

*United States Senate*

**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

*Committee on Homeland Security and Governmental Affairs*

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*Carl Levin, Chairman*

# **CATERPILLAR'S OFFSHORE TAX STRATEGY**

**MAJORITY STAFF REPORT**

**PERMANENT SUBCOMMITTEE  
ON INVESTIGATIONS**

**UNITED STATES SENATE**



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# CATERPILLAR’S OFFSHORE TAX STRATEGY

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# CATERPILLAR'S OFFSHORE TAX STRATEGY

## I. EXECUTIVE SUMMARY

For the last decade, the Permanent Subcommittee on Investigations of the U.S. Senate Homeland Security and Government Affairs Committee has examined how U.S. multinational corporations have exploited and, at times, abused or violated U.S. tax statutes, regulations, and accounting rules to shift profits and valuable assets offshore to avoid U.S. taxes. The Subcommittee's ongoing investigation has resulted in a series of hearings and reports.<sup>1</sup> Two recent hearings presented case studies of how some U.S. multinational corporations have employed complex transactions and licensing agreements with offshore affiliates to exploit tax loopholes, shift taxable income away from the United States to tax haven jurisdictions, and indefinitely defer paying their U.S. taxes, even when using some of that offshore income to run their U.S. operations.

This investigation offers another detailed case study of a U.S. multinational shifting taxable profits to a foreign affiliate in a tax haven to defer or avoid paying U.S. taxes. While the earlier investigations focused on corporations in the high tech field, this inquiry focuses on a manufacturing company with a substantial U.S. presence. It shows how an iconic American corporation, Caterpillar Inc. (Caterpillar), a U.S. manufacturer of construction equipment, power generators, and sophisticated engines, paid millions of dollars for a tax strategy that shifted billions of dollars in profits away from the United States and into Switzerland, where Caterpillar had negotiated an effective corporate tax rate of 4% to 6%.

Where Caterpillar once reported on its U.S. tax returns the vast majority of its worldwide profits from the sale of Caterpillar-branded replacement parts to non-U.S. customers – parts that were manufactured by third party suppliers located primarily in the United States – after the adoption of a Swiss tax strategy in 1999, it reported 15% or less of those profits in the United States and shifted 85% or more of the profits to Switzerland. Caterpillar accomplished that profit shift without making any real changes in its business operations. It continued to manage and lead the parts business from the United States.

Caterpillar also executed that profit shift despite the fact that its U.S. operations continued to play a far larger role in the parts sold to non-U.S. customers than its Swiss operations. The company's U.S. presence as a whole is far larger than its Swiss presence. Caterpillar's worldwide headquarters has long been in Peoria, Illinois, and all of its most senior executives are located there. Of its 118,500 employees worldwide, about 52,000, or nearly half, work in the United States, while only 400 employees, less than one-half of one percent, work in

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<sup>1</sup> See, e.g., U.S. Senate Permanent Subcommittee on Investigations, "Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," S.Prt. 107-82 (Jan. 2, 2003); "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," S.Hrg. 108-473 (Nov. 18 and 20, 2003); "Tax Haven Abuses: The Enablers, The Tools and Secrecy," S.Hrg. 109-797 (Aug. 1, 2006); "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals," S.Prt. 112-27 (Oct. 11, 2011); "Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft and Hewlett-Packard)," S.Hrg. 112-781 (Sept. 20, 2012); "Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.)," S.Hrg. 113-90 (May 13, 2013).

Switzerland. Of its 125 manufacturing facilities worldwide, 54 are in the United States, while none are located in Switzerland. In 2012, of the \$2 billion Caterpillar spent on research and development, 80% was spent in the United States, while less than 10% was spent in Switzerland.

The same contrast applies to Caterpillar's parts business. Of the nearly 8,300 Caterpillar employees specializing in parts, about 4,900 work in the United States, including almost all of the senior parts executives. Switzerland has about 65 employees working on parts, with one division head managing parts distribution in Europe and one worldwide parts manager who reports to a division head in the United States. Of the Caterpillar replacement parts manufactured by third parties for sale outside of the United States, nearly 70% are manufactured in and shipped from the United States; none are manufactured in or shipped from Switzerland. Of the company's 19 parts warehouses and distribution facilities worldwide, 10 are located in the United States storing 1.5 billion parts, including its largest distribution center in Morton, Illinois; no warehouses are located in Switzerland. Caterpillar's parts inventory is also managed and operated primarily from the United States using U.S.-run worldwide parts tracking, forecasting, and delivery systems that have no counterparts in Switzerland. In 2012, Caterpillar Board minutes described its parts distribution business as "U.S. centric."

Despite the fact that its parts business is managed and led primarily from the United States, Caterpillar used a series of complex transactions to designate a new Swiss affiliate called CSARL as its "global parts purchaser," and license CSARL to sell Caterpillar third party manufactured parts to Caterpillar's non-U.S. dealers. Caterpillar also signed a servicing agreement with CSARL in which it agreed to keep performing the core functions supporting the non-U.S. parts sales, including overseeing the U.S. parts supplier network, forecasting parts demand, managing the company's worldwide parts inventory, storing the parts, and shipping them from the United States. Caterpillar agreed to perform those functions in exchange for a service fee equal to its costs plus 5%. As a result of those licensing and servicing agreements, over the next thirteen years from 2000 to 2012, Caterpillar shifted to CSARL in Switzerland taxable income from its non-U.S. parts sales totaling more than \$8 billion, and deferred or avoided paying U.S. taxes totaling about \$2.4 billion.

Within the company itself, two professionals in the tax department warned that the Swiss tax strategy lacked economic substance and had no business purpose other than tax avoidance, raising their concerns to officers at the highest levels of the company through an anonymous letter in 2004, and a series of emails and memoranda by the company's Global Tax Strategy Manager beginning in 2007. In 2008, the Global Tax Strategy Manager wrote to the head of the Caterpillar tax department: "With all due respect, the business substance issue related to the CSARL Parts Distribution is the pink elephant issue worth a Billion dollars on the balance sheet." By 2010, Caterpillar's finance department calculated that, as a result of the Swiss tax strategy, the company's "Effective Tax Rate ha[d] dropped to lowest in the Dow 30."

Caterpillar paid over \$55 million to PricewaterhouseCoopers (PWC), one of the largest accounting firms in the world and Caterpillar's longtime auditor, to develop and implement the Swiss tax strategy, which was designed explicitly to reduce the company's taxes. In the 1999 planning documents, under a benefits analysis, PWC wrote that the CSARL transaction "will

migrate profits from CAT Inc. to low-tax marketing companies.” PWC added that, by doing so: “We are effectively more than doubling the profit on parts.” In 2010, Caterpillar’s tax department touted the company’s lower tax rate, explaining company operations had been structured so that: “Losses in high-tax rate countries, Profits in low.” By simultaneously acting as both auditor and tax consultant for the company, PWC audited and approved the very tax strategy sold by the firm to Caterpillar, raising significant conflict of interest concerns.

### **A. Subcommittee Investigation**

The Caterpillar case study came to the Subcommittee’s attention after a civil lawsuit was filed by a former Caterpillar employee who had served as Caterpillar’s “Global Tax Strategy Manager,” a position created specifically for him by the Chief Financial Officer.<sup>2</sup> The lawsuit alleged that Caterpillar had sold and shipped replacement parts for its machines from a warehouse in Illinois, while improperly attributing billions of dollars of profits from those sales to a related Swiss affiliate. According to the lawsuit, around 1999, Caterpillar designated a Swiss affiliate known as Caterpillar SARL (CSARL) as the company’s “global purchaser” of third party manufactured replacement parts instead of Caterpillar Inc., the U.S. parent corporation, and then began attributing profits from the non-U.S. parts sales to Switzerland instead of the United States, substantially lowering its tax bill.

According to the lawsuit, when Caterpillar designated CSARL as the company’s global parts purchaser, it made no changes in its business operations to justify shifting the parts profits to Switzerland, but retained management and control of the replacement parts business in the United States. The lawsuit further alleged that the CSARL transaction was improper, because it had no legitimate business purpose, but was done solely for tax reasons. The lawsuit also alleged that Caterpillar executives were well aware of the tax risks associated with aspects of the CSARL transaction, noting that senior tax officials had rated the risk as “high.” In 2012, the lawsuit was settled out of court, for an undisclosed sum.

As part of its investigation, the Subcommittee reviewed numerous corporate documents filed and depositions taken in connection with the lawsuit. In addition, the Subcommittee collected and reviewed over 150,000 pages of documents from Caterpillar and its auditor PricewaterhouseCoopers, obtained additional detailed information from Caterpillar through a questionnaire and other information requests, and reviewed publicly available information, including the company’s U. S. Securities and Exchange Commission (SEC) filings. The Subcommittee also conducted 15 interviews of current and former Caterpillar executives and managers, as well as PWC partners, including two PWC tax consultants who helped design the Swiss tax strategy and the PWC tax partner who reviewed Caterpillar’s tax status. The Subcommittee also spoke with academic tax experts and reviewed materials related to offshore profit shifting and transfer pricing issues. Both Caterpillar and PWC cooperated with Subcommittee requests for information.

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<sup>2</sup> Schlicksup v. Caterpillar Inc., Case No. 09-1208 (C.D. Illinois, Peoria Division 2009).

## **B. Investigation Overview**

Like other multinational corporations examined by the Subcommittee, Caterpillar is an American success story. Launched almost 90 years ago, Caterpillar is a quintessential American company with its worldwide headquarters in Peoria, Illinois, over 52,000 U.S. employees, and facilities located across the country. The company is a world leader in the manufacture of industrial equipment and engines, has significant sales in the United States, and is also one of the United States' largest exporters. The Caterpillar case study focuses on how this U.S. industrial manufacturer used tax planning techniques to direct billions of dollars in profits to a related affiliate in a tax haven.

The Subcommittee's investigation shows how Caterpillar paid over \$55 million to PWC to develop and implement a tax strategy designed to lower its taxes by sending more profits from its parts business to Switzerland, where the company had negotiated an effective tax rate between 4% and 6%. As part of that tax strategy, Caterpillar replaced its leading Swiss affiliate with a new Swiss affiliate, CSARL, and then used a series of licensing transactions with CSARL to enable it to sell Caterpillar's third party manufactured replacement parts to its non-U.S. dealers and customers without showing the parts profits as U.S. income. Caterpillar had previously purchased those parts directly, primarily from its U.S. third party suppliers, and sold the parts to its Swiss affiliate which, in turn, had sold the parts to Caterpillar's non-U.S. dealers in Europe, Africa, and the Middle East. After the Swiss tax strategy was implemented, Caterpillar was removed from the legal title chain for the non-U.S. parts. Instead, its U.S. third party suppliers typically sold Caterpillar brand parts directly to CSARL which then sold them either to Caterpillar or Caterpillar's non-U.S. dealers.

The removal of Caterpillar from the legal title chain did not, however, otherwise change how Caterpillar's replacement parts business functioned on the ground. Caterpillar retained the central role in managing its parts supply chain, and its replacement parts business continued to function as a U.S.-centric business that was led and managed primarily from the United States, with little operational assistance from Switzerland. Today, over 70% of the third party manufactured parts sold abroad are manufactured in, stored in, and shipped from the United States. Most parts are designed and have their patents registered in the United States, and carry the Caterpillar brand. Caterpillar's U.S. personnel continue to develop, support, and oversee its U.S. supplier network. They also forecast parts demand, monitor inventory levels, and store and ship parts abroad to meet customer orders and the company's pledge to deliver replacement parts anywhere in the world within 24 hours. Caterpillar's U.S. personnel also continue to develop, support, and oversee its worldwide dealer network and, in coordination with its marketing companies such as CSARL, help those dealers stock and sell parts to Caterpillar customers. The documents associated with CSARL's licensing transactions show that they were not designed to change those operational details or to achieve any business advantage other than lowering Caterpillar's effective tax rate.

For a transfer between related parties of valuable assets, such as licensing rights, to be valid under the tax code, the transfer must meet an arm's-length standard, including compensating the transferring party as though the transfer were a sale to an unrelated third party. In this case, Caterpillar received royalty payments that resulted in its receiving only 15% or less



of the profits from the sale of those replacement parts, while 85% or more of the profits went to CSARL in Switzerland. Prior to the CSARL transaction, those percentages were essentially reversed, with Caterpillar receiving 85% or more of the non-U.S. parts profits.

Caterpillar's replacement parts business was described internally as a "perpetual profit machine" analogous to an "annuity" that would continue to generate profits for as long as Caterpillar machines were in operation, a time period that averages 20 years per machine. Caterpillar Inc., which created, designed, and developed its replacement parts business over a period of nearly 90 years, not only gave up its right to 85% or more of the profits from its non-U.S. parts sales, it did so without receiving any compensation, such as a super royalty or lump sum payment, for turning over to CSARL the replacement parts business it had spent decades building and for foregoing future profits.

At the same time it gave away the vast majority of its profits from the non-U.S. parts sales and declined to seek compensation from CSARL for turning over that business, Caterpillar Inc. continued to perform the core business functions in exchange for a service fee equal to its costs plus 5%. Caterpillar Inc. also continued to bear the ultimate economic risks associated with the non-U.S. parts business because, even though CSARL took paper ownership of the parts inventory, CSARL's financial results were consolidated with those of the U.S. parent, which meant Caterpillar Inc. would be responsible for any CSARL losses. It is difficult to understand how these arrangements, when viewed in their totality, meet the arm's-length standard.

The purpose of the Subcommittee's investigation and this Report is to describe Caterpillar's offshore tax strategy and its relation to the company's non-U.S. parts business, compare the resulting U.S.-Switzerland profit split to the business functions performed in each country, and examine the policy implications of its transfer pricing arrangements. The investigation also examines the role and policy implications of PricewaterhouseCoopers' acting as both Caterpillar's auditor and tax consultant. In addition, the Report offers recommendations to close some of the offshore tax loopholes and address some of the transfer pricing weaknesses that enable some U.S. multinational corporations to defer or avoid paying substantial U.S. taxes.

### **C. Findings and Recommendations**

**Findings.** Based on the Subcommittee's investigation, the Report makes the following findings of fact.

- (1) Operating a U.S. Centric Business.** Caterpillar's third-party manufactured replacement parts business, which provides the company with its highest profit margins, is managed and led primarily from the United States.
- (2) Reversing U.S.-Swiss Allocation of Parts Profits.** Caterpillar negotiated a 4% to 6% effective tax rate with Switzerland and, in 1999, executed a tax strategy in which the company stopped allocating 85% or more of its non-U.S. replacement parts profits to the United States and 15%

or less to Switzerland, and instead allocated 15% or less of those profits to the United States and 85% or more to Switzerland.

- (3) **Generating \$2.4 Billion in Tax Benefits.** After executing its Swiss tax strategy, over a 13-year period beginning in 2000, Caterpillar allocated more than \$8 billion in non-U.S. parts profits to its Swiss affiliate, CSARL, and has so far deferred paying \$2.4 billion in U.S. taxes on those profits.
- (4) **Using Contradictory Valuations.** To justify sending 85% of its non-U.S. parts profits to its Swiss affiliate, CSARL, Caterpillar asserted that CSARL's development and support of its offshore dealer network was highly valuable, but when it later transferred to CSARL another marketing company performing the same functions, Caterpillar treated the value of those functions as negligible.
- (5) **Employing a Tax-Motivated "Virtual Inventory."** To track CSARL-owned parts stored in Caterpillar's U.S. warehouses, Caterpillar devised a "virtual inventory" system that used "virtual bins" of commingled CSARL and Caterpillar parts and only retroactively, after a sale, identified the specific parts belonging to CSARL. The virtual inventory system created a second set of inventory books for tax purposes and operated in addition to Caterpillar's global inventory system which tracked parts for business purposes.
- (6) **Creating a Potential Conflict of Interest.** By acting as both Caterpillar's independent auditor and tax consultant, PricewaterhouseCoopers (PWC) auditors audited and approved the very Swiss tax strategy sold by PWC tax consultants to the company, creating an apparent, if not actual, conflict of interest. PWC was paid over \$55 million for developing and implementing Caterpillar's offshore tax strategy.

**Recommendations.** Based upon the Subcommittee's investigation, the Report makes the following recommendations.

- (1) **Clarify IRS Enforcement.** When reviewing multinational corporate transfer pricing transactions to evaluate their compliance with Section 482 of the tax code, the IRS should analyze, in accordance with 26 U.S.C. 7701(o), whether the transactions have economic substance apart from deferring or lowering a multinational's U.S. taxes. The IRS should also clarify what types of transfer pricing transactions, if any, are not subject to an economic substance analysis.
- (2) **Rationalize Profit Splitting.** The 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, in the

agreement, identify, explain, and justify the profit allocation according to which parties performed the functions that contributed to those profits.

- (3) Participate in OECD Multinational Corporate Tax Effort.** The U.S. Treasury Department and IRS should actively participate in the ongoing OECD effort to develop better international principles for taxing multinational corporations, including by requiring multinationals to disclose their business operations and tax payments on a country-by-country basis, stop improper transfers of profits to tax havens, and stop avoiding taxation in the countries in which they have a substantial business presence.
- (4) Eliminate Auditing and Tax Consulting Conflicts of Interest.** Congress and the Public Company Accounting Oversight Board (PCAOB) should prohibit public accounting firms from simultaneously providing auditing and tax consulting services to the same corporation, and prevent the conflicts of interest that arise when an accounting firm's auditors are asked to audit the tax strategies designed and sold by the firm's tax consultants.

## II. BACKGROUND

In a globalized world where some U.S. corporations conduct much of their business in multiple countries and draw revenues from overseas as well as from U.S. sales and services, it has become increasingly difficult to determine appropriate allocations of taxable income between U.S. parents and their overseas subsidiaries. At the same time, while the percentage of tax revenues collected from corporations has declined for years, the U.S. federal debt has continued to swell, now surpassing \$16 trillion. The result is a greater burden on individual taxpayers and future generations. According to a report prepared for Congress:

“At its post-WWII peak in 1952, the corporate tax generated 32.1% of all federal tax revenue. In that same year the individual tax accounted for 42.2% of federal revenue, and the payroll tax accounted for 9.7% of revenue. Today, the corporate tax accounts for 8.9% of federal tax revenue, whereas the individual and payroll taxes generate 41.5% and 40.0%, respectively, of federal revenue.”<sup>3</sup>

A 2013 analysis found that, during the late 1960s and early 1970s, large U.S. companies listed on the current Dow 30 index routinely cited U.S. federal tax expenses that were 25% to 50% of their worldwide profits. By 2013, however, most were reporting less than half that percentage.<sup>4</sup> Over that same period, the percentage of corporate profits earned overseas increased.

The decline in corporate tax revenues is due in part to more corporate income being reported abroad in low-tax jurisdictions. A number of studies show that U.S. multinational corporations are moving income out of or away from the United States into low or no tax jurisdictions, including tax havens such as Ireland, Bermuda, and the Cayman Islands.<sup>5</sup>

<sup>3</sup> 12/8/2011 “Reasons for the Decline in the Corporate Tax Revenues,” Congressional Research Service, Mark P. Keightley, at 1. See also “Tax Havens and Treasure Hunts,” New York Times, Nancy Folbre, (April 4, 2011), <http://economix.blogs.nytimes.com/2011/04/04/tax-havens-and-treasure-hunts/>.

<sup>4</sup> “Tax Burden for the Dow 30 Drops,” Washington Post, Darla Cameron & Jia Lynn Yang (3/26/2013), [http://www.washingtonpost.com/business/economy/post-analysis-of-dow-30-firms-shows-declining-tax-burden-as-a-share-of-profits/2013/03/26/3dfe5132-7b9a-11e2-82e8-61a46c2cde3d\\_story.html](http://www.washingtonpost.com/business/economy/post-analysis-of-dow-30-firms-shows-declining-tax-burden-as-a-share-of-profits/2013/03/26/3dfe5132-7b9a-11e2-82e8-61a46c2cde3d_story.html).

<sup>5</sup> See, e.g., two hearings before the U.S. Senate Permanent Subcommittee on Investigations, “Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft and Hewlett-Packard),” S. Hrg. 112-781 (9/20/2012), and “Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.),” S.Hrg. 113-90 (5/21/2013). See also 3/8/2011 “The Revenue Effects of Multinational Firm Income Shifting,” Tax Notes, Kimberly A. Clausing (estimating that “income shifting of multinational firms reduced U.S. government corporate tax revenue by about \$90 billion in 2008, approximately 30% of corporate tax revenues”); 6/5/2010 “Tax Havens: International Tax Avoidance and Evasion,” Congressional Research Service, Jane Gravelle, at 15 (citing multiple studies); 3/8/2010 “Drug Company Profits Shift Out of the United States,” Tax Notes, Martin Sullivan, at 1163 (showing that nearly 80% of pharmaceutical company profits were offshore in 2008, compared to about 33% ten years earlier, and concluding “aggressive transfer pricing practices as the likely explanation for the shift in profits outside the United States”); 2/27/2006 “Governments and Multinational Corporations in the Race to the Bottom,” Tax Notes, Rosanne Altshuler and Harry Gruber; 9/13/2004 “Data Show Dramatic Shift of Profits to Tax Havens,” Tax Notes, Martin A. Sullivan; “Exporting Profits Imports U.S. Tax Reductions for Pfizer, Lilly, Oracle,” Bloomberg, Jesse Drucker (5/13/2010), <http://www.bloomberg.com/news/2010-05-13/exporting-profits-imports-u-s-tax-reductions-for-pfizer-lilly-oracle.html>; “Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes,” Bloomberg, Jesse Drucker (10/21/2010), <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>; “Yahoo, Dell Swell Netherlands’ \$13 Trillion Tax Haven,” Bloomberg, Jesse Drucker (1/23/2013), <http://www.bloomberg.com/news/2013-01-23/yahoo-dell-swell-netherlands-13-trillion-tax-haven.html>; “IBM Uses Dutch Tax Haven to Boost Profits as Sales Slide,” Bloomberg, Alex Barinka & Jesse Drucker

One study showed that foreign profits of controlled foreign corporations (CFCs) of U.S. multinationals significantly outpaced the total GDP of some tax havens.<sup>6</sup> For example, profits of CFCs in Bermuda were 645% and in the Cayman Islands were 546% as a percentage of GDP, respectively. In a recent research report, JPMorgan expressed the opinion that the transfer pricing of intellectual property “explains some of the phenomenon as to why the balances of foreign cash and foreign earnings at multinational companies continue to grow at such impressive rates.”<sup>7</sup>

The erosion of the corporate tax base caused by the shifting of profits into tax havens is not just a U.S. tax problem. In July 2013, the Organisation for Economic Co-operation and Development (OECD), which consists of 34 member countries with advanced economies including the United States, developed an action plan to assist governments with the growing challenge of multinational corporations engaging in base erosion and profit shifting to avoid paying tax where profits are earned.<sup>8</sup> The OECD noted that profits reported in tax havens or low-tax jurisdictions were becoming increasingly disproportionate to the location of actual business activity. The action plan was endorsed by the G20 world leaders during the global G20 Summit in September 2013; they stressed the importance to all developing and developed economies of combating multinational corporate tax avoidance.<sup>9</sup>

### A. Taxation and Deferral

U.S. corporations are subject to a U.S. statutory tax rate of up to 35% on their worldwide income, which is the highest statutory rate among OECD countries and among the highest in the world. However, the effective tax of U.S. corporations has been estimated at less than half that much, 13%, reduced through a variety of mechanisms, including tax provisions that permit multinational corporations to defer U.S. tax on active business earnings of their offshore subsidiaries until those earnings are brought back to the United States.<sup>10</sup> The ability of a U.S. firm to earn foreign income through overseas subsidiaries without paying U.S. tax until the subsidiaries’ earnings are repatriated is known as “deferral.”

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(2/3/2014), <http://www.bloomberg.com/news/2014-02-03/ibm-uses-dutch-tax-haven-to-boost-profits-as-sales-slide.html>; and “G.E.’s Strategies Let It Avoid Taxes Altogether,” *New York Times*, David Kocieniewski, (3/24/2011), [http://www.nytimes.com/2011/03/25/business/economy/25tax.html?ref=butnobodypaysthat&\\_r=0](http://www.nytimes.com/2011/03/25/business/economy/25tax.html?ref=butnobodypaysthat&_r=0).

<sup>6</sup> See 6/5/2010 “Tax Havens: International Tax Avoidance and Evasion,” Congressional Research Service, Jane Gravelle, at 14.

<sup>7</sup> 5/16/2012 “Global Tax Rate Makers,” JPMorgan Chase, at 2 (based on research of SEC filings of over 1,000 reporting issuers).

<sup>8</sup> See “About BEPS,” on the OECD website, <http://www.oecd.org/tax/beps-about.htm>. BEPS stands for “Base Erosion and Profit Shifting,” which was the subject of two OECD reports in 2013. The OECD website explains that the BEPS project is intended to address issues related to gaps in national laws that “can be exploited by companies who avoid taxation in their home countries by pushing activities abroad to low or no tax jurisdictions.” *Id.* The OECD has issued an “Action Plan” to “develop a new set of standards to prevent double non-taxation” by corporations operating in multiple countries, and “a multilateral instrument to amend bilateral tax treaties” to quickly implement BEPS solutions. *Id.* See also 5/29/2013 “Declaration on Base Erosion and Profit Shifting,” OECD, [http://www.oecd.org/tax/C-MIN\(2013\)22-FINAL-ENG.pdf](http://www.oecd.org/tax/C-MIN(2013)22-FINAL-ENG.pdf).

<sup>9</sup> 9/6/2013 “G20 Leaders’ Declaration” after St. Petersburg Summit, at 12, [https://www.g20.org/sites/default/files/g20\\_resources/library/Saint\\_Petersburg\\_Declaration\\_ENG.pdf](https://www.g20.org/sites/default/files/g20_resources/library/Saint_Petersburg_Declaration_ENG.pdf).

<sup>10</sup> See, e.g., 5/2013 “Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate,” Government Accountability Office (finding that, in tax year 2010, profitable U.S. corporations that filed a Schedule M-3 had an effective U.S. federal income tax rate of about 13%), <http://gao.gov/products/GAO-13-520>.

Deferral has created incentives for U.S. firms to report earnings offshore by subsidiaries in low-tax or no-tax jurisdictions to defer or avoid U.S. taxes and increase their after tax profits.<sup>11</sup> Many U.S. multinational corporations have become engaged in finding ways to shift large amounts of income in low-tax foreign jurisdictions, according to a 2010 report by the Joint Committee on Taxation.<sup>12</sup> Current estimates indicate that U.S. multinationals have more than \$1.7 trillion in undistributed foreign earnings and keep 50% to 60% of their cash overseas.<sup>13</sup> The large amounts of undistributed foreign earnings contribute to greatly-reduced corporate effective tax rates.<sup>14</sup>

## **B. Shifting Income to Offshore Subsidiaries**

A major method used by multinationals to shift profits from high-tax to low-tax jurisdictions, and then defer the resulting income from U.S. taxation, is through the transfer of profitable business income, operations, or assets to offshore subsidiaries.

Transfers between different subsidiaries of a single multinational corporation can happen for a variety of reasons. One part of the company may need to make use of an asset owned by a different portion of the company, for example. In order to account for the value transferred, Congress and the IRS set up a system of transfer pricing regulations to ensure that multinational corporations accurately assess the value of what is being transferred and do not use such transfers to avoid taxation.

Because of the complexity of intangible asset transfers, companies can be tempted to use intangible asset transfers to circumvent transfer pricing regulations and lower their tax liability. One common tactic is for a U.S. parent to transfer the rights to intangible property to a related party in a low-tax jurisdiction in exchange for a royalty or other payment. Intangible property transfers can involve patents, brand names, marketing rights, the right to use certain business practices, or similar assets. If the royalty payment is lower than the true value of the license, income will effectively be shifted to the low-tax jurisdiction, where U.S. income tax payments can then be deferred or avoided. Principles addressing these transfers are codified under Section 482 and Section 367 of the Internal Revenue Code and largely build upon the requirement that the transfers must be conducted as if they were arm's length dealings between unrelated parties.<sup>15</sup>

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<sup>11</sup> See, e.g., 12/2000 "The Deferral of Income Earned through U.S. Controlled Foreign Corporations," Office of Tax Policy, U.S. Department of Treasury, at 12 (finding tax haven deferral was done for tax avoidance purposes).

<sup>12</sup> 7/20/2010 "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation, (JCX-37-10), at 7. See also studies cited in footnote 5.

<sup>13</sup> See, e.g., 5/16/2012 "Global Tax Rate Makers," JP Morgan Chase, at 1; 4/26/2011 "Parking Earnings Overseas," Credit Suisse; U.S. Senate Permanent Subcommittee on Investigations, "Offshore Funds Located Onshore," 12/14/2011 Addendum to "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals," S.Prt. 112-27 (Oct. 11, 2011).

<sup>14</sup> See 5/2013 "Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate," Government Accountability Office, <http://gao.gov/products/GAO-13-520>.

<sup>15</sup> An "arm's length transaction" is a transaction that is conducted as though the parties were unrelated, thus avoiding any semblance of conflict of interest. Barron's Dictionary of Finance and Investment Terms (7<sup>th</sup> ed. 2010).

IRS regulations provide various economic methods that can be used to test the arm's length nature of transfers between related parties as well as evaluate any exchange of value or allocation of profits.<sup>16</sup> In many cases, the U.S. parent will transfer intangible property to an offshore subsidiary in exchange for an upfront payment or ongoing revenue stream. For some types of intangible property, such as the right to use established business practices, comparable values may have been established in the market and can guide proper valuation of the transfer. However, many intangibles relate to unique inventions or business assets, practices, or operations for which comparable transactions do not exist, making it very difficult to establish an arm's length price. Transfers involving unique intangible property are therefore difficult for the IRS to evaluate and challenge.

The Joint Committee on Taxation has stated that a "principal tax policy concern is that profits may be artificially inflated in low-tax countries and depressed in high-tax countries through aggressive transfer pricing that does not reflect an arms-length result from a related-party transaction."<sup>17</sup> A study by the Congressional Research Service raised the same issue: "In the case of U.S. multinationals, one study suggested that about half the difference between profitability in low-tax and high-tax countries, which could arise from artificial income shifting, was due to transfers of intellectual property (or intangibles) and most of the rest through the allocation of debt."<sup>18</sup> A Treasury Department study found that the potential for improper income shifting was "most acute with respect to cost sharing arrangements involving intangible assets."<sup>19</sup>

The transfer pricing regulations permit taxpayers to use several methods to satisfy the arm's-length standard. The valuation techniques can produce highly variable results, often because of the unique nature of the assets involved. This pricing variability is used by some multinationals to skew transfer pricing analyses in such a way as to increase reported income in low-tax jurisdictions. For example, if a technique provides a range of acceptable prices, the company may choose the lower end of the range for compensation to the U.S. parent corporation or use other aggressive transfer pricing practices. The Economist has described these aggressive transfer pricing tax strategies as a "big stick in the corporate treasurer's tax-avoidance armoury."<sup>20</sup> Edward Kleinbard, a professor at the University of Southern California and former chief of staff at the Joint Committee on Taxation, has described the valuation problems as "insurmountable."<sup>21</sup>

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<sup>16</sup> See 26 CFR § 1.482-4.

<sup>17</sup> 7/20/2010 "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation, (JCX-37-10), at 5.

<sup>18</sup> 6/5/2010 "Tax Havens: International Tax Avoidance and Evasion," Congressional Research Service, Jane Gravelle, at 8 (citing 3/2003 "Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Locations," National Tax Journal, vol. 56.2, Harry Grubert, at 221-42).

<sup>19</sup> 7/20/2010 "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation, (JCX-37-10), at 7 (citing November 2007 "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties," U.S. Treasury Department).

<sup>20</sup> 2008 "An Introduction to Transfer Pricing," New School Economic Review, vol. 3.1, Alfredo J. Urquidi, at 28 (citing "Moving Pieces"), The Economist, (2/22/2007).

<sup>21</sup> "IRS Forms 'SWAT Team' for Tax Dodge Crackdown," Reuters, Patrick Temple-West, (3/20/2012), <http://www.reuters.com/article/2012/03/20/us-usa-tax-irs-transfer-idUSBRE82J10W20120320> (quoting Edward Kleinbard).

There are several ways intangible property can be transferred to a foreign affiliate, and the method chosen frequently dictates whether the authority for determining the compensation received by the U.S. person in the transaction is under Section 482 or Section 367(d) of the tax code. Generally, a license or a sale of intangible property, or the provision of a service that uses intangible property, is subject to Section 482. However, an exchange of intangible property from one controlled foreign corporation to another is subject to Section 367(d).<sup>22</sup> Section 367(d) applies, for example, if the transfer of intangible property involves an exchange of stock under Sections 351 and 361. Where Section 367(d) applies, the transfer must include imputed income from annual payments over the useful life of the intangible as though the transferor had sold the intangible, a payment that is colloquially referred to as a “super royalty.”<sup>23</sup> The appropriate amounts of those imputed payments are determined under Section 482 and its regulations.

The Subcommittee’s previous investigations, as well as government and academic studies, have shown that some U.S. multinationals use transfer pricing to move income associated with intangible property to CFCs in tax havens or low tax jurisdictions, while they continue to attribute expenses to their U.S. operations, further lowering their taxable income at home.<sup>24</sup> This ability to artificially shift income to a tax haven can provide multinationals with an unfair advantage over U.S. domestic corporations by providing the multinationals not only with lower taxes, but also a taxpayer subsidy for their onshore operations.

### **C. Anti-Deferral Provisions and Subpart F**

As early as the 1960s, according to one international tax expert, “administration policymakers became concerned that U.S. multinationals were shifting their operations and excess earnings offshore in response to the tax incentive provided by deferral.”<sup>25</sup> At that time, circumstances were somewhat similar to the situation in the United States today. “The country faced a large deficit and the Administration was worried that U.S. economic growth was slowing relative to other industrialized countries.”<sup>26</sup> To help reduce the deficit, the Kennedy Administration proposed to tax the current foreign earnings of subsidiaries of multinationals and offered tax incentives to encourage investments at home.<sup>27</sup>

Although the Kennedy Administration initially proposed to end deferral of foreign source income altogether, a compromise was struck instead, which became known as Subpart F.<sup>28</sup> Under the Subpart F compromise, in general, “passive” income generated through investments or funds transfers (such as royalty payments, dividends, or interest) would be taxed currently in

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<sup>22</sup> See 7/20/2010 “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” Joint Committee on Taxation, (JCX-37-10), at 21.

<sup>23</sup> *Id.*, at 22-23.

<sup>24</sup> See, e.g., U.S. Senate Permanent Subcommittee on Investigations, “Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft and Hewlett-Packard),” S.Hrg.112-781 (Sept. 20, 2012).

<sup>25</sup> 6/26/2006 “The Evolution of U.S. International Tax Policy - What Would Larry Say?,” Tax Notes International, Paul Oosterhuis, at 2.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* (citing 1/11/1962 “Annual Message to Congress on the State of the Union,” President John F. Kennedy, 1 Pub. Papers, at 13-14).

<sup>28</sup> 6/26/2006 “The Evolution of U.S. International Tax Policy - What Would Larry Say?,” Tax Notes International, Paul Oosterhuis, at 3.



the United States, while “active” income (such as revenue from overseas manufacturing activities) would not be taxed until the money was brought into the United States. Subpart F was enacted by Congress in 1962, and was designed in substantial part to address the tax avoidance techniques being utilized today by U.S. multinationals in tax havens. In fact, to curb tax haven abuses, Congress enacted anti-tax haven provisions, despite extensive opposition by the business community.<sup>29</sup>

Subpart F explicitly restricts the types of income whose taxation may be deferred. The Subpart F rules are codified in tax code Sections 951 to 965, which apply to certain income of CFCs.<sup>30</sup> When a CFC earns Subpart F income, the U.S. parent as shareholder is treated as having received the current income. Subpart F was enacted to deter U.S. taxpayers from using CFCs located in tax havens to accumulate earnings that could have been accumulated in the United States.<sup>31</sup> “[S]ubpart F generally targets passive income and income that is split off from the activities that produced the value in the goods or services generating the income,” according to the Treasury Department’s Office of Tax Policy.<sup>32</sup> In contrast, income that is generated by active, foreign business operations of a CFC is permitted to continue to be deferred. But, again, deferral is not permitted for passive, inherently mobile income such as royalty, interest, or dividend income, as well as income resulting from certain other activities identified in Subpart F.<sup>33</sup> Income reportable under Subpart F is currently subject to U.S. tax, regardless of whether that income has been formally repatriated.

At the same time, regulations, temporary statutory changes, and certain statutory exceptions have undercut the intended application of Subpart F. For example, “check-the-box” tax regulations issued by the Treasury Department in 1997, and the CFC “look-thru rule” first enacted by Congress as a temporary measure in 2006 and subsequently renewed, have significantly reduced the effectiveness of the anti-deferral rules of Subpart F and have further facilitated the increase in offshore profit shifting which has gained significant momentum over the last 15 years. In addition, certain statutory exceptions have also weakened important provisions of the law, including regulations implementing the “manufacturing exception.”

#### **D. Foreign Base Company Sales Income – Manufacturing Exception**

A key type of taxable Subpart F offshore income is referred to in the tax code as Foreign Base Company Sales (FBCS) income. FBCS income generally involves a CFC which is organized in one jurisdiction, used to buy goods, typically from a manufacturer in another jurisdiction, and then sells the goods to a related CFC for use in a third jurisdiction, while

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<sup>29</sup> See, e.g., 12/2000 “The Deferral of Income Earned through U.S. Controlled Foreign Corporations,” Office of Tax Policy, U.S. Department of Treasury, at 21.

