

**WRITTEN TESTIMONY OF THOMAS F. QUINN
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**BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE
COMMITTEE ON HOMELAND SECURITY & GOVERNMENTAL AFFAIRS**

HEARING ON CATERPILLAR'S OFFSHORE TAX STRATEGY

April 1, 2014

INTRODUCTION

Good morning Chairman Levin, Ranking Member McCain, and Members of the Subcommittee.

My name is Thomas Quinn. I am a certified public accountant, and a partner at PricewaterhouseCoopers LLP ("PwC"). I began my career with PwC in 1984, and have been advising companies with respect to their federal income tax obligations for 30 years. I am joined by James Bowers, who also is a certified public accountant and a partner in PwC's tax practice. Having joined PwC in 1976, Mr. Bowers has been advising clients with respect to their tax obligations for over 37 years. I am also joined by Steven Williams, a Managing Director with PwC. Mr. Williams is an economist who holds a master's degree with a concentration in international economics. He has been with PwC since 1982, and has specialized in transfer pricing, that is, evaluating related-party transactions, for 28 years.

I understand that today's hearing relates to the tax implications of a business re-organization that Caterpillar, Inc. ("Caterpillar") began almost 15 years ago. I was one of the PwC partners who provided tax advice to Caterpillar and its outside law firm, McDermott Will & Emery ("McDermott") in connection with that matter. Mr. Bowers assisted PwC's audit team with its audit of the tax aspects of Caterpillar's financial statements. And Mr. Williams provided

Caterpillar with assistance regarding the application of the transfer pricing rules to transactions between affiliated companies.

At the outset, let me say on behalf of PwC, that we recognize both the longstanding interest of this Subcommittee in corporate tax issues and the importance of those issues. In that spirit, PwC has cooperated fully with the Subcommittee throughout this inquiry and willingly has accepted your invitation to testify here this morning.

PWC'S INTERNATIONAL TAX SERVICES PRACTICE

Before addressing our engagement with Caterpillar, allow me to provide an overview of PwC's tax practice in the United States. PwC is the leading provider of tax services worldwide in terms of both the size and scope of our tax practice, and we believe, our reputation. We strive to combine our specialized tax knowledge in national and local jurisdictions across the globe with a deep understanding of our clients' business and economic environments. As tax laws become increasingly complex and tax considerations more challenging, we assist companies to understand and meet their compliance obligations, identify and reduce tax risks, and consider tax alternatives that complement their business and operational objectives. To that end, we provide a full array of federal, international, state and local tax services to large multi-national businesses, middle-market companies, and individuals. In working with multi-national businesses, we routinely evaluate issues of international taxation. Many of our multi-national clients are subject to the tax systems of both the United States and the foreign countries in which they operate. These contexts are complex, and often the rules of various jurisdictions overlap.

We take pride in our role as an essential and productive part of global tax administration and compliance. Our policy specialists advise regulators, governments, corporations, and supra-national bodies worldwide on the technical and practical aspects of developing and implementing

tax policy initiatives. And we understand the responsibility of the Internal Revenue Service and other tax authorities to collect the revenue required by law.

**U.S. TAXATION OF FOREIGN PROFITS GENERALLY
IS DEFERRED UNTIL PROFITS ARE REMITTED TO THE U.S.**

U.S. tax laws regarding international income can be particularly complex. Generally, domestic corporations must pay corporate income tax to the Internal Revenue Service on all profits earned worldwide -- not just in the United States. Foreign corporations, on the other hand, generally pay income tax to their home country's government on income earned in their home country, and pay U.S. tax only on income from sources within the United States, and income that is effectively connected with a U.S. business. Generally, U.S. tax laws allow domestic parent companies to defer corporate income tax on profits earned by their foreign subsidiaries until the profits are remitted to the parent company in the United States. There are certain exceptions to this rule, however. For example, according to a part of the Internal Revenue Code known as Subpart F, current U.S. income tax is applied on the income of a foreign subsidiary if the income is derived from the sale of goods acquired from related parties. Under Subpart F, the U.S. tax consequences are distinctly different if a foreign subsidiary acquired property from a related party, or acquired property directly from an unrelated third-party supplier. On the other hand, generally income of a foreign subsidiary derived from the sale of goods to unrelated parties is not subject to current U.S. income tax, but rather deferred until remitted to the United States. In short, Subpart F overrides the general rule that a foreign subsidiary's foreign profit is not subject to tax until it is remitted to the United States.

