

**TESTIMONY OF PROFESSOR BRET WELLS BEFORE THE
US SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE
COMMITTEE OF HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
AT THE HEARING ON CATERPILLAR'S OFFSHORE TAX STRATEGY**

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My name is Bret Wells, and I am an Assistant Professor of Law at the University of Houston Law Center. I hold a JD (with honors) from the University of Texas School of Law. I have over twenty years of experience in the tax area and have published repeatedly on the topic of international taxation.

I would like to thank Senators Levin and McCain and the Subcommittee Staff for inviting me to testify¹ on the problem of homeless income and profit shifting. The Subcommittee and its staff should be commended for pursuing this important investigation on how to address profit-shifting strategies of global enterprises. The revenue lost to base erosion and profit shifting is hard to estimate due to the lack of publicly available information, but as past witnesses have testified there is a strong belief that the amount lost is substantial.² The Subcommittee's effort to protect the U.S. tax base from inappropriate base erosion is an important public service because revenue lost from profit shifting strategies exacerbates the deficit and undermines public confidence in the fairness of the tax system. We should not over-tax our multinational corporations, but Congress should ensure that our tax laws collect the nation's fair share of tax on the economic profits generated from business activities occurring within the United States.

I. Caterpillar's business strategy.

My testimony discusses the information developed by the Subcommittee Staff regarding Caterpillar's international tax planning. It is clear that Caterpillar is a highly successful company. The Caterpillar brand conveys to customers that its equipment and service is reliable, durable, and of high quality. Caterpillar's documentation confirms that the research and development related to the creation and design of the CAT equipment all occurred from within the United States. Thus, when we think about Caterpillar, we are thinking about a very successful American manufacturing business that has created remarkable equipment over a long period of time, but Caterpillar has also created a remarkable business system. In this regard, once a CAT machine is sold, it represents "an annuity" for Caterpillar because the customer will come back to Caterpillar dealerships for replacement parts to keep this machine working. In fact, a substantial portion of Caterpillar's consolidated profits is attributable to the sale of spare parts to its existing customers. Caterpillar management treats its spare parts business, and the

¹ My testimony is at the request of the Subcommittee, by letter dated March 13, 2014 from Chairman Carl Levin and Ranking Member John McCain. I am testifying in my personal capacity. My testimony does not represent the views of the University of Houston Law Center or the University of Houston.

² See Testimony of Stephen Shay Before the Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs at the Hearing on Offshore Profit Shifting and the Internal Revenue Code at 1 (May 21, 2013).

logistics surrounding this spare parts business, as a “core business” of the company. Outside suppliers are provided the exact specifications for manufacturing spare parts, and they are provided the design specifications for their production runs. Product managers are encouraged to incorporate proprietary part designs into the Caterpillar machines whenever possible to prevent Caterpillar machines from being easily repaired with generic parts. Caterpillar personnel monitor their suppliers’ personnel to ensure that the spare parts are made to their specifications.

Caterpillar commits to its customers that it will get them a spare part anywhere in the world within 24 hours, and its ability to execute on that promise represents a key competitive advantage for the company. Caterpillar claims that its logistics organization is the best in the world. The spare parts purchasing algorithms related to this spare parts business were developed in the United States, and the information technology necessary to administer this complex logistical exercise was also developed in the United States and spearheaded by personnel located at Caterpillar’s state-of-the-art warehouse in Morton, Illinois. The careful management of its spare parts inventory, the speed of its execution in getting spare parts to any customer faster than its competitors, and Caterpillar’s tight control over the quality of its supplier network all work together to create customer satisfaction and customer loyalty.

When a Caterpillar machine breaks down, the customer’s motivation is to get this idled equipment back into operation as quickly as possible. Caterpillar’s integrated business system gives Caterpillar the ability to deliver spare parts to a customer within 24 hours anywhere in the world, thus creating a sales opportunity at the exact moment when Caterpillar can extract substantial profit margins on spare parts sales. Consequently, the sale of the Caterpillar machine creates an annuity for the company in the form of a future captive market for spare part sales, and Caterpillar’s ability to execute in this environment represents a significant source of profitability.

The other core value driver for the company is its independent dealer network. Caterpillar does not sell its equipment or spare parts to customers directly. These market development efforts are handled by the independent Caterpillar dealerships that were developed on average more than 40 years ago. This dealer network is intensely loyal (the CAT dealers “bleed yellow”). The dealer network develops the brand value of the company in the local marketplace, responds to customer needs, rents and leases Caterpillar equipment, and provides repair services for Caterpillar equipment. The Caterpillar dealers have direct access to the home office whenever there is a quality problem, and they are the frontline support for the company with its customers. Internal documents provided to the Subcommittee substantiate that Caterpillar’s Customer and Dealer Support Network business segment located in the United States serves the central role in the development of the dealer networks, in the design of the marketing systems, and in overseeing the marketing functions. The Caterpillar dealerships are independently owned, but Caterpillar integrates them fully into the company’s logistical effort with respect to its spare parts strategy. The close relationship between Caterpillar and its independent dealer network creates a significant competitive advantage for the company - one that is difficult at this point for its competitors to replicate.

