ECONOMIC ANALYSIS

Cisco CEO Seeks Relief for Profits Shifted Overseas

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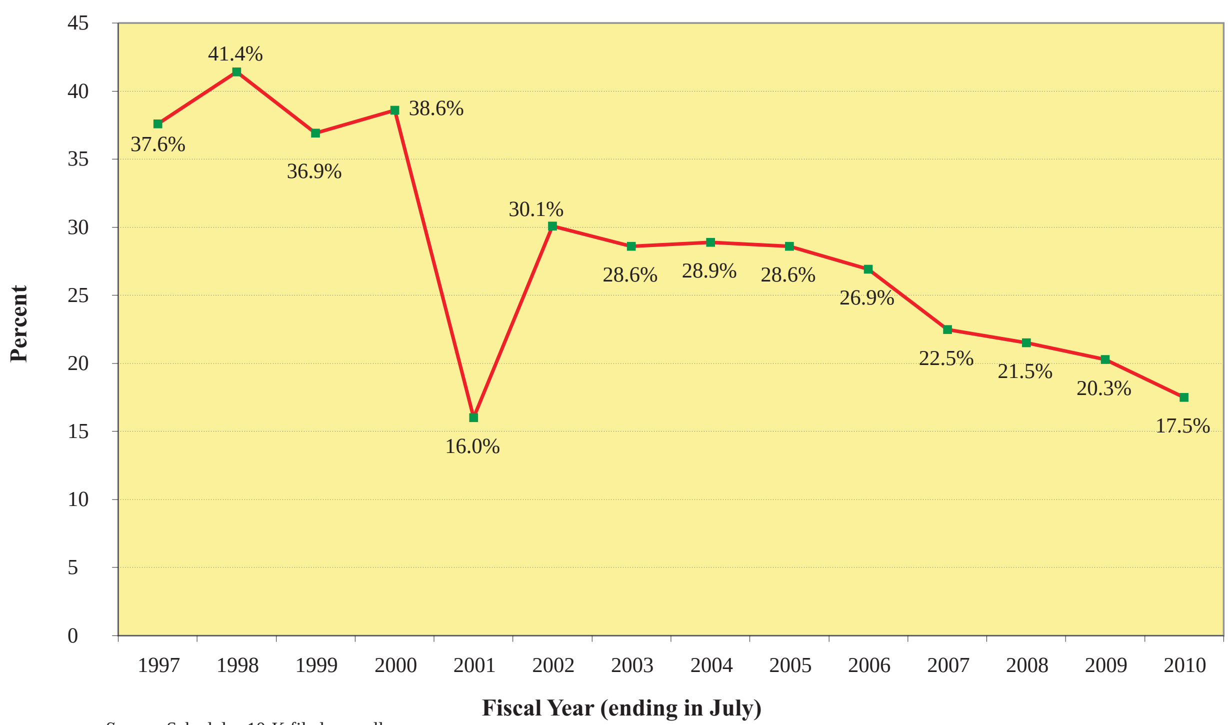
Lately Cisco Systems CEO John Chambers has not been keeping his stockholders happy. On August 11 Chambers cited "unusual uncertainty" as the reason for disappointing sales forecasts. Cisco makes the routers and switches that are the backbone of the Internet, and investors hoped the expected boom in Internet traffic because of cloud computing and video would boost sales. Cisco's share price dropped 8 percent after Chambers's comments ("Cisco CEO Chambers Stokes Fears of 'Downturn 2.0,'" Reuters, Aug. 12, 2010).