<sup>30</sup> A CFC is a foreign corporation more than 50% of which, by vote or value, is owned by U.S. persons owning a 10% or greater interest in the corporation by vote (“U.S. shareholders”). “U.S. persons” include U.S. citizens, residents, corporations, partnerships, trusts and estates. IRC § 957.

<sup>31</sup> See, e.g., *Koehring Company v. United States of America*, 583 F.2d 313 (7th Cir. 1978). See also 12/2000 “The Deferral of Income Earned through U.S. Controlled Foreign Corporations,” Office of Tax Policy, U.S. Department of Treasury, at xii.

<sup>32</sup> 12/2000 “The Deferral of Income Earned through U.S. Controlled Foreign Corporations,” Office of Tax Policy, U.S. Department of Treasury, at xii.

<sup>33</sup> IRC § 954(c).

retaining the income resulting from those transactions. The FBCS provision is meant to tax the retained profits of the intermediary CFC which typically sits in a tax haven. More specifically, taxable FBCS income is income attributable to related-party sales of goods made through a CFC if the country of the CFC's incorporation is neither the origin nor the destination of the goods and the CFC itself has not "manufactured" the goods.<sup>34</sup> In other words, for the income to be considered taxable foreign base company sales income, the goods must be both produced outside the CFC's country of organization and distributed or sold for use outside that same country, and an entity related to the CFC must be a party to the transaction.<sup>35</sup>

The purpose of taxing FBCS income under Subpart F was to discourage multinationals from splitting their manufacturing function from their sales function and then assigning the sales function to a subsidiary in a tax haven. The legislative history, in fact, describes precise scenarios intended to be included under Subpart F. For instance:

"The technique that is used for diverting profits from one company to another among European affiliates is also used to divert income from U.S. companies to foreign affiliates. Income that would normally be taxable by the United States is thrown into tax haven companies with the object of obtaining tax deferral. This is done, for example, by placing in a Swiss or Panamanian corporation the activities of the export division of a U.S. manufacturing enterprise."<sup>36</sup>

The FBCS income rules also, however, contain an exclusion known as the "manufacturing exception." Under this exception, the income retained by the intermediary CFC is not taxable under Subpart F, if the CFC itself is a manufacturer and added substantive value to the goods.<sup>37</sup> While this exception was originally restricted to CFCs engaged in physical manufacturing, in 2009, the regulations governing the manufacturing exception were liberalized to make it much easier for a foreign affiliate to claim the exception. As explained by the Joint Committee on Taxation, the 2009 regulations provided:

"A CFC can qualify for the manufacturing exception if it meets one of three tests. The first two [are] physical manufacturing tests: the substantial transformation test and the substantial activity test. The third test [is] the substantial contribution test."<sup>38</sup>

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<sup>34</sup> IRC § 954(d)(1).

<sup>35</sup> Id.

<sup>36</sup> Statement by Hon. Douglas Dillon, Secretary of the Treasury, before the House Committee on Ways and Means, at 163-66 (May 3, 1961).

<sup>37</sup> Id.; 26 CFR § 1.954-3(a)(4)(i) (providing that FBCS income excludes the income of a CFC derived in connection with the sale of goods that were "manufactured, produced or constructed" by the CFC).

<sup>38</sup> 7/20/2010 "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation, (JCX-37-10), at 38. See also 2/2/2009 "Guidance Regarding Foreign Base Company Sales Income," 2009-5 I.R.B., T.D. 9438, <http://www.irs.gov/pub/irs-irbs/irb09-05.pdf>, in which the IRS describes the manufacturing exception before and after the 2009 amendments as follows:

"The existing regulations further define FBCSI [foreign base company sales income] and the applicable exceptions from FBCSI, including the exceptions to the FBCSI rules for personal property that is: (1) manufactured, produced, constructed, grown, or extracted within the CFC's country of organization (same country manufacture exception); (2) sold for use, consumption or disposition within the CFC's country of

Moving from a requirement that the CFC demonstrate that it performed a manufacturing activity to demonstrating that it made a “substantial contribution” to the goods being sold transformed the manufacturing exception into another possible loophole to shield offshore income from Subpart F taxation.<sup>39</sup>

Through deferral and various regulatory and statutory exceptions, the tax code has created multiple incentives for multinational corporations to move income offshore to low or no tax jurisdictions and provided multiple methods to avoid current tax on those offshore transfers. A key objective of the Subcommittee’s ongoing investigation is to examine these exceptions and loopholes in action, and find an effective way of closing them where transactions have little or no economic substance other than tax avoidance.

## **E. Economic Substance**

Efforts by taxpayers to structure their business in a way that avoids taxation may result in transactions with little or no economic substance. Beginning with a Supreme Court case in 1935, the federal courts have developed an “economic substance doctrine” to determine whether a transaction has enough substance to be respected for tax purposes.<sup>40</sup> The 1935 case, Gregory v. Helvering, involved a woman who owned one company, transferred its stock to a second company she had just created, then three days later dissolved the second company, took back the first company’s shares and sold them. The taxpayer claimed to have engaged in a tax free corporate reorganization and assigned a high cost to the stock she sold to minimize her taxable gain. The Supreme Court ruled against her and for the IRS, finding that her actions had no

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organization; and (3) manufactured, produced, or constructed by the CFC (the manufacturing exception). See § 1.954-3(a)(2)-(4).

The existing regulations set forth certain tests to determine whether a CFC satisfies the manufacturing exception: the ‘substantial transformation test’ of § 1.954-3(a)(4)(ii) and the ‘substantive test’ and safe harbor of § 1.954-3(a)(4)(iii). For purposes of this preamble, the requirements of § 1.954-3(a)(4)(ii) and 1.954-3(a)(4)(iii) will be referred to collectively as the ‘physical manufacturing test’ and the satisfaction of either test will be described as ‘physical manufacturing.’

The proposed regulations provide a third test for satisfying the manufacturing exception, which may apply when a CFC is involved in the manufacturing process but does not satisfy the physical manufacturing test. In particular, the proposed regulations provide that a CFC will satisfy the manufacturing exception if the facts and circumstances evince that the CFC makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of personal property (substantial contribution test). The proposed regulations also propose other modifications to the existing regulations to address the treatment of contract manufacturing arrangements under the FBCSI rules.”

<sup>39</sup> The 2009 regulations were made effective for taxable years that began after June 30, 2009. In addition, the IRS allowed taxpayers to apply the new test retroactively to any open taxable year. 2/2/2009 “Guidance Regarding Foreign Base Company Sales Income,” 2009-5 I.R.B., T.D. 9438, <http://www.irs.gov/pub/irs-irbs/irb09-05.pdf>.

<sup>40</sup> See Gregory v. Helvering, 293 U.S. 465 (1935). See also 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, PSI\_Caterpillar\_17\_000003 - 023, at 008 (“[E]conomically meaningless transactions devoid of business purpose other than tax avoidance are generally not respected.”).

business purpose other than tax avoidance, and attempted to elevate form over substance, using a company that was entirely paper based, with no employees or business activities.

In 2010, Congress codified the judicial doctrine.<sup>41</sup> Using the case law as its guide in determining whether a transaction had economic substance, the statute established a two part test: the transaction must change the taxpayer's economic position in a meaningful way, and the transaction must have a substantial non-tax purpose.<sup>42</sup> The statute harmonized a split in the federal circuits as to whether both prongs had to be satisfied, or only one of them. It did not change the applicability of the economic substance doctrine, stating in 26 U.S.C. § 7701(o)(1) that the statute would apply "[i]n the case of any transaction to which the economic substance doctrine is relevant," while leaving the determination of relevance to the common law tests.<sup>43</sup> Under common law, the courts have held that the economic substance doctrine was not relevant in some circumstances.<sup>44</sup> One of those circumstances was described in a Joint Committee on Taxation analysis which said the doctrine may not be relevant to the "decision to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied."<sup>45</sup>

In July 2011, the IRS issued guidance to help its examiners determine when a transaction had economic substance under the statute.<sup>46</sup> The guidance provided 18 indicia and four circumstances indicating when a transaction had economic substance and 17 indicia indicating when it did not. For example, the IRS guidance recommended concluding that transactions between related parties that met the arm's length pricing standards of Section 482 were likely to meet economic substance requirements.<sup>47</sup> The guidance also recommended finding that a transaction lacked economic substance if the transaction had been "promoted/developed/administered" by the corporation's tax department or outside tax advisors.

Because the economic substance doctrine was codified less than four years ago and applies only to transactions after March 2010, only a limited number of cases have interpreted the statute to date.<sup>48</sup>

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<sup>41</sup> See § 1409(a) of the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, codified at 26 U.S.C. § 7701(o).

<sup>42</sup> 26 U.S.C. § 7701(o)(1).

<sup>43</sup> 3/21/2010 "Technical Explanation Of The Revenue Provisions Of The 'Reconciliation Act of 2010,' As Amended, in Combination With The 'Patient Protection and Affordable Care Act,'" prepared by the Joint Committee on Taxation, JCX-18-10, at 152-3.

<sup>44</sup> Id.

<sup>45</sup> Id.

<sup>46</sup> Id.

<sup>47</sup> Id. See also 26 CFR § 1.482-4.

<sup>48</sup> In several U.S. Tax Court opinions, the court has noted that "Congress codified the economic substance doctrine mostly as articulated by the Court of Appeals for the Third Circuit in ACM Partnership v. Commissioner, 157 F.3d 231, 247-48 (3d Cir. 1998)." The codified doctrine did not apply, however, to the cases at issue under its effective dates. See Crispin v. Commissioner, T.C. Memo. 2012-70, 2012 WL 858406, at 6, n.14; Blum v. Commissioner, T.C. Memo. 2012-16, 2012 WL 129801, at 17, n.21; Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225, 2011 WL 4374589, at 27, n.11.

## F. Export Exception

A final issue relevant to the Caterpillar case study is the tax treatment of goods held in the United States under the name of a foreign affiliate. Generally, if the foreign affiliate of a U.S. parent corporation holds inventory in the United States, it can do so without creating a taxable presence. Tax code Section 956(c)(2)(B) excludes from taxable U.S. property any goods located in the United States which were purchased in the United States for export to a foreign country. This export exception allows a foreign company (or a foreign affiliate of a U.S. company) to buy U.S. goods for export, route foreign goods through a U.S. port, or execute routine export functions, without incurring U.S. taxation as a U.S. business. However, there are limits to the scope of the export exception. If the export property is held in a common pool of inventory for the benefit of multiple parties as a joint enterprise, U.S. courts have held that, based on the facts and circumstances of the case, a de facto U.S. partnership may be created that would subject the individual partners to U.S. taxes.<sup>49</sup>

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<sup>49</sup> See Commissioner v. Culbertson, 337 U.S. 280 (1949) (stating that relevant inquiry is to determine whether the parties in good faith and acting with a business purpose intended to join together in the present conduct of a joint enterprise for profit). The Tax Court has set forth a list of factors that other courts have used to evaluate this factual inquiry. See Luna v. Commissioner, 42 T.C. 1067 (1964).

### III. CATERPILLAR CASE STUDY

#### A. Caterpillar In General

Caterpillar Inc. (Caterpillar) is a multinational corporation headquartered in the United States. It is a publicly traded company registered with the U.S. Securities and Exchange Commission and is listed on exchanges in the United States, France, and Switzerland.<sup>50</sup> Caterpillar stock is one of the 30 listed in the Dow Jones Industrial Average. Caterpillar is the parent company for approximately 450 subsidiaries or affiliates in 57 countries.<sup>51</sup>

Caterpillar is an iconic American company with a strong U.S. presence. Its worldwide headquarters is in Peoria, Illinois, the heartland of the country. Out of 118,500 employees worldwide, about 52,000, or roughly 44%, are located in the United States.<sup>52</sup> Out of 125 manufacturing facilities worldwide, 54 are located in the United States, far more than in any other country; the remaining 71 manufacturing facilities are located overseas.<sup>53</sup> The majority of the company's research and development activity and information technology planning and development occurs in the United States.<sup>54</sup> In 2012, Caterpillar spent about \$2 billion on research and development, 80% of which was conducted in the United States.<sup>55</sup> Caterpillar also holds title to most of the intellectual property for its products in the United States, where it coordinates its global registration and enforcement strategy.<sup>56</sup> Most of Caterpillar's senior executives are in the United States, including its Chief Executive Officer (CEO), Chief Financial Officer (CFO), and Chief Legal Officer, as well as most of the heads of its business segments and divisions.<sup>57</sup> The current Chairman of the Board and CEO is Douglas Oberhelman.<sup>58</sup>

Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines, and diesel-electric locomotives.<sup>59</sup> In 2012, Caterpillar generated record revenues of \$65.9 billion, earning it a ranking of number 46 on the Fortune 500 list of the largest American corporations.<sup>60</sup> In 2013, Caterpillar's revenues

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<sup>50</sup> 9/15/2011 "Caterpillar Inc. Transfer Pricing Analysis and Report For fiscal year ended December 31, 2010," PwC\_PSI\_CAT\_00007795 - 8204, at 815.

<sup>51</sup> Id.

<sup>52</sup> Caterpillar Inc. Presentation to the Senate Permanent Subcommittee on Investigations (2/21/2014), at PSI-Caterpillar-14-000001 - 010, at 002.

<sup>53</sup> Id. See also Caterpillar Inc. Annual Report (Form-10K), at 20 (12/31/2010).

<sup>54</sup> Craig T. Bouchard & James V. Koch, *The Caterpillar Way*, at 91 (2014).

<sup>55</sup> 8/30/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000066 - 108, at 076.

<sup>56</sup> Subcommittee interview of Thomas Quinn, PWC, Tax Partner (12/17/2013). See also 1/1/2001 Second Amended and Restated License Agreement, CAT-000306 - 699, at 373; 9/23/2013 letter from Caterpillar to Subcommittee, PSI-Caterpillar-04-000001 - 009, at 004.

<sup>57</sup> See 10/1/2013 "Chairman's Operating Council Organizational Chart," prepared by Caterpillar Inc. and on its website, <http://s7d2.scene7.com/is/content/Caterpillar/C10101108>.

<sup>58</sup> "2010 Year in Review," prepared by Caterpillar, at 18, <http://s7d2.scene7.com/is/content/Caterpillar/C10005394>.

<sup>59</sup> Caterpillar Inc. Annual Report (Form-10K), at 1 (2/19/2013).

<sup>60</sup> See "Fortune 500, Our annual ranking of America's largest corporations," *CNN Money*, (May 21, 2012), [http://money.cnn.com/magazines/fortune/fortune500/2012/full\\_list/](http://money.cnn.com/magazines/fortune/fortune500/2012/full_list/). See also 8/14/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000001 - 065, at 001.

dropped to \$55.7 billion, a 16% decline.<sup>61</sup> Even with that drop, over that two-year period, Caterpillar's revenues exceeded \$120 billion. As of the end of 2013, Caterpillar had total assets of \$85 billion, of which \$17 billion, or 20%, were indefinitely reinvested earnings held offshore.<sup>62</sup>

The entity that became Caterpillar Inc. was organized in 1925, in the State of California, when the Holt Manufacturing Company and the C.L. Best Tractor Company merged to form the Caterpillar Tractor Company.<sup>63</sup> By 1931, Caterpillar had perfected the diesel tractor engine and redesigned many of its old tractors, and witnessed a steady growth in its sales throughout the decade.<sup>64</sup> In 1967, Caterpillar's worldwide headquarters moved to Peoria, Illinois. On its website, the company has written that "Caterpillar has deep roots in Peoria," and "[s]ince the beginning when the company expanded its manufacturing from the West coast to the Midwest, [its] presence has deepened across the region."<sup>65</sup> In 1986, the U.S. parent company was reorganized as Caterpillar Inc. in the State of Delaware.<sup>66</sup>

Caterpillar has five principal business segments: Construction Industries, Energy and Power Systems, Resource Industries, Financial Products, and Customer and Dealer Support.<sup>67</sup> Construction Industries (CI) is focused on producing machinery used to construct infrastructure and buildings, such as railways, roads, schools and hospitals.<sup>68</sup> Caterpillar equipment produced by this segment includes backhoe loaders, small tractors, and mini-excavators. Energy and Power Systems (EP) produces energy-related engines, turbines, and related equipment. Its products include power plant generators, turbines, and locomotives serving such industries as the electric power, petroleum, and rail businesses. Resource Industries (RI) focuses on producing equipment that harvests natural resources such as coal, minerals, and lumber.<sup>69</sup> Its products include large mining trucks, underground mining equipment, and tunnel boring equipment.<sup>70</sup> The responsibilities of CI, EP, and RI include the design, manufacturing, marketing, and sales of their respective products.<sup>71</sup> Caterpillar's Financial Products segment is involved in the financing of dealers, suppliers, and customers to support the producing, purchasing, and leasing of Caterpillar products.

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<sup>61</sup> "Caterpillar Popping on Better-Than-Expected Profit, Outlook," *Forbes*, Maggie McGrath, (1/27/2014), <http://www.forbes.com/sites/maggiemcgrath/2014/01/27/caterpillar-popping-on-better-than-expected-profit-outlook/>.

<sup>62</sup> Caterpillar Inc. Annual Report (Form-10K) (2/18/2014); March 2014 "Foreign Indefinitely Reinvested Earnings: Balances Held by the Russell 1000; A Six-Year Snapshot," Audit Analytics, at 4.

<sup>63</sup> "Caterpillar Tractor Co. List of Deals," Lehman Brothers Collection, Harvard Business School Baker Library Historical Collections, [http://www.library.hbs.edu/hc/lehman/company.html?company=caterpillar\\_tractor\\_co](http://www.library.hbs.edu/hc/lehman/company.html?company=caterpillar_tractor_co).

<sup>64</sup> *Id.*

<sup>65</sup> 10/18/2013 "Peoria – The Home of Caterpillar," Caterpillar website, <http://www.jointeamcaterpillar.com/cda/layout?m=612335&x=333&id=4507617>.

<sup>66</sup> Caterpillar Inc. Annual Report (Form-10K), at 1 (2/19/2013).

<sup>67</sup> "2012 Year in Review," prepared by Caterpillar and on its website, at 33, <http://s7d2.scene7.com/is/content/Caterpillar/C10005383>.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

The fifth and final business segment, Customer and Dealer Support, focuses on customer service and dealer development.<sup>72</sup> The head of Customer and Dealer Support is Stuart Levenick, a Caterpillar group president based in Illinois.<sup>73</sup> Among other responsibilities, the segment is responsible for key aspects of Caterpillar's parts business, including supplying both third party replacement parts and Caterpillar's own worked parts for the machines sold by the CI, EP, and RI segments. Within the segment, the current head of the Customer Services Support Division is Stephen Gosselin, who is charged with "growing Caterpillar's aftermarket parts and services business."<sup>74</sup> He is based in Illinois. Another key person is Barbara Hodel, Director of Parts Distribution, who is also based in Illinois.<sup>75</sup>

Since the early 1990s, Caterpillar's five business segments have been further organized into various Business Divisions, each of which is led by a Vice President who reports to the Caterpillar Executive Office.<sup>76</sup> "[A] Business Division can include several subsidiaries or branches ('legal entities') or a legal entity can contain the activities of several Business Divisions."<sup>77</sup> The scope and role of Caterpillar's individual Business Divisions have evolved over time.<sup>78</sup> As of 2013, Caterpillar had 30 Business Divisions, which can be categorized into seven types including: Construction Industries, Resource Industries, Energy and Power Systems, and Customer and Dealer Support.<sup>79</sup> The Customer and Dealer Support divisions include a number that play key roles in the replacement parts business, including the Customer Services Support Division and the Distribution Divisions for the Asia Pacific region, the Europe, African and Middle East region, and the Americas.<sup>80</sup>

Caterpillar credits its business model as "the foundation of [its] success."<sup>81</sup> The company's business model focuses on the maintenance, repair, and operations component of its business, which the company views as helping to smooth its revenue stream and lock in its customer base.<sup>82</sup> Caterpillar describes its business model as operating in three phases: seed,

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<sup>72</sup> Id.

<sup>73</sup> See "Stuart L. Levenick," Caterpillar officer profile prepared by Caterpillar, <http://www.caterpillar.com/en/company/governance/officers/stuart-l-levenick.html>.

<sup>74</sup> See "Stephen A. Gosselin," Caterpillar officer profile prepared by Caterpillar, <http://www.caterpillar.com/en/company/governance/officers/stuart-l-levenick/stephen-a-gosselin.html>.

<sup>75</sup> Subcommittee interview of Deborah Kraft, Caterpillar, Accounting Manager (2/5/2014).

<sup>76</sup> 9/15/2011 "Caterpillar Inc. Transfer Pricing Analysis and Report For fiscal year ended December 31, 2010," PWC\_PSI\_CAT\_00007795 - 8204, at 817.

<sup>77</sup> Id.

<sup>78</sup> Id.

<sup>79</sup> See 10/1/2013 "Chairman's Operating Council Organizational Chart," prepared by Caterpillar Inc. and on its website, <http://s7d2.scene7.com/is/content/Caterpillar/C10101108>.

<sup>80</sup> Caterpillar's divisions have had a variety of names. For example, the divisions handling parts distribution and logistics have been variously known as the Parts & Services Support Division, CAT Logistics, Parts Distribution & Logistics Division, and Parts Distribution & Diversified Products Division. Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014); 4/13/2013 "Caterpillar Announces New Organization to Drive Sustained Improvements in Customer Deliveries and Operational Efficiencies and to Build on Recent Product Quality Improvements," Caterpillar press release, <http://www.caterpillar.com/en/news/corporate-press-releases/h/caterpillar-announces-new-organization-to-drive-sustained-improvements-in-customer-deliveries-and-operational-efficiencies-and-to-build-on-recent-product-quality-improvements.html>.

<sup>81</sup> "2010 Year in Review," prepared by Caterpillar and on its website, at 18, <http://s7d2.scene7.com/is/content/Caterpillar/C10005394>.

<sup>82</sup> Craig T. Bouchard & James V. Koch, The Caterpillar Way, at 168 (2014).



grow, and harvest.<sup>83</sup> It seeds the business with its initial sale of its products, taking a “life cycle perspective” during product development, with Caterpillar’s differentiated and proprietary parts being a key part of that perspective.<sup>84</sup> During the grow phase, Caterpillar grows the business by building the largest global field population of products, which in turn helps the company sell parts and services.<sup>85</sup> Caterpillar states that, by supporting its customers in the long run, it then harvests the opportunities created in the first two phases of the model.<sup>86</sup> Commenting on the company’s seed, grow, harvest business model, Stuart Levenick, head of the Customer and Dealer Support business segment, recently said: “The harvest part of that is once you create all this population, we’re much more vertical and we have a much more captive control of components and parts than anyone else in our business.”<sup>87</sup> Caterpillar’s strong focus on aftermarket parts and service is a vital element in all three phases of its business model.<sup>88</sup>

Caterpillar is a leading U.S. exporter, providing more than 300 products to customers in approximately 180 countries around the world.<sup>89</sup> From 2008 through 2012, Caterpillar exported more than \$82 billion in products from the United States.<sup>90</sup> In 2011, exports from the U.S. made up \$19.4 billion or about one-third of its \$60 billion in consolidated sales.<sup>91</sup> While in 1963, only 43% of the company’s consolidated sales and revenues came from international customers, in recent years most of Caterpillar sales come from international sales.<sup>92</sup> In 2013, the company reported that 67% of Caterpillar’s revenues came from sales outside of the United States.<sup>93</sup> While most sales now occur outside the United States, most of Caterpillar’s machines and parts are still built in the United States; for example, as discussed below, in 2012, about 70% of finished Caterpillar replacement parts sold offshore were manufactured in the United States.<sup>94</sup>

## **B. Caterpillar’s Dealer Network**

To sell its machines and support the operation of those machines over time, Caterpillar has an extensive network of independent dealers in the United States and around the world. Caterpillar and independent analysts credit the worldwide dealer network as one of its most important competitive advantages. Its dealers have extensive knowledge of Caterpillar products, are focused on the needs of the country or region in which the dealer is located, and provide independent marketing judgment and business efficiencies. In addition to selling machines, Caterpillar dealers typically offer repair services, including providing Caterpillar replacement parts. Many dealers keep an inventory of replacement parts on site.

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<sup>83</sup> 2010 Year in Review,” prepared by Caterpillar, at 18, <http://s7d2.scene7.com/is/content/Caterpillar/C10005394>.

<sup>84</sup> Id.

<sup>85</sup> Id.

<sup>86</sup> Id.

<sup>87</sup> 5/1/2013 “The Big Interview: Caterpillar’s Stuart Levenick,” Construction Week Online, Stian Overdahl, <http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/>.

<sup>88</sup> 2010 Year in Review,” prepared by Caterpillar and on its website, at 18, <http://s7d2.scene7.com/is/content/Caterpillar/C10005394>.

<sup>89</sup> 9/23/2013 letter from Caterpillar to Subcommittee, PSI-Caterpillar-04-000001 - 009, at 002.

<sup>90</sup> Id.

<sup>91</sup> Craig T. Bouchard & James V. Koch, *The Caterpillar Way*, at 80 (2014); Caterpillar Inc. Annual Report (Form-10K), at 1 (12/31/2011).

<sup>92</sup> Id. at 50.

<sup>93</sup> Caterpillar Inc. Annual Report (Form-10K), at 8 (2/19/2013).

<sup>94</sup> 3/7/2014 Caterpillar response to Subcommittee Questionnaire, CAT-001866 - 264, at 866 - 867.

On average, Caterpillar dealers have been in operation for 50 years, and turnover is rare.<sup>95</sup> In 1993, Caterpillar had a total of 183 Caterpillar dealers worldwide, with 65 dealerships located in the United States and 118 located outside the United States.<sup>96</sup> The overall number of dealers is now slightly lower, with 178 dealers worldwide, of which 48, or 27%, are located in the United States and four, or about two percent, located in Switzerland.<sup>97</sup>

Caterpillar's Customer and Dealer Support business segment, headed by Stuart Levenick in Illinois, is responsible for supporting and overseeing Caterpillar's worldwide dealer network. Among other responsibilities, it evaluates dealer performance and determines whether a dealer should be added or dropped from the network. In February 2014, the Customer and Dealer Support segment announced an initiative to improve the sales performance of Caterpillar's independent dealers. A media article described that initiative as follows:

“‘This is not a plan to cull our dealers or drive consolidation – although you can expect that some of that will occur,’ Levenick told Reuters in an interview on Wednesday.

‘But we do expect results. If you are not aligned, if you’re not progressing towards those results, then you can expect us to move judiciously to make changes ... They all get that.’

Caterpillar used to organize its global business – including dealer relations – regionally rather than by product category or customer type. So dealers were, in Levenick's words, ‘measured against the guy down the street’.

That changed when the company reorganized a few years ago. The far-flung dealer network was put under one executive in Peoria, Illinois, who began comparing the performance of dealers across the globe.

The disparities, Levenick says, were jaw-dropping. So, too, were the money-making possibilities – if the laggards sold machines, parts and services as efficiently as dealers in the top half of the dealer performance rankings. ...

Under the plan, underperforming dealers have until the end of 2014 to come up with a plan for raising key metrics. Once the plan is approved by Caterpillar, they have three years to meet the targets.”<sup>98</sup>

This new dealer oversight effort, which is being run from the United States, may result in some of the 178 dealers being removed from the Caterpillar network.<sup>99</sup> Before a new dealer may be

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<sup>95</sup> 9/17/2001 “Caterpillar Fiscal Year 2000 Transfer Pricing Documentation Report,” PwC\_CAT\_PSI\_00004975 - 5162, at 008 and 032.

<sup>96</sup> Caterpillar Inc. Annual Report (Form-10K), at 2 (12/31/1993).

<sup>97</sup> 2/21/2014 “Caterpillar Inc. Presentation to the Senate Permanent Subcommittee on Investigations,” PSI\_Caterpillar\_14\_000001 - 010, at 002; “Find Your Dealer,” Caterpillar worldwide dealer locator service on its website, [http://www.cat.com/en\\_US/support/dealer-locator.html](http://www.cat.com/en_US/support/dealer-locator.html).

<sup>98</sup> “Caterpillar dealer push may drive some out, Levenick says,” *Reuters*, James B. Kelleher (3/6/2014), <http://www.reuters.com/article/2014/03/06/us-caterpillar-dealers-idUSBREA250AZ20140306>.

<sup>99</sup> *Id.*

removed or added to the network or significantly change its territory, including dealers outside of the United States, approval must be obtained from Caterpillar Inc. executives in the United States, including CEO Doug Oberhelman.<sup>100</sup>

Several divisions within the Customer and Dealer Support business segment provide dealer support. For example, the Customer Services Support Division is responsible, among other tasks, for handling “dealer operational capability development and deployment support.”<sup>101</sup> That division is headed by Stephen Gosselin who is located in Illinois.<sup>102</sup>

Also within the Customer and Dealer Support segment, Caterpillar has three regional “Distribution Services” divisions, each headed by a Vice President located in the relevant region, and each responsible for dealer support and market development in the region in which it is based.<sup>103</sup> The “Americas Distribution Services” Division is headed by Pablo Kozner, who is located in the United States. The “EAME Distribution Division” is headed by Nigel Lewis, who is located in Switzerland at CSARL. The “Asia Pacific Distribution” Division is headed by James Johnson, who is located in Singapore. These three divisions are also often referred to as “marketing companies” since they focus on market development in their respective regions. In its most recent business re-alignment, the three marketing companies were part of a business group within Caterpillar’s Customer and Dealer Support segment known as the Center of Excellence.<sup>104</sup> Like their division heads, the key marketing company personnel for North and South America are located in the United States. The key marketing company personnel for Europe, Africa, and the Middle East are located in Switzerland at CSARL. The key marketing company personnel for Asia and the South Pacific are located in Singapore.

Caterpillar prides itself on its dealers having superb local knowledge of their markets and maintaining superior customer service in the areas in which they operate. Overseas dealers are recommended and also developed, administered, and supported by CSARL and its subordinate companies.<sup>105</sup> According to Caterpillar, dealer recommendations from CSARL and other marketing companies are almost never overruled; one Caterpillar employee intimately involved in the dealer network said that he had never seen the Customer and Dealer Support personnel in Illinois challenge a locally made dealer decision.<sup>106</sup>

The marketers at Caterpillar in most instances do not sell directly to customers.<sup>107</sup> Instead, the marketers serve as local Caterpillar representatives responsible for administering and maintaining local dealer relationships. For example, they assist dealers with sales calls, help

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<sup>100</sup> Subcommittee interview of David Picard, Caterpillar Product Support and Sales Operations Director for EAME Region (3/4/2014).

<sup>101</sup> “Stephen A. Gosselin,” profile prepared by Caterpillar, <http://www.caterpillar.com/en/company/governance/officers/stuart-l-levenick/stephen-a-gosselin.html>.

<sup>102</sup> See “Find Your Dealer,” [http://www.cat.com/en\\_US/support/dealer-locator.html](http://www.cat.com/en_US/support/dealer-locator.html).

<sup>103</sup> 9/17/2001 “Caterpillar Fiscal Year 2000 Transfer Pricing Documentation Report,” PwC\_CAT\_PSI\_00004975 - 5162, at 028.

<sup>104</sup> 9/15/2011 “Caterpillar Inc. Transfer Pricing Analysis and Report For fiscal year ended December 31, 2010,” PwC\_PSI\_CAT\_00007795 - 8204, at 819.

<sup>105</sup> Subcommittee interview of David Picard, Caterpillar (3/4/2014).

<sup>106</sup> Id.

<sup>107</sup> 9/17/2001 “Caterpillar Fiscal Year 2000 Transfer Pricing Documentation Report, PwC\_CAT\_PSI\_00004975 - 5162, at 029.

handle delivery of service issues, and communicate Caterpillar sales goals and other objectives.<sup>108</sup> Another responsibility is helping local dealers develop marketing programs and providing training to their sales personnel as well as training on dealer information systems.<sup>109</sup> Marketing companies may also help a dealer address import or export issues, or apply for financing from Caterpillar or the marketing companies themselves to purchase more inventory or expand its facilities. In addition, they oversee dealer compliance with the terms and conditions of their sales and service agreements with Caterpillar.

While its marketing companies, including CSARL's predecessor in Switzerland, Caterpillar Overseas, S.A. (COSA) which was formed in 1960, helped develop its dealer network, Caterpillar Inc., the U.S. parent, played the largest role in developing the company's worldwide network.<sup>110</sup> The majority of the 178 dealers in operation today were established prior to the 1990s.<sup>111</sup> Using identical language, Caterpillar's 1994, 1995, 1996, and 1997 transfer pricing reports described the relative roles of the U.S. parent and its marketing companies in developing its dealer network as follows:

“Cat Inc. has the largest role with regard to market and dealer development, since 1) it has the largest single market, 2) it was the originator of the basic marketing systems and concepts, and 3) it continues to be involved with the development and oversight of worldwide marketing approaches. The marketing companies also have major responsibility for market development; in fact, this is their primary responsibility.”<sup>112</sup>

Today, Caterpillar executives in the United States, through the Customer and Dealer Support business segment, continue to oversee and support the company's worldwide dealer network, which continues to be seen as playing a critical role in Caterpillar's success.

### **C. Caterpillar's Replacement Parts Business**

Caterpillar machines are known for dependability and durability.<sup>113</sup> In fact, the average age of a Caterpillar machines in operation around the world is over 20 years old.<sup>114</sup> Caterpillar is also known for its first class customer service. Customers rely on the company to service and

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<sup>108</sup> Id. at 027.

<sup>109</sup> Id. at 028.

<sup>110</sup> 12/19/1996 “Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995,” PwC\_CAT\_PSI\_00008881 - 9104, at 930; See also 1/26/1998 “Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1996,” PwC\_PSI\_CAT\_00009105 - 334, at 155; 9/15/1998 “Caterpillar, Inc. 1997 Documentation Report Final Report,” PwC\_PSI\_CAT\_00009335 - 612 at 392.

<sup>111</sup> Caterpillar Inc. Annual Report (Form-10K), at 2 (12/31/1993).

<sup>112</sup> 4/18/1996 “Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1994,” PwC\_CAT\_PSI\_00008634 - 880, at 685.

<sup>113</sup> 11/6/1998 PWC memorandum from John Hatch to Charles Larson and Steven Williams, “Subject: CAT and COSA,” PwC\_PSI\_CAT\_00169827 - 838. See also 8/29/2007 email from Steven R. Williams, PWC, to Clifford Mangano, PWC, PwC\_PSI\_CAT\_00024439 - 440 (indicating Caterpillar machines operate for 20 years or longer).

<sup>114</sup> Subcommittee interview of William Springer, Caterpillar, Vice President of Product Support (11/7/2013).

repair its machines quickly, minimizing downtime for consumers and contributing to the company's reputation for dependability.<sup>115</sup>

A key part of its customer service and repair operations is supplying and delivering replacement parts. Caterpillar considers its parts business to be a key competitive advantage.<sup>116</sup> Stuart Levenick, head of the Customer and Dealer Support business segment, has said: "Once someone buys a Caterpillar product, the single biggest driver of loyalty to Cat is parts availability."<sup>117</sup>

Replacement parts also represent a critical aspect of Caterpillar's profitability. Caterpillar machines are often sold at low profit margins, and the company then depends upon the machine's long service life to create long-term customer demand for replacement parts which Caterpillar can sell at higher profit margins.

### (1) Parts Business In General

Caterpillar documents indicate that, while the company typically earns only a relatively small profit margin from the sales of its machines, its replacement parts business has been a steady generator of major profits for Caterpillar.<sup>118</sup> For instance, in some years, Caterpillar's profit margins on machines were in the single digits, while profit margins on some parts exceeded 30%.<sup>119</sup> Parts profits also make up a significant portion of the company's profits, despite being only a small portion of its revenues. In one year, 80% of CSARL's profits came from replacement parts sales, despite making up only 20% of its sales revenues.<sup>120</sup>

<sup>115</sup> 11/6/1998 PWC memorandum from John Hatch to Charles Larson and Steven Williams, "Subject: CAT and COSA," PwC\_PSI\_CAT\_00169827 - 838.

<sup>116</sup> See, e.g., Caterpillar presentation, "Parts Growth & Distribution Network Transformation," by Caterpillar executives Steve Gosselin and Steve Larson, Feb. 2012 Caterpillar Board of Directors meeting, CAT-001885 - 898, at 886; 4/18/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1994," PwC\_CAT\_PSI\_00008634 - 880, at 684 ("parts distribution is one of Caterpillar's most important competitive advantages in the marketplace"). At times, Caterpillar has denied to the Subcommittee that it has a "parts business," explaining that "parts" is not one of its reportable business segments. It is clear, however, that Caterpillar views its parts business as critical to the company's success. For example, in minutes from a 2002 board meeting, the parts business was described as "Critical Success Factor #4." The minutes described "the parts business value chain" and stated in part that "the company has recently focused on parts sales and increased investment in parts products development, parts and service systems." 12/11/2002 minutes from Caterpillar Board of Directors meeting, CAT\_001855 - 865, at 855. See also, e.g., 12/8/2009 Caterpillar presentation to Caterpillar Board of Directors, CAT-001868 - 884, at 871 (stating, in an update on a business "enterprise alignment," that an "area for continued focus" was the "Parts Business"); 2/8/2012 minutes from Caterpillar Board of Directors meeting, CAT-001855 - 865, at 857 ("Mr. Levenick invited Mr. Gosselin and Larson to discuss the Company's parts business."); 5/1/2013 "The Big Interview: Caterpillar's Stuart Levenick," <http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/> (Mr. Levenick states: "That's the good thing about the parts business – it's really steady when you're in the bottom of a cycle. It's a very important business for us and for the dealers ...").

