Opening Statement of Senator Carl Levin
Senate Permanent Subcommittee on Investigations Hearing on
Caterpillar's Offshore Tax Strategy
April 1, 2014

This Subcommittee for many years has investigated how some of our most profitable corporations exploit loopholes in the U.S. tax code to shift income and profits to offshore tax havens, thereby denying tax revenue to Uncle Sam. Corporate income tax revenue accounts for a smaller and smaller share of federal receipts, and today is down to about 10% of federal revenue, despite the fact that corporate profits are at an all-time high. Tax avoidance through the use of dubious tax loopholes costs the treasury tens of billions each year, making it harder for us to invest in the education, innovation and infrastructure that promote our prosperity, and to adequately fund our national security, while at the same time increasing the tax burden on families and businesses who can't employ an army of tax lawyers.

The subject of our report and of today's hearing is Caterpillar Inc. Caterpillar is an American success story that produces iconic industrial machines. But it is also a member of the corporate profit-shifting club that has transferred billions of dollars offshore to avoid paying U.S. taxes. We will examine Caterpillar's tax strategy at today's hearing. But first I want to thank Caterpillar and its accounting firm, PricewaterhouseCoopers (PWC), for their cooperation with the Subcommittee.

Headquartered in Peoria, Illinois, Caterpillar designs and builds a wide range of heavy construction equipment, power generators, and engines, assembling most of them here in the United States. On worksites around the world, its bright yellow machines are symbols of U.S. manufacturing excellence. Its revenues exceeded $120 billion over the last two years.

In addition to manufacturing machines, Caterpillar operates a lucrative replacement parts business, selling Caterpillar-branded parts to customers around the world. It is this aspect of their business, specifically its foreign sales of replacement parts, on which this hearing will focus.

Caterpillar machines are known for their durability and dependability; they last literally for decades, a testament to their quality. To ensure their machines keep running well, Caterpillar works to deliver needed parts anywhere in the world within 24 hours of an order. This commitment limits the amount of time a machine is out of service as well as extending its life. Its parts operation helps the company maintain its reputation for building equipment that keeps working – a reputation that is key to its success.

The parts operation is also highly profitable. In many years, the parts business accounts for a majority of Caterpillar's profits despite making up just a fraction of sales. Caterpillar maximizes its parts profits by designing machines that can be repaired and maintained only with Caterpillar parts, ensuring decades of parts sales and profits.

Caterpillar branded parts are manufactured primarily by independent companies in the United States and shipped by Caterpillar around the world. Until 1999, Caterpillar Inc., or Caterpillar U.S., as we sometimes call it, was the initial buyer of these parts. When they were shipped to its foreign dealers, Caterpillar U.S. typically first passed title to marketing companies it had created, including one in Switzerland called COSA. Despite taking title, COSA never took physical delivery or even saw the parts it marketed.

COSA served as Caterpillar's marketing company and parts distributor in Europe, Africa, and the Middle East, acting as a liaison between Caterpillar U.S. and the foreign dealers, helping those dealers

with training, marketing campaigns, servicing issues, and parts inventory management. In exchange, COSA was allocated about 15% of the parts' foreign sales profits. Until 1999, the vast majority of the remaining profits from those offshore sales, usually 85% or more, were included in Caterpillar Inc.'s U.S. tax returns.

But starting in 1999, its parts operation assumed a new and key role in Caterpillar's tax strategy. That's when Caterpillar paid PWC to design and implement a Swiss tax strategy, at an eventual cost of more than $55 million. After Caterpillar put that strategy in place, it went from reporting about 85% or more of its foreign parts profits on its U.S. tax return to reporting 15% or less to Uncle Sam, and shifting the remaining profits offshore to its Swiss affiliate. In Switzerland, Caterpillar had negotiated a special effective Swiss tax rate varying from 4% to 6% , which was below the Swiss statutory tax rate of 8.5%.

This strategy left the real-world operation of its parts business virtually unchanged; in fact, the only significant real-world impact of this arrangement was an instant major drop in Caterpillar's U.S. tax bill. From 2000 to 2012, the Swiss tax strategy shifted $8 billion in profits from Caterpillar U.S. to its affiliate in Switzerland. This cut Caterpillar's U.S. tax bill by $2.4 billion during that period.

The law says that transfer pricing agreements between related parties must have an economic substance – meaning a business purpose other than lowering taxes. But when one of Caterpillar's key tax managers responsible for implementing the Swiss tax strategy, Rodney Perkins, was asked, under oath, whether there was any business advantage to the Swiss transaction other than the deferral or avoidance of corporate income taxes, he stated: "No, there was not."

Though the lion's share of Caterpillar's international parts profits shifted to its Swiss affiliate, the heart and soul of Caterpillar's parts business stayed right here in the United States. Only a shadow of the parts business took place in Switzerland. A few statistics showing the disparity are depicted on this chart.

- Of Caterpillar employees who handle parts, 4900 work in the United States; less than 100 work in Switzerland.