To make amends, Chambers offered a major concession to investors. He announced on September 14 that Cisco would tap into its enormous cash reserves and for the first time in its history would make dividend payments sometime before mid-2011. Because three-quarters of Cisco's $40 billion of cash was offshore, Chambers said the size of the dividend payments would depend on whether Congress would grant tax relief for repatriated profits. Unlike Microsoft, Cisco would not borrow to make dividend payments. Chambers said he would increase Cisco employment (currently about 70,000) by 10 percent if dividend relief became law ("Cisco Press Conference With CEO Chambers," *Tech Trader Daily*, Sept. 14, 2010). At least one prominent Wall Street tax expert suspected that Chambers's making the size of dividend payments conditional on congressional action was a political ploy ("Tech Firms Hoard Instead of Paying Dividends," *San Francisco Chronicle*, Sept. 16, 2010).

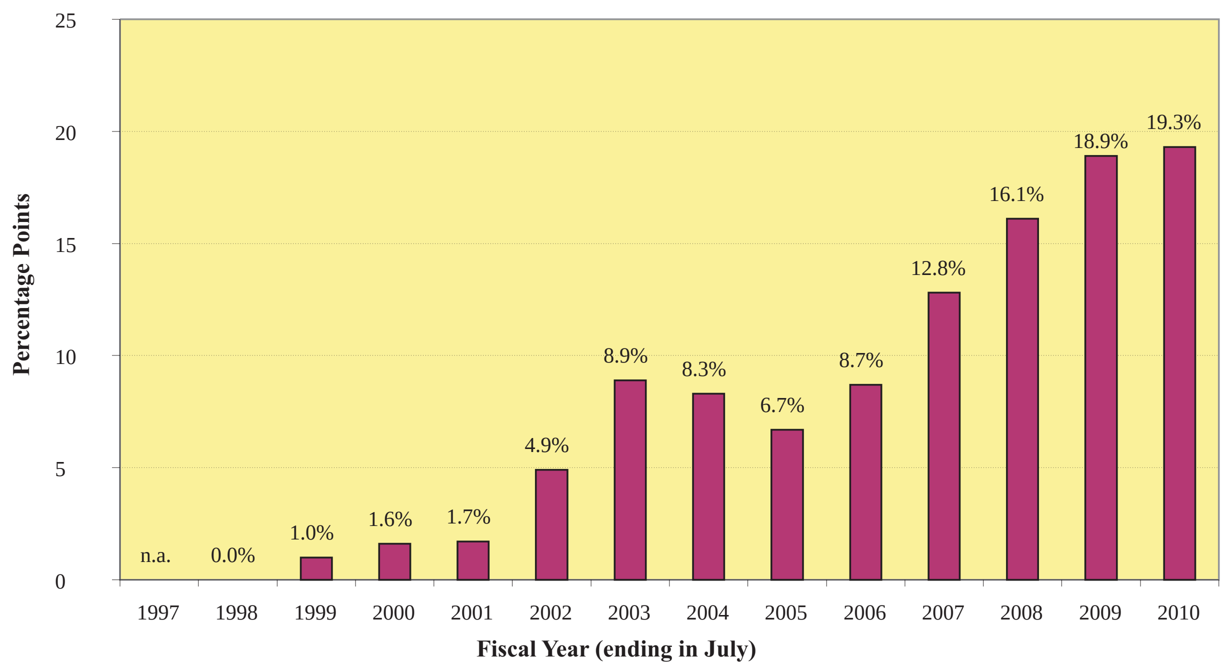
On November 10 Chambers ran into more trouble during his quarterly conference call with Wall Street analysts. Again, sales forecasts were surprisingly low. Cash-strapped, tech-savvy consumers were dropping their cable subscriptions,

Figure 1. Cisco Systems' Effective Tax Rate



Source: Schedules 10-K filed annually.

Figure 2. Cisco Systems' Reduction in Overall Effective Tax Rate Due to Low Taxation of Foreign Profits



Source: Schedules 10-K filed annually.