CATERPILLAR'S GLOBAL OPERATIONS

With that background, I will now briefly discuss Caterpillar's operations, which provide the background for our tax work. Headquartered in Peoria, Illinois, Caterpillar and its

subsidiaries (“the Caterpillar group”) are one of the world’s largest manufacturers of construction and mining equipment, diesel and natural gas engines, and industrial gas turbines. Caterpillar equipment is sold to customers around the globe and used to build and maintain critical infrastructure, including highways, dams, airports, and the like. The Caterpillar group sells both machines, such as bulldozers, mining trucks, excavators, and other heavy equipment, as well as replacement parts for those machines. The integrated nature of the machines business and parts business is fundamental to Caterpillar’s sales proposition to its customers: reliability. Machine sales lead to parts sales, and parts sales support and encourage machine sales. Because of the machines’ intensive use and longevity, replacement parts are a critical component of the total package offered to customers. The Caterpillar group manufactures machines and some replacement parts. It also purchases replacement parts from third-party suppliers. Replacement parts manufactured by the Caterpillar group are called “worked parts,” while parts that the group purchases from third-party suppliers are referred to as “purchased finished replacement parts.” The Caterpillar group sells these products through an independent dealer network, having recognized early on that a strong, independently owned dealer organization was key to differentiating its products from the competition. In 2012, the Caterpillar group sold more than 300 different types of products to customers in 180 countries from facilities on six continents across the globe.

Since forming as the Caterpillar Tractor Co. in 1925, Caterpillar’s business has been expanding throughout the world to meet increasing global demand. In the early 1960s, sales outside the United States comprised only 37 percent of Caterpillar’s consolidated sales. Five decades later, the situation had reversed: sales outside of the United States accounted for more than 65 percent of consolidated sales. To meet that demand, Caterpillar has established

subsidiaries outside the United States to market its products and provide product support abroad. Caterpillar formed its first overseas subsidiary, Caterpillar Tractor Co. Ltd., in the United Kingdom in 1951. This company was staffed by 125 personnel who would inspect, store and distribute parts to dealers. In the 1960s, Caterpillar formed Caterpillar Overseas SA (“Caterpillar Overseas”) in Switzerland, which served Europe, Africa, and the Middle East. Caterpillar also established marketing subsidiaries in other countries, including Caterpillar Brasil SA, Caterpillar Australia Pty. Ltd., and Caterpillar Far East, Ltd. By the late 1990s, Caterpillar owned interests in approximately 300 subsidiaries and other companies around the world.

Consistent with the increasing sales outside the United States, Caterpillar’s independent dealer network has expanded globally. In 1970, about 46 percent of the independent dealer network was based outside the United States. Thirty years later, almost 70 percent of the company’s dealers operated outside the United States. The company’s workforce has followed suit. In 1970, only about 20 percent of the Caterpillar group’s personnel were based outside the United States. In 2000, almost 60 percent of employees were located outside the United States. Still, in 2000, exports were responsible for 16,000 U.S. jobs and 30,000 U.S. supplier jobs, according to Caterpillar estimates.

In addition to establishing marketing facilities across the globe, Caterpillar has expanded its manufacturing facilities worldwide to meet global demand for its products. Throughout the first half of the last century, Caterpillar manufactured its products exclusively in the United States. During the post-war period, in the 1950s and 1960s, Caterpillar began establishing subsidiary manufacturing operations outside the U.S., including in the United Kingdom, Belgium, France, Brazil, and Australia. Today, the Caterpillar group manufactures products in more than a dozen states and 20 countries. In short, Caterpillar has transformed itself from a

U.S.-based manufacturer of machines and parts for sale to U.S. dealers to a global manufacturer of products and parts for dealers around the world.