- Of the company's 125 manufacturing plants, 54 are in the United States; none are in Switzerland.

- Of the company's 19 parts warehouses, 10 are in the United States; none are in Switzerland.

- Today, there are 1.5 billion parts stored in Caterpillar's U.S. warehouses; none are stored in Switzerland.

Put another way, despite the fact that Caterpillar now allocates only a small percentage of its worldwide parts profits to the United States, from the moment a part is first designed to when that part reaches a customer, Caterpillar U.S. is the engine behind the company's parts business:

- Parts design is centered here, with nearly 80% of the research and development dollars used to design Caterpillar machines and parts spent in the United States.

- Once designed, Caterpillar's replacement parts are manufactured primarily by third party suppliers in the United States, under the supervision of U.S. Caterpillar personnel. In 2012, those U.S. suppliers manufactured nearly 70% of the Caterpillar replacement parts sold offshore.

- Once the parts are built, the technology, expertise, and management behind a highly efficient distribution system are all here in the United States. Parts are distributed through

Caterpillar's parts logistics operation, which provides Caterpillar with one of its key competitive advantages. That operation is managed and run from the United States.

- Caterpillar's Inventory Management Group, located in Illinois, uses complicated algorithms to forecast parts demand and ensure parts are manufactured in the quantities needed.

- Caterpillar's largest parts warehouse is in Morton, Illinois, where it stores and coordinates the movement of parts around the world, helping Caterpillar's dealer network maintain inventory levels that meet customer demand and delivering even hard-to-find parts within 24 hours of an order anywhere in the world.

In short, most of Caterpillar's parts executives are here, most of its parts employees are here, most of its parts are designed here, most of its parts are built here, most of its parts are stored here, most of its orders are filled here, and most of its parts are shipped from here. Yet most of its international parts profits go to Switzerland.

In 2012, minutes of the Caterpillar Board of Directors meetings describe the company's parts distribution operations as "U.S. centric." So if the parts business is U.S centric, how do most of the profits end up at Caterpillar's wholly owned Swiss affiliate?

Here's how.

In 1999, PWC provided the company with a list of 49 potential tax strategies to lower its taxes, including a plan to avoid or defer U.S. taxes on the foreign sales of its parts. The transaction Caterpillar adopted was legally complex, but straightforward. Caterpillar created a new Swiss affiliate called Caterpillar SARL, or "CSARL." CSARL replaced COSA as Caterpillar's leading Swiss affiliate, and Caterpillar gave CSARL a license to distribute all of the company's replacement parts outside of the United States.

This arrangement changed nothing in the actual operation of the parts business, but caused a massive change in how profits on parts sales were split. Because CSARL lacks the personnel, infrastructure or expertise to actually run the parts business, it reimburses Caterpillar U.S. its costs and a small service fee to continue running the operation. CSARL also pays Caterpillar U.S. a so-called royalty payment equal to about 15% of the profits on international parts sales, with CSARL keeping the other 85%.

Although Caterpillar spent 90 years working to build up its international parts business, the license provided Caterpillar with no compensation for the assets transferred. That license gives CSARL the rights to use Caterpillar's patents and trademarks; contracts with suppliers with whom Caterpillar had built relationships; proprietary computer systems; and the know-how, methods and data used to manage the parts business. Caterpillar U.S. receives only the 15% of future profits from the operation it developed and continues to run. So Caterpillar in the U.S. did the lion's share of the work building the business, and does most of the work of operating the business, while Caterpillar in Switzerland gets 85% of the profit from the most profitable part of Caterpillar's business.

The law says that transfer pricing agreements between related parties must meet an arm's length transaction standard. In an arm's length transaction, no company would turn over a profitable business that took decades to develop without receiving compensation. Similarly, in an arm's length transaction, no business would relinquish 85% of ongoing profits in exchange for 15% of the profits.

Not only did the arrangement change nothing about the actual operation of the parts operation, it also changed nothing on the financial statements Caterpillar shows the public and investors. That's because Caterpillar and CSARL are related companies, with the parent company issuing a consolidated

financial statement. So Caterpillar still shows the 85% of the profits sent to CSARL as its own profits on the consolidated public financial statement, while telling Uncle Sam that those profits belong to its Swiss affiliate CSARL.

Caterpillar has provided several justifications for this change in profit allocation which appear to be inconsistent with the economic reality of its operations.

Caterpillar claims that the company merely cut out a redundant middleman – Caterpillar U.S. – and arranged for its third-party suppliers to sell directly to its Swiss affiliate. The fact is that Caterpillar U.S. is not a redundant middleman in its parts business. Caterpillar U.S. continues to play the vital role of managing and leading its non-U.S. parts business the same way it always did. Caterpillar U.S. is still designing parts for Caterpillar machines, forecasting parts demand, getting the parts built, and storing and shipping the parts to dealers and customers around the world.

Caterpillar also contends that shifting 85% of the parts profits to CSARL made sense, because its Swiss affiliate provided so-called "intangible marketing" services whose substantial value had not been recognized in the past and deserves the lion's share of profit.