<sup>117</sup> 5/1/2013 "The Big Interview: Caterpillar's Stuart Levenick," [Construction Week Online](http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/), Stian Overdahl, <http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/>.

<sup>118</sup> Id.

<sup>119</sup> 10/5/1999 "Caterpillar Inc. Global Value Enhancement Project Draft," PwC\_PSI\_CAT\_00004483 - 530, at 508; Subcommittee interview of William Springer, Caterpillar (11/7/2013).

<sup>120</sup> 11/14/2005 "Caterpillar SARL 2006-2012 Royalty Rate: Options and Implications," PwC\_PSI\_CAT\_00133127 - 180, at 148.

Donald Fites, Chairman and CEO of Caterpillar between 1990 and 1999, has characterized the sale of a Caterpillar machine to a customer as analogous to the generation of an annuity that continues to pay dividends over time, due to the revenues generated from machine repair and parts.<sup>121</sup> A 2012 company presentation given to the Caterpillar Board of Directors put it this way:

“The ‘seed, grow, harvest’ business model ingrained in the organization was a catalyst to aftermarket parts sales and services, creating an annuity continuing long after original equipment sales and generating customer loyalty, PINS, and profits.”<sup>122</sup>

In a Subcommittee interview, William Springer, who recently served as President of Caterpillar Third Party Logistics and as Vice President of Product Support, described the parts business in the same way, explaining that 2.5 million Caterpillar machines were in the field with an average life cycle of about 20 years, generating an ongoing demand for replacement parts and thereby creating a “parts annuity.”<sup>123</sup> Caterpillar has also described the replacement parts business as a “perpetual profit machine.”<sup>124</sup>

Demand for replacement parts for a Caterpillar machine can last for decades. For example, one 2007 analysis showed that roughly half of all replacement parts sold by Caterpillar went to service machines that had been in the field for ten years.<sup>125</sup> In addition, a substantial amount replacement parts sold by Caterpillar were used to service machines that were 20 years old or more.<sup>126</sup> Since some Caterpillar machines have parts that wear out and require frequent replacement, as much of 90% of some parts’ total production is sold in the aftermarket, rather than in new equipment.<sup>127</sup>

A 2014 book about Caterpillar observed that Caterpillar’s customers may frequently spend two to three times more on service and parts than they spend on the original equipment itself.<sup>128</sup> The book also cited a recent analysis which determined that, during the financial crisis of 2008-2009, parts revenue proved vitally important to both Caterpillar and its dealers as sales of some machines dropped by as much as 62%, but parts sales continued.<sup>129</sup> Stuart Levenick, Customer and Dealer Support head, has said: “That’s the good thing about the parts business –

<sup>121</sup> Craig T. Bouchard & James V. Koch, The Caterpillar Way, at 120 (2014).

<sup>122</sup> 2/8/2012 minutes from Caterpillar Board of Directors meeting, CAT-001855 - 865, at 857. Caterpillar’s auditor, PricewaterhouseCoopers also compared the company’s business model to that of “razors and razorblades,” referring to companies that give away a razor for free, knowing consumers will pay for the replacement blades. See undated PwC Planning document, PwC\_PSI\_CAT\_00004506 - 631, at 619. PINS is an Caterpillar acronym for “Percent Industry New Sales” and represents market share for new equipment.

<sup>123</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013). But see 5/1/2013 “The Big Interview: Caterpillar’s Stuart Levenick,” Construction Week Online, Stian Overdahl, <http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/> (“there are approximately 3.5 million Caterpillar machines and engines in use through-out the world”).

<sup>124</sup> 3/15/2010 “Caterpillar Inc. Worldwide Parts Management Final Closing Book, Draft Version as of March 15, 2010,” PwC\_PSI\_CAT\_00003876 – 168, at 912.

<sup>125</sup> 8/29/2007 email from Steven Williams, PwC, to Clifford Mangano, PwC, PwC\_PSI\_CAT\_00024439 - 440, at 439.

<sup>126</sup> Id.

<sup>127</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013).

<sup>128</sup> Craig T. Bouchard & James V. Koch, The Caterpillar Way, at 218 (2014).

<sup>129</sup> Id., at 120, citing “Fall in Sales in the Great Recession: Rachel Potts, Caterpillar Public Affairs.”

it's really steady when you're in the bottom of a cycle. It's a very important business for us and for the dealers, it really helps even out those swings in the business cycles.”<sup>130</sup>

**Parts Design.** Because of the revenue implications, aftermarket parts sales for a machine represent a very important set of design considerations for the company.<sup>131</sup> The Subcommittee was told that Caterpillar machines are designed on an individual basis, with a single Product Manager ultimately responsible for the design and production of all components of a particular machine.<sup>132</sup> The majority of Caterpillar's worldwide Product Managers are located in the United States.<sup>133</sup> To protect Caterpillar's replacement part revenue stream, Product Managers are encouraged to incorporate proprietary parts into Caterpillar machines whenever possible and to prevent Caterpillar machines from being repaired with generic parts from competitors.<sup>134</sup> According to a 2012 presentation to the Caterpillar Board of Directors, product design emphasizing proprietary parts was a key factor driving the company's future parts growth.<sup>135</sup> Caterpillar has registered numerous patents for its parts, most of which are in the United States.

**Third Party Parts Suppliers.** Caterpillar's aftermarket machine parts are produced primarily by third party suppliers as “purchased finished replacement parts” (PFRPs).<sup>136</sup> Parts produced by third party suppliers in the United States almost always carry the Caterpillar brand and are packaged as Caterpillar products. While Caterpillar does not own most of its major parts suppliers, it exercises oversight of them to maintain parts quality and protect its brand. At times, it stations Caterpillar personnel on site at supplier plants to oversee operations and promote Six Sigma compliance.<sup>137</sup> Currently, approximately half of Caterpillar's 48,000 third-party suppliers that produce purchased finished replacement parts are located in the United States.<sup>138</sup>

In some cases, Caterpillar itself produces the replacement parts needed in some of its machines. When Caterpillar manufactures the part, they are referred to as “worked parts,” to distinguish them from the “purchased finished replacement parts” manufactured by third party suppliers. Most of Caterpillar's worked parts are manufactured by its plants in the United States. However, the majority of Caterpillar replacement parts are produced by third parties rather than by the company itself.<sup>139</sup>

<sup>130</sup> 5/1/2013 “The Big Interview: Caterpillar's Stuart Levenick,” Construction Week Online, Stian Overdahl, <http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/>.

<sup>131</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013).

<sup>132</sup> Id.

<sup>133</sup> Id.; Subcommittee interview of Steven Williams, PWC (2/19/2014). See also 11/4/2008 email from Steven Williams, PWC, to Thomas Quinn, PWC, “is tomorrow really the only shot with DBB,” PwC\_PSI\_CAT\_00033157 (“Also, just curious – say they decide most PMs stay in US.”).

<sup>134</sup> Subcommittee interview of William Springer (11/7/2013).

<sup>135</sup> See Caterpillar presentation, “Parts Growth & Distribution Network Transformation,” by Caterpillar executives Steve Gosselin and Steve Larson, Feb. 2012 Caterpillar Board of Directors Meeting, CAT-001885 – 898, at 888. See also 2/8/2012 minutes from Caterpillar Board of Directors meeting, CAT-001855 - 865, at 857.

<sup>136</sup> “2012 Year in Review,” prepared by Caterpillar and on its website, at 33, <http://s7d2.scene7.com/is/content/Caterpillar/C10005383>.

<sup>137</sup> Craig T. Bouchard & James V. Koch, The Caterpillar Way, at 169 (2014); Subcommittee interview of David Burritt, former Caterpillar CFO (12/4/2013).

<sup>138</sup> 2/21/2014 Caterpillar Inc. Presentation to the Senate Permanent Subcommittee on Investigations, at PSI-Caterpillar-14-000001 - 010, at 002.

<sup>139</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 277.

**24-Hour Parts Delivery.** Caterpillar also maximizes its parts business by offering to its customers best in class parts replacement services. A 2012 Caterpillar Year in Review Report stated: “A key strength is [the company’s] ... ability to manufacture parts [and] ... deliver unmatched parts availability to dealer and customers anywhere in the world.”<sup>140</sup> The 2012 report highlighted the company’s focus on quick delivery of parts by citing an instance in which a Caterpillar dealer delivered a part to a customer only one hour after the customer called in.<sup>141</sup>

Caterpillar has set a goal of delivering its parts anywhere in the world within 24 hours of a request and views its ability to meet that goal as differentiating it from its competitors.<sup>142</sup> Caterpillar tracks its delivery performance and manages dealer inventory levels to assist with parts delivery.<sup>143</sup> According to Caterpillar, its dealers are able to fill 85% to 90% of parts orders immediately upon request from parts kept on site, and 95% of the remaining parts are delivered anywhere in the world within 24 hours.<sup>144</sup> Other similar industries, such as automobiles, can take 2-7 days to ship parts that are not held in stock at a dealership.<sup>145</sup> According to Caterpillar’s transfer pricing documentation, “Caterpillar’s guarantee to deliver parts anywhere in the world on very short notice enables it to sell more machines, since customers know that they will not be idled long by missing parts.”<sup>146</sup>

Caterpillar has been performing functions critical to the parts side of its business for decades. In the 1990s, for example, U.S. personnel were warehousing parts, setting stocking levels, forecasting parts usage and demand, managing support systems, invoicing, overseeing the

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<sup>140</sup> “2012 Year in Review,” prepared by Caterpillar, at 33, <http://s7d2.scene7.com/is/content/Caterpillar/C10005383>. See also 12/11/2002 minutes from Caterpillar Board of Directors meeting, CAT\_001855 - 865, at 856 (“product support is vitally important to the company and its dealers”).

<sup>141</sup> “2012 Year in Review,” prepared by Caterpillar, at 15, <http://s7d2.scene7.com/is/content/Caterpillar/C10005383>.

<sup>142</sup> See, e.g., 9/11/2006 “Caterpillar, Inc. Valuation of Caterpillar’s 100% Interest in Shareholder’s Equity of Caterpillar of Australia Pty. Limited,” Ernst & Young, PwC-PSI-CAT-00015198 - 272, at 218; 4/18/1996 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1994,” PwC\_CAT\_PSI\_00008634 - 880, at 684 (“parts distribution is one of Caterpillar’s most important competitive advantages in the marketplace”). See also “Building the World – Caterpillar,” article in Access, a publication of Federal Express (May 2012), <http://access.van.fedex.com/caterpillar/> (When asked about Caterpillar’s commitment to deliver a part anywhere in the world within 24 hours, Stuart Levenick, Group President of Caterpillar’s Customer Service and Dealer Support segment, said: “That’s a big commitment, and that’s worldwide. It means we’ve got an enormous network of parts distribution. We’ve got logistics people feeding parts into these depots, dealers carrying inventory. All of this has to work like a clock. ... Logistics is huge for us.”). Komatsu, a key Caterpillar competitor, has made an almost identical guarantee. See <http://www.komatsuamerica.com/komatsu-parts>.

<sup>143</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013).

<sup>144</sup> Id. See also Subcommittee interview of Thomas Quinn, PWC (10/2/2013) (Caterpillar’s success rate in meeting its 24-hour delivery standard is typically in the upper 90th percentile); 11/6/1998 PWC memorandum from John Hatch to Charles Larson and Steven Williams, PWC, “CAT and COSA,” PwC\_PSI\_CAT\_00169827 - 838, at 833 (“Dealers now provide 80% of parts orders immediately upon request, and 99% are shipped within a day of being requested”).

<sup>145</sup> See 11/6/1998 PWC memorandum from John Hatch to Charles Larson and Steven Williams, PWC, “CAT and COSA,” PwC\_PSI\_CAT\_00169827 - 838, at 833 (“contrast this to 2-7 days for car dealers that do not have a part in stock”).

<sup>146</sup> 4/18/1996 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1994,” PwC\_CAT\_PSI\_00008634 - 880, at 684-685.



parts introduction process, and working on parts delivery.<sup>147</sup> According to other Caterpillar documentation during the 1990s:

“Caterpillar’s after sales service, which includes supporting dealers in the servicing of equipment and the timely provision of parts around the world, is one of its major competitive tools. Caterpillar’s role in after-sales service includes developing servicing procedures and standards, technical manuals, technical support and training for dealers, and warranty support. The dealer network and parts distribution are the two keys to after-sales service. The marketing companies have responsibility for the dealer network, while P&SS [Parts & Services Support Division in the United States] performs the primary management activity for the parts distribution network. Cat Inc., as the designer of the system and owner of the Morton parts center, has the greatest strategic role.”<sup>148</sup>

According to Caterpillar representatives, CSARL and its subordinate marketing companies continue to play an instrumental role in fulfilling the 24 hour parts delivery promise by helping monitor local parts demand and ensure needed parts are stockpiled at local distribution centers.<sup>149</sup>

## (2) Role of the United States in Caterpillar’s Parts Business

Former Caterpillar CFO David Burritt told the Subcommittee that the company’s ability to provide high quality parts within 24 hours anywhere in the world depends upon logistic capabilities that were developed by the company over more than 75 years.<sup>150</sup> While Caterpillar’s replacement parts business has operations around the world and is supported by its marketing companies, including CSARL in Switzerland, and by dealer personnel worldwide, the company’s parts leadership and strategic functions remain centered in the United States.<sup>151</sup> Altogether, Caterpillar has over 8,300 employees who work on parts, about 4,900 of whom are located in the United States, more than any other country, despite the fact that 67% of Caterpillar sales occur offshore.<sup>152</sup> That concentration of U.S. employees is due in part to the fact that nearly 70% of

<sup>147</sup> Undated interview notes of Craig Barley – Manager, Peoria, Parts & Services Support Availability & Inventory Management, collected by PwC, PwC\_PSI\_CAT\_00179037 - 038. See also 12/1998, Caterpillar Inc., Global Tax Optimization, Risk Adjusted Benefit Analysis, Working Papers – Draft 1,” PwC-PSI-CAT-00001336 - 671, at 415 (“P&SS [Parts & Services Support division] appears to track parts (forecasting, scheduling, purchasing, shipping, inventory levels) on a global basis with great amounts of detail”); Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>148</sup> 1/26/1998 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1996,” PwC\_PSI\_CAT\_00009105 - 334, at 156. See also 9/15/1998 “Caterpillar, Inc. 1997 Documentation Report Final Report,” PwC\_PSI\_CAT\_00009335 - 612 at 393; 9/15/1999 “Caterpillar 1998 Documentation Report,” PwC\_PSI\_CAT\_00009613 - 928, at 674.

<sup>149</sup> Subcommittee interview of David Picard, Caterpillar (3/4/2014).

<sup>150</sup> Subcommittee interview of David Burritt, former Caterpillar CFO (12/4/2013).

<sup>151</sup> See, e.g., 2/8/2012 minutes from Caterpillar Board of Directors meeting, CAT\_001855 - 865, at 857 (describing Caterpillar’s parts distribution business as using a “U.S. centric model”); 9/1998 PwC report, “Caterpillar Inc. Global Tax Optimization Case for Action,” PwC\_PSI\_CAT\_00004632, at 670 (describing Caterpillar’s “U.S. ‘centric’ role” as a “Negative Tax Rate Driver”); 4/18/1996 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1994,” PwC\_PSI\_CAT\_00008634 - 880, at 686 and 698 (describing Caterpillar Inc. as playing the “greatest strategic role” in after sales service and stating that “Parts & Services Support, a division of Cat Inc. located in Morton, IL is charged with managing the worldwide parts distribution network”).

<sup>152</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 279.

purchased finished Caterpillar replacement parts sold offshore are still manufactured in the United States.<sup>153</sup> Both before and after the 1999 CSARL transaction, Caterpillar's replacement parts business has been led and managed primarily from the United States.

**Key Parts Personnel.** A number of organizations within Caterpillar Inc. manage key aspects of its replacement parts business. The Customer and Dealer Support business segment, headed by Stuart Levenick of Illinois, performs a number of the key functions, including parts logistics and distribution, inventory management, and parts pricing.<sup>154</sup> A key division is the Customer Services Support Division, which is charged with "growing Caterpillar's aftermarket parts and services business" and handling "parts distribution," among other tasks.<sup>155</sup> It is headed by Stephen Gosselin, who is based in Illinois. Within his division, Barbara Hodel, also located in Illinois, is the Director of Parts Distribution and oversees the company's warehouses and distribution centers.<sup>156</sup> Two additional key employees are Joseph Van Wassenhove, Parts Pricing Manager, and Timothy Gryl, Service Parts Manager and head of Caterpillar's Inventory Management Group. Both are Illinois residents.

Another key organizational unit is the Caterpillar Enterprise System Group, headed by David Bozeman who reports directly to CEO Douglas Oberhelman. Mr. Bozeman, too, is based in Illinois. This new "order-to-delivery organization" was formed in 2013.<sup>157</sup> A key employee is Frank Crespo, the head of Purchasing, which is responsible for developing and overseeing the company's supplier base which manufactures the purchased finished replacement parts sold abroad. Another key employee is Edward O'Neil, manager of Manufacturing Logistics.<sup>158</sup> Both are located in Illinois. Among other responsibilities, the new group is responsible for transporting Caterpillar parts around the world.

A former key member of the company's parts leadership was Steven Larson, who was head of the parts logistics division for the last nine years until he retired in February 2014.<sup>159</sup> Mr. Larson was also based in Illinois. After his retirement, the parts logistic division was dissolved and its functions integrated with the Customer Services Support Division.<sup>160</sup>

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<sup>153</sup> 3/7/2014 Caterpillar response to Subcommittee Questionnaire, CAT-001866 - 2264, at 866.

<sup>154</sup> See "Stuart L. Levenick," Caterpillar officer profile prepared by Caterpillar, <http://www.caterpillar.com/en/company/governance/officers/stuart-l-levenick.html>.

<sup>155</sup> See "Stephen A. Gosselin," Caterpillar officer profile prepared by Caterpillar, <http://www.caterpillar.com/en/company/governance/officers/stuart-l-levenick/stephen-a-gosselin.html>.

<sup>156</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>157</sup> "David P. Bozeman," Caterpillar officer profile prepared by Caterpillar, <http://www.caterpillar.com/en/company/governance/officers/david-p-bozeman.html>; 4/13/2014 Caterpillar Enterprise System Group press release.

<sup>158</sup> His group is the successor to the Manufacturing Logistics & Transportation Group formerly part of Steven Larsen's parts logistics division. 4/13/2014 Caterpillar Enterprise System Group press release.

<sup>159</sup> See 8/20/2013 "Caterpillar Announces Retirements of Long-Time Officers; Appointments and Changes in Responsibilities for Vice Presidents will Drive Company Strategy," Caterpillar press release, <http://www.caterpillar.com/en/news/corporate-press-releases/h/caterpillar-announces-retirements-of-long-time-officers-appointments-and-changes-in-responsibilities-for-vice-presidents-will-drive-company-strategy.html> (noting Mr. Larson was head of the division for nine years and "played a critical role in the successful divestiture of a majority interest in Caterpillar Logistics Services in 2012, and ... guided the build out, modernization and expansion of the Cat® parts distribution network").

<sup>160</sup> Id. ("Concurrent with the announcement of Steve Larson's retirement, Caterpillar is announcing a strategic realignment of the Parts Distribution & Diversified Products Division and the Customer Services Support Division.

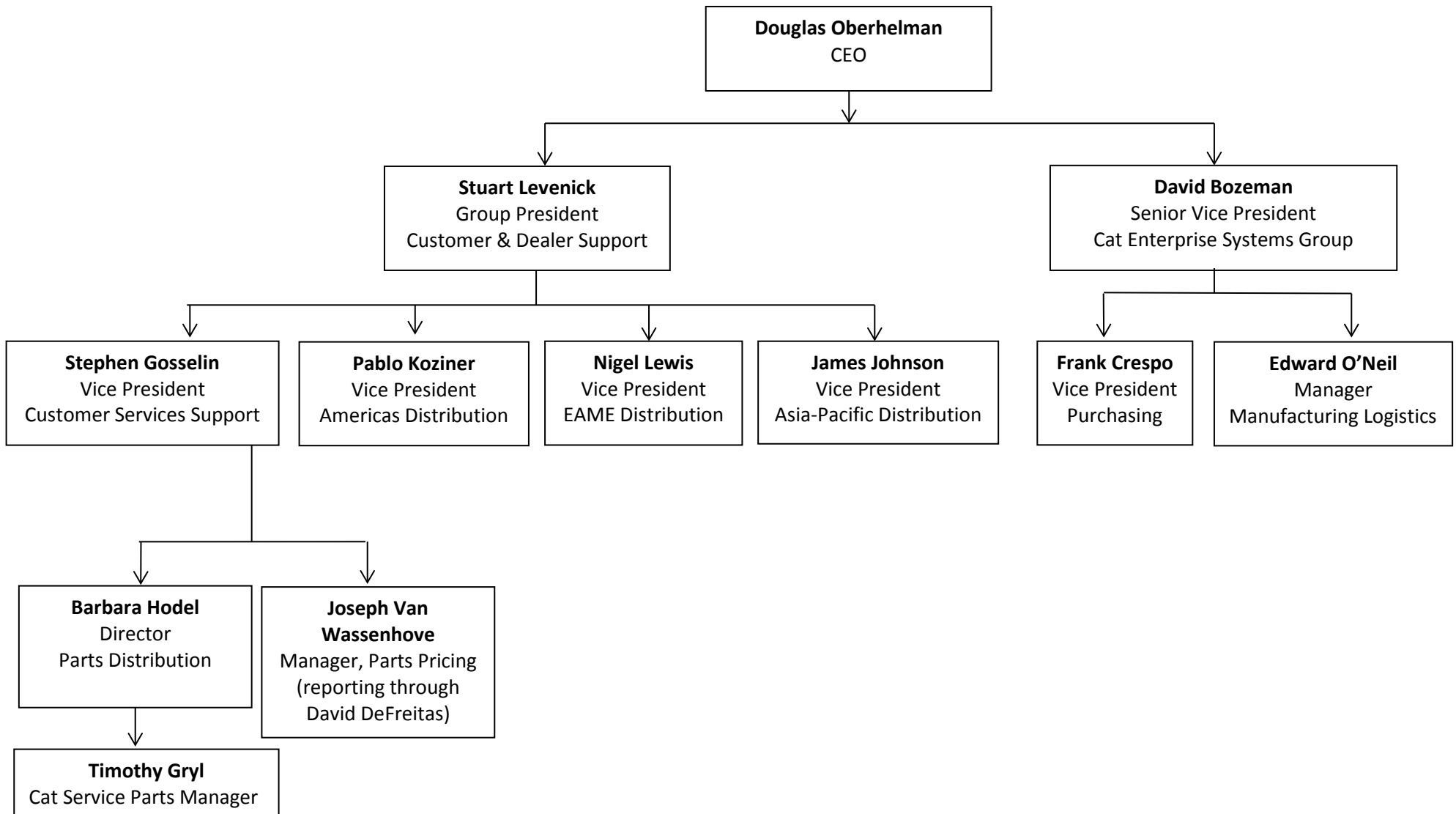
The following chart depicts Caterpillar organizations and executives who lead and manage key business functions supporting its non-U.S. parts sales.

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As part of this realignment, Caterpillar's Parts Distribution business will be integrated into the Customer Services Support Division, which is led by Vice President Steve Gosselin. The Customer Services Support Division is focused on aggressively growing Caterpillar's parts and product support. The division develops and supports deployment of parts and service products, processes and programs for our dealers, enabling them to deliver unmatched product support. Including Caterpillar Parts Distribution this division will form a single global parts organization that will allow a seamless Caterpillar focus on supporting customer requirements for product support.”).

# Caterpillar Organizations

## Performing Key Functions Related to Parts



**Storing Parts.** Illinois not only hosts the vast majority of Caterpillar's senior parts leadership, but is also the home of the Morton warehouse which is Caterpillar's central hub for stocking replacement parts.<sup>161</sup> Morton is twice the size of Caterpillar's next largest warehouse,<sup>162</sup> and is used by Caterpillar distribution centers, dealers, and customers around the world to obtain hard-to-get parts.<sup>163</sup> About 40% by value of CSARL-owned parts destined for sale abroad are stored in the Morton warehouse.<sup>164</sup> In addition to Morton, as of 2012, Caterpillar had five other warehouses in the United States, as well as smaller distribution centers across the country.<sup>165</sup> Outside of the United States, in 2012, Caterpillar had three warehouses, one each in South America, the Asia Pacific region, and the Europe, Africa, Middle East region, along with other distribution centers around the world.<sup>166</sup> In the last two years, Caterpillar has opened additional warehouse facilities within and outside of the United States. That the United States has continued to play a central role in the company's parts distribution business is reflected in the minutes of a February 2012 Caterpillar Board of Directors meeting in which management advocated converting Caterpillar's parts distribution business from a "U.S. centric" model into one that relied more on regional distribution centers.<sup>167</sup>

**Managing Parts Inventories.** Inventory supply levels at the Morton warehouse as well as Caterpillar's other warehouses and distribution centers around the world are monitored and managed by the Inventory Management Group, which is headquartered in the United States.<sup>168</sup> This group is included within the Customer Services Supports Division, headed by Timothy Gryl, and managed out of Illinois.<sup>169</sup> Caterpillar uses this group to monitor and determine the number and types of parts it should order from its suppliers and keep on hand at various locations. Under Caterpillar's obligations in its service agreement with CSARL, this group monitors and manages inventory levels for parts needed on a worldwide basis.<sup>170</sup>

The Inventory Management Group operates a global inventory monitoring system that tracks parts inventory levels around the world in Caterpillar's distribution network, forecasts

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<sup>161</sup> Subcommittee interview of Thomas Quinn, PWC (12/17/2013)

<sup>162</sup> Id. The next two largest parts warehouses are located in Grimbergen, Belgium and Singapore. Smaller distribution sites are located elsewhere in the United States and in other parts of the world.

<sup>163</sup> "85% of worldwide parts inventory is managed from Morton-moving toward 100%." Undated interview notes of Craig Barley – Manager, Peoria, P&SS Availability & Inventory Management, collected by PwC, PwC\_PSI\_Cat\_000179037 - 038. At one point, the Morton distribution center even controlled 100% of the physical parts inventory kept in Caterpillar's main European warehouse. Id.

<sup>164</sup> 11/26/2013 letter from Caterpillar to Subcommittee, CAT-000267 - 269, at 268.

<sup>165</sup> Caterpillar presentation, "Parts Growth & Distribution Network Transformation," by Caterpillar executives Steve Gosselin and Steve Larson, Feb. 2012 Caterpillar Board of Directors Meeting, CAT-001885 - 898 at 897 ("Cat Parts Distribution Future Footprint," chart); 2008 "Caterpillar Worldwide Locations," prepared by Caterpillar Inc. (listing 14 distribution centers across the United States), [http://pdf.cat.com/cda/files/113505/7/2008%20WW%20location\\_final.pdf](http://pdf.cat.com/cda/files/113505/7/2008%20WW%20location_final.pdf).

<sup>166</sup> Caterpillar presentation, "Parts Growth & Distribution Network Transformation," by Caterpillar executives Steve Gosselin and Steve Larson, Feb. 2012 Caterpillar Board of Directors Meeting, CAT-001885 - 898 at 897 ("Cat Parts Distribution Future Footprint," chart). The EAME warehouse is in Grimbergen, Belgium; none of the warehouses or distribution centers have ever been in Switzerland.

<sup>167</sup> 2/8/2012 minutes from Caterpillar Board of Directors meeting, CAT\_001855 - 865. See also Caterpillar presentation, "Parts Growth & Distribution Network Transformation," by Caterpillar executives Steve Gosselin and Steve Larson, Feb. 2012 Caterpillar Board of Directors Meeting, CAT-001885 - 898.

<sup>168</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>169</sup> Id.

<sup>170</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 296.

demand for particular parts, and transports parts on an emergency basis.<sup>171</sup> Its state-of-the-art inventory management software, which is at the heart of the company's logistics capabilities, was developed in and is administered from Caterpillar operations in Illinois. The group predicts demand for parts by evaluating historical demand patterns using sophisticated algorithms and generates recommended stocking levels for Caterpillar's worldwide distribution facilities.<sup>172</sup> On the issue of predicting future parts demand, Stuart Levinick, Customer and Dealer Support head, explained:

“We're able to understand how many hours a machine is being utilized each month, and we track that – by model, by industry, and by geography – so you can get ahead of how much these machines are being used, how much fuel they're burning, and that correlates back to future parts demand. So it's giving us a leg up to understand with our supply base when to start to dial up capacities, and when to ease back.”<sup>173</sup>

The Inventory Management Group also helps customers acquire parts on an expedited basis from manufacturers if the parts are not immediately available in Caterpillar's inventory.

Although the Inventory Management Group is managed from the United States, it is assisted by Caterpillar parts and service representatives located in distribution centers and marketing companies around the world. Those representatives assist dealers in monitoring and managing their parts inventories to facilitate sales. According to Caterpillar, the representatives spend roughly 50% of their time at dealer sites, and occasionally are co-located at a dealership.<sup>174</sup> Parts and service representatives help dealers maximize aftermarket part sales by systematically evaluating and predicting when parts will wear out, when they should be ordered and in what quantities, as well as helping dealers prevent counterfeit parts from entering their markets.<sup>175</sup> Representatives also assist in training dealer technicians on proper service and maintenance of Caterpillar machines.<sup>176</sup> Service manuals for parts and machines are designed by Caterpillar personnel in the United States and shipped to dealers around the world.<sup>177</sup> In addition, Caterpillar provides marketing consulting services, and creates and supports dealer marketing programs for replacements parts.<sup>178</sup>

Customers needing replacement parts typically turn first to their local Caterpillar dealer, which keeps a parts inventory on site and is able to provide the requested part 85-90% of the time.<sup>179</sup> If the part is not available on site, the dealer, or occasionally the customer, can place an order for the replacement part which is sent to the appropriate Caterpillar distribution facility, generally the closest location geographically. Inventory systems at the facility automatically check for availability of the part in the facility's onsite inventory. If the part is available it will be pulled from the facility's inventory and prepared for shipment. If the part is not available at

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<sup>171</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>172</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013).

<sup>173</sup> 5/1/2013 “The Big Interview: Caterpillar's Stuart Levenick,” Construction Week Online, Stian Overdahl, <http://www.constructionweekonline.com/article-22168-the-big-interview-caterpillars-stuart-levenick/1/print/>.

<sup>174</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013).

<sup>175</sup> Id.

<sup>176</sup> Id.

<sup>177</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>178</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 296.

<sup>179</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013).

the facility, the order will automatically be sent to the next closest warehouse or distribution center, the largest being the Morton warehouse in Illinois.<sup>180</sup> When the part is located, it is prepared for immediate shipment with the goal of delivering the part to the local dealer or customer within 24 hours of the order.

Caterpillar uses numerous inventory systems to monitor parts supplies in its warehouses. These systems anticipate what parts will be needed when and where to replenish inventories around the world. Its general parts inventory system was designed in and is run from the United States.<sup>181</sup> Caterpillar's U.S. software engineers developed the algorithms and other software elements integral to that system, which tracks inventory quantities throughout Caterpillar's worldwide distribution network.<sup>182</sup> Other systems keep track of orders, purchases, sales, and inventory pricing, and also generate parts invoices for dealers. Historically, distribution centers in Grimbergen and Singapore have had personnel to expedite and schedule orders, but all parts forecasting and ordering was done from Morton, Illinois, even for parts sourced in Europe.<sup>183</sup>

**Manufacturing Parts.** In connection with its parts business, Caterpillar not only has to forecast the types and numbers of replacement parts needed, but also order their manufacture in time to meet customer demand. Caterpillar Inc. has sophisticated proprietary ordering systems, which were developed and are mainly administered out of the United States and function worldwide.<sup>184</sup> While Caterpillar manufactures a portion of the required replacement parts itself, most of its replacement parts must be ordered from its third-party suppliers.<sup>185</sup>

The company dedicates significant resources to managing its relationships with its third-party parts suppliers. The company's Purchasing group, led by Frank Crespo of Mossville, Illinois, has been assigned primary responsibility for managing those relationships.<sup>186</sup> The Purchasing group works closely with the suppliers to ensure they build parts that meet Caterpillar's quality standards and price requirements.<sup>187</sup> Its duties include working with suppliers to procure materials and services, forecasting demand for materials and parts, and monitoring the business viability of the supply base, with the overall goal of ensuring parts orders will be filled on time. Purchasing personnel visit suppliers in the United States and abroad to ensure capability and quality control in compliance with Six Sigma management principles.<sup>188</sup> In some cases, Caterpillar personnel are embedded at supplier sites to oversee manufacturing, and suppliers undergo rigorous financial audits by Caterpillar personnel.<sup>189</sup>

In addition, under the service agreement signed between Caterpillar Inc. and CSARL referenced earlier, Caterpillar Inc. agreed to manage third-party suppliers within the United

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<sup>180</sup> Subcommittee interview of Edward Simpkins, Caterpillar (1/29/2014).

<sup>181</sup> *Id.* Backup systems are located in Belgium.

<sup>182</sup> *Id.*

<sup>183</sup> Undated interview notes of Craig Barley – Manager, Peoria, Parts & Services Support Availability & Inventory Management, collected by PWC, PwC\_PSI\_CAT\_00179037 - 038.

<sup>184</sup> See "Summary of Orders and Invoicing Systems," PwC\_PSI\_CAT\_00018032 - 036.

<sup>185</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 277.

<sup>186</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014). The Global Purchasing Division was also known, at times, as the Product Support Division.

<sup>187</sup> *Id.*

<sup>188</sup> See Craig T. Bouchard & James V. Koch, The Caterpillar Way, at 169 (2014); Subcommittee interview of David Burritt, former Caterpillar CFO (12/4/2013).

<sup>189</sup> *Id.*

States that produce parts sold around the world. Under this agreement, Caterpillar Inc. consults with CSARL on identifying potential U.S. suppliers, visits those suppliers, negotiates terms with them, arranges for the transportation and delivery of specified parts, and inspects those parts for quality.<sup>190</sup>

Once parts manufactured in the United States by Caterpillar or a third-party supplier are produced, they may be packaged by a third party contractor. Third-party packaging companies take delivery of the parts and package them under the Caterpillar brand so they are suitable for storage at warehouses and subsequent sale. The relationship with these third-party packaging companies in the United States is also managed by the Purchasing group in the United States. Packaged parts have historically been delivered to the Morton distribution center in Illinois prior to being shipped to the company's regional distribution centers.<sup>191</sup> Today, some parts are also packaged and shipped from points outside of the United States.

**Transporting Parts.** Caterpillar also typically arranges for the transportation of parts from its third-party suppliers to its regional distribution facilities, a service managed by Caterpillar's Transportation Division, which is headquartered at the Morton distribution center in Illinois.<sup>192</sup> The Transportation Division, which is part of the Caterpillar Enterprise System Group, assists in delivering parts to Caterpillar's 19 global storage and distribution centers, including the warehouses in Grimbergen and Singapore.<sup>193</sup> As the goods arrive, Caterpillar personnel here and abroad are responsible for conducting quality inspections to ensure the parts meet the company's standards. The distribution centers are also responsible for conducting ongoing oversight over the life of a product, in part to evaluate the performance of the replacement parts.<sup>194</sup> The head of Caterpillar's quality division is also located in the United States and operates out of the Morton distribution center.<sup>195</sup>

**Thousands of Parts Personnel.** In response to questions from the Subcommittee, Caterpillar provided information about how many of its U.S. employees are involved with the "purchase, storage, movement, and sales of replacement parts."<sup>196</sup> Caterpillar indicated that of the 8,300 Caterpillar employees involved in those functions in 2012, about 4,900 worked in the United States. Of those 4,900 U.S. employees, Caterpillar indicated that about 3,600 were involved with "[p]arts [d]istribution ([l]ogistics)," about 1,035 were involved with "[g]lobal [p]urchasing," about 35 were involved with "parts pricing," about 115 were involved with "[p]arts [m]arketing [s]upport," and about 100 worked for the "Distribution Services Division."<sup>197</sup>

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<sup>190</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 296.

<sup>191</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014). See also undated interview notes of Craig Barley – Manager, Peoria, Parts & Services Support Availability & Inventory Management, collected by PwC, PwC\_PSI\_CAT\_00179037 - 038 ("Most regional distribution centers are served from Morton, not from contract packagers, because of low volume at regional centers.").

<sup>192</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>193</sup> See undated PwC interview notes of Don Puryear, Caterpillar Purchasing Transportation and Technical Support Manager, PwC\_PSI\_CAT\_00179035 - 036.

<sup>194</sup> Subcommittee interview of Deborah Kraft, Caterpillar (2/5/2014).

<sup>195</sup> Id.

<sup>196</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 279.

<sup>197</sup> Id.



Caterpillar's replacement parts business is a complex and demanding undertaking that requires expertise in forecasting parts demand, managing inventory supply levels, ordering the manufacture of needed parts, exercising quality control, packaging parts for shipment, and delivering parts as needed. Senior leadership for the Caterpillar parts business has been and continues to be located primarily in the United States. Key inventory management systems and controls, as well as ordering systems, were developed in the United States and continue to be managed from there. The company's largest and most important distribution center and parts warehouse operates out of Illinois. The majority of Caterpillar parts manufacturing takes place in the United States. To date, Caterpillar's replacement parts business has been and continues to be led and managed primarily from the United States.