**PWC'S ENGAGEMENT TO ANALYZE CATERPILLAR'S
OPERATIONS AND INTERNATIONAL TAX ALTERNATIVES**

As the globalization of Caterpillar's business continued to evolve, in 1998, Caterpillar engaged McDermott, which in turn engaged PwC, to advise the company with respect to its international tax position. By this time, we had been providing tax services to Caterpillar for over a decade. To develop our advice, PwC tax professionals first engaged in an extensive study of Caterpillar's organization and global operating footprint, spending considerable time at Caterpillar's operating facilities. For example, we interviewed the leadership of marketing units for Europe, the Asia-Pacific region, and Latin America, and on multiple occasions visited regional marketing headquarters in Switzerland, Singapore, China, Japan, Canada, and the United States, to gain a deeper understanding of the interaction with foreign joint venture partners, the role of the dealer network, and the importance of the field population of machines. We also interviewed the leadership of key business units, including Engines, Track Type Tractors, Wheel Loaders, Excavators, Forestry, and Building and Construction Products, to understand the Product Manager's role and the current and future strategies that would impact Caterpillar's sales and operational footprint. On multiple occasions we visited manufacturing facilities in France, Belgium, Brazil, the United Kingdom, Mexico, and the United States to understand the scale and scope of manufacturing operations. We also made site visits to parts warehousing facilities in Belgium, Australia, Singapore, and the United States to observe the fulfillment and logistics activities.

By directly observing the functioning of the global business, we gained an understanding of the operations, including the financial and market risks faced by the global business. We

observed that this business organization, as it existed in 1998, both failed to capture the evolution of the true economics of the business, and subjected to current U.S. taxation income earned from the sale of products to foreign customers, largely under the Subpart F rules. Working with Caterpillar's tax department and McDermott, PwC analyzed alternatives that would better align Caterpillar's operations with the true economics of the business and positively affect its global effective income tax rate.

**CATERPILLAR REORGANIZED ITS OPERATIONS
TO REFLECT THE GLOBALIZATION OF ITS BUSINESS**

After collecting and analyzing substantial information about Caterpillar's global operations, McDermott and PwC presented Caterpillar with an understanding of the tax implications of its current global operating footprint, as well as alternatives to reorganize aspects of the business to better reflect current and anticipated future operations. After reviewing the information provided by McDermott and PwC, Caterpillar decided to undertake a significant reorganization of its foreign operations.

Broadly speaking, this global reorganization involved two categories of business activity. The first was the sale of machines, and the second was the sale of purchased finished parts. With respect to machine sales, prior to the reorganization, the company's machine manufacturers outside the United States sold products to affiliates outside the United States for resale to dealers outside the United States, such as Caterpillar Overseas. Even though these machines were not manufactured or sold in the United States, their sales were captured by the Subpart F rules, and the income therefrom was taxed currently to Caterpillar as constructive dividends, regardless of whether the profits were ever remitted to the United States.

Sales of worked parts followed a similar business model. Caterpillar and its affiliates (such as Caterpillar Belgium and Caterpillar France) sold the parts to other foreign affiliates

(such as Caterpillar Overseas) for ultimate resale to third-party dealers abroad. The profits generated from both the intercompany and third-party sales fit within the Subpart F rules, and were taxed currently to Caterpillar, even when the profits were not transferred back to the United States.

With respect to sales of purchased finished replacement parts, which accounted for the bulk of foreign parts sales, Caterpillar purchased certain parts from third-party suppliers and immediately resold the parts to Swiss-based Caterpillar Overseas, which used a warehouse in Belgium. Even though many finished replacement parts were purchased originally from suppliers outside the United States, and distributed to dealers outside the United States, Caterpillar's momentary ownership subjected the resale profits of Caterpillar Overseas to current U.S. taxation under the Subpart F rules.

