CASH
Apple	$256 B
Microsoft	$113 B
Cisco	$ 62 B
Oracle	$ 50 B
Alphabet (Google)	$ 50 B

The article is careful to say that all the Apple tax strategies are legal, but within the article it contrasts the wealth of Apple and the financial troubles of a local community college:

> *A mile and a half from Apple’s Cupertino headquarters is De Anza College, a community college that Steve Wozniak, one of Apple’s founders, attended from 1969 to 1974. Because of California’s state budget crisis, De Anza has cut more than a thousand courses and 8 percent of its faculty since 2008.*
>
> *Now, De Anza faces a budget gap so large that it is confronting a “death spiral,” the school’s president, Brian Murphy, wrote to the faculty in January. Apple, of course, is not responsible for the state’s financial shortfall, which has numerous causes. But the company’s tax policies are seen by officials like Mr. Murphy as symptomatic of why the crisis exists.*
>
> *“I just don’t understand it,” he said in an interview. “I’ll bet every person at Apple has a connection to De Anza. Their kids swim in our pool. Their cousins take classes here. They drive past it every day, for Pete’s sake.*

> *"But then they do everything they can to pay as few taxes as possible." (Duhigg & Kocieniewski, 2012)*

The article mentions some positives about Apple, such as the fact that the firm has over 47,000 full-time employees in all 50 states. It also describes the charitable contributions that Apple has made, including $50 million gifts to both Stanford University and an African aid charity. However, the end of the article returns the focus to the ailing college:

> *Still, some, including De Anza College's president, Mr. Murphy, say the philanthropy and job creation do not offset Apple's and other companies' decisions to circumvent taxes. Within 20 minutes of the financially ailing school are the global headquarters of Google, Facebook, Intel, Hewlett-Packard and Cisco.*
>
> *"When it comes time for all these companies — Google and Apple and Facebook and the rest — to pay their fair share, there's a knee-jerk resistance," Mr. Murphy said. "They're philosophically antitax, and it's decimating the state."*
>
> *"But I'm not complaining," he added. "We can't afford to upset these guys. We need every dollar we can get." (Duhigg & Kocieniewski, 2012).*

To some, the tax strategy of Apple and other large, multinational firms is consistent with the firms' fiduciary responsibilities to their shareholders. People with this view argue that repatriating income is entirely optional, and if there is no compelling economic reason for the firms to do so then they are making good business decisions by legally minimizing their U.S. tax liability.

To others, this strategy is a huge symptom of corporate greed. They argue, or imply, that the refusal to repatriate foreign earnings is unpatriotic and that firms are using tax loopholes to avoid paying their "fair share" of U.S. taxes. This argument implies a moral obligation on the part of these firms to pay more than they are legally required to pay.

INTERNATIONAL TAXATION BASICS

Countries generally use one of two international tax systems: the territorial system or the worldwide system. The territorial system generally only taxes domestic income. This system allows income from foreign subsidiaries to be wholly or partially tax exempt from home country tax. Under the territorial system, corporate taxes are paid by foreign subsidiaries in the foreign country where the income is earned, and companies can repatriate foreign earnings with little or no additional taxation. Thus, there is not a tax incentive to keep the earnings in a foreign country because the cash can be repatriated with little or no tax effect.

The second system, the worldwide system, taxes domestic companies on their worldwide profits, regardless of where the profit is earned. There are some credits applied for foreign taxes paid, but the earnings in a foreign country are deemed to be "home country" income for income

tax purposes. So, a U.S. company must pay U.S. taxes on its worldwide income. So, income in Germany would be subject to German income tax first and then on U.S. income tax if the earnings are repatriated to the United States.

The effect of this worldwide taxation is a great incentive for U.S. companies to hold foreign earnings outside the U.S. If the earnings are held in a foreign country, no U.S. taxes are due. When the earnings are repatriated to the United States, U.S. federal and state income taxes are triggered, with a maximum rate of about 40% (PwC, 2013).