#### **D. Caterpillar in Switzerland**

Although its major operations have always been in the United States, Caterpillar has also had a small continuous presence in Switzerland for decades. Today, out of 118,500 employees worldwide, about 400, or less than one half of one percent of its employees, are located in Switzerland.<sup>198</sup>

**COSA.** For forty years, from 1960 to 1999, Caterpillar's leading Swiss affiliate was Caterpillar Overseas, S.A. (COSA), which was based in Geneva.<sup>199</sup> COSA acted as Caterpillar's lead marketing company for the Europe, Africa, and Middle East (EAME) region.<sup>200</sup> COSA's responsibilities included purchasing machines and parts from Caterpillar for resale to EAME dealers, developing and maintaining the EAME dealer network, providing logistics support for parts delivery; providing EAME dealers with marketing information and sales training; acting as a liaison between EAME dealers and Caterpillar on product performance and service issues; helping EAME dealers obtain financing from Caterpillar or private banks to purchase inventory and improve their dealerships; and conducting oversight of EAME dealers to ensure their compliance with Caterpillar sales and service agreements. COSA worked with Caterpillar's U.S. employees who were in charge of approving new dealers, designing machines and their replacement parts, developing marketing campaigns and sales training materials for dealers, and providing dealer financing.<sup>201</sup> COSA had a regional focus, and was one of several offshore marketing companies that Caterpillar sponsored around the world.<sup>202</sup>

Aside from COSA's marketing work, Caterpillar had a very limited presence in Switzerland. Of its 125 manufacturing plants, none were or are located there.<sup>203</sup> Of its 19

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<sup>198</sup> 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, PSI-Caterpillar-17-000003 - 023, at 006 (CSARL in Switzerland currently has about 400 employees).

<sup>199</sup> 4/18/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1994," PwC\_CAT\_PSI\_00008634 - 880, at 673.

<sup>200</sup> Id.; 12/19/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995," PwC\_CAT\_PSI\_00008881 - 9104, at 916-917.

<sup>201</sup> 12/19/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995," PwC\_CAT\_PSI\_00008881 - 9104, at 930-931.

<sup>202</sup> Id. at 917-918.

<sup>203</sup> 2/21/2014 "Caterpillar Inc. Presentation to the Senate Permanent Subcommittee on Investigations," at PSI-Caterpillar-14-000001 - 010 at 002. See also 2008 "Caterpillar Worldwide Locations," prepared by Caterpillar Inc., [http://pdf.cat.com/cda/files/113505/7/2008%20WW%20location\\_final.pdf](http://pdf.cat.com/cda/files/113505/7/2008%20WW%20location_final.pdf). In 2004, Caterpillar purchased a local

distribution centers, none were or are in Switzerland. When EAME dealers needed replacement parts, the parts were generally shipped from Caterpillar's primary warehouse in Morton, Illinois or from other Caterpillar distribution centers, such as its warehouse in Grimbergen, Belgium. Very few replacement parts have ever been shipped from Switzerland to another country. In addition, during COSA's tenure, no worldwide or regional Product Managers were based in Switzerland.<sup>204</sup>

In addition to its headquarters in Switzerland, COSA also operated a branch office that was first in Hong Kong and later in Singapore, providing marketing support for Caterpillar dealers in Asia and the South Pacific.<sup>205</sup> Unlike Switzerland, in addition to the marketing office, Caterpillar maintained a parts distribution center and some manufacturing facilities in Singapore to serve Asian dealers.<sup>206</sup>

For years, Caterpillar's foreign marketing companies that helped support the sale of parts, including COSA's marketing operations in Switzerland and Singapore, were allocated a share of Caterpillar's non-U.S. parts profits. Although the amount fluctuated over time, the baseline apportionment was 50-50 on a legal entity basis prior to 1992.<sup>207</sup> During this time, Caterpillar had little incentive to have a more precise apportionment because all profits on parts were immediately taxable in the United States by operation of Subpart F. In 1992, the marketing companies' share was set at 4% of the profit of the 30% profit margin for non-U.S. parts sold in their region, which translated into roughly 13% of those non-U.S. parts profits.<sup>208</sup> That profit allocation for COSA continued until 1999.

**CSARL.** In 1999, as part of the Swiss tax strategy that is the focus of this Report, COSA and several other Swiss affiliates' assets and business activities were consolidated into a renamed Swiss entity, Caterpillar SARL (CSARL).<sup>209</sup> Since then, CSARL has served as Caterpillar's leading Swiss affiliate. It has continued to perform the same marketing functions as COSA, and the EAME regional marketing work is the focus of the vast majority of CSARL employees in Switzerland today.<sup>210</sup> In 2000, Caterpillar made the head of the EAME Distribution Division a Vice President reporting to the Customer and Dealer Support Group President.<sup>211</sup> That division head has been located in Switzerland at CSARL. The division head's duties were described by

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Swiss company that packaged, but did not manufacture, industrial turbines and related systems. "Caterpillar Inc. Completes Acquisition of Turbomach S.A.," (6/17/2004), *PRNewswire*, <http://www.prnewswire.com/news-releases/caterpillar-inc-completes-acquisition-of-turbomach-sa-75032792.html>.

<sup>204</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 281-294.

<sup>205</sup> 4/18/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1994," PwC\_CAT\_PSI\_00008634 - 880, at 673; 12/19/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995," PwC\_CAT\_PSI\_00008881 - 9104, at 916-917; 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 006.

<sup>206</sup> 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 006.

<sup>207</sup> Subcommittee interview of Steven Williams, PWC (2/19/2014).

<sup>208</sup> 12/19/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995," PwC\_CAT\_PSI\_00008881 - 9104, at 959.

<sup>209</sup> 2/16/2010 "Caterpillar Inc. CSARL Permanent File Chronological History: 1999-2010," PwC\_PSI\_CAT\_00003406 - 463, at 407.

<sup>210</sup> Subcommittee interview of David Picard, Caterpillar (3/4/2014).

<sup>211</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 284.

Caterpillar as “in charge of marketing of all Caterpillar Products, parts and services in the Europe, Africa, Middle East and Commonwealth of independent States Region.”<sup>212</sup> As part of that marketing work, CSARL has continued to support Caterpillar’s non-U.S. dealer network with respect to parts. Its duties have included helping to ensure dealer inventories have the parts they need, supporting Caterpillar’s commitment to deliver needed parts within 24 hours, and acting as a liaison between the dealers and Caterpillar parts personnel in the United States.<sup>213</sup> CSARL has also maintained the Singapore branch which, today, has about 400 employees.<sup>214</sup>

In addition, as part of the 1999 transaction, CSARL was designated as Caterpillar’s “global purchaser” of purchased finished replacement parts (PFRPs), the Caterpillar replacement parts manufactured by third-party suppliers. It took over that role from Caterpillar Inc., the U.S. parent corporation. Acting as the initial purchaser of parts, CSARL either instantaneously resold the PFRPs to Caterpillar in the United States or sold them over time to non-U.S. independent dealers, Caterpillar affiliates, or customers, as explained in more detail below.

Initially, CSARL became the nominal PFRP purchaser for the EAME region. Then, from 1999 to 2003, Caterpillar, the U.S. parent, designated CSARL as the nominal PFRP purchaser for more and more of its geographical regions, executing a series of licensing agreements with its Swiss affiliate.<sup>215</sup> The licensing agreements generally directed that between 4% and 6% of the sales of licensed products by CSARL be paid to Caterpillar as a royalty.<sup>216</sup> In addition, CSARL entered into a servicing agreement with Caterpillar Inc. to pay Caterpillar’s costs plus a 5% markup, for the U.S. parent to continue to perform a number of core parts functions, including managing the worldwide parts inventory, supervising suppliers, forecasting parts demand, supervising parts logistics, and storing CSARL-owned parts in the United States.<sup>217</sup> CSARL was unable then or now to perform those parts functions itself, lacking the necessary personnel, infrastructure, and expertise.

After the CSARL transaction, in 2000, Caterpillar relocated three regional Product Managers who worked on machines and products used in the EAME region, moving them from France and Belgium to Switzerland.<sup>218</sup> Most of the company’s Product Managers, however, have continued to work in the United States. In 2009, after the IRS issued new regulations requiring foreign affiliates of U.S. manufacturers to meet certain requirements to avoid Subpart F taxation, Caterpillar assigned one global Product Manager to CSARL.<sup>219</sup> In addition, Caterpillar created a new position at CSARL for a “Worldwide Parts Manager” which was filled by Quentin de Warlincourt, who was already working in Switzerland.<sup>220</sup> Mr. de Warlincourt was the first worldwide parts manager stationed in Switzerland. He was charged with establishing an “overall

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<sup>212</sup> Id.

<sup>213</sup> Subcommittee interview of David Picard, Caterpillar (3/4/2014).

<sup>214</sup> 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 006.

<sup>215</sup> 1/16/2003 Caterpillar’s legal counsel memorandum “History of Significant Changes in International Operations (Not Inclusive of Financing Arrangements) 1997 – 2002,” PSI-TWLF-02-000423 - 436.

<sup>216</sup> 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007.

<sup>217</sup> Id.

<sup>218</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 281-282.

<sup>220</sup> 1/2010, “Caterpillar Inc. CSARL 2009 activities Report to Audit Team,” 00003830 - 875, at 832, 847.

<sup>220</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, at CAT-000270 - 298, at 286.

parts strategy” in consultation with Caterpillar Inc.’s Executive Office and acting as a liaison among Caterpillar business units involved with parts management, as explained in more detail below.<sup>221</sup> He reported to Stephen Gosselin, head of the Customer Services Support Division, in the United States. Over the next five years, Mr. de Warlincourt assembled a staff of five to twelve persons in Switzerland.<sup>222</sup> Caterpillar witnesses told the Subcommittee that having a more localized worldwide parts manager resulted in operational efficiencies due to greater knowledge and awareness of local supply needs.<sup>223</sup> He was recently replaced by Thomas Zihlmann, who is located in Switzerland and whose job title has been changed to Worldwide Parts Strategy Manager.<sup>224</sup>

At the Subcommittee’s request, Caterpillar provided information about the total number of its Swiss employees involved with the “purchase, storage, movement, and sales of replacement parts.”<sup>225</sup> Caterpillar indicated that, of the 8,300 Caterpillar employees involved with those functions in 2012, about 66 were located in Switzerland. Caterpillar indicated that, of those 66 Swiss employees, 10 were involved with “parts pricing” and about 56 worked for the EAME Distribution Services Division.<sup>226</sup>

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<sup>221</sup> 3/15/2010, “Caterpillar Inc. Worldwide Parts Management Final Closing Book, Draft Version as of March 15, 2010,” PwC\_PSI\_CAT\_00003876 - 4168, at 906-907.

<sup>222</sup> Subcommittee interview of David Picard, Caterpillar (3/4/2014).

<sup>223</sup> Id.

<sup>224</sup> 3/27/2014 Information provided by Caterpillar to the Subcommittee, PSI-Caterpillar-21-000001 - 002.

<sup>225</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, at CAT-000270 - 298, at 279.

<sup>226</sup> Id.

#### IV. EMPLOYING A SWISS TAX STRATEGY TO AVOID U.S. TAXES

Since the company's inception, Caterpillar's replacement parts business has operated as a "U.S. centric" business, led and managed primarily from the United States. Prior to 1999, Caterpillar reported 85% or more of the profits from the sale of its replacement parts to non-U.S. customers as taxable U.S. income, while attributing 15% or less of the profits to its Swiss affiliate and other marketing companies. At that time, even the portion of the profits attributed to its market companies was included on Caterpillar's U.S. tax return as taxable income under Subpart F. Beginning in 1998, however, Caterpillar's tax department paid millions of dollars to PricewaterhouseCoopers (PWC) and McDermott Will & Emery to develop and implement a tax strategy to lower the company's global taxes. PWC designed a Swiss tax strategy to direct the lion's share of Caterpillar's non-U.S. purchased finished replacement parts (PFRP) profits away from the United States to Switzerland, where Caterpillar had negotiated an effective tax rate of 4% to 6%,<sup>227</sup> lower even than the Swiss federal statutory rate of 8.5%.<sup>228</sup>

In 1999, Caterpillar implemented the Swiss tax strategy, which it called the Global Value Enhancement or "GloVE" program.<sup>229</sup> As part of that program, it renamed a Swiss subsidiary Caterpillar SARL (CSARL) which became the nominal recipient of the purchased finished parts profits and enabled Caterpillar to direct those profits away from the United States to Switzerland.<sup>230</sup> Like its predecessor, CSARL also served as a marketing company, supporting Caterpillar's independent dealers in Europe. Over time, CSARL was also assigned responsibility for other Caterpillar marketing companies around the globe, and Caterpillar directed their parts revenues to Switzerland as well. By 2008, approximately 45% of Caterpillar's consolidated revenues and 43% of its profits had been shifted to CSARL, an entity with less than one half of one percent of CAT's 118,500 employees.<sup>231</sup> As a result, over the next thirteen years, from 2000 to 2012, Caterpillar shifted U.S. taxable income of more than \$8 billion offshore to Switzerland and deferred or avoided paying U.S. taxes totaling about \$2.4 billion.

##### A. Adopting the Swiss Tax Strategy

PricewaterhouseCoopers is Caterpillar's longtime auditor, having provided auditing services to the company since the 1920s, primarily from its offices in Chicago.<sup>232</sup> In the 1990s, in addition to serving as Caterpillar's independent auditor, PWC provided the company with special tax consulting services designed to reduce its global taxes.

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<sup>227</sup> 8/30/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000070; 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 274. When asked about the tax rate that Caterpillar paid in Switzerland, the PWC partner who led the tax consulting efforts and was also involved in Caterpillar's transfer pricing issues told the Subcommittee that Caterpillar had received a Swiss Government ruling that allows it to pay the statutory rate on only 20% of its non-Swiss source income, resulting in an effective tax rate of 4%. Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

<sup>228</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 270.

<sup>229</sup> 10/5/1999 "Caterpillar Inc. Global Value Enhancement Project Draft," PwC\_PSI\_CAT\_00004483 - 530.

<sup>230</sup> See 8/22/2008 "Delivering Vision 2020 Value Transformation: An After-Tax View," PwC\_PSI\_CAT\_00058419 - 472, at 429 and 449.

<sup>231</sup> 7/30/2008 PWC Presentation, "Caterpillar Sarl Overview," PwC\_PSI\_CAT\_00065585 - 610, at 589.

<sup>232</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

**GTOP Review.** In the late 1990s, PWC offered clients a program through its tax consulting services group known as the “Global Tax Optimization Program” (GTOP).<sup>233</sup> As part of that program, PWC offered to review a client’s business operations to identify potential tax savings. The goal of GTOP was to conduct a comprehensive assessment of the company’s tax practices at the state, national, and international levels, identify tax inefficiencies, and recommend ways to change its operations to lower its overall tax payments.<sup>234</sup> PWC described the program as “a coordinated, tailored approach to achieving [a company’s] lowest sustainable tax rate.”<sup>235</sup>

In 1997, PWC tax consulting services and Caterpillar began discussions regarding a potential GTOP review of Caterpillar’s business and tax practices.<sup>236</sup> In 1998, Caterpillar agreed to conduct the GTOP review, but did so by engaging a law firm, McDermott Will & Emery, which in turn engaged PWC on Caterpillar’s behalf to conduct the review.<sup>237</sup> Caterpillar relied on McDermott Will & Emery for tax advice. PWC initiated the GTOP review that same year. Internally, Caterpillar called the PWC tax reduction program the Global Value Enhancement (GloVE) program.<sup>238</sup>

**Five Year Effort.** PWC’s tax review and tax reduction strategy for Caterpillar took about a year to complete; implementing the tax strategy took several more years, for a total of nearly five years, from 1998 to 2003. Caterpillar’s tax department was the driving force behind the company’s decision to adopt PWC’s recommended tax strategy.<sup>239</sup> The tax department paid for the tax consulting services provided by PWC and McDermott Will & Emery as well as the business division costs associated with the CSARL structure.<sup>240</sup> Caterpillar has estimated the total five-year cost at over \$55 million.<sup>241</sup>

The bulk of PWC’s substantive work occurred in the first two phases of the program: the “analyze phase” and the “develop phase.”<sup>242</sup> The analyze phase involved PWC’s examining Caterpillar’s tax practices and the business and operational factors driving its value and tax liability and identifying ways to lower its effective tax rate. The develop phase involved PWC’s

<sup>233</sup> Id.

<sup>234</sup> Id.

<sup>235</sup> 4/14/1998, PWC presentation to Caterpillar, “Global Tax Optimization,” PwC\_PSI\_CAT\_00004892, at 895.

<sup>236</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

<sup>237</sup> 11/13/2006 PricewaterhouseCoopers National Office memorandum, “Independence Consultation Database,” PSI-TWLF-21-000228 - 231, at 229; Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

<sup>238</sup> Subcommittee interviews of Thomas Quinn, PWC (10/2/2013) and James Bowers, PWC (1/23/2014).

<sup>239</sup> Deposition of Sally Stiles in Schlicksup v. Caterpillar, PSI-TWLF-11-000113 - 114, at 106-107; Subcommittee interview of Robin Beran, Caterpillar, Chief Tax Officer (10/18/2013).

<sup>240</sup> Subcommittee interview of Robin Beran, Caterpillar (10/18/2013). See also August 2008 email chain among Robin Beran, Rodney Perkins, and others indicating that the tax department paid business unit costs for implementation, management, and inventory ownership related to CSARL. Mr. Perkins, Caterpillar International Tax Manager, wrote: “[C]harges were primarily implementation, then they became primarily maintenance. We’ve [tax department] been paying for both since Day 1.” 8/21/2008 email chain among Caterpillar tax department personnel, PSI-TWLF-02-001625 - 628. It also appears that the tax group in Geneva paid for the software package to keep track of CSARL’s legal entities and financial statements. Deposition of Rodney Perkins in Schlicksup v. Caterpillar, PSI-TWLF-10-000004, at 077-078.

<sup>241</sup> 3/21/2014 email from PWC’s legal counsel to Subcommittee, “Response regarding fees,” PSI-PWC-22-000001 - 003.

<sup>242</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

providing a specific set of recommendations as well as an operational feasibility analysis and a cost-benefit analysis of its proposals.<sup>243</sup>

According to PWC, during the initial analyze phase in 1998, PWC conducted an extensive set of interviews with Caterpillar's executive office and business unit leaders to assess the views of Caterpillar's corporate officials regarding the direction of the company.<sup>244</sup> This process also involved on-site visits to Caterpillar facilities, both inside and outside the United States.

**Swiss Tax Strategy Proposed.** Sometime in 1998, PWC submitted a report to Caterpillar containing a summary of ideas to reduce Caterpillar's tax liability.<sup>245</sup> In the report, PWC presented Caterpillar with a list of 49 potential strategies to lower the company's effective tax rate.<sup>246</sup> One of the report's key proposals focused on Caterpillar's replacement parts business, which produced a steady stream of taxable profits for the company. Under the then existing system, third party manufacturers made the replacement parts and sold them to the U.S. parent company, which then sold the parts to its marketing companies for subsequent resale to Caterpillar's non-U.S. independent dealers. The inclusion of the U.S. parent in the transactions meant that the parts' sales revenues were included on Caterpillar's U.S. tax return and also subject to tax under Subpart F. PWC proposed deferring or avoiding that tax by "remov[ing] Caterpillar Inc. from the chain of title passage for purchased finished parts (from U.S. or foreign sources) sold to foreign marketers," and replacing the U.S. parent with a new Swiss entity as the direct purchaser of the third party manufactured replacement parts.<sup>247</sup>

PWC explained to the Subcommittee that, by removing the U.S. parent, Caterpillar Inc., from the chain of title for third party manufactured parts sold to non-U.S. customers, Caterpillar would no longer have two related entities transacting business with each other in the supply chain.<sup>248</sup> According to PWC, if Caterpillar Inc. were removed and replaced by a non-U.S. entity, such as a Swiss corporation, Subpart F's foreign base company sales rules would no longer apply, and the offshore income would no longer be immediately attributed to Caterpillar Inc. as a sale and therefore taxed in the United States. Instead, the funds could be attributed to Switzerland, and Caterpillar would be able to defer paying any U.S. taxes on that income simply by keeping it offshore, avoiding the Subpart F provision that was intended to capture this kind of income. Moreover, by attributing the income to Switzerland, PWC reasoned that Caterpillar

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<sup>243</sup> Id.

<sup>244</sup> Id.

<sup>245</sup> See undated PWC presentation to Caterpillar, "Caterpillar GTOP Summary of Ideas," PwC\_PSI\_CAT\_00004566 - 631. See also 7/14/1998 email from Steven Williams, PWC, to Thomas Quinn, PWC, and others, PwC\_PSI\_CAT\_00204970 - 974 (listing three initial ideas: removing Caterpillar from the parts supply chain, increasing the profit margin on parts, and reducing the profit margin on machines).

<sup>246</sup> See undated PWC presentation to Caterpillar, "CATERPILLAR GTOP Summary of Ideas," PwC\_PSI\_CAT\_00004566 - 631.

<sup>247</sup> Id. See also 9/1998 PWC report, "Caterpillar Inc. Global Tax Optimization Case for Action," PwC\_PSI\_CAT\_00004632, at 674 (describing the proposal as PWC's "Solution #1" to reduce Caterpillar's taxes).

<sup>248</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

could take advantage of the very low tax rate of 4% that the company had negotiated with that country.<sup>249</sup>

PWC documents proposing the tax strategy stated that it involved only “relatively simple re-invoicing requirements.”<sup>250</sup> Caterpillar and PWC told the Subcommittee that the tax strategy required few changes in the company’s business operations, because its non-U.S. marketing companies were already selling the third party manufactured replacement parts to its non-U.S. dealers. They characterized the tax strategy as aligning the company’s tax structure with sales practices already in place.

Caterpillar, with the approval of its executive steering committee, which was comprised of business executives including the CFO, adopted PWC’s recommended tax strategy.<sup>251</sup> Caterpillar also decided, at the same time, to realign its European manufacturing operations, moving their headquarters to Geneva. Its decision led to the execution of a series of licensing and servicing agreements between Caterpillar Inc., the U.S. parent, and CSARL, its Swiss affiliate, as described below.

**Auditing Its Own Tax Strategy.** At the same time PWC was providing Caterpillar with tax consulting services and advocating the Swiss tax strategy, PWC continued to act as Caterpillar’s independent auditor. Independent auditors are typically charged with reviewing a corporation’s financial statements and expressing an opinion on whether they fairly present the corporation’s financial position under generally accepted accounting principles.<sup>252</sup> PWC performed that function with respect to Caterpillar’s financial statements, which included reviewing Caterpillar’s estimates of the company’s tax liabilities. As part of that review, PWC auditors were responsible for auditing and approving the company’s use of the very tax strategy developed, advocated, and sold to Caterpillar by their PWC colleagues.

PWC’s actions occurred prior to enactment of the Sarbanes-Oxley Act of 2002, which targeted various conflicts of interests that arise when a public accounting firm performs auditing and other services for a client, including tax consulting services, for the same corporation at the same time.<sup>253</sup> Prior to its enactment, federal regulations did not place any restriction on accounting firms providing both audit and tax consulting services contemporaneously. After its enactment, a public accounting firm was permitted to perform those services concurrently only if approved in advance by the client corporation’s Board of Directors Audit Committee.<sup>254</sup> PWC

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<sup>249</sup> Id. In addition, if the Swiss affiliate were to receive dividends or royalties from lower tier Caterpillar affiliates, it would be able to use the U.S. check-the-box rules to ensure those entities were disregarded for U.S. tax purposes and, again, avoid Subpart F taxes.

<sup>250</sup> Undated PWC presentation to Caterpillar, “Caterpillar GTOP Summary of Ideas,” PwC\_PSI\_CAT\_00004566 - 631, at 618; 9/1998 PWC report, “Caterpillar Inc. Global Tax Optimization Case for Action,” PwC\_PSI\_CAT\_00004632, at 674.

<sup>251</sup> Id.

<sup>252</sup> See, e.g., AU Section 110, Responsibilities and Functions of the Independent Auditor, Public Company Accounting Oversight Board (PCAOB) website, <http://pcaobus.org/Standards/Auditing/Pages/AU110.aspx> “AU” is a reference to “audit” standards.

<sup>253</sup> Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, 107th Cong. (2002).

<sup>254</sup> Id. at § 201(a), codified at 15 U.S.C. § 78j-1(h). PCAOB auditing standards relating to independence and advising on tax transactions include the following:



told the Subcommittee that, both before and after enactment of the Sarbanes-Oxley Act, the Caterpillar Audit Committee approved PWC's contemporaneous delivery of auditing and tax consulting services for the company.<sup>255</sup>

At PWC, the auditing team included a tax partner, James Bowers, who was responsible for assisting the audit team in auditing Caterpillar's financial statements, including Caterpillar's estimates of the company's tax liabilities based in part on its implementation of the Swiss tax strategy. Mr. Bowers told the Subcommittee that he initially introduced PWC's GTOPT team to Caterpillar and attended the initial presentation.<sup>256</sup> He also indicated that, for a three-year period from 1999 to 2002, while he was assisting with the audit of Caterpillar's financial statements, he also spent up to one-third of his time working on "GloVE implementation," meaning implementation of the Swiss tax strategy.<sup>257</sup> He said that his primary role involved explaining the details of Caterpillar's business operations and structure to PWC's tax consultants. Mr. Bowers said that, by 2003 or 2004, his work level on the Swiss tax strategy had "dropped significantly." In addition, he told the Subcommittee that, during the course of his audit work at Caterpillar, he conferred on issues related to the Swiss tax strategy with the same PWC tax consultants who had helped to design and implement it. According to Mr. Bowers, he performed an independent analysis of the Swiss tax strategy and concluded that it complied with the U.S. tax code.<sup>258</sup> He also told the Subcommittee that he did not memorialize his analysis of the Swiss tax strategy by putting it in writing.<sup>259</sup>

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RULE 3520. AUDITOR INDEPENDENCE. A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

RULE 3522. TAX TRANSACTIONS. A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction -

- (a) Confidential Transactions – that is a confidential transaction; or
- (b) Aggressive Tax Position Transactions – that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

RULE 3524. AUDIT COMMITTEE PRE-APPROVAL OF CERTAIN TAX SERVICES. In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall –

- (a) describe, in writing, to the audit committee of the issuer –
  - (1) the scope of the service, the fee structure for the engagement, and any side letter or other amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service; and
  - (2) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service;
  - (b) discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm; and
  - (c) document the substance of its discussion with the audit committee of the issuer.

<sup>255</sup> Subcommittee interview of James Bowers, PWC (1/23/2014).

<sup>256</sup> Id.

<sup>257</sup> Id.

<sup>258</sup> Id.

<sup>259</sup> Id.

**\$55 Million Tax Strategy.** From 1998 to 2004, Caterpillar paid PWC over \$80 million in tax consulting fees, including over \$55 million related to the development and implementation of the Swiss tax strategy involving CSARL.<sup>260</sup> From 2000 to 2012, Caterpillar also paid PWC another \$200 million in auditing fees.<sup>261</sup>

The Swiss tax strategy immediately lowered Caterpillar’s effective tax rate. A 2010 “Global Tax & Trade Update” prepared by Caterpillar’s Global Finance and Strategic Support Division reported that the company’s “Effective Tax Rate ha[d] dropped to lowest in the Dow 30.”<sup>262</sup> It summarized the effective tax rate “drivers” as “Losses in high-tax countries, Profits in low.”<sup>263</sup> According to Caterpillar, to date, the Swiss tax strategy has enabled the company to defer paying U.S. taxes of at least \$2.4 billion.<sup>264</sup>

## **B. Shifting Profits from United States to Switzerland**

As described earlier, Caterpillar developed its third party manufactured replacement parts business, which included parts design, a reliable third party supplier base, effective parts forecasting and inventory management, a worldwide parts distribution network, and an effective parts delivery system, over the course of decades. PWC’s Swiss tax strategy did not attempt to change any of those operational details. Instead, it focused on changing the legal entity that served as the paper owner of Caterpillar’s replacement parts and the recipient of the non-U.S. parts profits.

**Original Legal Title Chain.** Prior to the creation of CSARL in 1999, Caterpillar Inc., the U.S. parent corporation, bought the purchased finished replacement parts (PFRPs) needed for Caterpillar machines directly from the third party suppliers that manufactured the parts for the company.<sup>265</sup> Caterpillar often designed replacement parts that fit only Caterpillar machines, retained ownership of and patented the designs, and contracted with third party suppliers to manufacture them.<sup>266</sup> Many of the PFRP third party suppliers were located in the United States in close proximity to the Caterpillar manufacturing plants that produced its machines.<sup>267</sup> In fact, at the time of the CSARL transaction in 1999, according to a Caterpillar document, it appears that out of \$853 million in parts sales, \$712 million or 83%, were obtained from the United States.<sup>268</sup> Although Caterpillar has since taken steps to globalize its supplier base, in 2012,

<sup>260</sup> 3/21/2014 email from PWC’s legal counsel to Subcommittee, “Response regarding fees,” PSI-PWC-22-000001 - 003.

<sup>261</sup> Id.

<sup>262</sup> 4/13/2010 “Global Tax & Trade Update,” PwC\_PSI\_CAT\_00205974 - 990, at 975.

<sup>263</sup> Id. at 979.

<sup>264</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 298.

<sup>265</sup> See 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005-006.

<sup>266</sup> 12/19/1996 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1995,” PwC\_CAT\_PSI\_00008881 - 9104, at 921.

<sup>267</sup> Subcommittee interview of William Springer, Caterpillar (11/7/2013); see also Craig T. Bouchard & James V. Koch, *The Caterpillar Way*, at 200 (2014).

<sup>268</sup> 5/28/1999 “Global Value Enhancement Development Phase Status Report,” PwC\_PSI\_CAT\_00004349 - 455, at 365. Caterpillar uses the term “sourced” to indicate that an item was procured from that country or region.

nearly 70% of the finished parts purchased by CSARL for sale to foreign customers still came from the United States.<sup>269</sup>

Prior to 1999, Caterpillar was the initial buyer of its third party manufactured replacement parts, and if the replacement parts were to be sold in Europe, Africa, or the Middle East (EAME region), Caterpillar typically sold the parts to its affiliated marketing company, Caterpillar Overseas S.A. (COSA), which was incorporated in Switzerland.<sup>270</sup> COSA, in turn, sold the parts to Caterpillar's independent foreign dealers in the EAME region.<sup>271</sup> The non-U.S. PFRP legal title and supply chain was typically as follows:

**Third party supplier → Caterpillar Inc. (US) → COSA → non-US independent dealer**

Caterpillar's profits from its non-U.S. parts sales were taxable in the United States; COSA's profits were also taxable in the United States as foreign base company sales income under Subpart F.<sup>272</sup>

Caterpillar also manufactured some of its own replacement parts, which it referred to as "worked parts" to distinguish them from the purchased finished replacement parts manufactured by unrelated third party suppliers. The legal title and supply chain for the worked parts was as follows:

**Caterpillar Inc. (US) → COSA → non-US independent dealer**

The supply chain for Caterpillar's worked parts did not change and has continued to function unaltered except for the substitution of CSARL for COSA, including for worked parts sold offshore. Sales income from those Caterpillar parts continues to be included on the company's U.S. tax return.

Caterpillar's standard practice was to compensate the internal Business Divisions involved with the sales of its non-U.S. parts. Its practice was to assign a routine profit to the divisions that performed routine business services and the residual profits – sometimes called "entrepreneurial" profits – to the divisions that contributed directly to the creation of those residual profits.<sup>273</sup> According to Caterpillar, in its internal management books, Caterpillar treated COSA, the marketing company, as a routine parts distributor and gave it only a routine share of the non-U.S. parts profits.<sup>274</sup> Other U.S. divisions were awarded the residual profits. At

<sup>269</sup> 3/7/2014 Caterpillar response to Subcommittee Questionnaire, CAT-001866 - 2264, at 866.

<sup>270</sup> See 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005-007.

<sup>271</sup> Id.

<sup>272</sup> Id. at 003 - 004.

<sup>273</sup> 10/29/2007 "Caterpillar Inc. Transfer Pricing Discussion Items," PwC\_PSI\_CAT\_00129637 - 646, at 640. See also Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

<sup>274</sup> Id. In comparison, residual non-U.S. profits were also assigned to Caterpillar's French and Belgian affiliates, which had manufacturing facilities. See also 10/29/2007 PWC slide presentation "Caterpillar Inc. Transfer Pricing Discussion Items," PwC\_PSI\_CAT\_00129637 - 646, at 640. According to PWC, prior to Mr. Fites' setting the across-the-board share of accountable profits for Caterpillar marketing companies in 1992, Caterpillar had split the non-U.S. residual parts profits with the marketing companies on a 50/50 legal entity basis. The U.S. share of the sales profits were reported as U.S. taxable income on Caterpillar's U.S. tax return, while the

the same time, almost all of the profits, no matter which division received them, were typically included in Caterpillar's U.S. tax return and taxed.<sup>275</sup> The end result was that, from about 1994 to 1999, Caterpillar's internal management books matched Caterpillar's tax books in terms of profit allocations.<sup>276</sup>

### (1) Altering the Legal Title Chain for Finished Parts

Caterpillar's implementation of the Swiss tax strategy required multiple steps over the course of four years between 1999 and 2003.<sup>277</sup> They included forming CSARL, designating it as the nominal "global purchaser" of Caterpillar's finished parts in various licensing agreements, changing Caterpillar's invoice systems, and assigning CSARL tolling agreements with two Caterpillar affiliates.

**Forming CSARL.** CSARL was first formed under another name in 1997.<sup>278</sup> When Caterpillar decided to implement the Swiss tax strategy, CSARL was selected as the key Swiss entity and given a new name. According to PWC, CSARL is treated as a limited liability corporation – a Swiss SARL – for Swiss tax purposes, but as a limited liability partnership for U.S. tax purposes.<sup>279</sup> In connection with the tax strategy, CSARL was set up with six members or partners, all of which were Caterpillar foreign affiliates.<sup>280</sup> The six were COSA, Caterpillar Overseas Credit Corporation SARL, Caterpillar Overseas Investment Holding SARL, Caterpillar Commercial Holding SARL, Caterpillar Asia Pacific LP, and Caterpillar Product Development SARL. In 1999, each of the six partners contributed assets and business activities to CSARL, which emerged as Caterpillar's leading Swiss affiliate.<sup>281</sup> Later, Caterpillar added a seventh CSARL member, Caterpillar International Investment SARL.<sup>282</sup>

marketing companies' share was also reported on Caterpillar's tax return as Subpart F income. Subcommittee Interview of Steven Williams, a PWC Managing Director (2/19/2014).

<sup>275</sup> See 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 003-004.

<sup>276</sup> 8/22/2008 "Delivering Vision 2020 Value Transformation: An After-Tax View," PwC\_PSI\_CAT\_00058419-472.

<sup>277</sup> See 2/16/2010 "Caterpillar Inc. CSARL Permanent File Chronological History: 1999-2010,"

PwC\_PSI\_CAT\_00003406 - 463, at 407.

<sup>278</sup> See 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 003. CSARL acquired its current name in 1999, in connection with the implementation of the PWC tax strategy.

<sup>279</sup> 2/16/2010 "Caterpillar Inc. CSARL Permanent File Chronological History: 1999-2010,"

PwC\_PSI\_CAT\_00003406 - 463, at 406. "SARL" stands for Société à responsabilité limitée, a type of private limited liability corporate entity that exists in Switzerland, France, and a few other countries. A SARL is a company whose liability is limited to the contributions of its members. It is comparable to a limited liability partnership in the United States. See also 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023.

<sup>280</sup> 2/16/2010 "Caterpillar Inc. CSARL Permanent File Chronological History: 1999-2010,"

PwC\_PSI\_CAT\_00003406 - 463, at 406 (CSARL is treated as a partnership for U.S. tax purposes and is owned directly or indirectly (through disregarded entities) by controlled foreign corporations that are directly or indirectly owned by Caterpillar). See also 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023.

<sup>281</sup> See 2/16/2010 "Caterpillar Inc. CSARL Permanent File Chronological History: 1999-2010,"

PwC\_PSI\_CAT\_00003406 - 463, at 407 and 411.

<sup>282</sup> Id. at 411.

