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Tax Management
Transfer Pricing Report™

Grand Jury Probe in Caterpillar Case Raises Questions About Connection to Company's 'Swiss Strategy'

Buried in Caterpillar Inc.'s most recent quarterly report to the Securities and Exchange Commission is a blockbuster revelation: A grand jury investigation into the company's offshore activities involves the purchase and resale of replacement parts that were the focus of a recent Senate investigation.

In its SEC filing, the company revealed that it has been subpoenaed twice as part of a grand jury probe by the U.S. Attorney for the Central District of Illinois (see related story).

What information the U.S. Attorney seeks is not disclosed, but Caterpillar's filing makes clear that the subpoenas relate to the same transactions that aroused the ire of former U.S. Sen. Carl Levin (D-Mich.) during a Senate subcommittee hearing in April 2104.

Levin blasted the company's transfer pricing strategy for its profitable replacement parts business as a ''tax loophole,'' allowing Caterpillar to slash its federal income tax bill by $2 billion over a 10-year period. Regardless of Levin's outrage, however, practitioners say that transfer pricing by itself could not be the subject of a criminal investigation.

''In my view it is not possible to have a criminal transfer pricing violation,'' said David Rosenbloom, professor of taxation at the New York University School of Law. ''That is because the statute does not tell a taxpayer to do anything; in fact, it doesn't speak to the taxpayer at all.''

A Civil Matter

Section 482 empowers the Commissioner of the Internal Revenue Service to reallocate income to prevent tax evasion or more clearly reflect the income of the enterprise. Requirements imposed on the taxpayer are imposed entirely through regulation; while the transfer pricing regime involves penalties in the case of mispricing—the penalties are an entirely civil matter.

That suggests that if the criminal investigation is related to the transfer pricing in some way, it is more likely focused on conduct that might be connected to it—such as a potential misrepresentation made to the IRS in the course of an audit, or through sworn testimony. Such missteps could provide the basis of a criminal investigation if the misstatements related to the tax structures, practitioners say.

Proving that, however, presents a high bar for the government.

''If you're a prosecutor, and you're starting to look into a case such as this, which involves a very large company, international issues, and complex tax issues—whether they be transfer pricing or whathaveyou—it's going to be a difficult process for the government,'' said Peter Hardy, with Post & Schell P.C. in Philadelphia.

''Not only is this a tax matter, so therefore somewhat complicated by nature, but this is complicated for tax.''

Senate Investigation

The tax structure at the center of the controversy was laid bare in an April 2014 hearing conducted by the Senate Permanent Subcommittee on Investigations. Levin, who chaired the committee at the time, issued a scathing report that painted Caterpillar and its tax adviser, PricewaterhouseCoopers, as pursuing an opportunistic and cynical strategy that took the U.S. parent out of the supply chain for the sole purpose of reducing the company's U.S. corporate income tax.

Under a 1999 restructuring, Caterpillar designated a Swiss marketing subsidiary, Caterpillar SARL, or C-SARL, as the buyer and seller of its replacement parts. But as Levin noted, the activities that took place in the U.S. before the restructuring continued as before. In fact, Caterpillar U.S. accounts for most of the work that goes into designing and producing the parts and supervises the production of the parts, carried out largely by third-party manufacturers in the U.S., he said.

According to the subcomittee's report, Caterpillar's heavy equipment manufacturing serves as a loss leader—the machines it produces generate slim profit margins. The replacement parts, however earned profit margins approaching 30 percent.

Those margins doubled under the company's transfer pricing strategy. Through it, CSARL retained 85 percent of the profits from the parts distribution business, while paying the remaining 15 percent to Caterpillar Inc., for various service fees as the latter continued much of the distribution work.

As part of the transaction, Caterpillar Inc. transferred to C-SARL intangibles related to the sale and distribution of replacement machine parts—including the rights to its trademark and marketing intangibles, although, as Levin noted in the hearing, it received no initial compensation for that transfer, only a percentage of

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future profits. In other cases, Caterpillar said it identified valuable intangibles in a predecessor organization, Caterpillar Overseas S.A.

At the hearing, officials with PwC and Caterpillar defended the structure, arguing that it had operated for years even as IRS auditors signed off on the company's transfer pricing. In documents submitted to the committee, Caterpillar executives argued that the strategy did not violate the economic substance doctrine as Levin claimed because, rather than adding unnecessary complexity, the revamped tax structure simplified the company's supply chain.

''The fact that CSARL now directly purchases its parts inventory reflects nothing more than the standard business operations and tax planning that any prudent multinational enterprise would employ in conducting its operations and complying with applicable tax laws around the world,'' said Julie Lagacy, vice president in Caterpillar's financial services division. ''The entity in question has considerable business substance and is fully entrepreneurial as a matter of both functional reality and contractual form.''

Whistleblower Lawsuit

The transfer pricing strategy is now under fire on four fronts. In addition to the Senate hearing and the grand jury investigation, the company also disclosed that the SEC has launched its own probe and the IRS has issued a revenue agent's report claiming $1 billion tax deficiency directly connected to the replacement parts issue. The IRS, Caterpillar said, is claiming the deficiency on the basis of ''substance over form'' and ''assignment of income'' doctrines.

Some insight into what may have triggered the interest of investigators can be found in court documents related to a lawsuit filed by a disgruntled former employee, who claimed that he was penalized by the company after raising concerns about the transfer pricing structure.