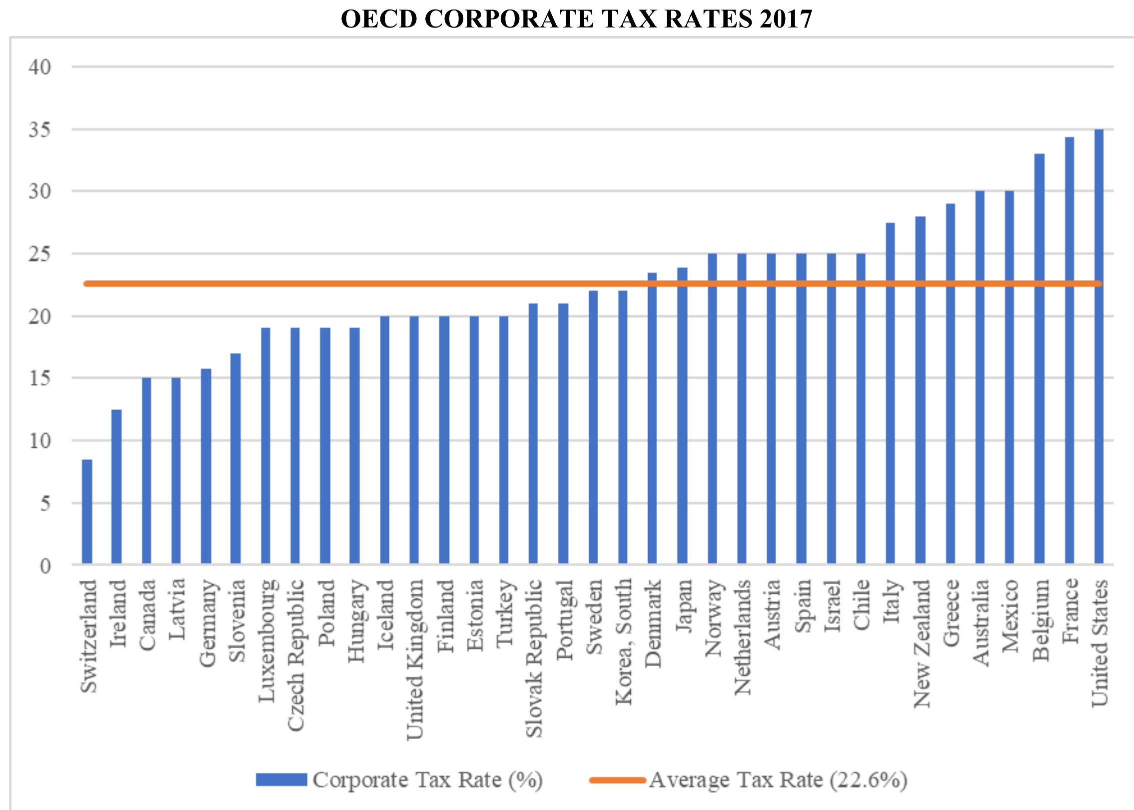
The Congressional Research Service summarized some key features of the U.S. tax system in this way:

> *The United States bases its jurisdiction to tax international income on residence. As a result, U.S.- chartered corporations are taxed on their worldwide income, but foreign corporations are taxed only on their U.S.-source income. Accordingly, a U.S. firm with overseas operations can indefinitely postpone its U.S. tax on its foreign income by operating through a foreign subsidiary. Using the same principle, U.S. taxes are deferred as long as its foreign earnings remain in the control of its foreign subsidiary and are reinvested abroad. The U.S. firm pays taxes on its overseas earnings only when they are paid to the U.S. parent corporation as intra-firm dividends or other income. (Marples & Gravelle, 2011, pp. 1-2)*

This incentive to hold cash outside countries that tax worldwide income is called the “lockout” effect. There is no such incentive for companies in countries with territorial tax systems. In April 2017, the United States had the highest corporate tax in the Organization for Economic Cooperation and Development (OECD) countries. The OECD is composed of developed countries committed to democracy and market economies. Because of the high tax rate in the U.S., more foreign earnings of U.S. companies are trapped overseas because of the lockout effect (PwC, 2013).

Figure 1

OECD CORPORATE TAX RATES 2017



In April 2017, 28 of the 35 OECD countries used the territorial tax system, so there is no lockout effect for these countries and there is no tax incentive to hold cash and investments outside the home country. Only seven of the OECD countries taxed worldwide income: the United States, Chile, Ireland, Israel, South Korea, Mexico, and Latvia. The United States had the highest corporate tax rate in the OECD at 35% in April 2017.

Mexico had a top tax rate of 30% in April 2017. The other worldwide taxation countries had top rates of 25% or lower. Ireland, the home of the Apple subsidiaries, had a top bracket of 12.5%. Figure 1 shows the 2017 corporate tax rates for all the OECD countries (Miller & Kim, 2017).

In an interview with Apple CEO Tim Cook, the Washington Post asked about the criticism of Apple's tax strategy:

> *What do you say in response to Nobel economist Joseph Stiglitz's comments on Bloomberg (television), where he called Apple's profit reporting in Ireland a "fraud"?*
>
> *I didn't hear it. But if anybody said that, they don't know what they're talking about. Let me explain what goes on with our international taxes. The money that's*

in Ireland that he's probably referring to is money that is subject to U.S. taxes. The tax law right now says we can keep that in Ireland or we can bring it back. And when we bring it back, we will pay 35 percent federal tax and then a weighted average across the states that we're in, which is about 5 percent, so think of it as 40 percent. We've said at 40 percent, we're not going to bring it back until there's a fair rate. There's no debate about it. Is that legal to do or not legal to do? It is legal to do. It is the current tax law. It's not a matter of being patriotic or not patriotic. It doesn't go that the more you pay, the more patriotic you are.