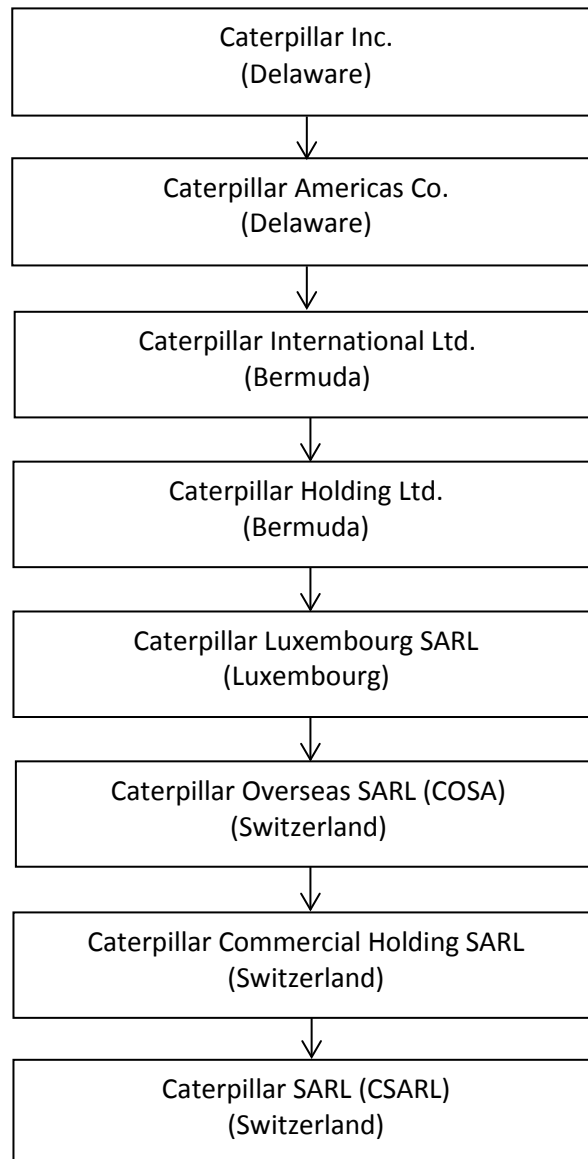
In 2006, Caterpillar reorganized its affiliates and added several new intermediate owners between itself and CSARL. The new owners were generally shell corporations located in tax havens, including Bermuda, Luxembourg, and Switzerland; all were affiliated with and ultimately owned by Caterpillar Inc. in the United States.<sup>283</sup> They included, in addition to COSA, Caterpillar International Ltd. of Bermuda; Caterpillar Holding Ltd. of Bermuda; Caterpillar Luxembourg SARL of Luxembourg; and Caterpillar Commercial Holding SARL.<sup>284</sup> The following chart depicts CSARL's current ownership.

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<sup>283</sup> 8/14/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000001 - 065, at 011 - 038.

<sup>284</sup> Id.

## Caterpillar Ownership of CSARL



Prepared by Permanent Subcommittee on Investigations, based on 8/14/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000001 - 065, at 011 - 038.

**Designating CSARL as Global Parts Purchaser.** In 1999, in accordance with the tax strategy designed by PWC, Caterpillar designated CSARL as the purchaser of its third party manufactured parts intended for sale outside of the United States. According to PWC, that designation resulted in two key changes.<sup>285</sup> First, Caterpillar Inc., the U.S. parent corporation,

<sup>285</sup> See 11/13/2006 PWC national office memorandum from Kevin Mitchell to Sharad Jain, "Caterpillar Inc.," PSI-TWLF-21-000001 - 265, at 229.

was removed from the non-U.S. parts supply chain, and replaced with CSARL which became the nominal “global purchaser” of PFRP parts.<sup>286</sup> The new parts legal title chain was as follows:

**Third party supplier → CSARL → non-US independent dealer**

The only operational change required by the new legal title chain was that the third party suppliers had to remove Caterpillar Inc.’s name from the top of their parts invoices and replace it with CSARL. Similarly, Caterpillar had to change its systems to remove its name from the parts purchase orders and replace it with CSARL. Other than those paper and system changes, the physical aspects of the company’s activities in purchasing, storing, and shipping Caterpillar’s parts did not change.

The tax consequences, however, were significant, according to PWC and Caterpillar. Because Caterpillar Inc. was removed from the legal title chain altogether, and CSARL bought the parts from and sold the parts to unrelated parties, PWC and Caterpillar claimed that the profits from those sales were no longer subject to Subpart F’s foreign base company sales rules, were not immediately taxable, and if kept outside of the United States could be protected from U.S. taxation through deferral.<sup>287</sup> In the 1999 planning documents for the CSARL transaction, under a benefits analysis, PWC wrote that the CSARL transaction “will migrate profits from CAT Inc. to low-tax marketing companies.”<sup>288</sup> PWC added that, by doing so: “We are effectively more than doubling the profit on parts.”<sup>289</sup>

**Executing Two Tolling Agreements.** The second key change, according to PWC, was that CSARL entered into “tolling agreements” with Caterpillar’s two main European manufacturing operations in France and Belgium.<sup>290</sup> Those tolling agreements required Caterpillar’s French and Belgian affiliates to provide manufacturing services to CSARL in exchange for the cost of their operations plus 7%. By limiting their profit margins to 7%, the tolling agreements shifted the residual or entrepreneurial profits for the manufactured goods from the two manufacturing facilities in France and Belgium to CSARL in Switzerland.<sup>291</sup> In addition, the Product Managers for the machines produced by the French and Belgian facilities

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<sup>286</sup> Id. See also 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005-006.

<sup>287</sup> See, e.g., See 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 006 (“The restructuring simply removed Caterpillar from the outbound PFRP supply chain. As a result, Caterpillar earned no profits (other than royalties and fees paid by CSARL described below) from outbound PFRP sales, and CSARL’s profits were no longer taxable under Subpart F because there was no longer a related party (Caterpillar under the old structure) in the supply chain, which Section 954(d) requires as a condition of foreign base company sales income.”).

<sup>288</sup> 12/1998, Caterpillar Inc., Global Tax Optimization, Risk Adjusted Benefit Analysis, Working Papers –Draft 1,” PWC-PSI-CAT-00001336 - 671, at 411.

<sup>289</sup> Id. at 412.

<sup>290</sup> See 11/13/2006 PWC national office memorandum from Kevin Mitchell to Sharad Jain, “Caterpillar Inc.,” PSI-TWLF-21-000001 - 265, at 229. See also 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 004.

<sup>291</sup> 11/30/2000 “European Manufacturing Initiative Caterpillar SARL,” PwC\_PSI\_CAT\_00016468 - 511, at 502.

moved to CSARL. The primary effect of the tolling agreements was to shift French and Belgian profits to Switzerland; they had relatively little effect on Caterpillar's U.S. tax savings.<sup>292</sup>

Caterpillar and PWC told the Subcommittee that, as a result of the tolling agreements and CSARL's new role as a "global parts purchaser," and because of the increasing importance of non-U.S. sales and its foreign dealer network, CSARL had become more than a routine distributor of parts entitled to a routine share of the profits. Instead, according to Caterpillar and PWC, CSARL was also entitled to the residual profits associated with the parts it purchased and sold.

In addition, Caterpillar and PWC claimed that CSARL had "newly recognized intangibles" associated with its marketing duties that had been present when COSA performed those duties, but had not been appropriately compensated. As a result, Caterpillar and PWC claimed that, as of 1999, Caterpillar could appropriately allocate 85% or more of the non-U.S. replacement parts profits to CSARL, instead of the 15% or less allocated to its predecessor, COSA. At the same time, as detailed below, Caterpillar decided not to change its internal allocation of profits, which decided employee incentive pay and bonuses; on Caterpillar's internal management books, CSARL continued to receive credit only for the type of routine profits allocated to a parts distributor. For years after the CSARL transaction, as explained further below, Caterpillar's internal profits allocation for business purposes no longer matched its profits allocation for tax purposes.<sup>293</sup>

## (2) Licensing Intangible Rights In Exchange for Royalties

In order for CSARL to replace Caterpillar Inc. in the parts legal title chain, Caterpillar engaged in a number of complex related party transactions. Beginning in 1999, in addition to the tolling agreements, Caterpillar, the U.S. parent, entered into a series of licensing agreements with its new Swiss affiliate, CSARL. Those agreements gave CSARL the right to manufacture and sell Caterpillar goods outside of the United States in exchange for paying certain royalty fees to its U.S. parent. The licenses generally permitted CSARL to "make, purchase, use, market, offer for sale, sell, and import" Caterpillar products, including replacement parts, in markets outside of the United States.<sup>294</sup>

**First License Agreement.** On September 1, 1999, Caterpillar Inc. and CSARL entered into their first license agreement for PFRPs and worked parts.<sup>295</sup> The license gave CSARL certain exclusive and nonexclusive rights to buy PFRPs from third party suppliers and worked parts from Caterpillar, as well as the right to sell those replacement parts to non-U.S. customers in the Europe, Africa, and Middle East (EAME) region.<sup>296</sup> In exchange for those rights, CSARL

<sup>292</sup> See 8/22/2008 "Delivering Vision 2020 Value Transformation: An After-Tax View," PwC\_PSI\_CAT\_00058419 - 472, at 429.

<sup>293</sup> In the mid-2000's, CSARL's marketing companies became a cost center and profits became reallocated to the product groups. Subcommittee interview of Jananne Copeland, Caterpillar (10/30/2013).

<sup>294</sup> See, e.g., 1/1/2001 Second Amended and Restated License Agreement, CAT-000306 - 699, at 373. See also 9/23/2013 letter from Caterpillar to Subcommittee, PSI-Caterpillar-04-000001 - 009, at 004.

<sup>295</sup> 1/16/2003 Caterpillar's legal counsel memorandum "History of Significant Changes in International Operations (Not Inclusive of Financing Arrangements) 1997 - 2002," PSI-TWLF-02-000423 - 436, at 423.

<sup>296</sup> Id.



agreed to pay a 15% royalty for PFRPs and a 7% royalty for worked parts to Caterpillar Inc. on net sales in the EAME region.<sup>297</sup>

As a temporary aside, Caterpillar and CSARL also entered into a year-long purchasing agency agreement in which Caterpillar agreed to act as the purchasing agent for parts purchased from third party suppliers.<sup>298</sup> That agreement permitted Caterpillar Inc.'s name to continue to appear on the PFRP purchase orders and invoices by making it clear that Caterpillar Inc. was acting on behalf of CSARL in relation to the third-party suppliers.<sup>299</sup> That purchasing agency agreement, which ended after a year, provided Caterpillar with time to make systems changes so that the name on the purchase order and invoices could be changed to CSARL.

**Service Agreement.** In addition to the licensing agreement, Caterpillar Inc. and CSARL entered into a service agreement under which Caterpillar Inc. agreed to provide certain services for CSARL relating to the management and sales of replacement parts.<sup>300</sup> The services specified by the agreement were extensive and included: developing service manuals, performing parts logistics and warehousing services; engaging in strategic parts planning; managing third-party suppliers within the United States (including visiting suppliers, negotiating terms, arranging for transportation, and conducting quality inspections); managing part flows such as inventory management worldwide; performing parts pricing determinations; maintaining accounting, shipping, customs and other records; processing parts returns; providing marketing consulting services for dealers; and covering inland freight charges for materials destined for U.S. contract packagers.<sup>301</sup> In essence, the service agreement required Caterpillar to continue to manage the parts business, since CSARL did not have the personnel, infrastructure or expertise to perform those functions. In exchange for providing those services, CSARL agreed to pay Caterpillar a fee equal to the cost of the services plus 5% of the costs.<sup>302</sup>

<sup>297</sup> Id.

<sup>298</sup> Id. at 427. See also 9/1/1999 Purchasing Agency Agreement (unexecuted copy), PwC\_PSI\_CAT\_00053632 - 641; "Reallocated Parts Purchasing Agreement, December 1, 1999," CAT-000306 - 699, at 535-542.

<sup>299</sup> 1/16/2003 Caterpillar's legal counsel memorandum "History of Significant Changes in International Operations (Not Inclusive of Financing Arrangements) 1997 - 2002," PSI-TWLF-02-000423 - 436, at 427.

<sup>300</sup> Id. at 423-424. See also, e.g., 9/1/1999 Fifth Amended and Restated Services Agreement, CAT-000653 - 663.

<sup>301</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 295 - 296. A September 1999 services agreement stated the services "shall include, but not be limited to: 1. Creation, translation, and dissemination of services manuals, service literature, and other materials for replacement parts; 2. Inventory availability management; 3. Providing parts customer service to dealers (i.e., dealer order inquiries, dealer order expediting); 4. Providing parts pricing determinations; 5. Processing of dealer parts returns; 6. Human resources assistance; 7. Maintenance and support with respect to information systems; 8. Marketing consulting (i.e., creation and support of dealer marketing programs); 9. Strategic planning; and 10. Accounting services." In addition with respect to CSARL inventory in U.S. warehouses: "11. Manage and monitor inventory levels worldwide and perform expediting services; 12. Arrange for transportation of CAT SARL goods; 13. General warehousing services and facilities for such; and 14. Inventory management services at U.S. warehouses." 9/1/1999 Fifth Amended and Restated Services Agreement, CAT-000653 - 663, at 661. PWC's initial planning document indicated that a payment would be made to Caterpillar Inc. in the United States for parts procurement and for management of the parts system. 12/1998, Caterpillar Inc., Global Tax Optimization, Risk Adjusted Benefit Analysis, Working Papers - Draft 1," PwC-PSI-CAT-00001336 - 671, at 408.

<sup>302</sup> See, e.g., 9/1/1999 Fifth Amended and Restated Services Agreement, CAT-000653 - 663, at 663. Subcommittee interview of Thomas Quinn, PWC (10/2/2013).

**Bundled License Agreement and Royalty Rate.** Following that first licensing agreement for the EAME region, CSARL entered into several similar agreements covering nearly all of Caterpillar's offshore regions including Latin America, Canada, Mexico, India, Asia, Australia, and the South Pacific.<sup>303</sup> The resulting tax planning led to the creation of 37 partnerships between CSARL and other Caterpillar affiliates.<sup>304</sup> Ultimately, Caterpillar Inc. cancelled the individual licensing agreements and bundled all of the licenses and royalty payments into a single agreement resulting in a combined royalty rate for replacement parts and its prime products, including Caterpillar machines.<sup>305</sup> The bundled royalty payment to Caterpillar Inc. involved a sliding scale that ranged from 4% to 6% of the combined net sales of Caterpillar parts and machines.<sup>306</sup> The sliding scale was constructed so that the higher the total net sales, the higher the royalty rate. For the first five years of the bundled royalty agreement, CSARL paid a combined royalty of just under 4%, which then increased to 5% and ultimately to 6%.<sup>307</sup> By entering into this license agreement, Caterpillar U.S. gave up rights to 85% or more of the finished replacement parts profits in exchange for a royalty of less than 15% for finished replacement parts.<sup>308</sup>

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<sup>303</sup> 1/16/2003 Caterpillar's legal counsel memorandum "History of Significant Changes in International Operations (Not Inclusive of Financing Arrangements) 1997 - 2002," PSI-TWLF-02-000423 - 436.

<sup>304</sup> See 11/13/2006 PWC national office memorandum from Kevin Mitchell to Sharad Jain, "Caterpillar Inc.," PSI-TWLF-21-000001 - 265, at 229.

<sup>305</sup> See 1/16/2003 Caterpillar's legal counsel memorandum "History of Significant Changes in International Operations (Not Inclusive of Financing Arrangements) 1997 - 2002," PSI-TWLF-02-000423 - 436.

<sup>306</sup> See, e.g., 1/1/2011 License Agreement, CAT-000306 - 699. The licensing agreement specified a 4% bundled royalty payment, based upon a "weighted average" of 15% parts royalty and 3% machine royalty. See, e.g., 3/2005 "Caterpillar Inc. Summary Meeting Notes, Revised Draft," from March 7-9, 2005 meeting in Geneva, PwC\_PSI\_CAT\_00150466 - 488, at 470.

<sup>307</sup> Subcommittee interview of Thomas Quinn, PWC (12/17/2013); 1/16/2003 Caterpillar's legal counsel memorandum "History of Significant Changes in International Operations (Not Inclusive of Financing Arrangements) 1997 - 2002," PSI-TWLF-02-000423 - 436, at 423-424; 3/2005 "Caterpillar Inc. Summary Meeting Notes, Revised Draft," from March 7-9, 2005 meeting in Geneva, PwC\_PSI\_CAT\_00150466 - 488, at 470; See 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005.

<sup>308</sup> These percentages are based on financial figures provided by Caterpillar to the Subcommittee. Typically, CSARL aggregates the profits from non-U.S. sales of Caterpillar parts and machines and provides Caterpillar Inc. with one bundled royalty amount for use of all Caterpillar licensed property. Since the Swiss tax strategy focused solely on Caterpillar's purchased finished replacement parts (PFRP) business, however, the Subcommittee requested data on just the portion of CSARL's profits and royalty payments related to non-U.S. PFRP sales. Caterpillar provided the Subcommittee with an estimate of CSARL's total PFRP profits before tax over an eight-year period. For that eight-year period, according to Caterpillar, CSARL's non-U.S. PFRP profits before tax totaled \$8,075,907,000. See 12/3/2013 Caterpillar response to Subcommittee questionnaire, CAT-000270 - 298, at 277. Caterpillar also provided the Subcommittee with an estimate of CSARL's annual royalty payments to Caterpillar Inc. associated with the non-U.S. replacement parts business. For that same period of time, according to Caterpillar, CSARL's royalty payments to Caterpillar Inc. totaled \$1,098,149,000. See 1/14/2014 Caterpillar response to Subcommittee Questionnaire, CAT-000299 - 303, at 301. That royalty amount includes payments made by CSARL for both PFRP parts manufactured by independent third parties and parts manufactured by Caterpillar. Using the figures provided by Caterpillar, the royalty, or license fee, paid by CSARL to Caterpillar Inc. for profits related to parts averaged 13.6% of CSARL's PFRP profits over the eight-year time period. Over that same time period, CSARL retained the remaining 86.4% of the PFRP profits. CSARL also paid Caterpillar Inc. service fees during that eight-year time period for services provided by Caterpillar Inc. related to the replacement parts business in an amount equal to Caterpillar's costs plus 5%. For the 8 year period, using data provided by Caterpillar on the total amount of service fees paid by CSARL to Caterpillar Inc., the Subcommittee estimated that the 5% markup related

The adequacy of the royalty paid by CSARL to Caterpillar was cited as a concern on several occasions by the Caterpillar tax department and PWC tax advisors. In 2002, a PWC presentation noted that CSARL was experiencing such high profits, it raised questions about the 4% royalty it was paying to Caterpillar: “High profit in Licensed Business puts pressure on 4% bundled royalty.”<sup>309</sup> The 4% royalty nevertheless remained in place for another three years. PWC’s transfer pricing subject matter expert told the Subcommittee that every CSARL licensing fee percentage point was worth approximately \$100 million in parts profits that could be kept in Switzerland with U.S. taxes deferred.<sup>310</sup> Another 2006 PWC email reported:

“We did a lot of work in Q4 2005, to decide whether the 4% needed to be raised in 2005. We recommended not to change it in 2005, but to raise it to 5% beginning in 2006. We are putting together documentation now to support the sliding scale provision from 2006-2010.”<sup>311</sup>

The 5% royalty paid by CSARL in 2006, was later raised to 6%.

In 2008, Rodney Perkins, Caterpillar’s International Tax Manager who worked on CSARL, sent an email to PWC expressing concern about CSARL’s continuing to pay the 6% royalty rate on Caterpillar products with a high profit margin:

“[A]s we place high margin product in CSARL, wouldn’t the bundled royalty rate have to increase as well. I doubt we can defend continued usage of 6% royalty; we already have difficulty with the existing structure to keep CSARL within acceptable profit ranges.”<sup>312</sup>

When asked about this email, Mr. Perkins told the Subcommittee that he saw a tax risk associated with the adequacy of the royalty rate paid to Caterpillar Inc.<sup>313</sup>

At the Subcommittee’s request, Caterpillar provided data on the annual parts profits reported by CSARL and the annual royalty payments made to Caterpillar related to parts over an

to those fees totaled about \$75 million, which, if accurate, would alter the 13.6% and 86.4% profit split by only about 1 percentage point.

<sup>309</sup> 7/2/2002 “Caterpillar, CSARL Technology Ownership,” PwC\_PSI\_CAT\_00024791 - 808, at 799. Caterpillar explained to the Subcommittee that the transfer pricing method it used yield a range of potentially acceptable royalty rates, and the 4% rate was heading toward the bottom of the acceptable range, hence the “pressure” to increase the rate. Subcommittee interview of Steven Williams, PWC (2/19/2014).

<sup>310</sup> Subcommittee interview of Steven Williams, PWC (2/19/2014). See also 1/25/2006 email from Christopher Dunn, PWC, to Steven Williams, PWC, “CSARL royalty rate,” PwC\_PSI\_CAT\_00132905 - 909.

<sup>311</sup> 1/23/2006 email from Steven Williams, PWC, to Mark Dalbey, PWC, “CSARL royalty rate,” PwC\_PSI\_CAT\_00018341.

<sup>312</sup> 10/27/2008 email from Rodney Perkins, Caterpillar, to Edward Bodnam, PWC, “Alignment VPs and PMs by Subject Facilities,” PwC\_PSI\_CAT\_00059123 - 127, at 125.

<sup>313</sup> Subcommittee interview of Rodney Perkins, Caterpillar (1/15/2014). James Bowers, the PWC tax partner who reviewed Caterpillar’s tax issues, including with respect to CSARL, also expressed discomfort about the royalty level, explaining that it was always difficult to evaluate. Subcommittee interview of James Bowers, PWC (1/23/2014). See also other documents raising concerns about the CSARL royalty rate, 1/25/2006 email from Christopher Dunn, PWC, to Steven Williams, PWC, “CSARL royalty rate,” PwC\_PSI\_CAT\_00132905 - 909; 11/14/2005 draft “Caterpillar SARL 2006 - 2010 Royalty Rate: Options and Implications,” PwC\_PSI\_CAT\_00133088 - 115; 12/6/2005 “Caterpillar SARL 2006 - 2010 Royalty Rate: Executive Summary,” PwC\_PSI\_CAT\_00133120 - 126.

eight year period. The data showed that the parts profits reported by CSARL over that eight-year period totaled about \$8 billion, while the royalty payments paid by CSARL to Caterpillar totaled about \$1 billion.<sup>314</sup> When the annual royalty payments were compared to the annual parts profits each year during the eight-year period, the data showed that the royalties paid to Caterpillar Inc. ranged from 9% to 16% of the total parts profits, with an overall eight-year average of 14%. The data also showed that CSARL retained 84% to 91% of the parts profits each year, leading to an overall eight-year average of 86%. This data confirmed that, overall, Caterpillar obtained 15% or less of the non-U.S. parts profits, while CSARL obtained 85% or more.

Caterpillar takes the position that, rather than focus on the division of profits related to parts alone, the appropriate focus is on the division of profits resulting from the single bundled royalty rate under the latest licensing agreement, which aggregates both parts and machine profits. Over an eight-year period, that aggregated royalty rate leads to total gross profits of \$11 billion, reflecting both parts and machine sales, and a total royalty payment of \$3 billion. The resulting profit split directs about 31% of the combined profits to Caterpillar Inc. in the United States, and about 69% to CSARL in Switzerland. Aggregating the two types of profits, however, disregards the fact that the planning and motivation for the Swiss tax strategy that produced the licensing agreement focused solely on parts profits and did not mention machines.

**Purchaser for Caterpillar Inc.** In addition to CSARL’s acting as Caterpillar’s “global purchaser” for its non-U.S. affiliates, CSARL also became the initial purchaser of PFRPs for its U.S. parent, Caterpillar Inc., even for PFRPs manufactured by third party suppliers located in the United States. Caterpillar’s outside tax expert explained: “[B]ecause U.S. suppliers did not want to deal with more than one purchaser, CSARL purchased not only outbound PFRP but also goods destined for U.S. dealers and customers.”<sup>315</sup> CSARL purchased and then automatically and instantaneously resold the PFRPs to Caterpillar Inc. in paper transactions referred to as “flash title” transactions. CSARL performed the flash title transactions at cost, with no markup or profit for the role played by the Swiss affiliate.<sup>316</sup> While Caterpillar did not permit CSARL to make a profit on the parts sold to it in the United States, Caterpillar continued to allocate 85% or more of the non-U.S. parts profits to CSARL in Switzerland.

While the licensing agreements designated CSARL as the company’s “global parts purchaser,” they did not lead to CSARL’s hiring a significant number of new personnel. CSARL continued to operate with less than one percent of Caterpillar’s worldwide employees.

### (3) Constructing a Virtual Parts Inventory

In addition to setting up CSARL, altering the third party parts legal title chain, and drafting the licensing, royalty, and service agreements, Caterpillar Inc.’s tax department created an Inventory Tax Accounting System (ITAS) to track the Caterpillar parts owned by CSARL in the United States as a result of its new purchasing activities. ITAS created a software-based,

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<sup>314</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 277; 1/14/2014 Caterpillar response to Subcommittee Questionnaire, CAT-000299 - 303, at 301.

<sup>315</sup> 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005.

<sup>316</sup> Id.

virtual parts inventory that served as a second set of inventory books for CSARL parts held in U.S. warehouses and played a key role in carrying out the Swiss tax strategy.<sup>317</sup>

The ITAS software system was created to exist in addition to Caterpillar's general global inventory system, which ITAS drew upon for data. Caterpillar's general global inventory system tracked parts on an individual basis, so that the company knew exactly how many parts it had, what types of parts they were, and where they were located. ITAS did not alter or replace the inventory tracking system Caterpillar used in its day-to-day business operations; instead, for tax purposes only, it tracked "virtual parts bins" consisting of commingled parts owned by Caterpillar Inc. and CSARL.

Before initiation of the Swiss tax strategy in 1999, Caterpillar Inc. owned all of the replacement parts in its U.S. warehouses prior to selling them to its marketing companies.<sup>318</sup> With the designation of CSARL as the nominal "global purchaser" of the company's third party manufactured replacement parts, however, Caterpillar had to create a system to show CSARL as the owner of the relevant replacement parts in the U.S. warehouses that were expected to be exported to foreign countries, including Canada and Mexico. The ability to show CSARL as the owner of the parts was needed to enable Caterpillar and CSARL to take advantage of the export tax exemption under tax code Section 956(c)(2)(B), which allows foreign affiliates to store goods in a U.S. warehouse without creating a taxable U.S. presence.<sup>319</sup> At the same time, Caterpillar did not want to incur the expense and inconvenience of formally segregating the CSARL parts from the other parts owned by Caterpillar Inc.<sup>320</sup>

According to PWC, Caterpillar tax and accounting personnel conceived of the ITAS approach, and then worked with PWC and McDermott Will & Emery personnel to design the system to track ownership of parts kept in a "physically commingled inventory" while ensuring technical tax compliance.<sup>321</sup> ITAS was supposed to show that CSARL had separate ownership of parts stored in Caterpillar's U.S. warehouses, even though the CSARL parts were completely commingled with the Caterpillar Inc. parts, there were no separate ownership labels, and Caterpillar employees did not and could not distinguish between the two sets of parts in any way.<sup>322</sup>

ITAS attempted to solve the problem by declaring that Caterpillar and CSARL each owned a portion of the parts in a "virtual bin," that the parts could be treated on an

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<sup>317</sup> 6/8/2006 email from Robin Beran, Caterpillar, to James Bowers, PWC, "Fw: FYI – 2006 Corporate Tax Audit Committee Presentation," PwC\_PSI\_CAT\_00004799 - 827, at 823; Deposition of Robin Beran in Schlicksup v. Caterpillar, PSI-TWLF-12-000064.

<sup>318</sup> Subcommittee interview of Thomas Quinn, PWC (12/17/2013).

<sup>319</sup> See Background chapter, Export Exception.

<sup>320</sup> See Subcommittee interviews of Thomas Quinn, PWC (10/2/2013 and 12/17/2013) (indicating that when a PWC representative suggested segregating the two sets of replacement parts, he was "laughed out of the room").

<sup>321</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013); 9/8/2009 "Caterpillar Inc. CSARL Briefing," PWC-PSI-CAT-00069730 - 772, at 759 - 61; Deposition of Robin Beran in Schlicksup v. Caterpillar, PSI-TWLF-12-000064 - 065, at 057-058.

<sup>322</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013); 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005.

interchangeable basis, and that CSARL's ownership of a particular part could be determined at a particular point in time, such as after the part was sold and shipped to a non-U.S. customer.

If either CSARL or Caterpillar ran out of parts in a "virtual bin" as tracked in the ITAS system, ITAS assumed that each party could automatically borrow needed parts from the other and return those borrowed parts when future parts deliveries came in.<sup>323</sup> The virtual borrowing took place without notice and without either party charging or paying a fee to the other. Caterpillar's tax director explained the ITAS system this way: "[I]t was designed to reflect that the parts are basically common parts and to the extent that CSARL or [Caterpillar] Inc. would have parts in the same bin, they might be shared back and forth and replaced."<sup>324</sup>

Caterpillar and PWC personnel advised the Subcommittee that it was not uncommon for each entity to engage in that type of virtual borrowing. According to Caterpillar, over a five-year period between 2008 and 2013, Caterpillar and CSARL borrowed from one another more than three million parts with a collective value of more than \$800 million.<sup>325</sup> Caterpillar also calculated that, on average each year, more than 10% of the parts stored in Caterpillar's U.S. warehouses were borrowed between the two related companies.<sup>326</sup>

The end result was that instead of segregating the Caterpillar versus CSARL parts,<sup>327</sup> Caterpillar warehouse personnel stored all of the replacement parts together, pulled parts to fill orders the same way they always had, without regard to CSARL's ownership, and then shipped the parts to the dealers or customers who had ordered them. The ITAS system then retroactively determined, for all parts shipped to non-U.S. customers, that those parts had belonged to CSARL. As Caterpillar's auditor observed:

"[T]he effect of 'virtual bins' is that it allows inventory physically located in the US to be viewed in total (for group inventory management purposes), but different parties can own the inventory. Thus, CSARL owns inventory in the US and can use that inventory to fulfil both customer and marketing entity requirements outside the US, any sales transacted in the US continue to be transacted by Cat Inc."<sup>328</sup>

In some ways, the ITAS solution could be compared to how farmers have used grain silos: fungible goods belonging to separate owners are deposited and commingled in the same silo and, when an owner requests a withdrawal, that owner's inventory is recorded as reduced

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<sup>323</sup> Subcommittee interview of Rodney Perkins, Caterpillar (1/15/2014). PWC's tax consultant and partner, Thomas Quinn, referred to the interchangeable use of each other's parts as an "accommodation," rather than a "borrow." He advised that entities did not borrow back and forth, since that type of borrowing would create a problem. Instead, he described the activity as follows: if one of the parties ran out of its allocation in a bin, it would take parts allocated to the other party, but would replace those parts at later date from future deliveries. Subcommittee interview of Thomas Quinn, PWC (12/17/2013). See also 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 005.

<sup>324</sup> Deposition of Robin Beran in *Schlicksup v. Caterpillar*, PSI-TWLF-12-000065, at 058.

<sup>325</sup> 3/13/2014 letter from Caterpillar's legal counsel to Permanent Subcommittee on Investigations, PSI-Caterpillar-18-000001 - 003, at 003.

<sup>326</sup> *Id.*

<sup>327</sup> Deposition of Jananne Copeland in *Schlicksup v. Caterpillar*, PSI-TWLF-15-000007, at 052-053.

<sup>328</sup> 6/11/2005 memorandum from PWC Swiss Tax Team, "Morton," PwC\_PSI\_CAT\_00206146 - 149.

even though no one knows exactly whose grain was provided. In contrast to the ITAS situation, however, the owner of grain stored in the silo cannot draw more than the owner had deposited without purchasing the excess grain at a market rate.

The ITAS system was an artificial inventory system created solely for tax purposes. It existed outside of and in addition to Caterpillar Inc.'s general global inventory system, which provided the data for ITAS. The second inventory book created by the ITAS system did not change how any of Caterpillar's parts were warehoused, tracked, or shipped. The tax consequences of the ITAS system are discussed in more detail below.

#### **(4) Making Paper, Not Operational, Changes**

The end result of the CSARL transaction was that changes were made on paper, but not in how the replacement parts business actually functioned. Beginning in 1999, CSARL became the nominal "global purchaser" of all of Caterpillar's finished replacement parts sold to non-U.S. customers in all areas of the world other than the United States. To implement that change, CSARL's name, instead of Caterpillar Inc.'s name, appeared on the parts invoices.

The 1998 and 1999 planning documentation prepared by PWC and Caterpillar indicated that altering the invoices was the primary change needed to implement the Swiss tax strategy, and that no other substantive changes in Caterpillar's parts operations were planned or expected. The original PWC proposal, for example, described the "Benefits/Costs" of the Swiss tax strategy as involving "[r]elatively simple re-invoicing requirements."<sup>329</sup> Another PWC document offered these "Main Implementation Observations":

"There will be no change with respect to sales of parts by COSA. Changes are proposed to the purchase of parts for resale. ... There will be no change in the physical locations of Accounts Payable processing. ... Invoicing from suppliers will be changed from CAT HE and Morton HE to COSA 'HE.' ... There is no change to dealer pricing."<sup>330</sup>

A later Caterpillar document referred to the removal of the U.S. parent company from the legal title chain for third party manufactured replacement parts as having "minimal business substance."<sup>331</sup>

In interviews, Caterpillar and PWC personnel told the Subcommittee that, at the time of the 1999 transaction, no substantive changes were made in how the replacement parts business actually functioned, and no Caterpillar personnel were moved to CSARL with respect to parts.<sup>332</sup>

<sup>329</sup> Undated PWC report, "Caterpillar CTOP Summary of Ideas," PwC\_PSI\_CAT\_00004566 - 631, at 618. See also 9/1998 PWC report, "Caterpillar Inc. Global Tax Optimization Case for Action," PwC\_PSI\_CAT\_00004632, at 674.

<sup>330</sup> Undated PWC report, "Caterpillar Inc. Operational Feasibility Analysis High Level Target Designs: Migration/Deferral," PwC-PSI-CAT-00004548 - 565, at 551. 7/14/1998 email from Steven Williams, PWC, to Thomas Quinn, PWC, and others, PwC\_PSI\_CAT\_00204970 - 974.

<sup>331</sup> Caterpillar presentation, "Product Management Alignment," (1/9/2009), PwC-PSI-CAT-00224682 - 686, at 685.

<sup>332</sup> Subcommittee interviews of Robin Beran, Caterpillar (10/18/2013), Rodney Perkins, Caterpillar (1/15/2014), and Steven Williams, PWC (2/19/2014) (each acknowledging they analyzed the CSARL transaction under a transfer pricing analysis and indicating that it was not necessary to move personnel); James Bowers, PWC (1/23/2014). All documents discussing moving product managers to CSARL related to CSARL's entering into tolling agreements with Caterpillar's manufacturing facilities in Belgium and France; none related to parts. See, e.g., 6/1/1999 minutes

William Springer, former Caterpillar Vice President of Product Support, told the Subcommittee that he was unaware of any changes in business function related to parts as a result of the CSARL transaction.<sup>333</sup> Sally Stiles, a senior Caterpillar tax manager, provided the same information, telling the Subcommittee that there was no substantive change in Caterpillar's purchased finished replacement parts business as a result of the CSARL transaction.<sup>334</sup> A 2006 PWC document explained the lack of operational changes at the time by stating that the CSARL transaction was intended simply to reflect what was already occurring and "better align the taxation of transaction flows with how Caterpillar actually manages those operations."<sup>335</sup>

None of the sworn deposition testimony provided by Caterpillar's personnel contradicted the information provided to the Subcommittee. When asked about the changes required in Caterpillar's business operations, for example, Caterpillar's tax department head, Robin Beran, said under oath:

"Q. What changes in business operations did it require?

A. It changed who actually bought the parts because CSARL became the acquirer of all the parts from the beginning. It changed various customs and logistics issues because of who the importers of record might be. There's a lot of changes that come into play.

Q. Well, other than paper issues that were caused by the entities that became involved, were there any other changes to the physical flow of purchased finished replacement parts?

A. Physical flow, probably not substantially."<sup>336</sup>

In addition, Edward Rapp, who was located in Switzerland between 1995 and 2004, and from 2000 to 2004, was Vice President of the EAME Marketing Division, testified in a deposition, that while in Geneva, he was familiar with CSARL's predecessor COSA, but had not even heard of CSARL.<sup>337</sup>

Caterpillar's Chief Accounting Officer also indicated in a Subcommittee interview that the 1999 transaction resulted in no change before tax in the total amount of Caterpillar profits from third party manufactured replacement parts sales.<sup>338</sup> That information matched her earlier deposition testimony in which she said that the operating profit for parts sales was the same both before and after the 1999 transaction.<sup>339</sup>

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of GloVE Steering Committee meeting, PwC\_PSI\_CAT\_00168292 - 296, at 295 (proposal to move product managers to Geneva related to implementation of manufacturing tolling agreements).

<sup>333</sup> William Springer, Caterpillar (11/7/2013). See also Deposition of William Springer in Schlicksup v. Caterpillar, at PSI-TWLF-18-000003, at 013.

<sup>334</sup> Subcommittee interview of Sally Stiles, Caterpillar, Director of Global Tax and Trade Operations (9/4/2013).

<sup>335</sup> 11/13/2006 PWC national office memorandum from Kevin Mitchell to Sharad Jain "Caterpillar Inc.," PSI-TWLF-21-000001 - 265, at 229. See also Subcommittee interview of Robin Beran (10/18/2013).

<sup>336</sup> Deposition of Robin Beran in Schlicksup v. Caterpillar, at PSI-TWLF-10-000008, at 178.

<sup>337</sup> Deposition of Edward Rapp in Schlicksup v. Caterpillar, at PSI-TWLF-19-000019.

<sup>338</sup> Subcommittee interview of Jananne Copeland, Caterpillar (10/30/2013).

<sup>339</sup> Deposition of Jananne Copeland in Schlicksup v. Caterpillar, PSI-TWLF-15-000018, at 039.



Several Caterpillar representatives explained that, beginning in 1999 and continuing to the present, CSARL paid Caterpillar Inc. a service fee for Caterpillar personnel to continue to perform key business functions supporting non-U.S. parts sales, including parts design, parts forecasting, inventory management, supplier oversight, and parts storage and delivery.<sup>340</sup> Caterpillar’s ongoing role in performing those parts functions was described in a report prepared for the Subcommittee by Caterpillar’s outside tax expert as follows:

“CSARL reimburses Caterpillar ... for various engineering and logistical services provided by Caterpillar personnel located in the United States involved in engaging with suppliers and storing and managing inventory in U.S.-situs warehouses. ... [M]uch of the purchasing and logistical functions relating to outbound PFRP continued after the restructuring to be carried out by Caterpillar personnel located in the United States.”<sup>341</sup>

The ongoing servicing arrangement is additional evidence that Caterpillar continued to perform the same parts functions it always had – an unsurprising development since CSARL did not have the personnel, infrastructure, or expertise to take on those tasks.