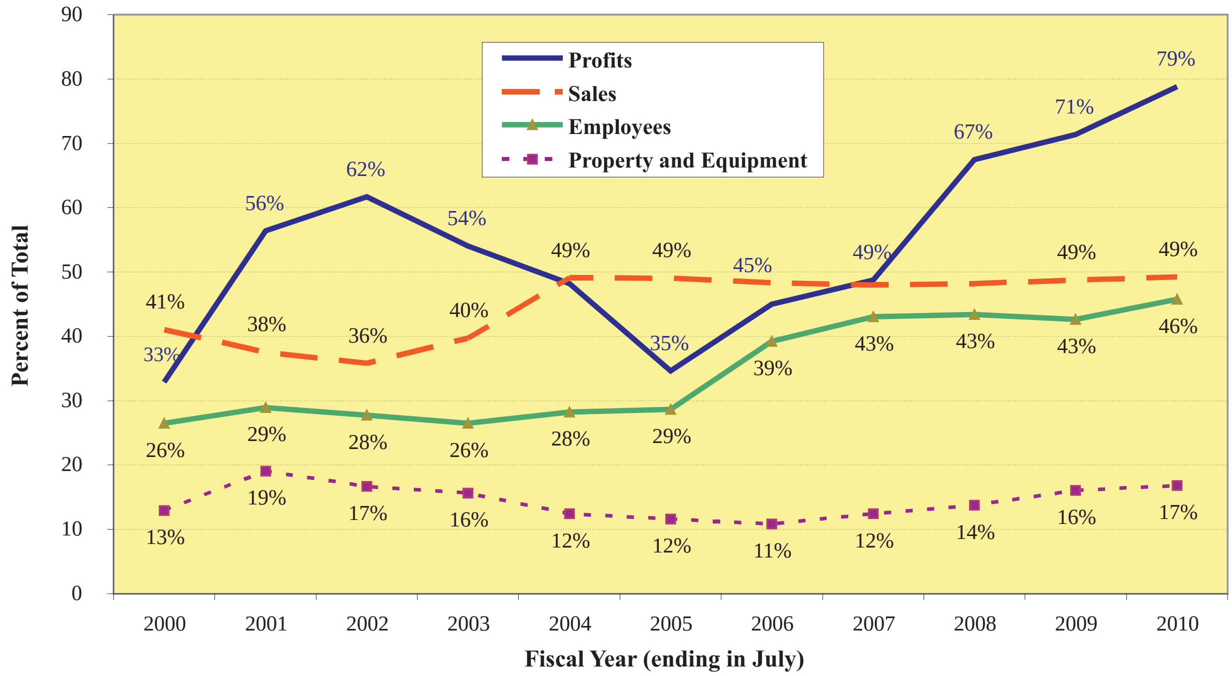
and so cable companies slowed their purchases of Cisco-manufactured set-top boxes. Even more damaging was the fall in public-sector sales. Pick up any newspaper and you can see that governments in Europe and state governments in America are cutting spending. That includes routers and switches, and that's a major blow to Cisco — which depends on governments for more than one-fifth of its business. Cisco's share price dropped 13 percent ("Cisco CEO Drops a Bomb With Sales Guidance," *The Wall Street Journal*, Nov. 10, 2010). The following week at the company's annual shareholder meeting, Chambers apologized for the "surprise" weak forecast ("Cisco CEO Contrite on Outlook," *Silicon Valley/San Jose Business Journal*, Nov. 18, 2010).

During the November 10 conference call, analysts understandably wanted to stay focused on the downward-revised projections. But Chambers found an opportunity to change the subject and do a bit of lobbying. As he wrote in a recent op-ed with Oracle President Safra Catz, Chambers wants a repeat of the "one-time" repatriation holiday enacted by Congress in 2004 ("The Overseas Profit Elephant in the Room," *The Wall Street Journal*, Oct. 20, 2010). Paying just 5.25 percent U.S. tax (instead of the normal 35 percent, less any foreign tax credits), Cisco repatriated $1.2 billion under the provisions of the 2004 legislation.