Considering the growth of its foreign operations, Caterpillar determined that it made business sense to centralize within one company the manufacture and distribution of products outside of the United States. This global reorganization involved substantial changes in the organizational structure of the Caterpillar group, including the transfer of functions, modification of purchase and sale activities, a shift of economic risk and opportunity, and relocation of personnel. The reorganization affected multiple entities, lines of business, and internal systems, and cut across multiple jurisdictions.

Beginning in 1999, Caterpillar Overseas transferred its assets to Caterpillar SARL, a company based in Switzerland that was largely akin to a U.S. limited liability company. Through Caterpillar Overseas, Caterpillar already had a substantial business presence in Switzerland, with hundreds of personnel based in a multi-story facility in Geneva, including a number of key corporate executives. Over the next several years, the remaining foreign marketing companies

integrated themselves into Caterpillar SARL. For example, the manufacturing and distribution operations in Singapore were transferred to Caterpillar SARL. Caterpillar SARL also engaged Caterpillar Belgium and Caterpillar France as toll manufacturers. Over the next few years, Caterpillar SARL began handling sales of machines and parts outside of the United States, while Caterpillar continued to handle sales of machines and parts in the United States. After the global business reorganization, Caterpillar SARL (i) initiated purchase orders for machines (such as medium track type tractors, wheel loaders, and hydraulic excavators) and finished replacement parts, (ii) paid for and held title to the machines and purchased finished replacement parts, (iii) bore the risk of loss (including market risk) with respect to the machines and parts, and (iv) bore the operational expenses of the sales operations. The reorganization yielded a tangible economic benefit, as Caterpillar SARL became a risk-bearing entrepreneurial company and its margins increased consistent with the increase of functions and risks.

In sum, from its outset, Caterpillar SARL carried the business and market risks and received the profits or losses from being the owner and seller of the machines and purchased finished replacement parts in the international markets. Caterpillar SARL purchased finished parts directly from third-party suppliers, and sold finished parts directly to third-party dealers. Because the sales no longer involved related-party transactions between Caterpillar and its foreign affiliates, or between foreign affiliates themselves, they were subject to the fundamental U.S. tax rule that foreign business income is not currently taxed until the income is remitted to Caterpillar in the United States. The culmination of these changes resulted in an overall increase to the operational efficiency for the Caterpillar group and significant tax savings, while allowing Caterpillar to keep jobs and assets in the United States. Caterpillar's annual effective tax rate averaged about 29 percent during the time-period.

**PWC'S EVALUATION OF CATERPILLAR SARL'S ROYALTY
RATE PURSUANT TO IRS TRANSFER PRICING RULES**

After the global business reorganization, Caterpillar's role in the reorganized business included serving as a service provider for certain purchases made by Caterpillar SARL. Caterpillar also licensed its rights to Caterpillar SARL to make machines, to purchase and distribute replacement parts, and to use Caterpillar technology and trademarks on those products for sale outside the United States. U.S. tax rules required that Caterpillar be compensated for those rights and services with an arm's length payment, which was subject to current U.S. taxation.

Because Caterpillar and Caterpillar SARL were related companies, the payment of royalties and services compensation by Caterpillar SARL to Caterpillar was subject to IRS transfer pricing rules. These rules generally address the method of testing and determining the arm's length nature of the transfer of goods, intangibles, and services to a related-party. The arm's length range of prices must reflect the prices that would have been charged in a comparable transaction between unrelated parties.

There is not one accepted method for determining whether a price falls within the arm's length range. Rather, the tax rules provide for a number of alternatives that may be considered to test the arm's length nature of prices between related parties. Under U.S. rules, the taxpayer must apply the method that will yield the most reliable result, given the facts and circumstances of the transactions, known as the "Best Method Rule." One method for determining an arm's length range in connection with the transfer of property is the Comparable Profits Method. This method analyzes objective measures of profitability, that is, whether the related party's profits fall within the range of profits earned by unrelated parties engaged in similar business activities

under similar circumstances. The Treasury regulations also require multinational entities to develop and maintain documentation memorializing their transfer pricing analysis.

