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CATERPILLAR AND PwC COME UNDER FIRE AT SENATE HEARING

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At a five-hour hearing April 1, members of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (PSI) grilled executives from Caterpillar Inc. and representatives from its accounting firm on a series of transactions that enabled the manufacturer to avoid paying about \$ 2.4 billion in U.S. taxes.

A March 31 report (2014 TNT 62-30) that PSI released on its investigation of Caterpillar states that from 2000 to 2012, the company shifted taxable income from its non-U.S. parts sales totaling more than \$ 8 billion to a Swiss affiliate and deferred paying a substantial amount of U.S. taxes.

At the hearing, subcommittee Chair Carl Levin, D-Mich., said that Caterpillar's Swiss strategy is not the result of conscious policymaking to support U.S. manufacturing. It's a tax loophole, he said, adding that allowing Caterpillar to continue its tax planning practices would be unfair to other companies and to American families.

PSI ranking minority member John McCain, R-Ariz., thanked Levin for his continuing passion on the issue but emphasized the high U.S. corporate tax rate as a factor in companies' decisions to move their operations overseas, as well as the need for broader tax reform to ensure that the United States remains globally competitive. McCain refrained from signing on to the subcommittee's report on Caterpillar, telling Tax Analysts March 26 that he disagrees with Levin on the "egregiousness" of the company's overseas operations. (Prior coverage: Tax Notes, Mar. 31, 2014, p. 1417.)

Levin told reporters at a March 31 press briefing on the report that the investigation was a bipartisan effort, adding that while McCain may have reached a different conclusion, the two worked closely on the investigation and their staffs collaborated on the report.

Departing even further from Levin on the matter was Sen. Rand Paul, R-Ky., who said, "I would like to take my time to apologize to Caterpillar for this proceeding," adding, "Rather than having an inquisition, we should probably bring Caterpillar here to give them an award."

Caterpillar is the latest in a string of high-profile U.S. companies that have been called before the subcommittee to testify about their offshore tax practices. In May 2013 Levin and his colleagues grilled Apple Inc. CEO Tim Cook on his company's use of offshore subsidiaries with

no tax residence. (Prior coverage: Tax Notes, May 27, 2013, p. 971, 2013 TNT 99-1.) Hewlett-Packard Co. and Microsoft Corp. executives appeared at a similar hearing in September 2012. (Prior coverage: Tax Notes, Sept. 24, 2012, p. 1506, 2012 TNT 184-1.)

Swiss Structure Under Scrutiny

Under subcommittee scrutiny was a series of complex transactions Caterpillar used in 1999 to designate a new Swiss affiliate called Caterpillar SARL (CSARL) as its "global parts purchaser," and to license CSARL to sell third-party-manufactured parts to Caterpillar's non-U.S. dealers. Caterpillar previously purchased those parts directly and sold them to its Swiss affiliate, which in turn sold the parts to Caterpillar's non-U.S. dealers in Europe, Africa, and the Middle East, the report says. After Caterpillar implemented the strategy, it removed itself from the legal title chain for non-U.S. parts.

Under a servicing agreement with CSARL, Caterpillar agreed to keep performing core functions supporting the parts sales, including managing inventory, storing the parts, and shipping the parts from the United States, in exchange for a service fee equal to cost plus 5 percent, according to the PSI report.

Before implementing the strategy, Caterpillar received 85 percent or more of non-U.S. parts' profits, the report says. After the CSARL arrangement was put in place, Caterpillar received royalty payments that resulted in its receiving 15 percent or less of the profits from the sale of replacement parts, while 85 percent of the profits were attributed to CSARL.

The report states that from 2000 to 2012, Caterpillar shifted taxable income from its non-U.S. parts sales totaling more than \$ 8 billion to CSARL, and deferred or avoided paying U.S. taxes totaling about \$ 2.4 billion. At the same time it was reconfiguring its legal structure, Caterpillar negotiated a deal with Swiss officials whereby its effective tax rate in Switzerland was between 4 and 6 percent, according to the report. Switzerland's general federal corporate tax rate is 8.5 percent.

In his opening remarks (2014 TNT 63-39), Levin said that "though the lion's share of Caterpillar's international parts profits shifted to its Swiss affiliate, the heart and soul of Caterpillar's parts business stayed right here in the United States." He said that of Caterpillar's employees who handle parts, 4,900 work in the United States and fewer than 100 work in Switzerland. There are no manufacturing plants or parts warehouses in Switzerland, he said.

"Caterpillar U.S. continues to play the vital role of managing and leading its non-U.S. parts business in the same way it always did," Levin said.