But now there is much more at stake for Cisco. During the conference call, in response to a question about plans to continue acquiring more companies, Chambers explained:

> The majority of our cash, as all of you are aware, is overseas. I'm still optimistic that I think our country should recognize the leverage that $1.2 trillion [the estimated accumulated unrepatriated foreign earnings of all U.S. multinationals] represents that will be invested outside the U.S. if we don't create a favorable environment to bring it back. And I don't mean to imply that the whole group will come back, but Cisco will be bringing almost all ours that's overseas, which is well in excess of $30 billion. And I think the odds are reasonably good . . . well, better than 50-50 that our government will come to the same conclusion on that, and it is one of the few levers that they can really hit that does not cost the taxpayer anything — in fact, the taxpayer makes money on it. And that could create not just jobs, but investment in assets here, investment in manufacturing capability, investment in, candidly, doing acquisitions or paying dividends.

Figure 3. Foreign Shares of Cisco Systems' Business Activity (Three-year moving average)



Source: Schedules 10-K filed annually. Moving averages used to smooth choppiness, especially in the profits data. Each data point is the ratio of three years' foreign activity over three years' total activity. The three years are the year indicated and the prior two, all taken from the annual report of the year indicated.

Tax as a Profit Center

Ironically, Cisco's limited ability to make shareholders happy with dividends may stem from its efforts to make shareholders happy with higher earnings per share. It has become routine for America's largest corporations to improve their bottom line by cutting their effective tax rates. A reduction in the effective tax rate from 35 percent to 25 percent, for example, increases reported profits by 15 percent. Figure 1 shows that Cisco has cut its effective tax rate in half since the late 1990s. In fiscal 2010 (ending in July), it reached a new low of 17.5 percent.

By far the most important driver of this reduction in the tax rate is the increasing share of Cisco profits in foreign jurisdictions with low tax rates. In the 1990s, low rates on foreign profits had little impact on Cisco's effective tax rate. By 2010 they accounted for an almost 20 percentage point decline in the effective tax rate. This is shown in Figure 2.

Some of that is attributable to more business activity outside the United States by Cisco. But as shown in Figure 3, the share of foreign profits is out of proportion with metrics of foreign business. Over the last decade, the foreign percentage of Cisco's worldwide sales has increased from the high 30s to the high 40s. The foreign percentage of Cisco's worldwide employment has increased from the high 20s to the low 40s. The foreign percentage of Cisco's worldwide property and equipment has hardly changed, remaining below 20 percent. The share of foreign profits is generally higher than those indicators and has been steadily growing.

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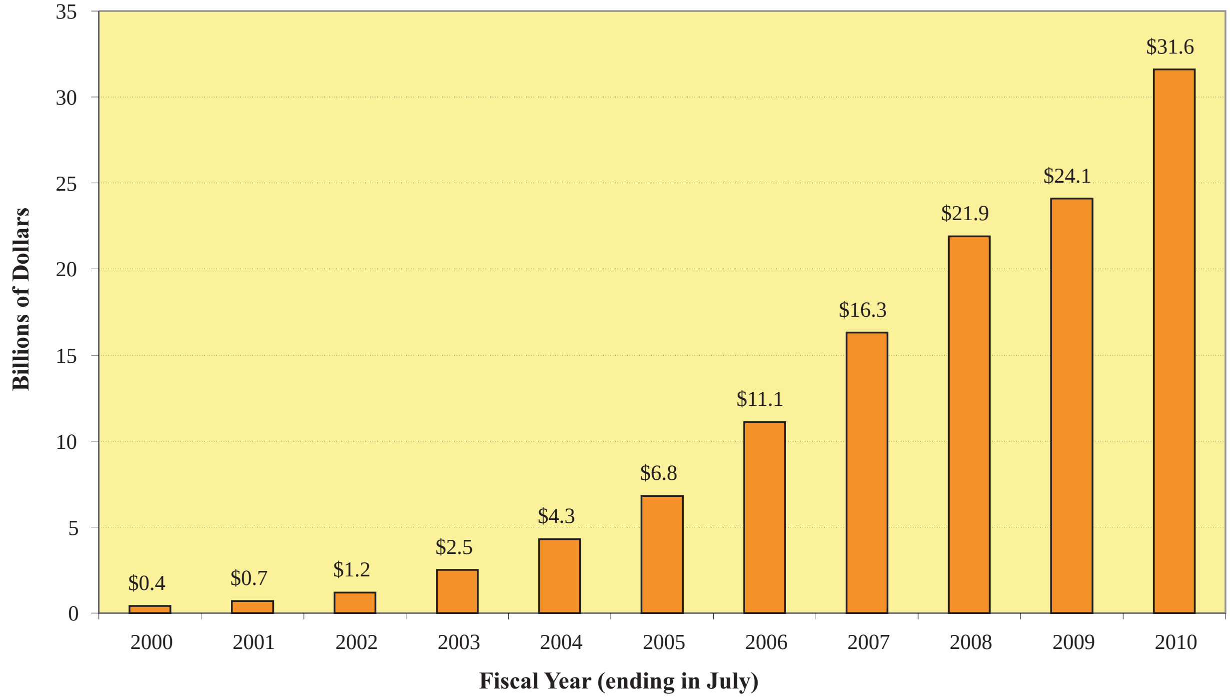
All other things equal, we would expect profits generally to track these indicators of real activity. Most of Cisco's value is based on its technology, and despite new development centers in China and India, it still conducts the bulk of its research in the United States. Therefore we would expect foreign profit shares to be less, not more, than the share of these measurable business activities.