Caterpillar’s parts business has been and continues to be led and managed primarily from the United States. Nearly all the senior leadership of the parts business has been and remains in Illinois. Caterpillar’s U.S. warehouses continue to operate in the same way as in the past. Caterpillar continues to manage the parts inventory and parts forecasting on a worldwide basis and manage the supplier base in the United States, just as it did before the transaction. CSARL continues to pay Caterpillar to keep doing the same work, which CSARL continues to be unequipped to perform.

### **(5) Managing the Offshore Cash Buildup**

After the Swiss tax strategy was put in place, Caterpillar not only saved on U.S. taxes, it also experienced a “cash buildup in Geneva.”<sup>342</sup> According to the company, while CSARL collected a “significant portion of profit” for the company, Caterpillar had “[p]rimary cash needs in the U.S.,” creating what the company referred to as a “[u]se [d]ilemma.”<sup>343</sup> In 2002, Caterpillar wrote that it would “[n]eed to [r]epatriate [c]ash in the US,” that “CSARL need[ed] to repatriate \$60-\$70m per year” to meet Caterpillar’s U.S. cash requirements, and that “Subpart F after-tax income alone may be insufficient to meet cash repatriation needs.”<sup>344</sup>

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<sup>340</sup> Subcommittee interviews of Robin Beran, Caterpillar (10/18/2013) and Rodney Perkins, Caterpillar (1/15/2014). See also servicing agreements.

<sup>341</sup> 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report, John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007. See also 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 296.

<sup>342</sup> 4/13/2010 Caterpillar report Global Tax & Trade Update, PwC\_PSI\_CAT\_00205974 - 990, at 984.

<sup>343</sup> 1/22/2008 Caterpillar presentation for meeting with Edward Rapp, Caterpillar Global Finance & Strategic Support, PSI-TWLF-19-000001 - 215, at 094. The additional tax costs would presumably be due to the growth of Caterpillar’s pool of offshore earnings outpacing the amount of previously taxed income the company had on hand and available for repatriation to the United States without additional tax. Id.

<sup>344</sup> 7/2/2002 PwC presentation, “CSARL Technology Ownership,” PwC\_PSI\_CAT\_00024791 - 808, at 797.

In 2005, Caterpillar's tax director, Robin Beran, notified the company's Chief Financial Officer about CSARL's offshore cash buildup:

“[D]ue to successful planning from prior years, significant low taxed earnings (over \$1.5 billion) have accumulated in CSarl. This cash is now increasing at about \$70 million per month at tax rates of about 10%. This is resulting in offshore cash balances that can no longer be managed through intercompany loans and purchases without triggering significant additional tax costs, and an increase in CAT's effective tax rate.”<sup>345</sup>

Mr. Beran asked for authorization to proceed with a restructuring to facilitate repatriation of the offshore cash to the United States, noting that “failure to proceed will result in significant additional tax costs.”<sup>346</sup> Mr. Beran also noted in a 2006 memo that “ever-increasing cashflows from non-US sources to service US cash needs continue to place pressure on the indefinite reinvestment status of CSARL earnings. We are working on planning, which is projected to provide between \$1 billion to \$1.5 billion [in] repatriation relief.”<sup>347</sup>

In 2010, Caterpillar's finance department identified a “Crossover” cash buildup problem which it defined as “when offshore cash no longer can be accessed in the U.S. without incremental U.S. tax cost,”<sup>348</sup> meaning having to pay the U.S. corporate tax rate when the funds were repatriated to the United States. The finance department noted the “[h]igh enterprise tax cost of repatriation – 25% additional tax,” and stated that it was “[d]eveloping tax efficient repatriation strategies” to return \$3 billion to the United States.<sup>349</sup> It listed several possible strategies for returning funds to the United States, including making “[l]oans to U.S. with minimal tax impact ... [p]repay[ing] royalties ... [and] [e]xpand[ing] goods prepayment – CSARL purchases from U.S. affiliates.”<sup>350</sup>

Caterpillar appears to have executed at least one of these strategies. According to a memorandum prepared by Caterpillar's auditor, PWC, in 2011, Caterpillar Inc. entered into an agreement with CSARL “whereby CSARL made \$4 billion of advance payments for certain prime product up to 2 years in advance and received a discount for orders placed against this advance payment.”<sup>351</sup> As of the end of 2013, Caterpillar's offshore cash assets totaled \$17 billion, giving the company the 33rd largest offshore amount of 1,000 corporations reviewed.<sup>352</sup>

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<sup>345</sup> 2/28/2005 email from Robin Beran, Caterpillar, to David Burritt, Caterpillar, “Authorization to proceed with planning and ABP [sic] cost adjustment,” PSI-TWLF-12-000008, at 315. The “significant additional tax costs” refers to the company's having to pay the U.S. corporate tax rate of up to 35% if the funds were to be repatriated to the United States.

<sup>346</sup> Id.

<sup>347</sup> 7/14/2006 memorandum from Robin Beran, Caterpillar, to David Burritt, Caterpillar, PSI-TWLF-16-000262 - 263.

<sup>348</sup> 4/13/2010 Caterpillar Inc. presentation to Audit Committee, “Global Tax & Trade Update,” PwC\_PSI\_CAT\_00205974 - 990, at 984.

<sup>349</sup> Id.

<sup>350</sup> Id.

<sup>351</sup> 12/31/2011 PWC Audit Memo, “Review intercompany transaction including company reorganizations and significant agreements,” PwC-PSI-CAT-00194435 - 436.

<sup>352</sup> See March 2014 “Foreign Indefinitely Reinvested Earnings: Balances Held by the Russell 1000; A Six-Year Snapshot,” Audit Analytics, at 4.

### C. Identifying the Swiss Tax Strategy as High Risk

Internal Caterpillar and PWC documentation shows that Caterpillar knew, at the highest levels of the company, that critical elements of the Swiss tax strategy it had adopted had high risk aspects. In 2006, Caterpillar's tax department devised a tax risk rating system to evaluate the risks associated with the company's tax positions, analyzed two key elements of the Swiss tax strategy, and gave aspects of those elements a high risk rating. Rather than turn away from its aggressive tax position, however, Caterpillar instead sought ways to reduce the risk rating; when that did not happen, the company stopped using the rating system altogether in 2008.

**Tax Reserves.** One sign of Caterpillar's recognition that its new Swiss tax strategy was high risk was the action taken by the company at one point to set aside a "tax reserve" equal to 50% of CSARL's profits in case the IRS challenged the strategy.<sup>353</sup> A tax reserve is a position recorded in a company's audited financial statements to set aside money in case an uncertain tax position taken by the company on a tax return is successfully challenged by the IRS. The PWC auditor who reviewed Caterpillar's tax issues, James Bowers, told the Subcommittee that the tax reserve was established due to uncertainties associated with the complex transaction flows, the adequacy of the royalty rates, and accounting issues related to CSARL.<sup>354</sup> That reserve was later reduced, after adoption of new tax accounting rules, to reflect 5% of the CSARL profits in each tax year.<sup>355</sup>

**Adopting the Tax Risk Guard Rails System.** Another sign of Caterpillar's concerns about the risky nature of its Swiss tax strategy was action taken by an internal council of senior tax and accounting personnel, during the course of developing and implementing a new tax risk management process, to rate aspects of the Swiss tax strategy as "higher" risk.

The Swiss tax strategy was evaluated for risk at Caterpillar in connection with a new tax risk management tool known as the "Tax Risk Guard Rails" (TRGRs) project. The objective of the TRGRs project was to "develop a documented, more objective process" to identify and convey the business risks associated with uncertain tax positions to both company executives and the Audit Committee of the Board of Directors "in a non-technical manner."<sup>356</sup> Current and former Caterpillar employees interviewed by the Subcommittee attempted to downplay the significance of the TRGRs tax risk rating, but the evidence shows it was used to inform senior levels of the company about the risks associated with two critical elements of the Swiss tax strategy. The TRGRs system was developed at the direction of Caterpillar's former CFO, David Burritt, its ratings were assigned by consensus of company tax and accounting experts, and remained in place for two years.

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<sup>353</sup> Subcommittee interview of James Bowers, PWC (1/23/2014). See also 6/2004 "Presentation to Caterpillar Inc. Audit Committee," CAT - 001899 - 939, at 912; 4/10/2007 "FIN 48 Adoption and Corporate Tax Update," at CAT-002037 and 040; 4/13/2010 Caterpillar Inc. presentation to Audit Committee, "Global Tax & Trade Update," PwC\_PSI\_CAT\_00205974 - 990, at 982.

<sup>354</sup> Subcommittee interview of James Bowers, PWC (1/23/2014).

<sup>355</sup> 4/10/2007 "FIN 48 Adoption and Corporate Tax Update," at CAT- 002041. FIN 48 stands for FASB Interpretation No. 48.

<sup>356</sup> Caterpillar report, "Caterpillar Inc., Global Finance —Tax Risk Management, World Class Global Finance Operations to Support Vision 2020," PSI-TWLF-4-000091 - 097, at 093.

In 2004, when Mr. Burritt became Caterpillar Inc.'s CFO, he took steps to improve the company's tax risk management processes.<sup>357</sup> Mr. Burritt had previously worked with Daniel Schlicksup in Caterpillar's Geneva office. When he took over as CFO, Mr. Burritt brought Mr. Schlicksup back to Caterpillar's tax department in the United States to assist with tax risk management and improve the company's global tax practices. Upon his return, Caterpillar announced the following concerning Mr. Schlicksup's new position as its "Tax Strategy Manager":

"Effective March 1, [2005,] D.J. (Dan) Schlicksup will become Tax Strategy Manager for Corporate Tax Services. In this new role, Dan's primary function will be to provide leadership to our Global Tax Strategy, including benchmarking our performance and processes versus world-class and developing metrics to measure our progress. In addition, Dan will help provide leadership to Global Tax Communications, Personnel and Succession Planning.

Dan's educational background and work experience brings additional diversity to the Corporate Tax team. Dan has a very strong educational background with a Law degree and a Masters in Taxation coupled with a CPA. His previous experience working at Price Waterhouse in the tax department and at Cat as a Tax Manager in Peoria, Accounting & Tax Strategy Manager in Gosselies, and Director of European Tax Services in Geneva will serve him well in this new role."<sup>358</sup>

Early in his new position, Mr. Schlicksup learned about the TRGRs risk management tool from a leading business advisory organization, the Corporate Executive Board.<sup>359</sup> Mr. Schlicksup brought the concept to the attention of Mr. Burritt who encouraged him to develop the TRGRs system for Caterpillar.<sup>360</sup> The Tax Risk Guard Rails system was designed to evaluate tax positions for the following types of risks: technical, operational, compliance, financial statement, management, and reputational.<sup>361</sup> The system further broke down those risks into 19 "indicative criteria," requiring ratings on such factors as "industry practice," "magnitude of cash impact," "legal advice," and "impact on financial statements."<sup>362</sup> The last criteria required the tax position to be rated on what was referred to as the "WSJ Test," apparently referring to how it might be portrayed by the Wall Street Journal.<sup>363</sup> Each of the criteria was scored using a rating system of 1 to 5, with 5 being the highest risk. A weighting

<sup>357</sup> 8/19/2005 email from David Burritt, Caterpillar, to Daniel Schlicksup, Caterpillar, "Re: Gene Fife – 210 of 250 companies remove CFO when there is material weakness," PSI-TWLF-04-000131 ("This is exactly why we must step up the rigor on tax processes").

<sup>358</sup> 2/21/2005 email from Deborah Schrader, Caterpillar, to Elaine Atchley, Caterpillar, "General Mailing – Personnel Announcement," PSI-TWLF-04-000004.

<sup>359</sup> For more about the Corporate Executive Board, see its website, <http://www.executiveboard.com/exbd/about/index.page?>

<sup>360</sup> Subcommittee interview of David Burritt, Caterpillar, former CFO (12/4/2013). See also 2/10/2006 email from David Burritt, Caterpillar, to Daniel Schlicksup, Caterpillar, "Re: Fw: Meeting re Tax Guardrails," PSI-TWLF-04-000038. See also 9/23/2005 email from David Burrett, Caterpillar, to Douglas Oberhelman, Caterpillar, and others, "FYI Only – Meeting with Gene Fife on Sept 26," PSI-TWLF-04-000039.

<sup>361</sup> See "Caterpillar Inc., Global Finance-Tax Risk Management, World Class Global Finance Operations to Support Vision 2020, PSI-TWLF-16-000188 - 194, at 190.

<sup>362</sup> See 3/21/2006 TRGRs presentation with ratings chart, prepared by Caterpillar, PSI-TWLF-11-000225.

<sup>363</sup> Id.

system was also used, making some factors more important than others. Once specific tax position risks were evaluated and scored, they were to be plotted on a graph indicating whether their risk was low, medium, or high.<sup>364</sup> Once the risks were identified, they were to be presented to company executives.<sup>365</sup>

In September 2005, Mr. Burrirt shared the TRGRs concept with Douglas Oberhelman who was then Group President of the finance department, explaining that “[w]e will follow a process based on research done by the Corporate Executive Board that enables us to better analyze and understand our risks.”<sup>366</sup> Mr. Burrirt also asked Mr. Schlicksup to present the TRGRs concept to Caterpillar’s Audit Committee Chairman, Eugene Fife.<sup>367</sup> Mr. Fife responded positively and asked for the TRGRs concept to be included on the agenda for a December Audit Committee meeting.<sup>368</sup> In December 2005, Robin Beran, Caterpillar’s tax director, presented the TRGRs concept to the full Audit Committee and identified several deliverables for the February 2006 Audit Committee meeting, including identifying the tax risk categories and defining low, medium, and high risks.<sup>369</sup>

**Assigning Tax Risk Ratings.** Caterpillar’s Tax Council began its initial substantive work on the TRGRs project in January 2006 and continued through March.<sup>370</sup> The Tax Council was a group of senior personnel from Caterpillar’s tax and accounting departments, formed at the suggestion of Mr. Burrirt, to address key tax issues for the company.<sup>371</sup> According to Caterpillar’s Tax Director and Senior International Tax Manager for CSARL, the Tax Council

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<sup>364</sup> “Caterpillar Inc., Global Finance-Tax Risk Management, World Class Global Finance Operations to Support Vision 2020,” at slide 6, PSI-TWLF-16-000188 - 194, at 193.

<sup>365</sup> Rodney Perkins Deposition in *Schlicksup v. Caterpillar*, PSI-TWLF-10-000004, at 117.

<sup>366</sup> 9/23/2005 email from David Burrirt, Caterpillar CFO, to Douglas Oberhelman, Caterpillar Group President for Finance, “Meeting with Gene Fife on Sept 26,” PSI-TWLF-04-000039.

<sup>367</sup> 9/26/2005, Presentation re Global Tax Management, PSI-TWLF-04-000040 - 073, at 040 and 066.

Subcommittee interview of Daniel Schlicksup (8/29/2013 - 8/30/2013).

<sup>368</sup> See 10/28/2005 email from Robin Beran, Caterpillar, to Daniel Schlicksup, “Dec. audit comm mtg,” PSI-TWLF-04-000341 - 344 (“Gene was very excited about this when we met with him, indicated that he wants this [TRGRs] to be part of every audit committee meeting and obviously wanted it on the Dec agenda (Doug [Oberhelman] even mentioned that to us). I would ask, when was the last time Gene acted in this manner about a tax issue?”).

<sup>369</sup> 12/13/2005 Presentation re Global Tax Management, slides 1 and 27, PSI-TWLF-16-000167 - 180, at 167 and 180; Subcommittee interview of Daniel Schlicksup (8/29/2013 - 8/30/2013).

<sup>370</sup> 1/3/2006 email from Rodney Perkins to Daniel Schlicksup, Jananne Copeland, and others, “Need asap please ... creating Tax Ri[s]k Guard Rails,” PSI-TWLF-04-000345-346; 2/7/2006 email from Daniel Schlicksup to David Burrirt, “Tax Risk Guard Rails-audex,” PSI-TWLF-04-000978 (“David, I have a solid draft to the guard rails done .... I feel comfortable that if Gene [Fife] demanded to see something today and you came and got me, I could present the draft and get the Aud Comm comfortable that we are meeting our commitments.”); 2/9/2006 email from Brad Halverson, CAT controller, to Daniel Schlicksup, “Tax Risk Guardrails, PSI-TWLF-04-000356-357; 2/10/2006 email from David Burrirt to Daniel Schlicksup, “Meeting re Tax Guard Rails,” PSI-TWLF-04-000358-359 (“Meeting with Brad Halverson and Robin Beran week of Mar 13 - 2 hours (BradH, RobinB, DanS, Janie Copeland) Meeting week of Feb 20 off-site, all day at Ivy Club (Rod, Sally, Gary, JamesC, Al, Robin, JohnC, DanS JanieC and Terri Pierpont) Meeting week of Feb 27 off-site, all day at Ivy Club (Rod, Sally, Gary, JamesC, Al, Robin, JohnC, DanS, JanieC and Terri Pierpont).” 02/27/2006 email from Daniel Schlicksup to David Burrirt, “A/C meeting,” PSI-TWLF-04-000089 (“We had a two offsite last week to finalize the guard rails. We have two more days next week to plot the tax positions on the guard rails.”).

<sup>371</sup> Subcommittee interview of Rodney Perkins, Caterpillar (1/15/2014) and Robin Beran, Caterpillar (10/18/2013). Mr. Beran told the Subcommittee that CFO David Burrirt formed the idea for the Tax Council.

reviewed, identified, and evaluated a broad range of Caterpillar tax risks, acting by consensus and in “good faith” with deference given to individuals with a higher level of expertise.<sup>372</sup>

In March 2006, the Tax Council evaluated two critical elements of the Swiss tax strategy which raised concerns: CSARL’s bundled royalty rate and the ITAS virtual inventory system.<sup>373</sup> The Tax Council assigned multiple 5 ratings – meaning the highest risk rating – to several criteria related to the CSARL’s bundled royalty rate, including with respect to “industry practice,” “business purpose and substance,” and “magnitude of cash impact.”<sup>374</sup> The Tax Council assigned even more 5 ratings to the ITAS virtual inventory system, including a 5 high-risk rating for the legal advice provided in connection with the system and for the reputational risk associated with the “WSJ test.” Overall, when those and other individual ratings were combined, averaged, and weighted, the Tax Council ranked those two elements of the Swiss tax strategy as among the highest risk tax issues it examined.<sup>375</sup>

Although the Tax Council’s TRGRs findings were planned to be presented to the Audit Committee in earlier meetings,<sup>376</sup> they were actually included on a meeting agenda in June 2006. On June 13, 2006, it appears that the Audit Committee was not presented with the TRGRs findings, but instead with a description of the TRGRS process including the steps to be taken to identify and define risks categories and the associated criteria, although Caterpillar officials who attended that meeting told the Subcommittee that they could not remember any details about the presentation.<sup>377</sup>

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<sup>372</sup> See, e.g., Subcommittee interview of Rodney Perkins, Caterpillar (1/15/2014). Mr. Perkins described two meetings on the tax risk guardrails project, each of which was “offsite” and about 1-2 days in length. He told the Subcommittee one additional meeting took place about a year after the initial meetings. Mr. Perkins said the meetings were very thorough, and everyone weighed in. He indicated that there was a sense in the meetings to move on as quickly as possible, but that the participants put in a good faith effort during the meetings. See also Sally Stiles Deposition in Schlicksup v. Caterpillar, PSI-TWLF-11-000008, at 65; Deposition of Rodney Perkins in Schlicksup v. Caterpillar, PSI-TWLF-10-000004, at 115; deposition of Robin Beran in Schlicksup v. Caterpillar, at PSI-TWLF-12-000008, at 32.

<sup>373</sup> 3/21/2006 Tax Risk Guard Rails presentation, PSI-TWLF-11-000224 - 227.

<sup>374</sup> 3/21/2006 TRGRs presentation, prepared by Caterpillar, ratings chart at PSI-TWLF-11-000225.

<sup>375</sup> Id. Of the 15 tax positions it reviewed, the Tax Council rated the bundled royalty rate and the virtual inventory system as the third and sixth highest risk tax positions.

<sup>376</sup> See, e.g., 1/11/2006 email from David Burritt to Daniel Schlicksup, “the Audit Committee & Tax Risk Guard Rails,” PSI-TWLF-04-000076 (“Please plan to include in Feb advance material”); 2/9/2006 email from David Burritt to Daniel Schlicksup, “Tax Risk Guard Rails,” PSI-TWLF-04-000080 (“We need to move this forward .... The issue was not raised but I think we missed a due date. Let’s make sure this gets included in the April material in ‘final’ form.”); and 5/12/2006 email from David Burritt to Robin Beran “Audit Committee- June,” PSI-TWLF-16-000217 (“I will call Ali but our instruction from Gene [Fife, Audit Committee Chairman] was on [tax risk] guard rails”); 5/12/2006 email from David Burritt to Robin Beran “Audit Committee- June” (responding to a question from Mr. Burritt about whether they were ready to present to the Audit Committee, Mr. Beran wrote: “We were done with them [the TRGRs] about 5 weeks ago.”).

<sup>377</sup> 6/13/2006 Audit Committee Presentation, “Income Tax Update,” CAT 001949 - 965; 6/13/2006 “Agenda Audit Committee,” PSI-TWLF-16-000214 (“this presentation will provide an update on World Class Tax initiatives supporting our Global Finance Transformation, including “tax guard rails.”) Robin Beran testified that the “Income Tax Update” presentation noted above looked like part of the presentation given to the Audit Committee in June, but he was unsure whether he gave the presentation. Deposition of Robin Beran in Schlicksup v. Caterpillar, PSI-TWLF-12-000008, at 114. The Subcommittee obtained from PWC a similar copy of a 6/13/2006 Audit Committee presentation, which was an attachment to an email between Robin Beran, Caterpillar, and James Bowers, PWC tax partner, which included an email that indicated the presentation was sent to Caterpillar senior executives Douglas

Caterpillar's tax department also shared the TRGRs findings with PWC partner James Bowers who assisted in the audit of the company's financial statements, including Caterpillar's estimates of its tax liabilities. Mr. Bowers advised the Subcommittee that he had received the TRGRs risk ratings and believed that they were later presented to the company's Audit Committee.<sup>378</sup> He said that the TRGRs process had identified risks associated with the Swiss tax strategy, but recalled that they were similar to the risks identified when Caterpillar increased its tax reserves.<sup>379</sup> He said that he had been unaware that the Tax Council had rated certain CSARL tax elements as "high" risk.<sup>380</sup>

On August 11, 2006, Mr. Schlicksup wrote CFO Burrirt that he was being pressured to lower the TRGR risk ratings for some tax positions. Mr. Schlicksup advised the following about the TRGRs status:

"Tax Council will be meeting in near future to update TRGRs. The pressure I am getting is focused on the risk shown on the guard rails. For example, I am being questioned why the structured finance deals should be considered to have high reputational risk .... I think he [Robin Beran, the tax director] is very concerned about showing any risk at all.

I need to understand where you want to go with the TRGRs. Are we going to stop where we are at which is just informing the board about the process we went through to create the guard rails, or are we going to show the board the results and have a meaningful discussion explaining our risk profile and to determine the board's comfort with it? I don't want to spend a lot of time on this if it's not going to go anywhere. I recommend the latter as I believe it is a best practice and the whole point for going down this path in the first place."<sup>381</sup>

Mr. Burrirt responded: "The latter is the way to go, of course. Why would we have started this if we weren't going to do it right?"<sup>382</sup> However, Mr. Burrirt also wrote in a later email: "Focus now on Oct A/C [Audit Committee] meeting. Let's meet after that. But no more emails on this, pls. I get too many already." Around this time, the Tax Director, Robin Beran, sent an email to Mr. Schlicksup indicating that he understood that it was implicit the tax department would keep

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Oberhelman and David Burrirt. 6/8/2006 email from Robin Beran to James Bowers, "Fw: FYI – 2006 Corporate Tax Audit Committee Presentation," PwC\_PSI\_CAT\_00004799 - 827. The attachment to this email set out plotted tax positions identifying risk for various positions including CSARL's Bundled Royalty rate and the Virtual Inventory. *Id.* at 827. It does not appear that these positions were presented to the Audit Committee at the June 2006 meeting. Neither Robin Beran nor the Audit Committee Chairman, Eugene Fife, recalled any details about the TRGRs presentation to the Audit Committee. Subcommittee interviews of Robin Beran, Caterpillar (10/18/2013) and Eugene Fife, Caterpillar (11/13/2013). In fact, Mr. Fife had no recollection of the phrase "Tax Risk Guard Rails." Former CFO David Burrirt remembers the concept of TRGRs being discussed with the Audit Committee, but he does not recall whether the actual TRGRs were presented. Subcommittee interview of David Burrirt, Caterpillar (12/4/2013).

<sup>378</sup> Subcommittee interview of James Bowers, PWC tax partner (1/23/2014). He advised that the ratings were presented to the Audit Committee in April 2008.

<sup>379</sup> *Id.*

<sup>380</sup> *Id.*

<sup>381</sup> 8/11/2006 emails between Daniel Schlicksup and David Burrirt, "Tax Risk Guard Rails," PSI-TWLF-04-000126 - 128, at 127.

<sup>382</sup> *Id.* at 126.

the ratings below high risk: “Assuming guidance is to stay below high [risk] in all areas, how do we utilize?”<sup>383</sup>

**2008 TRGRs Report to Audit Committee.** The Tax Risk Guard Rails project remained in place for approximately two years, from 2006 to 2008.<sup>384</sup> Its risk ratings were reviewed twice each year by the Tax Council which retained the high risk ratings assigned to the royalty and virtual inventory issues associated with CSARL.<sup>385</sup> As late as April 8, 2008, a presentation with a “Global Tax Update” touting implementation of the TRGRs tax risk management tool was prepared for the Audit Committee.<sup>386</sup> The presentations noted that the “Tax Risk Guards Rails” risk ratings were part of Caterpillar’s “robust” tax risk management process.<sup>387</sup> It also advised the Audit Committee that Caterpillar’s “risks are actively managed.”<sup>388</sup>

One of the slides in the 2008 presentation identified the “CSARL – Parts Distribution – Management & Reputation” as one of the “Higher Risk Areas.”<sup>389</sup> The Audit Committee was also advised in the presentation that the company had developed a plan with outside counsel to mitigate this risk.<sup>390</sup> The presenter’s note to this presentation stated, with regard to parts distribution:

“CSARL and CAT Inc. trade parts in a manner that increases the Parts Sales that qualify for favorable tax treatment. The complexity of the activity could be cast in unfavorable light. To ensure our position is correct, we worked extensively with outside counsel and accountants on the process involved.”<sup>391</sup>

Together, the evidence indicates that the TRGRs risk ratings served to focus attention on the Swiss tax strategy, led to a consensus among participants on Caterpillar’s Tax Council that the strategy had risky elements, and alerted Caterpillar’s Board of Directors, through the Board’s Audit Committee, as well as its senior executives, to the ongoing risks posed by the Swiss tax strategy.

**Downplaying the TRGR High Risk Ratings.** When asked about the TRGR risk ratings related to the Swiss tax strategy, Caterpillar downplayed their significance. During interviews

<sup>383</sup> 7/28/2006 email from Robin Beran to Daniel Schlicksup, PSI-TWLF-04-000368.

<sup>384</sup> Subcommittee interview of David Burritt, former Caterpillar CFO (12/4/2013); “Caterpillar Inc. Report to Audit Committee,” PSI-TWLF-16-000114 - 124, at 121. The report was provided as part of Caterpillar’s “World Class Tax Update” that it had “implemented the Tax Risk Guard Rails to reduce Risk and Complexity.”

<sup>385</sup> 3/21/2006 Tax Risk Guardrails, PSI-TWLF-04-000382; 10/15/2007 Tax Risk Guardrails, PSI-TWLF-04-000383; 3/18/2008 Tax Risk Guardrails, PSI-TWLF-04-000384 and 2/8/2006, Tax Risk Guardrails Criteria (draft), PSI-TWLF-04-000381.

<sup>386</sup> 4/8/2008 Caterpillar “Global Tax Update,” CAT-002087 - 112; 5/13/2008 email from James Bowers, PWC audit partner, to Sharad Jain, “Tax Presentation,” PwC\_PSI\_CAT\_00036773. Mr. Bowers advised the Subcommittee that the attachment to the email was presented to the Audit Committee. Subcommittee interview of James Bowers, PWC (1/23/2014).

<sup>387</sup> Id. The presentation showed that Caterpillar’s tax risk management processes were “robust,” 4/8/2008 Caterpillar “Global Tax Update,” CAT-002087 - 112, at 094.

<sup>388</sup> 4/8/2008 Caterpillar “Global Tax Update,” CAT-002087 - 112. See also 5/13/2008 email from James Bowers, PWC, to Sharad Jain “Tax Presentation” PwC\_PSI\_CAT\_00036773.

<sup>389</sup> Id.

<sup>390</sup> Id.

<sup>391</sup> 5/13/2008 email from James Bowers, PWC, to Sharad Jain “Tax Presentation” PwC\_PSI\_CAT\_00036774 - 791, at 785.



with the Subcommittee, senior executives from Caterpillar’s tax department, as well as Caterpillar’s CFO at the time they were implemented, told the Subcommittee that the TRGRs risk ratings were of limited value in informing either the Board of Directors or the Audit Committee about Caterpillar’s tax risks, and the risk ratings were therefore abandoned in 2008. During interviews, these executives recalled little detail about the tax risks or ratings identified during TRGRs process or how they were used. The Audit Committee Chairman at the time, Eugene Fife, told the Subcommittee he had no recollection of the phrase “Tax Risk Guard Rails,” despite the fact that he appeared to have played an active role in their adoption.<sup>392</sup> The Caterpillar Tax Director, Robin Beran, said that he had been skeptical of the usefulness of the risk ratings from the beginning,<sup>393</sup> and viewed the ratings as flawed because anything involving a large amount of money would lead to a high risk rating.<sup>394</sup> He told the Subcommittee that rather than rely on the TRGRs ratings assessed by his senior staff, he relied on expert tax advice from PWC and McDermott Will & Emery. Another senior tax department official, Rodney Perkins, told the Subcommittee that the TRGRs process was not a useful tool and that he didn’t remember the risks associated with CSARL.<sup>395</sup> Former CFO David Burritt acknowledged that he was originally in favor of implementing the TRGRs process, but later concluded that the process was too “heavy” and time and resource-intensive. He told the Subcommittee that he did not recall any specific risks that the TRGRs identified.<sup>396</sup>

#### **D. Swiss Tax Strategy Policy Concerns**

The Swiss tax strategy that PWC designed and Caterpillar adopted to lower its U.S. taxes raises multiple policy questions. They include whether the strategy lacked economic substance, whether the agreements between Caterpillar Inc. and CSARL violated arm’s-length principles, and whether its use of a virtual inventory system created a taxable U.S. presence for CSARL. Together, these and related problems demonstrate why transfer pricing agreements between a U.S. parent corporation and its foreign affiliate raise multiple policy concerns; the agreements are between related parties with aligned interests and too often function, not to allocate costs or profits fairly between the parties, but simply to shift profits offshore to avoid U.S. taxes, exploiting loopholes and weaknesses in U.S. transfer pricing regulations.

##### **(1) Economic Substance Concerns**

The first policy issue raised by Caterpillar’s Swiss tax strategy is whether the CSARL transaction lacked economic substance. At least two tax professionals within Caterpillar concluded that the CSARL transaction lacked economic substance and had no business purpose other than tax avoidance, bringing those concerns to the attention of officers at the highest levels of the company through an anonymous letter in 2004, and a series of emails and memoranda by the company’s Global Tax Strategy Manager beginning in 2007. Even though company

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<sup>392</sup> Subcommittee interview of Eugene Fife, Caterpillar Audit Committee Chair (11/13/2013).

<sup>393</sup> Deposition of Robin Beran in Schlicksup v. Caterpillar, PSI-TWLF-12-000008, at 23.

<sup>394</sup> Subcommittee interview of Robin Beran, Caterpillar (10/18/2013).

<sup>395</sup> Subcommittee interview of Rodney Perkins, Caterpillar (1/15/2014). Mr. Perkins also advised the Subcommittee that he was more concerned with the adequacy of the amount of the licensing fees paid by CSARL, than the lack of a business purpose or economic substance in the CSARL transaction.

<sup>396</sup> Subcommittee interview of David Burritt, former Caterpillar CFO (12/4/2013).

executives knew the CSARL transaction had been tax motivated, the employee concerns were dismissed. While Caterpillar does not dispute that the CSARL transaction was the result of a tax strategy designed to lower the company's taxes, Caterpillar says that fact is irrelevant and its actions should be judged solely on whether it has complied with U.S. transfer pricing laws and regulations, which it contends the company did.

**Anonymous Letter.** In 2004, an anonymous letter was received by Caterpillar's CEO and the tax department alleging that the CSARL transaction lacked any business purpose other than tax avoidance.<sup>397</sup> The letter stated in part:

"I do not believe Caterpillar's transfer pricing practices (past and present) meet the IRS' tests. The Officers and Board of Directors need to examine the transfer pricing issue before Caterpillar ends up in court and in the press .... [T]he Tax Code does not permit transactions or an organizational structure that have no substantial business purpose other than for tax avoidance purposes. The CSARL reorganization in my opinion, does not meet this test. When you look through the reorganization, the primary purpose was to avoid taxes.

Over the past few years, Caterpillar's tax rate has dropped significantly due to very questionable transactions and organizational changes. I work in the Tax Department and I strongly disagree with how we have conducted our business over the past few years. I have not spoken out before, because of the fear of retribution. I am speaking out now for the long term good of Caterpillar. An independent investigation (not PWC or our outside tax counsel) is needed. If there is no independent investigation or if there is any retribution, I will go the IRS."<sup>398</sup>

Caterpillar's Tax Director, Robin Beran, forwarded the anonymous letter to the CEO along with a memorandum disputing its analysis and recommending against further investigation, because he considered the issues raised to be without merit.<sup>399</sup> Mr. Beran wrote that the allegations were untrue, and the author was misinformed. With regard to the transfer pricing issue, he stated: "CAT's transfer pricing policy is the result of detailed analysis of the functional activities of the various entities in strict accordance with Treasury Regulations."<sup>400</sup> He also noted that two independent accounting firms had assisted in Caterpillar's analysis. With regard to the allegations concerning the lack of a business purpose other than tax avoidance, he explained that CSARL was formed to facilitate and coordinate Caterpillar's non-U.S. business activities throughout the world, which had been previously carried out by CSARL's predecessor, COSA. He also noted: "The basic operations of Caterpillar SARL are no different than any other valid and legal partnership operating anywhere in the world."<sup>401</sup>

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<sup>397</sup> Robin Beran told the Subcommittee that he shared the anonymous letter with the IRS auditors stationed at the company. Subcommittee interview of Robin Beran, Caterpillar Tax Director (10/18/2013).

<sup>398</sup> 5/6/2004 memorandum from Robin Beran, Caterpillar, to Douglas Oberhelman, Caterpillar, "Tax Concerns Raised by an Unnamed Source," PSI-TWLF-02-0001393 - 396, at 395.

<sup>399</sup> Id.

<sup>400</sup> Id. at 393.

<sup>401</sup> Id. at 394.

**Tax Strategy Manager Concerns.** Three years later, in 2007, Daniel Schlicksup, Caterpillar's Global Tax Strategy Manager, began raising similar concerns inside the company. In January 2007, Mr. Schlicksup wrote an email to Caterpillar's Tax Director raising questions about the CSARL transaction and the "economic substance" tax doctrine. He wrote: "To my knowledge there is no one in CSARL managing the parts business or managing the subcontracting of all the activity to [Caterpillar] Inc."<sup>402</sup> He suggested that a review of the facts and case law would be prudent, sending several recent cases from the Seventh Circuit.<sup>403</sup> From July through September, Mr. Schlicksup repeated his concerns to the company's legal department about the lack of business substance in the CSARL transaction, as well as raising concerns about other aspects of Caterpillar's business.<sup>404</sup> In September 2007, Mr. Schlicksup sent an email to Caterpillar's ethics officer reiterating his concerns. He wrote:

"There is about approximately \$1b on the balance sheet representing profit after tax generated by the CSARL parts initiative. The number increases by about \$200-250M per year .... In January 2007, I raised the issue of whether the judicial doctrines of Economic Substance and Business [P]urpose have been adequately addressed.... The essence of the issue is that to my knowledge, the parts business is managed from the US, yet we are running the parts profits through Switzerland as if the business was managed by CSARL."<sup>405</sup>

He also wrote: "I believe an inquiry into this issue is appropriate."

In April 2008, when Mr. Schlicksup was preparing a presentation for the Caterpillar Board of Directors discussing CSARL among other high risk tax strategies, he sent an email to the head of the tax department, Robin Beran, again raising the economic substance issue and urging that it be discussed with the Board:

"With all due respect, the business substance issue related to the CSARL Parts Distribution is the pink elephant issue worth a Billion dollars on the balance sheet. I have been asking for more than a year if we have memos with proper facts and analysis of case law. ... I don't think you can talk about CSARL without addressing this issue and it is not addressed in the charts you have included."<sup>406</sup>

When the formal inquiry and Board discussion that he requested failed to materialize, in May 2008, Mr. Schlicksup sent Caterpillar's Executive Office a memorandum detailing his concerns about improprieties occurring at the company, including his concerns about the lack of

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<sup>402</sup> 1/19/2007 email from Daniel Schlicksup, Caterpillar Global Tax Strategy Manager, to Robin Beran, Caterpillar, PSI-TWLF-02-000349 - 352, at 349.