In combination, the above elements serve to create a business system that represents an intangible asset, and it is this intangible asset that explains the residual profits that can be generated from the sale of spare parts that are custom designed to fit the CAT equipment.

Caterpillar is an American manufacturing success story, and the objective of the US international tax rules, and specifically the U.S. transfer pricing rules, should be to ensure that the multinational profits of this successful company are allocated appropriately to the country where those profits are created and generated.

II. Caterpillar's tax structure for its business system.

Prior to 1999, Caterpillar, Inc. purchased U.S.-origin spare parts directly from its suppliers. Caterpillar, Inc. then sold the exported spare parts to a Swiss affiliate which then on-sold those parts to the Caterpillar foreign dealerships. The profits related to the spare parts business were shared between Caterpillar, Inc. and its independent dealers. The Swiss affiliate earned only a routine profit, all of which was taxable under the Subpart F rules. The routine profit earned by this Swiss affiliate was appropriate because this minimal profit was commensurate with its minimal functional contribution in the company's supply chain.

In 1999, Caterpillar engaged in a supply chain restructuring exercise. In this restructuring, a new Swiss affiliate ("CSARL")³ would purchase spare parts directly from the Caterpillar part suppliers, thus cutting Caterpillar, Inc. out of the trading pattern. CSARL would then resell the spare parts to Caterpillar's independent foreign dealerships.⁴ CSARL acquired other internal marketing entities, and Caterpillar assigned almost no value to these marketing functions at the time Caterpillar made an outbound transfer of marketing functions to CSARL. Yet, after CSARL was created and the restructuring exercise completed, Caterpillar claimed it had found "newly discovered" marketing intangibles in the hands of CSARL that justified drastically increasing the profits allocated to Switzerland. To the extent that these intangibles originated from contributions from US affiliates, CSARL should have paid a super royalty under Section 367(d) to compensate the US affiliate in an amount commensurate to the newfound profitability of these contributed US intangibles, but the Subcommittee was provided no evidence that this was done. Caterpillar, Inc. executed an intercompany agreement to license intangibles related to the spare parts business to CSARL, and the information

³ CSARL is a partnership for US tax purposes that is owned by Caterpillar Overseas S.A., Caterpillar Overseas Credit Corporation S.A.R.L., Caterpillar Overseas Investment Holding S.A.R.L., Caterpillar Commercial Holding S.A.R.L., Caterpillar Asia Pacific L.P. and Caterpillar Product Development S.A.R.L.). For purposes of my testimony, I refer to CSARL as the relevant entity for clarity even though for some purposes under US law it is a pass-through entity for US tax purposes.

⁴ To evidence the assignment of the intangibles related to this spare parts business strategy to CSARL, Caterpillar, Inc. entered into an intercompany license agreement whereby Caterpillar, Inc. assigned all intangibles with respect to its spare parts business to CSARL in exchange for a 15% royalty. The company indicates that the royalty rate on this intercompany licensing agreement was determined so that Caterpillar, Inc. would receive only half of the residual profits related to its spare parts business. The company later reduced the royalty rate from 15% down to 4% to 6% applied on a bundled basis machine sales.

provided to the Subcommittee indicates that approximately 85% of the profits from the parts business was allocated to CSARL⁵ while less than 15% of the combined profits was allocated to Caterpillar, Inc. Statements from company personnel to the Subcommittee Staff indicates that nothing changed from a business perspective in the way that the business was operationally run as a result of this tax restructuring exercise. Caterpillar, Inc. remained the creator and developer of the equipment designs, and Caterpillar, Inc. maintained operational control over the logistics business related to the spare parts product design, procurement, and inventory management process. During this period, Caterpillar, Inc. publicly stated that its management of spare parts and its logistical capabilities represented a critical competitive advantage for the company. However, although nothing operationally changed as a result of the 1999 tax restructuring exercise, the allocation of residual profits arising from the spare parts business changed significantly. Even though the substantive functions that created the residual profits remained in Caterpillar, Inc., more than \$8 billion in profits (resulting in approximately \$2.4 billion in tax savings) was shifted away from Caterpillar, Inc. to CSARL over a twelve year period. Because CSARL bought from unrelated part supplies and sold to unrelated Caterpillar independent dealers under the new supply chain strategy, the company claimed that CSARL's income was not taxable under the Subpart F rules.⁶

III. Policy Implications.

A. Reform Proposal One: Require residual profits to be allocated under a residual profit split basis with rigorous proof needed to show that non-US affiliates provided nonroutine contributions in the creation of residual profits.