In 2010 foreign profits were 38 percent of foreign sales, while U.S. profits were only 10 percent of U.S. sales. The disparity in per-employee profitability is even greater. In 2010 profits per foreign employee were $757,000, while profits per U.S. employee were only $151,000.

Figure 4. Cisco Systems' Accumulated Unrepatriated Foreign Earnings



Source: Schedules 10-K filed annually.

These data showing disproportionate profitability outside the United States — combined with the large reduction in effective tax rates due to foreign activity — strongly suggest that Cisco has aggressively shifted profits to low-tax jurisdictions. U.S. tax rules on deferral may have trapped Cisco's cash overseas. But it is Cisco's opportune use of lax U.S. transfer pricing rules that puts it there.

Figures 1 through 3 indicate an acceleration of this profit shifting over the last five years. Figure 4 shows an extraordinary buildup of "permanently" invested foreign profits over that period. From 2005 to 2010 the total tripled — from $10.1 billion to $31.6 billion. Is it possible that after passage of the American Jobs Creation Act of 2004, Cisco became more aggressive in its transfer pricing practices because it was confident it would eventually be able to enjoy another repatriation holiday?

Politics

Chambers wants to make California Sen. Barbara Boxer happy. Although she is a liberal and he is conservative (having served as top adviser to the 2008 McCain campaign), Chambers strongly supported Boxer in her successful reelection campaign. Chambers and Cisco's political action committee donated tens of thousands of dollars to Boxer's campaign, even though her opponent was a Republican and a veteran Silicon Valley CEO like Chambers. And one week before Election Day, Chambers lavished praise on Boxer at a town hall meeting at Cisco's headquarters in San Jose.

In return, Boxer does a lot to make Chambers happy. She coauthored the repatriation legislation that was included in the Jobs Act. And in February 2009 she cosponsored an amendment to the stimulus bill that would have granted a second repatriation holiday. That amendment failed by a 42-55 vote.

"I'd be very surprised if repatriation does not happen," Chambers told Bloomberg television on November 11. He could be right. Since 2009, the political momentum has swung in favor of pro-business, antitax Republicans. The much-touted economic benefits of a repatriation holiday are wildly overstated. But with Boxer's support, a repatriation holiday could be one of those rare issues in the 112th Congress on which Democrats and Republicans can agree. (For prior analysis, see *Tax Notes*, Nov. 15, 2010, p. 759, *Doc 2010-24246*, or *2010 TNT 219-2*.) ■