<sup>403</sup> Id. Mr. Schlicksup sent another email to Mr. Beran about the lack of economic substance in the CSARL transaction in March 2008. Mr. Beran responded: "I didn't get to mention it you ... but it [is] covered extensively in 4 memos" prepared by outside counsel. 3/24/2008 email from Robin Beran, Caterpillar, to Daniel Schlicksup, Caterpillar, PSI-TWLF-02-000469.

<sup>404</sup> 7/19/2007 email from Daniel Schlicksup, Caterpillar, to Debra Kuper, Caterpillar Senior Corporate Counsel, "FYI, I assume you want this information as it comes up," PSI-TWLF-02-000368; 8/14/2007 email from Daniel Schlicksup, Caterpillar, to James Buda, Caterpillar, "Tomorrow's Meeting," PSI-TWLF-02-000369 - 379.

<sup>405</sup> 9/07/2007 email from Daniel Schlicksup, Caterpillar, to Nancy Snowden, Caterpillar Director of Business Resources, "OBP Complaint – Accounting Practices- No. 2," PSI-TWLF-02-000387 - 392, at 387.

<sup>406</sup> 4/1/2008 email from Daniel Schlicksup, Caterpillar, to Robin Beran, Caterpillar, "Pls review again before we send in AM," PSI-TWLF-07-000022.

business substance in the CSARL transaction.<sup>407</sup> Mr. Schlickup's memorandum identified the following problems: the CSARL transaction lacked a business purpose other than tax avoidance; there was no real change in the company's business functions as a result of the CSARL transaction; there was no non-tax related change in Caterpillar's economic position after the CSARL transaction; and the transaction was tax motivated.<sup>408</sup>

Another senior tax manager in Caterpillar's tax department, Rodney Perkins, when asked about the CSARL transaction in a deposition, made statements that raised further questions about the tax strategy's business purpose. Mr. Perkins, Caterpillar's Senior International Tax Manager with direct responsibility for CSARL, was asked in a deposition about whether the CSARL transaction had any "business advantage" other than "the avoidance or deferral" of U.S. tax and said under oath the following:

- "Q. What was the benefit to Caterpillar Inc., to have CSARL purchase finished replacement parts instead of having Caterpillar, Inc., buy them and sell them to CSARL?
- A. It would alter the character of income from CSARL from includable deemed distribution income to the U.S.
- Q. So the advantage to Caterpillar, Inc., would be that it would pay less federal income tax?
- A. Yes.
- Q. And that would be an advantage to the enterprise as a whole in the sense that the tax was at least deferred?
- A. Yes.
- Q. Was there any business advantage to Caterpillar, Inc., to have this arrangement put in place other than the avoidance or deferral of income taxation at higher rates?
- A. No, there was not.

[Caterpillar Counsel]: Let's take a break."<sup>409</sup>

Other factors also support the view that the CSARL transaction lacked economic substance. They include that the Swiss tax strategy, for which PWC's tax consultants were paid

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<sup>407</sup> 5/1/2008 memorandum from Daniel Schlicksup, Caterpillar, to the Caterpillar Executive Office (Douglas Oberhelman, Group President; and Edward Rapp, Group President), PSI-TWLF-02-001208 - 222.

<sup>408</sup> Mr. Schlicksup was later demoted from his position in the Caterpillar tax department and filed a lawsuit against his employer charging retaliation under the Sarbanes-Oxley Act. Schlicksup v. Caterpillar, Case No. 09-1208 (C.D. Illinois, Peoria Division 2009). In 2012, the lawsuit was settled for an undisclosed amount and dismissed. One Caterpillar representative expressed the view that Mr. Schlicksup may have decided to file the lawsuit earlier and wrote emails while at the company to help his case.

<sup>409</sup> Deposition of Rodney Perkins in Schlicksup v. Caterpillar, PSI-TWLF-10-000004, at 111. When the Subcommittee asked Mr. Perkins about his deposition testimony, he claimed that what he meant was that there was no advantage in a lower effective tax rate for the business units. This explanation didn't appear credible in the context of the questions and answers given during his deposition cited above.

over \$55 million, was explicitly designed as a tax reduction effort; it was driven and paid for by the company's tax department;<sup>410</sup> and was touted as Caterpillar's "primary tax structure" used to lower its U.S. effective tax rate.<sup>411</sup> One of the indicators that the IRS has identified as suggesting an economic substance problem is when a transaction is "promoted/developed/ administered" by the corporation's tax department or outside tax advisors.<sup>412</sup> In addition, as recounted earlier, the CSARL transaction made changes on paper, but not in the actual functioning of Caterpillar's replacement parts business which continued to be led and managed from the United States.

Moreover, Caterpillar's profit before tax on a consolidated basis remained essentially unchanged compared to before the CSARL transaction. At the same time, only a small portion of those consolidated profits were reported in the United States as taxable income.<sup>413</sup> In short, the point of the CSARL transaction was not to increase Caterpillar's earnings, but simply to send more of its profits abroad to lower the company's effective tax rate.

Caterpillar contends that the CSARL transaction, while tax motivated, reflected the changing nature of its parts business, which included increasing sales outside of the United States. According to the company's 2013 annual report, for example, about 67% of Caterpillar's total revenues were generated by non-U.S. sales.<sup>414</sup> Caterpillar executives attribute that increased sales activity to its marketing companies, including CSARL, whose job is to re-sell Caterpillar products and parts to its non-U.S. dealer network. Caterpillar asserts that the CSARL transaction was simply a matter of removing the unnecessary presence of the U.S. parent company from the legal title chain for third party manufactured parts sold abroad. However, of the Caterpillar finished replacement parts sold abroad, nearly 70% were manufactured in the United States, and the U.S. parent company continued to manage and lead the company's parts business primarily from the United States. The ongoing dominant role of Caterpillar's U.S. personnel in the company's parts business raises questions about whether the CSARL transaction, and the resulting allocation of non-U.S. parts profits to Switzerland, accurately reflect the economic reality of Caterpillar's parts business.

**2007 Review and Report.** In 2007, the same year Mr. Schlicksup raised concerns about the CSARL transaction, a PWC document shows that Caterpillar's tax department initiated a review to determine whether CSARL had sufficient "operational substance" to support Caterpillar's decision to direct most parts profits to Switzerland.<sup>415</sup> A PWC chronology of events related to the CSARL transaction noted that the Caterpillar tax department's review had concluded in a written report that "sufficient substance was maintained by CSARL" so that no

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<sup>410</sup> Deposition of Sally Stiles in Schlicksup v. Caterpillar, PSI-TWLF-11-000008, at 106-107; Subcommittee interview of Robin Beran, Caterpillar (10/18/2013).

<sup>411</sup> Caterpillar presentation from Robin Beran, Caterpillar, to Edward Rapp, Caterpillar, Global Tax & Trade, PSI-TWLF-19-000090 - 097, at 093.

<sup>412</sup> See 7/15/2011 "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties," prepared by the IRS, <http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties>.

<sup>413</sup> Subcommittee interviews of Rodney Perkins, Caterpillar (1/15/14) and Jananne Copeland, Caterpillar (10/30/2013); Deposition of Jananne Copeland Schlicksup v. Caterpillar, PSI-TWLF-15-000007, at 039.

<sup>414</sup> Caterpillar Inc. Annual Report (Form-10K), at 8 (2/19/2013).

<sup>415</sup> 2/16/2010 "Caterpillar Inc., CSARL Permanent File, Chronological History: 1999-2010," PwC\_PSI\_CAT\_00003406 - 463, at 409-410.

“material exposure” existed for the company.<sup>416</sup> When the Subcommittee requested a copy of that report from both Caterpillar and PWC, however, neither provided one. Caterpillar told the Subcommittee that it was unable to identify any responsive document other than documents for which it was asserting attorney-client privilege, and PWC advised it was unable to locate a copy in its files.<sup>417</sup>

**2009 Review and Actions to Preserve \$300 Million Annual Tax Benefit.** In late 2008, the IRS proposed a regulation creating a new test to allow a manufacturer to claim that a controlled foreign corporation (CFC) was exempt from U.S. taxation under a manufacturing exception to Subpart F.<sup>418</sup> To meet the new test and qualify for the tax exemption, a CFC had to show that it made a “substantial contribution” to the manufacturing process.<sup>419</sup> During that 2008 time period, Caterpillar was also conducting an unrelated realignment of its business operations. At that time, PWC and Caterpillar’s tax department conducted another review of CSARL to determine whether it met the new IRS requirements, whether CSARL’s parts business had adequate substance to preserve its annual parts tax benefit, and whether it would need to increase the royalty paid to Caterpillar.

In November 2008, an email exchange between two PWC transfer pricing experts assigned to Caterpillar discussed the possible problems with CSARL.<sup>420</sup> Steven Williams, a PWC Managing Director, wrote:

“[J]ust curious—say they [Caterpillar] decide most PMs [Product Managers] stay in U.S. How do we retain CSARL parts profits if those ‘US entrepreneurs’ claim both machine AND parts profit?”

Thomas Quinn, a PWC tax partner who helped design the CSARL transaction, replied:

“PMs in US will put some pressure on the parts profit model. These guys are really bought into the PM is king concept. We are going to have to create a story that will put some distance between them [product managers] and parts (eg. all the parts that are non-current) to retain the benefit. Get ready to do some dancing.”

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<sup>416</sup> Id.

<sup>417</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 297.

<sup>418</sup> For more information about the proposed regulation, see background chapter of this report, Foreign Base Company Sales Income – Manufacturing Exception.

<sup>419</sup> See Treas. Reg. § 1.954-3(a)(4)(iii).

<sup>420</sup> 11/4/2008 emails between Steven Williams, PWC Managing Director, Global Transfer Pricing, and Thomas Quinn, PWC International Tax Service Partner, PwC\_PSI\_CAT\_00033157 - 159.

Mr. Williams responded:

“What the heck. We’ll all be retired when this audit comes up on audit. [Edward] Bodnam and [C]hris Dunn will have to solve it. Baby boomers have their fun, and leave it to the kids to pay for it.”<sup>421</sup>

A few days after this email exchange, Mr. Williams and Mr. Quinn worked with Caterpillar’s Tax Director, Robin Beran, on a presentation for Caterpillar’s Executive Office alerting them to the potential problems involving CSARL.<sup>422</sup> Their November 11, 2008 presentation described CSARL’s tax benefits, analyzed its potential problems in meeting the new IRS regulatory requirements, and recommended additional actions to bolster its substantive parts operations. The presentation began by noting that, since 1999, the CSARL transaction had produced \$1.3 billion in cumulative after-tax benefits and forecasted an additional \$250 million tax benefit for 2008.<sup>423</sup> With regard to the related tolling agreements, the presentation noted a total of \$200 million in after-tax benefits to date, while forecasting a loss for 2008. The presentation indicated that, overall, CSARL “today” produced a tax benefit of “250 - 300M” per year, resulting in a lower effective tax rate of 5 - 6 percentage points and \$0.40 - \$0.48 profits per share.<sup>424</sup>

The presentation then described the new IRS requirements for qualifying a foreign affiliate to claim the manufacturing exception to Subpart F, which required a showing that the affiliate made a “substantial contribution” to the manufactured goods being sold. The presentation expressed doubt that CSARL had the entrepreneurial or substantive manufacturing operations called for by the IRS requirements. The presentation stated: “IRS insisted on substantial local entrepreneurial decision-making.”<sup>425</sup>

To meet the IRS requirements and preserve CSARL’s tax benefits, the presentation recommended that four worldwide product managers be moved to Geneva.<sup>426</sup> It warned that “[r]egional product managers will not be sufficient under the proposed IRS regulations,” and the “failure to take action weakens current CSARL structure,” which meant its “\$250 million tax benefit would be at risk.”<sup>427</sup> Another presentation in January 2009, urged that worldwide

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<sup>421</sup> Id.

<sup>422</sup> See 11/6/2008 emails between Steven Williams, PWC, and Thomas Quinn, PWC, PwC\_PSI\_CAT\_00033229 - 234.

<sup>423</sup> 11/11/2008 email from Rodney Perkins, Caterpillar, to Thomas Quinn, PWC, “Exec Office Slides - Business Alignment,” PwC\_PSI\_CAT\_00033241; 11/11/2008 presentation, Caterpillar Inc., “2009 Business Alignment Update Briefing,” PwC\_PSI\_CAT\_00033242 - 252.

<sup>424</sup> Id. at 245.

<sup>425</sup> Id.

<sup>426</sup> Id. at 247 and 350. See also 11/6/2008 email from Steven Williams, PWC, to Thomas Quinn, PWC, PwC\_PSI\_CAT\_00033229 (“need five guys outside US to maintain CSARL benefits (250 in parts, 50+ in machines in normal years)”).

<sup>427</sup> 11/11/2008 email from Rodney Perkins, PWC, to Thomas Quinn, PWC, “Exec Office Slides - Business Alignment,” PwC\_PSI\_CAT\_00033241; 11/11/2008 presentation, Caterpillar Inc., “2009 Business Alignment Update Briefing,” PwC\_PSI\_CAT\_00033242 - 252.

product managers and a “Global Parts Management” organization be located in Geneva to address “optics concerns” related to “[t]axation in CSARL with minimal business substance.”<sup>428</sup>

On December 4, 2008, Rodney Perkins, Caterpillar’s Senior International Tax Manager for CSARL, sent an email copying Caterpillar’s Tax Director and CFO and forwarding a message to PWC expressing concern about the potential impact of the proposed IRS regulations on CSARL and urging that steps be taken to expand CSARL beyond a regional role and give it more “entrepreneurial substance.”<sup>429</sup> He wrote in part:

“After realignment, benefits for both machine and parts are at risk unless there’s sufficient entrepreneurial substance in Geneva (worldwide product managers, not regional product managers, achieve this) .... Regional entrepreneurship doesn’t create worldwide entrepreneurship for parts---PARAMOUNT IMPORTANCE CSARL is not regional .... Current language in examples of proposed US regulations states: where substantial operational responsibilities and decision making regularly exercised by domestic parent employees [Worldwide Product Mgrs employed by Cat Inc in the US], who are directing the activities of a principal’s employees [regional product managers in CSARL], the principal does not meet the manufacturing exception [immediate US taxation of CSARL profits, including those arising from parts] .... [D]epending upon final language when regs released, could be PARAMOUNT IMPORTANCE[.] Absence of any worldwide product manager in Geneva and relocation of some regional managers have significantly weakened existing substance.”<sup>430</sup>

The IRS’ proposed regulations were finalized in February 2009. Despite the warnings and recommendations of PWC and the company’s Tax Director, however, it appears Caterpillar chose not to move any worldwide Product Managers to CSARL in Switzerland; nor did it transfer additional regional Product Managers there to replace some who had left. Instead, according to an internal PWC document, the company simply worked with PWC “to ensure that the responsibilities of Geneva-based ‘Regional Product Managers’ complied with new Treas Reg. 1.954-3 which required CSARL employees demonstrate [a] ‘substantial contribution’ in the manufacturing process.”<sup>431</sup>

During this same period, Caterpillar also created a new worldwide parts position at CSARL, the first in Switzerland. In November 2009, the company created the position of “Worldwide Parts Manager,” which was filled by a non-U.S. employee, Quentin de Warlincourt, at CSARL.<sup>432</sup> According to Caterpillar’s outside legal counsel, the new Worldwide Parts

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<sup>428</sup> 1/9/2009 email from Michael Murphy, PWC, to Steven Williams, PWC, “CAT Slides,” PwC\_PSI\_CAT\_00224682; 2009 presentation, Caterpillar Inc., “Product Management Alignment,” PwC\_PSI\_CAT\_00224683 - 686, at 685.

<sup>429</sup> 12/05/2008 email from Rodney Perkins, PWC, to Thomas Quinn, PWC, “Business Alignment-Product Manager Conference Calls-Global Tax Observations,” PwC\_PSI\_CAT\_00060748 - 749.

<sup>430</sup> Id.

<sup>431</sup> PWC presentation, “Caterpillar Inc. CSARL 2009 activities Report to Audit Team January 2010,” PwC\_PSI\_CAT\_0003830 - 0003875, at 833 [emphasis in original]. See also 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 281-293.

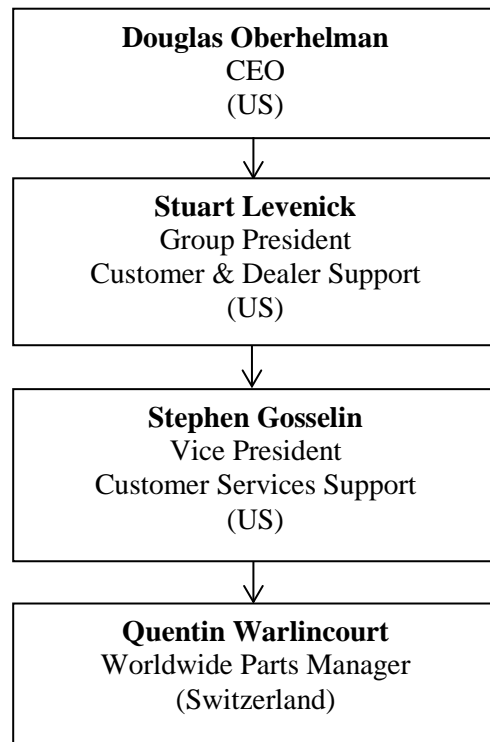
<sup>432</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 286; PWC presentation, “Caterpillar Inc. CSARL 2009 activities Report to Audit Team January 2010,” PwC\_PSI\_CAT\_0003830 - 875, at 848.



Manager was “in charge of WW [worldwide] parts management” and “[a]ccountable for the aftermarket strategy for all Machine Business Divisions, and Engine Business Divisions.”<sup>433</sup> The presentation also stated: “Runs the WW Parts Roundtable, [d]rives implementation through other groups that impact aftermarket business sales and strategy (Components, Logistics, Distribution Services, Purchasing, etc.).”

Mr. Warlincourt’s position was made part of the Customer Services Support Division, and he reported to the division head, Stephen Gosselin, in the United States.<sup>434</sup> The resulting position fit into Caterpillar’s organization as follows:

### CSARL’s Worldwide Parts Manager



In a January 2010 report prepared by PWC’s tax consulting services summarizing its 2009 CSARL activities for PWC’s Caterpillar auditing team, the PWC tax partners described the creation of the new Worldwide Parts Manager position as enabling CSARL to “have closer management, supervision, and entrepreneurial responsibilities over WW [worldwide] parts.”<sup>435</sup> The PWC tax consulting services presentation also informed the PWC auditing team: “The WW

<sup>433</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 286.

<sup>434</sup> 5/17/2010 email from Michael Murphy, PWC Manager Autonomy and Technology, to Steven Williams, PWC, “WW Parts Manager,” PwC\_PSI\_CAT\_00213059 - 064, at 063.

<sup>435</sup> PWC presentation, “Caterpillar Inc. CSARL 2009 Activities Report to Audit Team January 2010,” PwC\_PSI\_CAT\_0003830 - 875, at 847.

Parts Management Structure provides further substance to preserve annual parts benefit of \$300m.”<sup>436</sup>

In March 2010, an internal draft PWC report included Caterpillar materials describing additional details about the new CSARL position. It noted that the Worldwide Parts Manager was the “global steward” of a Worldwide Parts Strategy Roundtable, which was comprised of senior personnel representing all of the machine and engine business divisions.<sup>437</sup> At the same time, neither the Worldwide Parts Manager nor the Roundtable appears to have been given any key decision-making authority with regard to parts. For example, the Roundtable was empowered to provide advice, but apparently not to exercise decision-making authority, with respect to parts margin targets, sale targets, cost targets, or pricing.<sup>438</sup>

Over the following five years, Mr. Warlincourt assembled a small staff of five to twelve persons in Switzerland.<sup>439</sup> He continued to report to the Customer Services Support Division head in the United States. He was not joined by other senior parts executives.<sup>440</sup> Mr. Warlincourt has since been replaced by Thomas Zihlmann, who is located in Switzerland and whose job title has been changed to Worldwide Parts Strategy Manager.<sup>441</sup>

**Caterpillar’s Response to Allegations of Lack of Economic Substance.** Caterpillar disagrees with the claim that the CSARL transaction lacked economic substance and had no business purpose other than to reduce the company’s taxes. The company provided the

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<sup>436</sup> Id. at 848.

<sup>437</sup> 3/15/2010 “Caterpillar Inc. Worldwide Parts Management Final Closing Book, Draft Version as of March 15, 2010,” PwC\_PSI\_CAT\_00003876 - 168, at 882.

<sup>438</sup> Id. at 888-891 and 906-912.

<sup>439</sup> Subcommittee interview of David Picard, Caterpillar (3/4/2014).

<sup>440</sup> Caterpillar’s legal counsel sent the Subcommittee a letter identifying four key parts personnel who were transferred to CSARL in connection with the restructuring of the Swiss entity, COSA: “[T]here has been substantial movement of personnel with significant responsibilities within, and to, Switzerland including: (i) the promotion of a Vice-President as a new Group President responsible for all of EAME operations, (ii) the movement of several Product Managers to Switzerland, and (iii) the appointment of a Parts Purchasing Manager in Switzerland. Further, the Worldwide Parts Manager was later located in Switzerland together with a newly appointed Vice-President in Singapore.” 9/23/2013 Caterpillar letter to the Subcommittee, PSI-Caterpillar-04-000001 - 009, at 004. In a subsequent letter, Caterpillar’s legal counsel provided additional detail about the positions shifted to CSARL after its creation, and included a list of more than three dozen positions, many of which had already been located in Switzerland. The list was composed primarily of positions at the manager level. 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 281-293. The listed positions appear to have been primarily regional in focus, often associated with CSARL’s tolling agreements with Caterpillar’s Belgian and French manufacturing facilities, and seemed to bear little direct connection with or responsibility for the company’s global parts business. For example, Gerard Vittecoq, who was a managing director in Caterpillar Belgium S.A., responsible for the Belgium manufacturing facilities, moved to CSARL and became the Vice President of EAME. His new responsibilities included “joint responsibility with the newly created Product Development Division for EAME, excluding Marketing.” He also had responsibility for enterprise profitability for manufacturing facilities within EAME. His responsibilities appear to have been limited to the machines manufactured in EAME, and included only a minimal role at best in connection with the global PFRP parts business or third party parts suppliers. Another example offered in the letter was the promotion of Edward Rapp, who became Vice President for EAME Marketing. Mr. Rapp, who served in Geneva between 1995 and 2004, received this promotion without changing his location. Mr. Rapp, who presumably had day-to-day contacts with EAME dealers, testified at a deposition in 2011, that while in Geneva he was familiar with CSARL’s predecessor, COSA, but had not heard of CSARL. Deposition of Edward Rapp in *Schlicksup v. Caterpillar*, PSI-TWLF-19-000001, at 019.

<sup>441</sup> 3/27/2014 Information provided by Caterpillar to the Subcommittee, PSI-Caterpillar-21-000001 - 002.

Subcommittee with a report prepared by an outside tax expert, New York University School of Law Professor John Steines, who was hired by Caterpillar to analyze the economic substance issue and who concluded the CSARL transaction did not offend that doctrine:

“Legislative history of the codification of the economic substance doctrine makes clear that the decision to remove Caterpillar from the outbound PFRP supply chain did not violate the economic substance doctrine. And case law interpreting the substance-over-form and economic substance doctrines reveals that they are primarily reserved for highly engineered transactions, frequently unrelated to the taxpayer’s core business and involving tax-indifferent parties with no stake in the outcome other than a fixed return, that Congress would not have countenanced as consistent with the purpose of the statutes it enacted – in other words, transactions that most impartial tax professionals would concede are tax shelters.

“Caterpillar’s restructuring is of an entirely different realm – a sensible business decision to remove a redundant middleman between supplier and customer, fully within the text and spirit of subpart F, notwithstanding that it deferred some U.S. tax. The inventory accommodation and flash title features of Caterpillar’s inventory control system are pragmatic business solutions to normal business problems and do not approach what would raise a problem under the case law digested above.

“In my professional judgment, it is extremely unlikely that a court adjudicating with fidelity to the law presented in this report would find that the restructuring or the countless ensuing outbound PFRP transactions offend the doctrines of substance over form or economic substance.”<sup>442</sup>

The outside expert’s report did not view CSARL’s six Swiss partners, each assigned a separate profit stream that included a stream for worked parts, PFRPs, and various machines; its licensing agreements with 37 Caterpillar affiliates; its service agreement with Caterpillar to run the non-U.S. parts business; or its use of flash titling or a virtual inventory system, as an example of a “highly engineered transaction.” Instead, the report viewed it as reflecting a “sensible business decision to remove a redundant middleman between supplier and customer ... notwithstanding that it deferred some U.S. tax.” The report failed to explain, however, why the decision to remove Caterpillar Inc. from the supply chain made business sense from a non-tax perspective, in particular since Caterpillar Inc., the “redundant middleman,” continued to play the central role in the company’s physical supply chain and parts business, from designing parts and forecasting parts demand, to overseeing the company’s third party parts suppliers, to tracking, storing, and delivering the parts, to providing the leadership needed to run such a complex, far-flung business – all functions that CSARL did not have the personnel, infrastructure, or expertise to perform.

Caterpillar’s Tax Director and its Senior International Tax Manager told the Subcommittee that the key analysis was, not whether the CSARL transaction lacked economic substance, but whether the licensing transactions were executed in conformance with U.S.

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<sup>442</sup> 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, PSI-Caterpillar-17-000003 - 023, at 017 - 018.

transfer pricing laws and regulations, under the arm's length standard.<sup>443</sup> They assert that the company complied with all U.S. transfer pricing requirements.

## (2) Arm's Length Transaction Concerns

A key policy issue, then, is whether the CSARL licensing agreements complied with the arm's length principle that is critical to valid transfer pricing agreements between related parties. An arm's length transaction is a transaction conducted as though the parties were unrelated.<sup>444</sup> The arm's length principle requires that Caterpillar have executed the licensing and related agreements with CSARL at a price and in a manner in which it would have transacted those agreements with an unrelated third party.<sup>445</sup>

Prior to the 1999 CSARL transaction, approximately 15% of the company's parts profits were attributed to Caterpillar's Swiss affiliate, COSA, an allocation which represented what had previously been a routine share of the profits for the Swiss affiliate's work in servicing Caterpillar's foreign dealers.<sup>446</sup> COSA profits were reported as subpart F income and taxed in the United States.<sup>447</sup> Nearly all of the remaining 85% of the parts profits were attributed to Caterpillar and also taxed in the United States.<sup>448</sup> After the CSARL transaction, in 2000, however, Caterpillar gave a significant portion of the profits from its non-U.S. finished replacement parts business to CSARL in exchange for a licensing fee.

In its final form, the Caterpillar licensing agreement required CSARL to pay a bundled royalty rate for selling both parts and machines. According to data provided by Caterpillar, the aggregated royalty rate ended up providing Caterpillar Inc. with an amount equal to about 31% of the total combined non-U.S. replacement parts and machine profits, while the other 69% or more of the combined profits went to CSARL.<sup>449</sup> When just the parts profits are considered, the profit split is even more dramatic: instead of 85% or more of the profits from non-U.S. parts sales going to Caterpillar Inc. in the United States as it had for decades prior to 1999, the

<sup>443</sup> Subcommittee interviews of Robin Beran, Caterpillar (10/18/2013) and Rodney Perkins, Caterpillar (1/15/2014). Those issues are addressed below.

<sup>444</sup> See Treas. Reg § 1.482-1(b).

<sup>445</sup> See Treas. Reg § 1.482-1(b) Arm's length standard ("In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.").

<sup>446</sup> Caterpillar's 1995 transfer pricing documentation described the portion of parts profits allocated to Caterpillar's Swiss marketing affiliate as 4% of the cumulative 30% return on part sales earned by Caterpillar. 12/19/1996 "Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995," PwC\_CAT\_PSI\_00008881 - 9104, at 959. See also 11/14/2005 "Caterpillar SARL 2006-2012 Royalty Rate: Options and Implications," PwC\_PSI\_CAT\_00133127 -180, at 164; 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007; Subcommittee interview of Thomas Quinn, PWC (12/17/2013).

<sup>447</sup> See 3/7/2014 "In the Matter of Caterpillar Inc.," Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 006.

<sup>448</sup> See id. at 003 - 004.

<sup>449</sup> 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 277.

licensing agreement directed 15% or less of those profits to Caterpillar in the United States and 85% or more of the parts profits to CSARL in Switzerland. While Caterpillar contends that the aggregated royalty rate is the more appropriate rate to consider, since that is the rate contained in the final license agreement which covers both parts and machines, it is notable that the Swiss tax strategy that led to the licensing agreement targeted only the company's non-U.S. parts profits, without mentioning machines. In any event, both profit splits have resulted in lopsided profits allocations in favor of CSARL over Caterpillar.

At the same time, Caterpillar continued to perform key functions supporting the non-U.S. sales of Caterpillar branded parts, including much of the parts design, parts forecasting, inventory management, parts ordering, supplier oversight, quality control, parts pricing, and parts storage and delivery. It did so for cost plus a 5% markup, which produced only limited income for the U.S. parent. Caterpillar also continued to bear the ultimate economic risk for the parts business, since its consolidated financial statements included CSARL's financial results. Whether profitable or unprofitable, CSARL necessarily affected Caterpillar's overall financial results.

It defies logic that Caterpillar would have entered into a licensing transaction with an unrelated party in which it gave away 69%, 85%, or more of its business profits on an annual basis in exchange for a 31%, 15%, or smaller share of the profits, while continuing to perform core functions to support those profits and continuing to bear the ultimate economic risk. Caterpillar only engaged in the CSARL transaction, because the profits sent to Switzerland went to CSARL, a related party, and enjoyed a low Swiss tax rate of 4%. In addition, CSARL's profits were included in Caterpillar's consolidated financial statements, so that CSARL's financial success contributed directly to Caterpillar's positive results.

It is also notable that CSARL paid nothing to Caterpillar Inc. to compensate the company for the decades Caterpillar spent developing its parts business before turning it over to CSARL, including developing a third party supplier base, designing a large selection of proprietary parts, and creating a world class logistics system to store and deliver those parts anywhere in the world within 24 hours. Nor did CSARL compensate Caterpillar Inc. for the right to the future profit streams associated with the non-U.S. parts business – billions of dollars in parts “annuities” that would last as long as Caterpillar's durable machines. In fact, CSARL made no “buy-in” or other payment or provided any super royalty to compensate Caterpillar Inc. for the business it had built or for the future profits that would be generated. Instead, CSARL paid Caterpillar Inc. only an annual royalty equal to 15% or less of the profits produced by the non-U.S. parts business each year plus a service fee for performing key parts functions on a cost plus 5% basis.<sup>450</sup> It is hard to understand how Caterpillar would ever have entered into such an arrangement with an unrelated party.

Caterpillar contends, however, that CSARL fully compensated Caterpillar Inc. for all property and services provided by Caterpillar Inc. related to its parts business, in accordance with

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<sup>450</sup> 11/14/2005 “Caterpillar SARL 2006-2012 Royalty Rate: Options and Implications,” PwC\_PSI\_CAT\_00133127 - 180; 9/23/2013 Caterpillar Letter to Subcommittee, PSI-Caterpillar-000002 - 009, at 004 (CSARL license permitted it “to make, purchase, use, offer for sale, sell, and/or import” PFRPs in exchange for paying an “arm's length” annual royalty).

the transfer pricing rules.<sup>451</sup> Caterpillar also contends that the CSARL transaction's profit split was an appropriate arm's length result under current transfer pricing regulations and case law, highlighting the aggregated royalty rate that produced a 69/31% profit split. In a letter to the Subcommittee, Caterpillar wrote:

“Caterpillar Inc. has paid an immediate U.S. tax on approximately 35 percent of the total system profit from the licensed business [parts and machines]. This allocation of profit to the licensor exceeds the 25-75 percent ‘rule of thumb’ profit split articulated by the U.S. Tax Court in *Ciba-Geigy Corp. v. Comm’r*, 85 T.C. 172 (1985).”<sup>452</sup>

In the *Ciba-Geigy Corp.* case cited by Caterpillar, however, the court found that the petitioner had “retained more than 80 percent of the net profits before royalties,” and held, “under the rule of thumb emphasized by respondent, petitioner retained more than a reasonable amount of net profits.”<sup>453</sup> That holding raises obvious questions about the reasonableness of the 85/15% profit split favoring CSARL with respect to non-U.S. parts profits. But even if the 69/31% aggregate profit split were considered, other cases evaluating profit splits between related corporate entities have disregarded the 75/25% rule of thumb in favor of more balanced profit allocations that the courts have found to be more equitable.<sup>454</sup>

The arm's length principle provides the bedrock upon which U.S. transfer pricing regulations are built. In this case study, Caterpillar replaced an 85/15% profit split with a 15/85% profit split of the non-U.S. parts profits, while continuing to perform the core functions of the parts business and retaining the economic risks. It makes little business sense for Caterpillar to take those actions without receiving any compensation for the future revenue stream or the value of the parts business that Caterpillar had built up over decades.<sup>455</sup> The Caterpillar case study provides, in a manufacturing setting, a transfer pricing agreement between a U.S. parent and foreign subsidiary that seems to be less about constructing an arm's length transaction to divide economic contributions and risk, and more about shifting billions of dollars in profits to an offshore tax haven in ways designed to lower the U.S. parent's U.S. taxes.

### (3) Assignment of Income Concerns

Another issue raising arm's length questions involves Caterpillar's decision to split its parts profits off from its machine sales, and direct those parts profits to CSARL without receiving any compensation for the economic value associated with its past and future machines, under the Assignment of Income Doctrine. The Assignment of Income Doctrine is a judicial

<sup>451</sup> 9/23/2013 Caterpillar Letter to the Subcommittee, PSI-Caterpillar 000001 - 009, at 003.

<sup>452</sup> Id. at 007.

<sup>453</sup> *Ciba-Geigy Corp. v. Comm’r*, 85 T.C. 172, 229 (1985).

<sup>454</sup> See, e.g., *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), rev'd in part and aff'd in part, 856 F.2d 855 (7th Cir. 1988) (approving 55/45 profit split); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987) (approving 44/66 profit split); *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 584 (1989), aff'd, 933 F.2d 1084, 1089 (2d Cir. 1991) (approving 50/50 profit split).

<sup>455</sup> When Caterpillar's PWC tax consultants were asked if true unrelated parties would ever give away income in this manner, they deflected the question, responding that the transaction merely needed to be justified under current transfer pricing rules. Subcommittee interviews of Thomas Quinn, PWC (12/17/2013) and Steven Williams, PWC (2/19/2014).

doctrine that prohibits an inequitable distribution of profits. Under Lucas v. Earl, a taxpayer cannot separate the “fruit,” or income, from the “tree on which it grew.”<sup>456</sup> Yet in this transaction, Caterpillar acted to separate the “fruit,” the sale of its high-profit-margin parts, from the “tree,” the sales of its low-profit-margin machines on which the parts profits depend, and did so without seeking any compensation for producing the machines on which future parts rely to have value.

When Caterpillar sells a machine, it often does so at extremely low profit margins.<sup>457</sup> At the same time, the replacement parts used to service that Caterpillar machine can bring profit margins that are multiple times larger. The majority of Caterpillar’s overall profits are attributable to its parts profits. The same is true for CSARL. In some years, as much as 80% of CSARL’s profits from its licensed business have come from parts sales, despite only making up 20% of its sales revenues.<sup>458</sup> CSARL has itself recognized that Caterpillar’s “sale of replacement parts is dependent on the sale of machines.”<sup>459</sup> In fact, at the time of the 1999 CSARL transaction, Caterpillar’s tax consultants observed that “the field population of CAT prime products, which is created as CSARL markets prime products in its territory, creates the demand for CAT replacement parts.”<sup>460</sup> However, as a result of the transaction, the profits for Caterpillar’s parts business were split off from the profits of the machine business, without CSARL’s offering any compensation for Caterpillar’s development of the underlying business.

Historically, the majority of Caterpillar’s machines have been built in the United States and then sold around the world. In addition, the majority of all research and development for the machines is conducted in the United States, and nearly all of the intellectual property is retained here as well.<sup>461</sup> In 1997, 75% of Caterpillar’s consolidated machine sales came from machinery and engines manufactured in the United States.<sup>462</sup> Although Caterpillar has since globalized its

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<sup>456</sup> Lucas v. Earl, 281 U.S. 111 (1930). In Lucas, a man attempted to lower his tax payments by assigning the legal right to his work income, through contract, to his wife. The court determined that the husband had performed the work accruing the right to the income, with no role played by his wife, and that his income could not be assigned to her. The court wrote:

“There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.”

Id. at 114-115.

<sup>457</sup> See 10/5/1999 “Caterpillar Inc. Global Value Enhancement Project Draft”, PwC\_PSI\_CAT\_00004483 - 530, at 508.

<sup>458</sup> 11/14/2005 “Caterpillar SARL 2006-2012 Royalty Rate: Options and Implications,” PwC\_PSI\_CAT\_00133127 - 180, at 148.

<sup>459</sup> 2/16/2010 “Caterpillar Inc. CSARL Permanent File Chronological History: 1999-2010,”

PwC\_PSI\_CAT\_00003406 - 463, at 406.

