<u>Caterpillar case</u>

Facts:

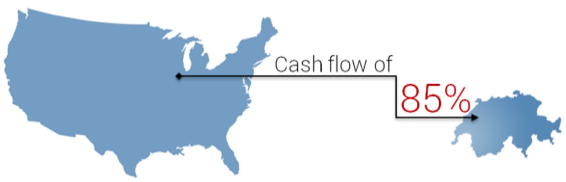
In 1999, Caterpillar Inc. (U.S. manufacturer of construction equipment, power generators etc.) adopted a tax strategy formulated by its tax advisor PwC through which it shifted the majority of its profit from the sale of Caterpillar-branded replacement parts to non-US customers from the US (where such profits had historically been reported) and into Switzerland, where Caterpillar had negotiated an effective corporate tax rate of 4% to 6%. In the below actions, it is alleged that Caterpillar accomplished this profit shift without making any real changes in its business operations (i.e., that it continued to manage and lead the parts business from the US)

<u>Stage A: U.S. Senate Subcommittee Investigation</u>

The Caterpillar case study came to the Subcommittee's attention after a civil lawsuit was filed by a former Caterpillar tax department employee in June 2009. From 2012 to 2014 the Senate committee conducted an extensive investigation into Caterpillar's change in business model for the sale of its replacement parts to non-US customers and an analysis of the functions performed in the US and Switzerland. Interviewees were conducted with Caterpillar's representatives as well as PwC's representatives involved in setting up this structure in 1999. The interviews by the committee took place in 2014 in which the following facts were disclosed:

a) The senior executives of Caterpillar Inc. were located in the US headquarters.
b) 52,000 FTEs were on the payroll of US entity, while only 400 FTEs were on the payroll of Swiss affiliate.
c) Out of total 125 manufacturing entities, 54 were located in US, while none were located in Switzerland.
d) Out of the total amount spent on R&D, 80% was spent by US entity, while less than 10% was spent by Swiss affiliate.
e) The US entity reported 15% of the total profit while Swiss entity reported 85% of the total profits in its books.

CATERPILLAR®



	The United States	Switzerland
No. of employees	52,000	400
No. of manufacturing facilities	54	0
Capital spent on R&D	80%	< 10%
Profit/FTE		

The Senate investigation concluded that through this restructuring, Caterpillar effectively evaded taxes amounting to $2.4 billion for the period 2000-2012.

Stage B: IRS Tax Audit

The IRS is challenging the set-up of the Swiss based spare parts business and especially the economic substance for the restructuring and the resulting allocation of profits to Switzerland (which profit were before reported mostly in the US). It is noted that the same former employee also initiated an IRS whistleblower complaint against Caterpillar in late 2008. This complaint has triggered tax audit covering the years 2007 to 2012 by the IRS with the following contentions:

a) Caterpillar faces approximately $2 billion in back-taxes and penalties resulting from its tax strategy.
b) Some of Caterpillar's transactions between subsidiaries are invalid based on doctrines of "substance-over-form" and "assignment of income," thus creating new taxable income.
c) Around $125 million of foreign tax credits from financing arrangement between subsidiaries should be disallowed.

Stage C: Shareholder Lawsuits

With the information disclosed in stage A becoming public (and as a result the subsequent federal raid at three Caterpillar Inc. offices on March 2, 2017), the company is also facing a few shareholder lawsuits alleging that Caterpillar management, aided by the company auditor PwC, breached their fiduciary duties allowing the company to engage in an improper, illegal and possibly criminal course of conduct spanning more than a dozen years. The claims included:

a) Caterpillar's management board had exposed the company to billions of dollars in liabilities by agreeing with PwC to implement a tax strategy which led to evasion of $ 2.4 billion of taxes.
b) There was a breach of fiduciary duties as a result of the management board approving an elaborate tax avoidance scheme.

An initial individual shareholder lawsuit was filed in 2016 while a second class action lawsuit was initiated following the multiple federal agency raid on Caterpillar offices. These shareholder lawsuits are still pending today.

The tax dispute referred to in stage B which covers years 2007 to 2012 show that this is a clear 'beps avant la lettre' case study. Thus, even prior to BEPS it is apparent to stakeholders and/or revenue authorities that 'economic reality' and 'conduct by parties' drives the profit levels to be reported, rather than an 'artificial and fragmented representation of facts.

The key takeaways are:

1. There is an increasing scrutiny by governments and tax authorities in respect of companies taking advantage of ‘tax havens’ while structuring their business models. Further, stringent measures are now been taken by tax authorities as a result of BEPS to prevent any cases of tax evasion.
2. The management board of a company should inform stakeholders about all its business decisions.
3. Tax advisors are now also being held directly responsible by tax authorities for proposing tax avoidance structures.