But that explanation for sending most of its international parts profits to Switzerland is also inconsistent with how Caterpillar itself has valued the kind of services that CSARL provides. Prior to 1999, COSA, CSARL's predecessor as Caterpillar's Swiss affiliate, was one of many marketing companies Caterpillar had around the world, each performing essentially the same function of working with Caterpillar's foreign dealers to sell and service Caterpillar parts and machines. In 1999, as part of the Swiss tax strategy, Caterpillar consolidated several of those marketing companies into CSARL. Just a few years later, in 2001, Caterpillar merged into CSARL another of its marketing companies called CACO, which represented Caterpillar with its dealers in Latin America, the Caribbean, and Canada. In connection with the CACO merger, PWC, the same firm that designed the CSARL transaction, evaluated the intangible marketing assets being transferred from CACO to CSARL, and concluded that they had little value. In other words, when CSARL was the recipient of the marketing intangibles from CACO, Caterpillar said the value was negligible. But when valuing those same intangibles as provided by CSARL, Caterpillar claimed they were so valuable they justified transferring 85% of its profits.

That's not all. For many years, Caterpillar used an internal profit allocation system it called accountable profits, to help it decide how to award incentive pay, such as bonuses, to employees in its various divisions. Beginning in 1992, Caterpillar awarded each of its marketing companies an accountable profits share totaling about 13% of the parts profits within their regions. But when CSARL began receiving 85% or more of profits related to parts, supposedly in recognition of how valuable CSARL's functions were, CSARL's employees stayed at the 13% profit figure internally when it came to allocating bonuses. In other words, Caterpillar again told one thing to Uncle Sam and another to its employees about the proportionate value of CSARL's work.

The unreality of Caterpillar's current profits split can be illustrated by an example. Caterpillar builds a type of mining truck, the 797, shown in this chart, which works in mines around the world, for instance in the Alberta tar sands in Canada. Major components are designed, manufactured, and assembled in the United States. The engine is manufactured by Caterpillar in Indiana; the transmission is manufactured by Caterpillar in Illinois; the axles are manufactured by Caterpillar in North Carolina; the tires are manufactured by a third party supplier in South Carolina; and the driver's cab is manufactured by a third party supplier in Illinois. When those mining trucks are assembled and sold to those mines in Alberta, they are exported from the United States, and 100% of the profits from those sales are reported on its U.S. tax return. But when an order for finished replacement parts comes in to service those trucks, even though the parts are manufactured in the United States, stored at a Caterpillar U.S. warehouse, and shipped by Caterpillar U.S. employees to Alberta, the profits on those parts go to Switzerland.

Switzerland has nothing to do with those trucks from start to finish. There is no economic basis for allocating those parts profits to Switzerland, yet that's where they go.

There's more. The unreality of the Swiss strategy can also be seen in Caterpillar's so-called "virtual inventory system." Caterpillar maintains a second set of parts inventory books solely for tax purposes. CSARL has $525 million worth of parts stored here in the United States. None are stored in Switzerland. The parts CSARL purportedly owns here in the United States are completely commingled with the parts owned by Caterpillar U.S. So when a U.S. warehouse employee fills an order for a part, that employee has no way of knowing which part is owned by which company. The part is just shipped.

After the fact, Caterpillar's virtual inventory system flags the parts shipped outside of the United States and retroactively marks them as CSARL-owned. For hundreds of thousands of parts shipped abroad each year, however, the parts that were shipped actually belonged to Caterpillar U.S. When that happens, the virtual inventory system nevertheless shows the part as owned by CSARL, indicates it was borrowed from Caterpillar U.S. at cost, and later replaces the part when new parts are added to the warehouse inventory. This after-the-fact virtual ownership system is one more sign of how transparent the whole Swiss tax strategy is.

What is real is the U.S. tax revenue that the Swiss strategy erases. From 2000 to 2012, Caterpillar shipped $8 billion in profits to its Swiss affiliate, reducing Caterpillar's U.S. tax bill by $2.4 billion. At bottom, the Caterpillar case study centers on a tax strategy purchased by its tax department whose purpose was tax avoidance. It used a licensing agreement that no company would enter into with an unrelated third party. It relied on a virtual inventory system that didn't track ownership of parts. It allocated profits for tax purposes that bore no relationship to the profit allocations made for its own business purposes.

I am as big a supporter of U.S. manufacturing as you will find. But the Caterpillar case study demonstrates that offshore profit shifting is not reserved for those high tech companies that transfer intellectual property to themselves offshore. Some manufacturers, too, use offshore tax strategies to avoid paying taxes. The revenue lost to those strategies increases the tax burden on working families, and it reduces our ability to make investments in education and training, research and development, trade promotion, intellectual property protection, infrastructure, national security and more – investments on which Caterpillar and other U.S. companies depend for their success. It is long past time to stop offshore profit shifting and start ensuring that profitable U.S. multinationals meet their U.S. tax obligations.