<sup>460</sup> See 10/5/1999 “Caterpillar Inc. Global Value Enhancement Project Draft,” PwC\_PSI\_CAT\_00004483-530, at 498.

<sup>461</sup> 8/30/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000066 - 108, at 076.

<sup>462</sup> Caterpillar Inc. Annual Report (Form-10K), at A-17 and A-18 (1997).

manufacturing operations and two-thirds of its sales now come from overseas, the majority of Caterpillar machines and replacement parts are still manufactured in the United States.<sup>463</sup>

Due to the Swiss tax strategy, however, the initial purchaser of all of Caterpillar's purchased finished replacement parts is CSARL in Switzerland. That means, for example, that for a mining truck designed and built in the United States and exported to Canada, the majority of the profits from that machine sale would be allocated to the United States and result in taxable U.S. income. In contrast, for any Caterpillar branded parts manufactured by U.S. third party suppliers to repair that mining truck and shipped to Canada from Caterpillar's U.S. warehouse, the majority of the parts profits would go to Switzerland, thereby splitting the parts profits from the machine profits in a way that does not reflect the business reality that the same company is responsible for both profit streams.

When Caterpillar builds a machine in the United States and exports it, it creates a years-long stream of income that results from the selling of the replacement parts. By executing the CSARL transaction, the company transferred its parts annuity to a foreign affiliate without receiving any compensation for the forfeited income stream or for the development and of the underlying business, thus separating the parts fruit from the machine tree. The Assignment of Income Doctrine may require those parts profits to be reassigned to Caterpillar Inc., which continues to design, manufacture, and sell the original machines.

#### **(4) Virtual Inventory System Concerns**

A fourth policy issue relates to the practice of Caterpillar and CSARL sharing parts stored in U.S. warehouses and using a virtual inventory system, separate and apart from the company's general inventory system, to track CSARL ownership of parts for tax purposes. As discussed earlier, the virtual inventory system, which splits ownership of groups of parts between Caterpillar Inc. and CSARL without assigning ownership of any particular part to either company, uses a retroactive after-the-sale method of assigning parts ownership. This inventory system could be viewed as establishing CSARL partnership activity on U.S. soil which would trigger U.S. taxation of its U.S. parts profits.

According to Caterpillar, the third party manufactured replacement parts that are attributed to CSARL are stored in U.S. warehouses and shipped from the United States directly to Caterpillar's foreign dealers or customers, without ever passing through Switzerland. In 2012, CSARL held nearly \$525 million worth of purchased finished replacement parts (PFRPs) in Caterpillar's U.S. warehouses, which made up over 35% of all PFRPs located in those U.S. warehouses and 40% by value of CSARL's worldwide parts inventory.<sup>464</sup>

In addition, on paper, CSARL routinely acquires replacement parts from third party suppliers for instantaneous pass-through resale to Caterpillar Inc. in the United States.

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<sup>463</sup> In 2012, 54% of Caterpillar machines and nearly 70% of Caterpillar replacement parts sold abroad were manufactured in the United States. None of the machines or replacement parts have ever been manufactured in Switzerland. 1/14/2014 Caterpillar response to Subcommittee Questionnaire, CAT-000299 - 303, at 302.

<sup>464</sup> 11/26/2013 letter from Caterpillar to Subcommittee, CAT-000267 - 269, at 268. Since Caterpillar has no parts warehouses in Switzerland, CSARL's remaining parts are stored in warehouses and distribution centers located in a variety of other countries around the world.



According to Caterpillar, CSARL sells 40 to 50% of its total PFRP purchases immediately to Caterpillar Inc. using what is referred to as a “flash title.” A flash title simply means that CSARL makes the initial purchase of the part and automatically and instantaneously transfers the ownership title to Caterpillar Inc. CSARL’s purchases the flash-titled parts using Caterpillar’s internal forecasts of the quantities of parts that will be sold to U.S. customers.<sup>465</sup> When CSARL flash-titles parts to Caterpillar Inc., it does so at cost and without charging any fee,<sup>466</sup> which suggests the sales are little more than paper transactions between related parties, as opposed to arm’s-length transactions.

Caterpillar provided the Subcommittee with dollar figures over a three year period showing the volume of replacement parts CSARL has purchased from third party suppliers, the amounts flashed-titled to Caterpillar Inc., the amounts retained by CSARL after the flash-titling, and the amounts of CSARL-owned parts stored in U.S. warehouses. Caterpillar indicated, for example, that in 2012, CSARL acquired about \$2.3 billion worth of parts from third-party suppliers and immediately flash-titled \$1 billion of those parts to Caterpillar Inc. CSARL then retained apparent ownership of the remaining \$1.3 billion of parts inventory, storing nearly \$525 million of those parts in U.S. warehouses.

As explained earlier, CSARL and Caterpillar Inc. parts are commingled in storage bins in the U.S. warehouses, and U.S. warehouse personnel have no way to differentiate between the parts owned by the two companies. Instead, warehouse employees simply fill orders as they come in, with no regard for paper ownership of particular parts. For instance, if an order came in for a quantity of air filters to service Caterpillar equipment at a mine in Canada, the warehouse would pull the requested filters from the storage bins and ship them to the customer, a nearby dealer, or a nearby Caterpillar distribution center. After the sale, since the order was destined for Canada, ITAS, the virtual inventory system, would retroactively determine that the order was filled using CSARL-owned parts. However, if at the time of the order, all of the air filters in the U.S. warehouse bin were already allocated to and owned by Caterpillar Inc., ITAS would automatically “borrow” the parts from Caterpillar Inc.’s inventory, and credit them to CSARL on the virtual inventory system. When the next supply of air filters was delivered by the third-party manufacturer, the ITAS system would automatically and virtually “replenish” the parts CSARL had borrowed from Caterpillar.

The ITAS virtual inventory system does not operate like a normal inventory system. It places groups of parts in “virtual bins,” determines what percentage of the parts in each bin belongs to CSARL, and then decides whether a particular part shipped from the U.S. warehouse should be viewed as a CSARL-owned part. As explained earlier, while the inventory system arguably functions similar to the way a grain silo mixes fungible grains deposited by various owners and then dispenses the grain without tracking its precise ownership, in those circumstances the grain owners typically pay market rates if they draw grain in excess of the amount they deposited; there is no wholesale borrowing with no notice and no cost. ITAS’ virtual approach to tracking CSARL’s parts in the United States is not only unusual, it operates

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<sup>465</sup> See 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007; Subcommittee Interview of Thomas Quinn, PWC (10/2/2013).

<sup>466</sup> See 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007.

as a second set of books in addition to Caterpillar’s regular inventory program, which tracks individual parts.

Under the U.S. tax code, while foreign entities like CSARL are allowed to hold goods awaiting export in U.S. warehouses without creating a taxable presence in the United States,<sup>467</sup> if those goods are commingled, co-owned, or co-managed as a joint enterprise, they may create a taxable U.S. presence for the foreign company.<sup>468</sup> CSARL’s parts, which are intended for export, have never been physically segregated in the U.S. warehouses from the Caterpillar parts intended for domestic sales. In fact, according to PWC, when its tax consultant suggested establishing that practice at Caterpillar’s U.S. warehouses, he was “laughed out of the room.”<sup>469</sup>

Rather than being physically segregated, CSARL and Caterpillar parts are routinely commingled in the warehouse storage bins. In addition, “ownership” of particular parts can transfer back and forth between CSARL and Caterpillar as needed while stored in the U.S. warehouses, including through flash-titling and automatic borrowing. According to information provided by Caterpillar, hundreds of thousands of parts worth millions of dollars and involving as much as 10% of the parts stored in Caterpillar’s U.S. warehouses are borrowed through the ITAS system each year.<sup>470</sup>

When a common pool of inventory is jointly managed for the mutual benefit of two entities, the courts have long held that a de facto U.S. partnership may exist.<sup>471</sup> While an argument could be made that the Caterpillar-CSARL arrangement did not create a common pool of inventory in the sense that ownership of particular parts was ultimately assigned, the facts are plain that, on the warehouse floor, the two companies shared commingled parts without regard to which company owned which parts. Another argument is that the inventory practices do not involve joint management in the sense that CSARL pays Caterpillar to manage its parts while stored in U.S. warehouses, but the service agreement between CSARL and Caterpillar says nothing about flash-titling, borrowing parts back and forth, or assigning parts ownership after sales are made, practices that provide evidence of joint management of the parts inventory. At the least, the facts suggest a review is warranted to determine whether Caterpillar Inc. and CSARL, in fact, have a common pool of inventory that is jointly managed for the benefit of both parties.

If a de facto U.S. partnership exists between Caterpillar Inc. and CSARL, it would, in turn, create a taxable U.S. presence for each partner. The inventory profits of each partner, including those attributed to CSARL, would then become subject to U.S. taxation.<sup>472</sup> Caterpillar’s tax consultants were well aware that using the ITAS virtual inventory potentially created that type of tax risk, warning in one 2009 presentation:

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<sup>467</sup> See IRC § 956(c)(2)(B).

<sup>468</sup> See, e.g., Commissioner v. Culbertson, 337 U.S. 280 (1949).

<sup>469</sup> See Subcommittee interview of Thomas Quinn, PWC (12/17/2013).

<sup>470</sup> 3/13/2014 letter from Caterpillar’s legal counsel to Permanent Subcommittee on Investigations, PSI-Caterpillar-18-000001 - 003, at 003.

<sup>471</sup> See, e.g., Commissioner v. Culbertson, 337 U.S. 280 (1949) (stating that the relevant inquiry is to determine whether the parties in good faith and acting with a business purpose intended to join together in the conduct of a joint enterprise for profit). The Tax Court has also set forth a list of factors that courts have used to evaluate this factual inquiry. See Luna v. Commissioner, 42 T.C. 1067 (1964).

<sup>472</sup> See Article 7 (2) of the Swiss-U.S. Bilateral Income Tax Treaty (1996).

“The physical inventory commingled into a single inventory stock, as long as the information systems (ie-ITAS) supporting the financial inventory records can confirm the ownership of that inventory stock belonging to CSARL and CAT Inc. Separate inventory records for Cat Inc. and CSARL must be available at any point in time. ITAS must not inadvertently represent the commingled inventory arrangement as a partnership /joint tenancy between CSARL and CAT Inc., or intercompany transactions as a sale or loan between CSARL and CAT Inc.”<sup>473</sup>

Caterpillar disagrees with the view that its virtual inventory is either invalid or creates a taxable U.S. partnership. Yet CSARL’s virtual inventory system, which was designed in consultation with Caterpillar’s tax department, is a redundant inventory system that tracks CSARL ownership of parts by applying ownership percentages to commingled bins of parts without bothering to identify which specific parts belong to CSARL until after those parts are sold. It may have been used to mask the fact that the two sets of CSARL and Caterpillar parts are commingled and jointly managed. At the same time, for the virtual inventory system to function at all, it appears to require “virtual bins” containing a common pool of inventory parts, jointly managed. That jointly managed pool of inventory, in turn, could produce an ongoing partnership between Caterpillar Inc. and CSARL on U.S. soil, making each partner subject to U.S. taxation.

### (5) Intangible Valuation Concerns

Another key policy issue involves how, as a result of its licensing agreements with CSARL, Caterpillar justified reducing its share of the non-U.S. parts profits from an 85/15% split to a 15/85% split, and sending the larger share of the profits to Switzerland, a low tax jurisdiction.<sup>474</sup> Caterpillar told the Subcommittee that its Swiss operations had valuable marketing intangibles that had not been previously recognized and which justified allocating the lion’s share of the non-U.S. parts profits to CSARL. That analysis, however, marks a dramatic change from past valuations.

**COSA Intangibles.** Caterpillar told the Subcommittee that CSARL’s predecessor Swiss entity, COSA, which began operating in Switzerland in 1960, had valuable “marketing intangibles” that were transferred to CSARL, and that those intangibles were previously unrecognized but valuable enough that they warranted the company’s attributing most of the non-U.S. parts profits to Switzerland. For 40 years, until 1999, COSA was the locus of Caterpillar’s operations in Switzerland. It was the shareholder for many of Caterpillar’s foreign marketing companies, acted as a marketing company itself, and supported the Caterpillar dealer network in the Europe, Africa, and Middle East (EAME) region.<sup>475</sup> A COSA branch office in Singapore provided the same marketing and support services for the Caterpillar dealer network in Asia and the South Pacific.

<sup>473</sup> 9/8/2009 “CSARL Briefing,” prepared by PWC, PWC\_PSI\_CAT\_00093950 - 992, at 981.

<sup>474</sup> See 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 277; 1/14/2014 Caterpillar response to Subcommittee Questionnaire, CAT-000299 - 303, at 301.

<sup>475</sup> 4/18/1996 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1994,” PwC\_CAT\_PSI\_00008634 - 880, at 673.

In the planning documentation supporting the 1999 CSARL transaction, PWC wrote that, for years, COSA had been undercompensated for its marketing intangibles. PWC noted that COSA had been allocated 4% of the cumulative 30% profit margin on non-U.S. parts, meaning it had received only about 13% of the total parts profits.<sup>476</sup> PWC depicted that level of compensation as appropriate for a routine parts distributor or marketer, but not for a marketing company that also supported and helped to develop the Caterpillar dealer network.

In 1998, PWC wrote: “[U]p through 1998, we have characterized COSA (and other marketers[]) as routine marketers. ... This will change and our documentation reports will rely on greater discussion of the value of the marketers['] contribution.”<sup>477</sup> PWC also observed: “We are not transferring an intangible, we are just recognizing an intangible they had already.”<sup>478</sup> PWC’s Managing Director explained to the Subcommittee that, without the added valuable intangibles, Caterpillar could not have justified shifting so much profit to its Swiss affiliate, which would otherwise have been entitled to only the routine profits of a routine parts distributor.<sup>479</sup> Instead, after finding that COSA had previously unrecognized “significant marketing intangibles,” PWC concluded that COSA should have been awarded a higher percentage of the parts profits and proposed dramatically increasing the previous allocation of parts profits for COSA’s successor, CSARL.<sup>480</sup>

**Intangibles Already Recognized.** PWC’s claim that COSA had previously unrecognized, valuable marketing intangibles is contradicted by other documents showing that Caterpillar was well aware of and had long acknowledged the valuable work of its marketing companies. For example, three years earlier, in 1996, PWC had cited the role of Caterpillar’s marketing companies in helping to distribute its prime products and parts to the Caterpillar network of dealers.<sup>481</sup> Its 1996 transfer pricing documentation, which is required to be maintained by law to defend transfer pricing positions, stated:

“Parts distribution is one of Caterpillar’s most important competitive advantages in the marketplace. Caterpillar’s guarantee to deliver parts anywhere in the world on very short notice enables it to sell more machines, since customers know that they will not be idled

<sup>476</sup> See undated, unattributed handwritten PWC notes, PwC\_PSI\_CAT\_00011180 - 183, at 181; 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007.

<sup>477</sup> 12/1998, Caterpillar Inc., Global Tax Optimization, Risk Adjusted Benefit Analysis, Working Papers –Draft 1,” PWC-PSI-CAT-00001336 - 671, at 412.

<sup>478</sup> Id. Caterpillar’s tax consultant also told the Subcommittee that PWC realized it took a risk in changing the intercompany transfer pricing method and documentation for the company. Subcommittee interview of Thomas Quinn, PWC (12/17/2013). See also 12/1998, Caterpillar Inc., Global Tax Optimization, Risk Adjusted Benefit Analysis, Working Papers –Draft 1,” PWC-PSI-CAT-00001336 - 671, at 411 (identifying as a “Risk” the “change from current intercompany pricing method and documentation”).

<sup>479</sup> Subcommittee interview of Steven Williams, PWC (2/19/2014).

<sup>480</sup> Subcommittee interview of Thomas Quinn, PWC (10/2/2013; 12/17/2013); 9/1998 PWC report, “Caterpillar Inc. Global Tax Optimization Case for Action,” PwC\_PSI\_CAT\_00004632, at 675-676; 12/1998 Caterpillar Inc., Global Tax Optimization Risk Adjusted Benefit Analysis, Working Papers—Draft 1” prepared by PWC, PwC\_PSI\_CAT\_00001411, at 412.

<sup>481</sup> 12/19/1996 Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions, Year Ended December 31, 1995, Prepared by Price Waterhouse LLP, Final Report, PwC\_CAT\_PSI\_00008881 - 971, at 930 - 971.

by long missing parts. The parts distribution function at Caterpillar is very closely associated with the marketing functions because of its strategic importance in sales and aftermarket services.”<sup>482</sup>

The 1996 transfer pricing documentation continued:

“Caterpillar’s after sales service, which includes supporting dealers in the servicing of equipment and the timely provision of parts around the world, is one of its major competitive tools .... The dealer network and parts distribution are the two keys to after-sales service. Since the marketing companies are responsible for both, they have responsibility for this important entrepreneurial activity.”<sup>483</sup>

In 2000, after it created CSARL, PWC described the role of Caterpillar’s marketing companies in a nearly identical fashion in its transfer pricing documentation, suggesting that nothing had changed with respect to their duties or their intangible value.<sup>484</sup> Caterpillar also noted at that time that the average length of a dealer relationship with CSARL’s predecessor in the EAME territory, COSA, was more than 45 years with little dealer turnover, showing that Caterpillar had long understood the importance of its marketing companies in supporting its dealer network.<sup>485</sup>

**Justifying the Higher Value.** Other documents suggest that PWC realized it needed to change Caterpillar’s transfer pricing documentation to justify attributing greater value to CSARL’s “marketing intangibles.” One PWC analyst framed the issue this way:

“To recap, the primary issue is trying to attribute some of the high profits earned by CAT to COSA. To do so, we want to identify COSA’s establishment and maintenance of the dealer network as a source of intangible values.”<sup>486</sup>

The PWC analyst then provided a detailed analysis of the company’s “intangibles” and offered ways to support the claim that the marketing companies’ relationship with the dealers was a valuable asset. The analyst noted first that valuing the intangibles was a “purely” qualitative exercise.<sup>487</sup> He wrote that he was unable to identify any studies that supported a quantitative valuation and was himself unable to quantify their dollar value.<sup>488</sup> He wrote: “To sum up, we

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<sup>482</sup> Id. at 929.

<sup>483</sup> Id. at 931.

<sup>484</sup> 9/17/2001 “Caterpillar Fiscal Year 2000 Transfer Pricing Documentation Report,” PwC\_CAT\_PSI\_00004975 - 5162, at 029 - 030. This same language was repeated in Caterpillar’s report the following year. 9/16/2002 Caterpillar U.S. Transfer Pricing Documentation Report Year Ended December 31, 2001, PwC\_CAT\_PSI\_00005163 - 305, at 212-213.

<sup>485</sup> 9/17/2001 “Caterpillar Fiscal Year 2000 Transfer Pricing Documentation Report,” PwC\_CAT\_PSI\_00004975 - 5162, at 032.

<sup>486</sup> 11/6/1998 PWC memorandum from John Hatch to Charles Larson and Steven Williams, “Subject: CAT and COSA,” PwC\_PSI\_CAT\_00169827 - 838, at 827.

<sup>487</sup> Id. at 832.

<sup>488</sup> Id. at 828. “The analysis should make clear the difficulties faced in trying to quantify a share of profits from parts sales attributed to the field population.” Id. at 830.

can provide very convincing stories for the argument that COSA should retain some share of the high profits, but actually quantifying their share may be difficult to do with any precision.”<sup>489</sup>

The analyst then identified several of the intangibles that had supposedly escaped previous recognition as valuable. One was the marketing companies’ potential contribution to cost efficiencies through the company’s worldwide network of dealers. The analyst explained: “[B]y having a worldwide network already established, CAT can increase its cost advantages due to the economies of scale over competitors who lack such an extensive network.” He also noted that the Caterpillar distribution network was already capable of replacing almost any part within 24 hours for a machine anywhere in the world, which was a valuable asset that marketing companies could help support.<sup>490</sup> He also theorized that “the dealer network may contribute to the design of better products through customer feedback that is essential to the design process.”<sup>491</sup> He concluded that Caterpillar’s dealer relationships set it apart from its competitors, and that its marketing companies contributed to the well-being of that network.<sup>492</sup>

It is difficult to see how this analysis identified new marketing intangibles that had previously escaped recognition. In addition, while the analysis described how marketing companies contributed to Caterpillar’s success, what the analysis left out was how Caterpillar itself had significantly contributed to the development and maintenance of its worldwide dealer network and to the design, management, and delivery of its parts. That Caterpillar, as U.S. parent of the global company, had itself made a major contribution to its worldwide dealer network had long been recognized. For example, in 1994 transfer pricing documentation, written prior to the CSARL transaction, PWC wrote:

“CAT has the largest role with market and development, since 1) it has the largest single market, 2) it was the originator of the basic marketing systems and concepts, and 3) it continues to be involved with the development and oversight of worldwide marketing and approaches. The marketing companies also have major responsibility for market development; in fact, this is their primary responsibility.”<sup>493</sup>

Given the outsized role of Caterpillar in establishing its worldwide dealer network – which was in place long before the CSARL transaction – and in leading and managing its parts business – a role which has remained largely unchanged after CSARL’s creation – the decision to increase the allocation of the non-U.S. parts profits to Switzerland from 13% in 1999, to 85% in 2013, has not been justified.<sup>494</sup>

**Inconsistent Valuation.** Still another set of documents that contradict the claims about the value of the marketing intangibles held by CSARL date from 2001, when CSARL acquired a related U.S. marketing company responsible for Caterpillar’s marketing efforts in Latin America, the Caribbean, and Canada, and treated its intangible assets as having little economic value.

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<sup>489</sup> Id. at 828.

<sup>490</sup> Id. at 836.

<sup>491</sup> Id. at 834.

<sup>492</sup> Id. at 836.

<sup>493</sup> 4/18/1996 “Caterpillar Inc. Evaluation of Arm’s Length Pricing for Intercompany Transactions Year Ended December 31, 1994,” PwC\_CAT\_PSI\_00008634 - 880, at 685.

<sup>494</sup> See, e.g., 12/3/2013 Caterpillar response to Subcommittee Questionnaire, CAT-000270 - 298, at 295.

In 2001, Caterpillar expanded CSARL's reach to include parts sold in the Americas region, outside of the United States. Later that year, CSARL entered into a complicated, restructuring transaction with a related entity known as Caterpillar Americas (CACO), a U.S. company wholly owned by Caterpillar and located in Miami, Florida.<sup>495</sup> CACO had served as Caterpillar's marketing company for Latin America, the Caribbean, and Canada for the prior forty years.<sup>496</sup> Like CSARL and its predecessor COSA, CACO had purchased machines and parts from Caterpillar Inc. and its affiliates for resale to dealers in Latin America, the Caribbean, and Canada, and helped develop and support the dealer network in its assigned region.<sup>497</sup>

CACO's activities appear to have been nearly identical to those performed by COSA for the EAME region. Its responsibilities included:

“(i) the negotiation and signing of contracts with dealers in the CACo assigned region; (ii) the purchase of products and parts from Cat Inc. and other Caterpillar affiliates for resale to dealers; (iii) taking title to products purchased from Cat Inc. (and other Caterpillar affiliates) destined for dealers; (iv) arranging logistics support for prime product and part shipments; (v) maintaining minor inventory levels of prime product for quick delivery to dealer customers; (vi) assisting dealers in identifying product performance issues and conveying technical data about such problems to Cat Inc.; (vii) providing dealers with marketing information and sales training programs; (viii) assisting dealers in arranging financing; and (ix) conducting monitoring and oversight activities to insure compliance by dealers with the terms of dealer sales and service agreements.”<sup>498</sup>

On December 1, 2001, CACO transferred its responsibilities and certain tangible and intangibles assets to another Caterpillar Swiss affiliate known as Caterpillar Americas SARL (CAmSARL). As part of that transaction, CAmSARL shares were transferred to CSARL.<sup>499</sup> Subsequently, PWC prepared a formal report with an economic analysis of the intangible assets transferred by CACO to CAmSARL and, ultimately, to CSARL.<sup>500</sup>

PWC listed and described CACO's marketing intangibles, which included its dealer relationships and contracts, marketing brochures and website, procedures and manuals, good will, and a going-concern value. PWC then concluded that CACO's intangibles were “routine in nature and easily reproducible by another comparable marketing and distribution company.”<sup>501</sup> PWC further noted that “the value of the Intangible Asset Transferred had only limited legal protection and economic life.”<sup>502</sup> PWC found nothing particularly valuable in the intangibles transferred to CSARL.

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<sup>495</sup> 11/26/2001 Caterpillar Inc., “Economic Analysis of Intangible Assets Transferred by Caterpillar Americas Co. to Caterpillar Americas Sarl Prepared by Price Waterhouse Coopers,” PwC\_PSI\_CAT\_00142353 - 367, at 357.

<sup>496</sup> Id.

<sup>497</sup> Id.

<sup>498</sup> Id.

<sup>499</sup> 11/26/2001 Caterpillar Inc., “Economic Analysis of Intangible Assets Transferred by Caterpillar Americas Co. to Caterpillar Americas Sarl Prepared by Price Waterhouse Coopers,” PwC\_PSI\_CAT\_00142353 - 367, at 357.

<sup>500</sup> Id. at 367.

<sup>501</sup> Id. at 356.

<sup>502</sup> Id.

Subsequent PWC and Caterpillar documentation took note of that analysis. For example, in 2007, when a PWC managing director was considering how to value CSARL's marketing intangibles, he noted: "CSARL (or its predecessor COSA, or CFEL, or CACO) has spent decades building up the dealer network around the world. And has spent decades building brand name through advertising." But, he wrote: "Caveat is that in 2001, we said in another transaction [CACO] that there is no significant marketing intangibles."<sup>503</sup> An internal Caterpillar document from 2005, analyzing CSARL's profit split, put it even more bluntly: "Should we expand profit split analysis – additional income to CSARL for part[s] responsibility, dealers/marketing intangibles (but consider agreements in LAD [Latin America Division] restructuring stating that dealer IP is not very valuable)?"<sup>504</sup>

The bottom line is that when CSARL acquired marketing intangibles from CACO in 2001, it assigned almost no value to them. Yet when CSARL was created, Caterpillar claimed it had found "newly recognized" marketing intangibles that were so valuable they justified dramatically increasing the portion of non-U.S. parts profits sent to Switzerland. Those two positions are irreconcilable. The larger policy issue is that valuing intangibles held by foreign affiliates is an inherently subjective exercise undertaken by transfer pricing parties like Caterpillar that are less interested in getting the valuation right than in figuring out a way to send profits offshore to a low-tax jurisdiction to defer and avoid U.S. taxes.

## **(6) Conflicting Profit Allocation Concerns**

Still another policy issue focuses on how Caterpillar has allocated its non-U.S. parts profits one way for tax purposes and a different way internally for business purposes such as assigning incentive pay.

For tax purposes, beginning in 1999, Caterpillar claimed that the majority of its non-U.S. parts profits should go to its Swiss affiliate, CSARL, because of CSARL's valuable marketing intangibles, and accordingly sent billions of dollars over the years to Switzerland. Internally, however, Caterpillar's business divisions kept track of their individual operating profits, which were known across the company as "accountable profits." The accountable profits were tracked and used to calculate incentive pay awarded to individual business divisions and their employees.<sup>505</sup> In contrast to the profits recorded for tax purposes, since at least 1992, the company's accountable profits allocated the majority share of the parts profits to business divisions in the United States, and only a routine distributor's share to CSARL in Switzerland, which was the same share that its predecessor COSA as well as Caterpillar's other marketing companies had traditionally received.

For years prior to the CSARL transaction, Caterpillar's internal and external profits reports did not diverge. From 1992 to 1999, CSARL's predecessor COSA, as well as all of Caterpillar's other foreign marketing companies, were awarded the same amount of accountable profits. Their share was set at 4% of the profit of the total 30% profit margin for non-U.S. parts,

<sup>503</sup> 7/9/2007 email from Steven Williams, PWC, to Christopher Dunn, PWC, PwC\_PSI\_CAT\_00122483 - 484.

<sup>504</sup> 3/2005 "Caterpillar Inc. Summary Meeting Notes, Revised Draft," from March 7-9, 2005 meeting in Geneva, PwC\_PSI\_CAT\_00150466 - 488, at 469.

<sup>505</sup> Subcommittee interview of David Burritt, former Caterpillar CFO (12/4/2013).



which translated into roughly 13% of the overall non-U.S. parts profits.<sup>506</sup> The remainder of the parts profits went to Caterpillar's commercial entities or product groups (16%), its manufacturing plants (3%), component profit centers (4%), and the U.S. Parts Division (3%).<sup>507</sup> Any residual or entrepreneurial profits were typically awarded to the product groups responsible for the parts or underlying machines. According to Caterpillar, the 4% share of accountable profits attributed to the foreign marketing companies was set by former CEO Donald Fites in 1992, to avoid disputes over the accountable profits. The percentage apparently reflected Mr. Fite's view of the marketing companies as routine parts distributors and marketers. In addition, historically, Caterpillar's internal accountable profits matched the profits reported by its legal entities for tax purposes.<sup>508</sup>

In 1999, when the CSARL transaction was being designed, the PWC tax consultants were told that the business lines did not want any changes to how accountable profits were calculated.<sup>509</sup> The end result was that the company changed how the profits were split for tax purposes, but not how they were reported for internal business purposes, such as assigning bonuses. PWC observed before the CSARL transaction would eliminate the company's ability to show that its external and internal profit allocations matched. In 1998, PWC wrote:

“Issue of changing transfer pricing and resulting differences of US documentation reports: up through 1998, we have characterized COSA (and other marketers[]) as routine marketers. We have also relied on conformity of management and legal books as one of our [transfer pricing] defenses. This will change and our documentation reports will rely on greater discussion of the value of the marketer[']s contribution (support[ed] by additional external research).”<sup>510</sup>

PWC also noted: “Operational Issues: 1. will create different transfer prices for legal [entities] vs. management books.”<sup>511</sup>

<sup>506</sup> See 3/7/2014 “In the Matter of Caterpillar Inc.,” Caterpillar Expert Witness Report by John P. Steines, Jr., Professor of Law, New York University, at PSI-Caterpillar-17-000003 - 023, at 007 (describing the 4% share as “a relatively small gross profit”).

<sup>507</sup> 12/19/1996 “Caterpillar Inc. Evaluation of Arm's Length Pricing for Intercompany Transactions Year Ended December 31, 1995,” PwC\_CAT\_PSI\_00008881 - 9104, at 959.

<sup>508</sup> 8/22/2008 “Delivering Vision 2020 Value Transformation: An After-Tax View,” PwC\_PSI\_CAT\_00058419 - 472, at 446- 447. According to PWC, prior to Mr. Fites' setting the across-the-board share of accountable profits for Caterpillar marketing companies in 1992, Caterpillar had split the non-U.S. residual parts profits with the marketing companies on a 50/50 legal entity basis. The U.S. share of the sales profits were reported as U.S. taxable income on Caterpillar's U.S. tax return, while the marketing companies' share was also reported on Caterpillar's tax return as Subpart F income. Subcommittee interview of Steven Williams, PWC (2/19/2014).

<sup>509</sup> See undated, unattributed handwritten PWC notes, PwC\_PSI\_CAT\_00011180 - 183, at 181 (“don't want to change accountabilities. People won't like”); “Caterpillar Inc. Operational Feasibility Analysis High Level Target Designs: Migration/Deferral,” prepared by PWC, PwC\_PSI\_CAT\_00004548 - 565, at 552 (“Preliminary Operational Issues: . . . (3) Reconciliation of divergence between legal entity and accountable profit.”).

<sup>510</sup> See also 12/1998, Caterpillar Inc., Global Tax Optimization, Risk Adjusted Benefit Analysis, Working Papers – Draft 1,” PwC-PSI-CAT-00001336 - 671, at 415, at 411-413 [emphasis omitted from original].

<sup>511</sup> Id. at 413. See also 9/2006 “Caterpillar European Business Model Review, PwC\_PSI\_CAT\_00028030 - 095, at 085 (“Accountable (vs legal entity) concepts are often referred to. However the key personnel who would be involved in a tax audit are well educated regarding legal entity. The risk of people in the business without an understanding of the differences between the two should be closely managed.”).

As PWC predicted, after the CSARL transaction, the accountable profits no longer matched the legal entity profits, and the difference at CSARL continued to grow with each additional parts license it signed. CSARL's accountable profits remained at the 4% level,<sup>512</sup> while its legal entity profits increased dramatically to reflect all of the third party manufactured non-U.S. parts income it was receiving, including residual and entrepreneurial profits (but minus the royalty fee and cost plus 5% service fee paid to Caterpillar Inc.). Despite the increase in CSARL's profit allocation for tax purposes, CSARL's accountable profits within Caterpillar remained the same. For years, its employees' incentive pay continued to be calculated with reference to the 4% accountable profits assigned to marketing companies. In other words, Caterpillar did not change its internal view of which business functions created value and profit for the company, but maintained that same view until the accountable profits system ended in the mid-2000's.<sup>513</sup>

### **(7) Transfer Pricing Concerns**

In response to policy concerns related to economic substance, arm's length principles, the virtual inventory system, the intangible valuations, and profit allocations, Caterpillar took the position that what the Subcommittee should really focus on is whether the company had complied with U.S. transfer pricing laws and regulations. It asserts that it has.

In correspondence with the Subcommittee, Caterpillar explained that the CSARL transaction was simply a restructuring of the company's supply chain resulting in Caterpillar having a more closely aligned business and legal structure.<sup>514</sup> Caterpillar wrote:

“[T]he fact that a company may have structured its transaction flows one way for some period of time does not prevent the company from structuring its transactions flows in a different way later. Of course there must be compensation for any property transferred and services performed in connection with a restructuring, as there was in Caterpillar's case, but changing a supply chain structure is not, in and of itself, a taxable event.”<sup>515</sup>

Caterpillar also wrote that there “was no taxable transfer of intangible property as a result of the mere fact that Caterpillar used to purchase from a particular set of manufacturers, and now Caterpillar SARL does.”<sup>516</sup> In fact, according to Caterpillar's PWC tax consultant, no taxable transfer of intellectual property occurred as a result of the CSARL transaction.<sup>517</sup>

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<sup>512</sup> Subcommittee interview of Jananne Copeland, Caterpillar (10/30/2013). Ms. Copeland told the Subcommittee that it was understood that CSARL and its related transaction would impact the legal entity reported profits, but the CSARL changes were required to have a “zero impact” on the accountable for the business units. See also 1/16/2003 CNAMSARL Accounting Guidebook, PSI-TWLF-10-000173.

<sup>513</sup> Subcommittee interview of Jananne Copeland, Caterpillar (10/30/2013). Ms. Copeland told the Subcommittee that in the mid-2000s, the accountable profits system changed. The marketing groups no longer were allocated accountable profits, but instead were to be treated as cost centers; any profits were instead reallocated to the product groups.

<sup>514</sup> See 9/23/2013 letter from Caterpillar to the Subcommittee, PSI-Caterpillar-04-000001 - 009.

<sup>515</sup> Id. at 004.

<sup>516</sup> Id.

<sup>517</sup> Subcommittee interview of Thomas Quinn, PWC (12/17/2013).

Caterpillar also told the Subcommittee that it was not a necessary participant in the parts legal title chain for non-U.S. customers, and the company had every right to arrange its affairs to minimize its taxes, including by forming CSARL and designating it as the company's global purchaser of parts.

Caterpillar's assertions that it is allowed to arrange its affairs to minimize its taxes and is free to change its operations over time are, of course, true. But those permissible activities do not provide license for the company to engage in a transaction which has no economic substance other than tax avoidance or which violates arm's length principles.

Caterpillar's focus on its compliance with U.S. transfer pricing regulations, rather on the substance of its offshore transfers, also lays bare the contradiction at the center of the transfer pricing system. General tax principles – including the principle that U.S. multinational corporations are supposed to pay tax on their worldwide income – too often get lost in an analysis of whether a transfer pricing agreement was properly priced and can be justified under existing regulations and case law. Missing from that analysis is the overarching fact that related parties do not operate as if they were unrelated and so rarely engage in a true arm's length transaction. Instead, corporate affiliates often act in concert, using dubious transfer pricing agreements, to shift profits offshore and defer and avoid paying U.S. taxes on those profits.

Caterpillar has been and remains an American success story. Its headquarters, corporate leadership, and manufacturing facilities, as well as its profitable parts business, are still based primarily in the United States, but it now sends 85% or more of its non-U.S. parts profits to Switzerland. While Caterpillar claims it is sending the profits there because its Swiss affiliate has valuable marketing intangibles, the facts show that the real reason is a Swiss tax strategy – bought and paid for by the company's tax department – to take advantage of a 4-6% Swiss corporate effective tax rate while deferring and avoiding U.S. taxes. That Swiss tax strategy has so far enabled Caterpillar to defer paying U.S. taxes totaling \$2.4 billion.

The facts also raise questions about whether the CSARL transaction could meet a true arm's length standard. Caterpillar shifted billions of dollars in parts profits to a related party offshore without being compensated for developing its parts business over decades or for surrendering its right to future parts profits. It appears to have done so for tax reasons, while making use of gimmicks like virtual inventories, Swiss intangibles, and internal corporate profit allocations for tax purposes that bore no relationship to profit allocations made for business purposes, such as awarding pay. The Caterpillar case study shows that offshore profit shifting is not reserved for high tech companies transferring intellectual property to tax havens, but is also the province of traditional manufacturers using financially engineered transactions to transfer billions of dollars of profits offshore to a tax haven affiliate.