Beginning in 1994, Caterpillar engaged PwC to assist the company with its analysis of the arm's length nature of certain transactions, including the royalty rate and licensing fees paid by Caterpillar SARL to Caterpillar, in order to satisfy U.S. transfer pricing documentation requirements. After evaluating each of the relevant transfer pricing methods contained in the Treasury regulations, and based on the facts and circumstances of Caterpillar's business, PwC concluded and advised Caterpillar that the Comparable Profits Method was the most reliable method. This method revealed that Caterpillar SARL's operating margins were consistent with the operating margins earned by unrelated parties engaged in similar business activities under similar circumstances. In addition to conducting this analysis under the Comparable Profits Method, PwC also analyzed these prices under each of the other relevant transfer pricing methods prescribed by the Treasury regulations. Each analysis supported the arm's length nature of Caterpillar's related-party pricing. PwC's analysis and conclusions were detailed in reports that PwC prepared for Caterpillar.

PWC'S AUDIT SERVICES TO CATERPILLAR

In addition to providing Caterpillar with various tax services as described above, PwC also has been auditing Caterpillar's financial statements for many years. We have been asked to explain how the concurrent delivery of these tax and audit services to Caterpillar complied with applicable independence rules. The delivery of tax consulting services (including tax structuring and transfer pricing advice) to audit clients subject to applicable safeguards has long been permitted by the rules of the Securities and Exchange Commission ("SEC"), the Public Company Accounting Oversight Board ("PCAOB"), and the American Institute of Certified Public

Accountants. For example, in the 2002 Sarbanes-Oxley Act, Congress endorsed the delivery of permissible tax services to audit clients, with pre-approval from the client's audit committee. In 2003, the SEC "reiterate[d] its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence."¹ Accordingly, accountants may continue to provide tax services (such as tax compliance, tax planning, and tax advice) to audit clients, subject to the normal audit committee pre-approval requirements under 2-01(c)(7). At the same time, the PCAOB Chairman made clear that: "Neither the [Sarbanes Oxley] Act nor the SEC's rules prohibit tax services that are preapproved by the company's audit committee," with the exception of certain specified categories.² Policy makers have been well aware of arguments for and against having independent audit firms also provide tax advice to the same client, and after revisiting the issue more than once, always have concluded that providing tax advice should be a permitted service, if properly approved and subject to certain safeguards.

PwC's tax and audit services to Caterpillar complied with these independence standards. PwC assessed independence before the commencement of new services and on a quarterly and yearly basis. In addition, because of our position as auditor, PwC disclosed to Caterpillar's Audit Committee any relationship that in our professional judgment bore on our independence, including our tax services. PwC also complied with the Audit Committee's policies regarding pre-approval of both audit and non-audit services, including tax services. Furthermore, during the global business reorganization, Caterpillar – not PwC – made its tax accounting and business decisions. And PwC continues to firmly believe that its tax advice and Caterpillar's tax positions

¹ SEC Final Rule, *Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103; FR-68, File no. S7-49-02 (effective May 6, 2003).

² Testimony of William J. McDonough, Chairman, PCAOB, before the U.S. Senate Committee on Finance (Oct. 21, 2003).

were correct under applicable tax laws. In sum, PwC's provision of tax services to Caterpillar as our audit client was entirely appropriate.

CONCLUSION

Chairman Levin, Ranking Member McCain, and Members of the Subcommittee, thank you again for this opportunity to testify about PwC's tax services with respect to Caterpillar. We firmly believed then, and firmly believe today, that the tax services we provided, and the positions that Caterpillar took in that regard, complied with the law and were entirely appropriate. Likewise, we believe that our tax and audit engagements satisfied both the letter and the spirit of the independence rules that govern our practice. We would be happy to answer any questions you have.