The supply chain restructuring implemented by Caterpillar and its tax advisors is premised on a transfer pricing mistake. The mistaken notion is that Caterpillar's residual profits attributable to its business system can be allocated away from the functions that generate these profits and instead allocated to a Swiss "entrepreneur entity" whose functions did not meaningfully contribute to the generation of those residual profits. The functions that contribute to customer loyalty in the foreign marketplace are attributable to Caterpillar, Inc.'s logistical capabilities developed in the United States and to the customer relationships created by the Caterpillar independent dealers. Thus, CSARL's role is that of a minimal-risk distributor that possesses no significant external customer contacts and no significant manufacturing function. In this posture, CSARL's profit margin should approach a cost-plus return. Statements from company personnel indicate that there was no functional business advantage in having CSARL inserted into the supply chain. No operational changes relative to the parts business occurred after the creation of CSARL. The only meaningful change that appears to have occurred was that product line managers were moved to Geneva, but internal documents provided to the

⁵ Over an eight year period, CSARL paid royalties to Caterpillar, Inc. representing only 9% to 16% of its reported parts profits, with an overall average of 13%. These figures imply that CSARL retained 91% to 84% of the parts each year, leading to an eight-year average of 87%.

⁶ See §954(d)(1).

committee indicate that those product line managers had a minimal role in the significant functions that contributed to the value of the spare parts business.⁷

A court should look through this supply chain restructuring exercise and see that CSARL should not receive a share of the residual profits of the parts business. But, even though a court has ample means at its disposal under current law to reach the correct substantive transfer pricing result in the Caterpillar case study, current U.S. tax law provides less guidance than it should because Section 482 does not explicitly mandate a specific transfer pricing methodology. Instead, current law leaves it to the parties and ultimately to a court to decide upon which transfer pricing methodology is the most appropriate.⁸ In Caterpillar's situation, the company took the position that no nonroutine intangibles existed when functions were transferred to CSARL, but thereafter Caterpillar inconsistently claimed that these same functions deserve a share of residual profits. This is where Congress should step in. Congress needs to make clear that residual profits cannot be allocated under any methodology that departs from a profit-split methodology and that every transfer pricing result must be confirmed by the use of a profit-split analysis.⁹ Allowing residual profits to simply migrate to a "tax haven entrepreneur" is a mistake. If all of the functions that create residual profits reside in the United States, then all the residual profits should be allocated to the United States. The residual profit split methodology¹⁰ ensures that this is done because that specific transfer pricing methodology requires that all residual profits be allocated solely to the substantive nonroutine functions that create residual profits and requires an affirmative showing that the foreign affiliate made a substantial contribution toward the creation of the business system that generates those residual profits as a condition precedent to receiving a share of residual profits.

The Caterpillar case study presents a base erosion problem by a U.S. multinational company, but the base erosion opportunities afforded by aggressive supply chain restructuring transactions are equally available to foreign-owned multinational companies as well. So, reform should apply even-handedly and must work in both the inbound and outbound context. To achieve an even-handed reform, Congress must fix the U.S. transfer pricing rules.

B. Caterpillar's unwillingness to make operational changes as part of the 1999 restructuring may have created a de facto partnership.

The fact that nothing operationally changed as a result of Caterpillar's 1999 tax restructuring exercise represents a potentially fatal implementation flaw. All inventory is initially purchased in the name of CSARL, and the US-destined portion of the inventory

⁷ A representative internal email stated as follows:

Yes. We actually view it as almost no change in that the Geneva based PMs never had WW responsibility to begin with. But, we worry about making it sound like the Geneva based PMs have very little authority going forward, or that we publicly state the Geneva management isn't very involved in managing these products.

⁸ See Treas. Reg. §1.482-1(c).

⁹ See Treas. Reg. §1.482-6(c).