Levin took issue with the marketing intangible that Caterpillar contends its Swiss affiliate provided as justification for shifting 85 percent of the parts profit to CSARL. He said that in 2001, when Caterpillar merged another marketing company operating in Latin America, the Caribbean, and Canada into CSARL, Caterpillar and its accountant, PricewaterhouseCoopers LLP, concluded that the same kind of intangibles had little value.

The subcommittee report states that the Caterpillar case study came to PSI's attention after a civil lawsuit was filed by a former Caterpillar employee who had served as the company's global tax strategy manager.

In 2009 then-Caterpillar employee Daniel Schlicksup sued the company, alleging that he faced retaliation from management after he raised ethical objections to Caterpillar's tax practices. In the complaint (2014 TNT 57-37), Schlicksup alleged that Caterpillar's tax liabilities in 2003 would have been \$ 160 million greater but for the tax dodge. Schlicksup and Caterpillar settled the suit out of court in 2012.

Julie A. Lagacy, vice president of Caterpillar's financial services division, testified (2014 TNT 62-46) that Caterpillar has fully complied with U.S. tax law. "We do not invent artificial tax structures," she said, adding that when the company identifies options that align with its business structures and generate tax savings, it may pursue them, as it did with the CSARL transactions.

Lagacy said that CSARL is a "vital business subsidiary" that is responsible for manufacturing, marketing, and selling machines, engines, and parts outside the United States. She added that CSARL's purchases and sales of parts have more than sufficient business substance to be respected for tax purposes.

According to its most recent annual report, Caterpillar had sales and revenue of \$ 55.66 billion in fiscal 2013.

Academics Weigh In

The supply chain restructuring Caterpillar implemented in 1999 is premised on a transfer pricing mistake, testified (2014 TNT 63-56) professor Bret Wells of the University of Houston Law Center. The company operated under the mistaken notion that the residual profits attributed to Caterpillar's integrated spare parts business can be allocated away from the functions that economically generated those profits and instead assigned to a Swiss entity that did not contribute to the value of that business, Wells said.

Under section 7701, economic substance requires a subjective intent to make a profit and an objective ability to make a profit, testified (2014 TNT 63-57) professor Reuven S. Avi-Yonah of

the University of Michigan School of Law. In this case, the information before the subcommittee shows that no business purpose existed for the transaction other than the shifting of income from the United States to Switzerland, he said. It's hard to see an objective purpose to the transaction when 85 percent of profits were shifted without any change taking place on the ground and everything still being done in the United States like it was before, he said.

"I don't think that 1999 transaction has economic substance," Avi-Yonah said.

Wells said that after CSARL's formation, Caterpillar claimed that CSARL had newly discovered marketing intangibles that justified a dramatic increase in the profits allocated to the entity. To the extent those intangibles originated in the United States, CSARL should have paid a superroyalty every year thereafter under section 367(d) to compensate Caterpillar in an amount commensurate with the newfound profitability of the contributed U.S. intangible. The subcommittee found no evidence that was done or is being done, Wells said.

Avi-Yonah agreed, stating that to the extent that the goal of Caterpillar was to shift the intangible, it should have paid the superroyalty.

In Defense of Caterpillar

Several senators came to Caterpillar's defense, including Paul, who said that companies have a responsibility to their shareholders to minimize taxes. Pushing companies overseas because of a high corporate tax rate and then bringing them in for ridicule is insulting to U.S. business, Paul said.

Caterpillar is a U.S. company that is manufacturing in the United States and exporting its profits overseas, said Sen. Ron Johnson, R-Wis., who questioned whether Caterpillar is the kind of company that the subcommittee ought to investigate.

If Caterpillar had done something wrong, the proper venue for adjudication would be the courts, not Congress, Johnson said.

The problem isn't Caterpillar but a broken tax code, agreed taxwriter and PSI member Rob Portman, R-Ohio. Like Paul, he emphasized that publicly traded companies have a responsibility to minimize costs.

PwC Defends Its Role

Three accountants from PwC were grilled about their role in the CSARL transaction, but they maintained that their advice was legal and proper.

"We firmly believed then, and we firmly believe today, that the tax services we provided and the positions Caterpillar took in that regard complied with the law and were entirely appropriate," testified (2014 TNT 63-55) Thomas F. Quinn of PwC.

Quinn challenged Levin's focus on Caterpillar's parts business. "There is no separate parts business," he said, adding that activities are integrated and organized around product groups.

Before developing its advice, PwC engaged in an extensive study of Caterpillar's operations and global footprint, Quinn said. The firm observed that Caterpillar's business organization as it existed in 1998 had failed to capture the evolution of the business from a U.S. manufacturer to a global manufacturer, he said, adding that PwC analyzed alternatives that would better align the true economics of the business with Caterpillar's operations and improve its tax rate.