And so what we've said — we think it's fine for us to pay more, because right now we're paying nothing on that and we leave it over there. But we — like many, many other companies do — wait for the money to come back.

In the meantime, it's important to look at what we do pay. Our marginal rate, our effective rate in the U.S. is over 30 percent. We are the largest taxpayer in the United States. And so we're not a tax dodger. We pay our share and then some. We don't have these big loopholes that other people talk about. The only kind of major tax credit that we get is the R&D tax credit, which is available to all companies in the United States. That's important to know. The second thing I would point out is we have money internationally because we have two-thirds of our business there. So we earn money internationally. We didn't look for a tax haven or something to put it somewhere. We sell a lot of product everywhere. And we want to bring it back, and we've been very honest and straightforward about that. (McGregor, 2016).

TAX HOLIDAYS

It is important to note that when Tim Cook said, "we're not going to bring it back until there is a fair rate," that was not a statement based on a fantasy about future lower tax rates. The U.S. has periodically enacted special "tax holidays" on repatriated earnings, under the theory that temporarily lowering the rate will bring foreign-held cash flooding back into the U.S. and create a stimulatory effect on the economy. The most recent one-year tax holiday was part of the American Jobs Creation Act of 2004, when the top rate on repatriated earnings was slashed to 5.25% (Marples & Gravelle, 2011). Table 4 shows the stunning growth of the Apple cash and marketable securities.

The actual economic impact of these temporary tax cuts is hotly debated, with some arguing that they do provide meaningful stimulus for the economy, while others argue that the stimulatory effect is not large enough to offset the lost tax revenue. What is not in debate, however, is that the mere possibility of a future tax holiday provides a dramatic incentive for firms to delay repatriation.

Table 4
APPLE INC. CASH AND MARKETABLE SECURITIES

YEAR	TOTAL CASH (IN MILLIONS)
2006	$ 10,110
2007	$ 15,386
2008	$ 24,490
2009	$ 33,992
2010	$ 51,011
2011	$ 81,570
2012	$121,251
2013	$146,761
2014	$155,239
2015	$205,666
2016	$268,895
2017	$237,585

TAX POLICY

A country's tax policy can affect its economy both positively and negatively. A well-designed tax code can make it easy for companies (and individuals) to comply, while raising sufficient tax revenue for the country. The tax system of a country also affects foreign investment and economic growth. People, companies, and their capital are mobile in the long term. When investors seek investment opportunities, they seek higher returns at reasonable risk levels. A complicated tax system with high rates can increase costs and therefore reduce returns and slow economic activity.

In the global marketplace, countries compete for corporate investment and the jobs created by that investment. This competition is on a wide variety of dimensions, including quality and cost of labor, governmental and economic stability, and the regulatory and tax environment, among many others. Countries with the right combination of competitive factors will attract more international capital, thus producing more economic growth in the country and therefore increasing tax revenues, all else equal.

The Tax Foundation publishes a study on international tax competitiveness. In that study, the U.S. is ranked 31 of 35 OECD countries in tax competitiveness (Pomerleau, 2017).

> *A competitive tax code is one that keeps marginal tax rates low. In today's globalized world, capital is highly mobile. Businesses can choose to invest in any number of countries throughout the world in order to find the highest rate of return. This means that businesses will look for countries with lower tax rates on investment in order to maximize their after-tax rate of return. If a country's tax rate is too high, it will drive investment elsewhere, leading to slower economic growth. In addition, high marginal tax rates can drive tax avoidance. (Pomerleau, 2017).*

SHOULD APPLE REPATRIATE ITS INTERNATIONAL EARNINGS?

Apple repatriating its overseas earnings is an economically complex and potentially emotional issue. By repatriating the cash held abroad, Apple would trigger additional taxes that would otherwise be avoidable, resulting in a tax bill of approximately $92 billion ($256 billion in cash times 90% held offshore times 40% tax rate on repatriated earnings). This would allow Apple to invest or spend the remaining $164 billion domestically, while potentially currying favor with politicians and with consumers who believe it is unethical to keep that cash overseas.

On the other hand, it could be very hard for Apple to justify paying an “optional” tax of $92 billion to its shareholders, particularly considering that Apple already paid more U.S. taxes than any other corporation. Furthermore, by delaying repatriation, there is a reasonable probability that Apple could bring that cash back to the U.S. at some future date at a substantially lower tax rate.

This is a real concern for Apple in 2017. The tax rules provide incentives for keeping cash overseas. There is political pressure to repatriate to pay taxes now. Other technology firms that hold cash overseas may continue that policy. Apple would have a competitive disadvantage if it paid taxes now. Is waiting for a potential tax rate cut a good strategy?

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