¹⁰ See Treas. Reg. §1.482-6(c).

is then immediately resold over to Caterpillar, Inc. at cost. This division of the common inventory is based on a projection of where the spare parts will actually be used. Tax advisors to the company told the Subcommittee Staff that they had originally suggested that the company physically segregate the inventory so that this bifurcated ownership would be clearly defined from the outset, but this suggestion (in the advisor's own words) was "laughed out of the room." Although the company's spare parts inventory is purchased entirely for CSARL, a substantial portion of the spare parts is bought by CSARL with the expectation that it will be sold to Caterpillar, Inc. at cost. Furthermore, after the inventory is initially divvied up, the inventory is regularly shared back and forth among CSARL and Caterpillar, Inc. on an ongoing basis as inventory is needed in different locations. So, both parties (Caterpillar, Inc. and CSARL) have an expectation to jointly profit from the unsold inventory, and the course-of-conduct among the parties indicates that both affiliates share the financial benefits of this unsold inventory based on which territory the products are ultimately needed, not based on which affiliate is designated as the owner of the physical inventory at any particular time. If the inventory is needed in the United States, then CSARL simply assigns the inventory back to Caterpillar, Inc. Thus, from a factual perspective, the ongoing operational conduct of the Caterpillar affiliates demonstrates that this property is seamlessly treated as a co-ownership arrangement where the property is co-managed for the mutual profit of both entities.

When a common pool of inventory property is owned and co-managed jointly for the mutual benefit of two entities as a joint enterprise, the courts have found that a de facto U.S. partnership arrangement has been created using a substantive facts and circumstance inquiry.¹¹ The IRS has recently argued that the internal cooperation of two related affiliated companies created an informal partnership in the domestic context, and the facts that led the IRS to that conclusion appear to be analogous to the Caterpillar case study.¹² Thus, although this issue is ultimately a factual question, a case can be made that the spare parts inventory business is being run as a joint activity for the mutual benefit of Caterpillar, Inc. and CSARL given how this virtual inventory is operationally managed.¹³

If the joint management of inventory has created a de facto U.S. partnership between Caterpillar, Inc. and CSARL, then the US partnership is likely to have a US permanent establishment.¹⁴ The existence of a U.S. permanent establishment on the part of the de facto U.S. partnership creates a U.S. taxable presence for each of the partners,

¹¹ See *Commissioner v. Culbertson*, 337 U.S. 733 (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).

¹² See CCA 201323015 (June 7, 2013) (where the IRS found that the working relationship among the affiliates created a deemed partnership among related party affiliates).

¹³ Caterpillar wants to claim that the inventory owned by CSARL should be separately respected, but then Caterpillar regularly conducts its operations in a manner that disregards the independent and exclusive ownership of that inventory, and so the operational demands of the logistics group does not match up with a fundamental precept of the 1999 tax restructuring exercise.

¹⁴ The permanent establishment is created due to Caterpillar, Inc. selling the co-managed inventory on behalf of the US partnership in the US marketplace with contract concluding authority.

including CSARL.¹⁵ Under this construct, all profits from the inventory regardless of which “partner” sold the inventory would be computed at the US partnership level.¹⁶ CSARL’s profits, therefore, would be assigned to the US partnership and subjected to US taxation since they are attributable to a US partnership that has a US taxable presence. The allocation of the profits (after-US tax) related to the foreign sales of the partnership’s inventory would represent a partnership allocation to CSARL to which US branch profits tax at a rate of 5% would apply.¹⁷ Consequently, the effect of a de facto U.S. partnership is that Caterpillar actually may be subject to a higher US tax result versus the tax results that would have occurred if Caterpillar had never conducted its 1999 tax restructuring exercise in the first place.

IV. Conclusion.

The Subcommittee is to be commended for taking the time to understand the international tax practices of multinational enterprises. These practices and strategies are not easily discernable from public filings, and Congress needs to understand this background information before it can properly formulate reform proposals that fit the current reality. The learning derived from this hearing and other similar hearings hopefully will inform Congress that base erosion and profit shifting is an important problem that needs to be addressed, and part of the solution would be to mandate that all transfer pricing results use a profit-split analysis as the primary transfer pricing methodology or as a required confirmatory check to any other methodology. Profits attributable to US-created intangibles should not end up in a jurisdiction without real substance, nor should they end up in an entity that did not meaningfully contribute toward the generation of the residual profits.

Thank you for allowing me to speak. I would be happy to answer any of your questions.

¹⁵ The sales of the common inventory into the U.S. territory by Caterpillar, Inc. on behalf of the de facto U.S. partnership creates a permanent establishment for the de facto partnership. See Article 5(5) of the Swiss-U.S. bilateral income tax treaty (1996). A permanent establishment of the de facto U.S. partnership creates a permanent establishment for each of the partners of the de facto U.S. partnership, including CSARL’s owners. See §875(1); *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); Rev. Rul. 90-80, 1990-2 C.B. 170 (same).

¹⁶ All of the profits of both Caterpillar, Inc. and CSARL arising from the sale of the spare parts inventory, wherever sold, are likely to be attributed to the de facto U.S. partnership. See Article 7(2) of the Swiss-U.S. bilateral income tax treaty (1996).

¹⁷ See Article 10(7) of the Swiss-U.S. bilateral income tax treaty (1996).