Because Caterpillar and CSARL are related companies, the transactions were subject to IRS transfer pricing rules, Quinn said. PwC tested them annually, and each analysis supported the arm's-length nature of the pricing, he said.

As for PwC's role as both auditor and tax adviser, Quinn said that the firm assessed its independence quarterly and annually, and that it properly reported its findings to the board. The firm believes that its independence complied with both the letter and the spirit of all applicable regulations, Quinn said.

Apparently unsatisfied with the responses he got, Levin asked Quinn several times whether there was any way Caterpillar would have, for no compensation or consideration, transferred its rights and profits to a company to which it was not related. Quinn repeatedly said he could not give Levin a yes or no answer.

Congress Taking Over for IRS?

Regarding whether Caterpillar violated any tax laws, Levin told reporters March 31, "We don't reach those kinds of judgments in the subcommittee." It is up to law enforcement, the IRS, and the courts to make those decisions, he said.

Levin said he doesn't know whether the IRS has looked at this particular case but added that he doesn't think the agency has generally been effective at addressing profit-shifting situations like Caterpillar's.

At the hearing, Robin D. Beran, Caterpillar's director of global tax and trade, testified that Caterpillar is under continuous audit and that on average, half a dozen IRS employees are

working at the company at any time. He said that the agency has closed out its examination of the company's returns through 2006.

When Johnson asked whether that means the IRS has basically given its blessing to the 1999 transaction, Beran replied, "That's how I've taken it."

Avi-Yonah said that the IRS had multiple opportunities to go after Caterpillar but did not. According to Avi-Yonah, the IRS should have attacked the CSARL transaction on economic substance and assignment of income grounds and considered whether a superroyalty should have been paid.

Avi-Yonah acknowledged that some of the information presented to the subcommittee would not have been available to the IRS, adding that stakeholders have much more information now. The transactions are complicated and extensively documented, and the IRS is already overburdened, he said. Still, the agency should have done a better job in this case, Avi-Yonah said.

"So when there is something this egregious going on, it requires a congressional hearing for the IRS to act?" asked McCain. As for information the agency might have had in its possession, McCain said he thought the IRS got a letter from a whistleblower about the tax strategy in 2004.

"The American people and I don't have a lot of confidence in the IRS, and now we have less," McCain said.

The PSI report makes four recommendations. First, it calls on the IRS to clarify its regulation of transfer pricing transactions and to analyze whether transactions have economic substance. Second, it states that IRS transfer pricing regulations should require the U.S. parent corporation to identify and value the functions of the related parties participating in a transfer pricing agreement, and to justify the profit allocation according to which of the parties performed the functions that contributed to those profits.

Third, the report states that Treasury and the IRS should participate in efforts at the OECD to develop better international principles for taxing multinational corporations.

Finally, focusing on the role of accounting firms, the report says that Congress and the Public Company Accounting Oversight Board should prohibit public accounting firms from simultaneously providing auditing and tax consulting services to the same corporation.

Broader Tax Reform

Although the hearing focused on Caterpillar's tax strategy, the discussion frequently turned toward reform of the U.S. tax system to encourage greater global competitiveness for U.S. companies. The U.S. corporate tax rate and worldwide system of international taxation both came under fire.

Too few companies want to stay in the United States, Johnson said, asking, "What do we need to do to make America an attractive place?"

Reiterating companies' responsibility to consider how to minimize their costs, Portman said the U.S. tax code is so uncompetitive that it is driving jobs overseas. "I hope that this hearing will shine a light on the fact that we have a broken code," he said.

Tax considerations are at the forefront of many decisions taking place at U.S. companies, Quinn testified, adding that the worldwide system puts them at a considerable disadvantage with their foreign competitors, as does the high corporate rate. Quinn said that if U.S. corporations were subject to a tax rate of 20 percent or less, there would be little incentive to keep moving their activities outside the United States.

Avi-Yonah said that Congress could cut the corporate tax rate to between 20 and 25 percent and apply it to all overseas profits of U.S. multinationals without putting them at a competitive disadvantage.

Before Congress looks at reform, section 482 must be clear that a company can't just designate a foreign entrepreneur to take the profits of a U.S. multinational, Wells said. Profits must be scored in the proper jurisdiction first, he said, adding that the treatment of foreign income should be considered only after that issue is resolved.

Levin agreed that the tax code needs to be reformed. However, the use of tax loopholes that encourage companies to shift profits to tax havens is completely unacceptable, he said. Congress ought to close those loopholes, and it can't wait for total reform to do so, because "you'd be waiting forever," Levin said.

"We've been sounding the alarm for years now in our subcommittee about the weaknesses in our tax law that let profitable multinationals continue to dodge U.S. taxes," Levin told reporters. "The American public is already angry, and they are ready to demand that U.S. profitable multinationals pay their taxes like everyone else."