Daniel Schlicksup, formerly the global tax manager for Caterpillar, claimed that the company retaliated against him, forcing him to accept a demotion as punishment for continuing to press for answers on the transfer pricing. Schlicksup's lawsuit was ultimately settled, and the terms are not public record. However, according to documents filed in the case, Schlicksup feared that the arrangement with C-SARL lacked economic substance.

Schlicksup asserted that the company relied on the Swiss strategy to justify a $1 billion reduction in its tax expense as reported on public financial statements. This led to what he termed ''an overstatement of earnings reported to the investing public.''

In internal communications with the company, Schlicksup characterized the overstatement of earnings as ''shareholder fraud,'' due to the lack of adequate reserves against what he characterized as risky tax positions.

Rodney Perkins, a former senior manager in Caterpillar's tax department, testified in a deposition taken during the litigation that the C-SARL structure did not provide a business purpose beyond the reduction of income in the United States. When asked if there were a business advantage to the company for the arrangement, he replied, ''no, there was not.''

When Levin asked for an explanation during the subcommittee hearing, Perkins admitted that he'd made that statement, but he explained that he was looking at the structure from the viewpoint of a taxation specialist.

''The activities associated with the removal of CAT Inc. from the supply chain did, in fact, have significant business activities accompanying them,'' Perkins said, according to the official Senate record.

A Criminal Matter

Practitioners who specialize in criminal tax matters told Bloomberg BNA that the pursuit of criminal tax charges typically center on conspiracy to impede the IRS, on tax evasion committed by individuals, or on the filing of a false return—an allegation Schlicksup raised in his court filings. The charges also could relate to perjury or a false representation made during legal and legislative proceedings.

A criminal tax charge must involve ''willfulness''—a deliberate intention to violate the Internal Revenue Code, Hardy said. In a transfer pricing case—in which, by definition, the taxpayer relies on ranges and estimates—that can be especially difficult to establish.

Further, internal debates over whether a tax structure is sound—which, in this case, are in the public record because of the whistleblower lawsuit and the Senate investigation—don't necessarily amount to a smoking gun.

''That's subject to interpretation,'' Hardy said. ''Was it warnings that went willfully ignored, or was it a debate taken in good faith by people trying to figure out what to do?'' he asked. ''You definitely have a spectrum there, and it all comes down to the actual contents of documents.''

Miriam Fisher of Latham & Watkins LLP in Washington, D.C., agreed that the case presents some serious challenges for the government if the investigation involves some kind of fraud that is connected to the substance of the transfer pricing structure.

''These are very complicated, doctrinal tax issues—substance over form, assignment of income—that we don't normally associate with fraud or allegations of fraud,'' she said.

Parallel Proceedings

Also puzzling to practitioners experienced with tax law is that the IRS appears to be pursuing an adjustment while a criminal investigation is underway. Normally, civil tax proceedings are brought to a halt if there is a parallel criminal tax matter, to avoid complications or the perception that the taxpayer is being strong-armed into making a settlement.

''The civil process seems to be proceeding as usual, as recently as three months ago. It doesn't make it clear to me that the focus of this is an alleged tax crime,'' Fisher said.

Nevertheless, the case has attracted notice across the tax planning world.

''I think it's fair to say that people are aware that this is a focus of the IRS and the Senate,'' Hardy said. ''If this were to eventually produce a criminal charge, whether corporate or individual—and that's very up in the air and down the road—it is definitely something about which people would take notice. It would definitely be a shot across the bow, about these sorts of arrangements, which are very common.''

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Hardy also noted that the IRS will occasionally refer cases to the Justice Department, if its own criminal investigations department finds evidence that a crime has been committed. The rigorous internal review process was put in place after alleged abuses of IRS authority during the Nixon administration, he said.

However, there's no indication as to whether that occurred in this case.

Substance Over Form

The original restructuring under which C-SARL was created is now out of reach for the IRS—the statute of limitations has run on those years. But the IRS apparently is challenging the results of the structure in its audit of Caterpillar's 2007-09 tax years.

The fact that the IRS is pursuing the case under the substance over form and assignment of income doctrines suggests that it is not simply questioning the pricing—but challenging the arrangement altogether.

According to Prof. Reuven S. Avi-Yonah, of the University of Michigan School of Law, the substance over form doctrine as been invoked numerous times by the IRS over the years, though it has not been raised often in the context of transfer pricing.

The doctrine originally was interchangeable with the concept of economic substance, he said. Over time, however, the courts have developed a two-pronged approach that distinguishes the concepts.

The threshold questions are whether an entity has a business purpose and a reasonable expectation of earning a profit. If it does, then the entity has economic substance, he said. However, an individual transaction itself can still be problematic.

''It is not relevant to substance over form whether a transaction was profitable or a business was profitable,'' said Avi-Yonah, who testified at the Senate subcommittee hearing.

As with Caterpillar, there can be considerable profit involved, but the question is whether the transaction changed the way the company did business, so that the profits that were claimed by the Swiss affiliate were actually earned there.

In his view, the answer is no. Caterpillar's Swiss affiliate held nominal ownership of the parts, but as a practical matter, ''the parts were mixed together and were substantially owned by the U.S. company. It didn't change anything on the ground,'' he said.

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