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Whistleblowing and Caterpillar Inc.'s Swiss Tax Strategy

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Abstract. This case describes the background of the whistleblower complaint, filed by Daniel Schlicksup, questioning the propriety of Caterpillar Inc.'s "Swiss tax strategy". The Swiss tax strategy was recommended by its independent auditor, PricewaterhouseCoopers (PwC), and designed to transfer to a Swiss entity the profits earned on its sales of "purchased finished replacement parts" to foreign marketers. This strategy enabled Caterpillar to shift $8 billion in replacement parts sales to Switzerland and to avoid or defer paying U.S. taxes on that income. Daniel Schlicksup, a member of Caterpillar's tax staff, filed an Internal Revenue Service (IRS) whistleblower complaint against Caterpillar and provided the IRS extensive documentation that served as the foundation for the IRS's claim Caterpillar owed $2 billion in back taxes and penalties, potentially entitling Schlicksup to a huge whistleblower award ranging from $300 to $600 million. Careful review of this case facilitates student discussion, and enhances student understanding, of the wisdom and morality of Schlicksup's whistleblowing activities.

Keywords: auditor independence, annual financial reports, back taxes and penalties, economic substance, external whistleblowing, federal income tax avoidance, Internal Revenue Service, internal whistleblowing, offshore profits, taxation, whistleblower retaliation, protection, whistleblower rewards.

1. Introduction

On April 1, 2014, the United States Senate Permanent Subcommittee on Investigations released its majority staff report accusing Caterpillar Inc., an iconic U.S. manufacturing company producing power generators, construction equipment, and sophisticated engines, of implementing a tax strategy which, between 2000 and 2012, shifted approximately $8 billion in replacement part sales (approximately 85% or more of its profits) to Switzerland and thereby avoided paying $2.4 billion in taxes to the United States (Subcommittee on Investigations Report 2014, p. 1; Douglas 2014). These sales were taxed in Switzerland at a negotiated corporate tax rate of 5% to 6%, which enabled Caterpillar to achieve the lowest effective tax rate among companies listed in the Dow 30, an index containing the most popular and widely held stocks in the world, which are generally considered some of the most solid "blue chip" stocks on the market (Subcommittee on Investigations Report 2014, p. 41, 46; Dividend.com).

The person who triggered the Permanent Subcommittee on Investigation's interest in Caterpillar was Daniel Schlicksup, a tax accountant who had worked for Caterpillar for 16 years and who continually reported to his superiors his concerns that the Swiss tax strategy was illegal (Gruley *et al.* 2017). Schlicksup grew up close to Peoria, Illinois, one of eight siblings whose family had deep ties to the area. He received his finance and law degrees from Northern Illinois University, and went on to earn a Master of Laws from Chicago-Kent College of Law. He worked for several years for Arthur Andersen & Co. in Chicago, and moved back to Peoria, where he joined PwC to work on the Caterpillar account. Caterpillar then hired him as part of its tax staff. That experience would prove invaluable to Schlicksup, because it provided him the opportunity to gather documentation on the Swiss tax strategy, which would form the basis of his potentially lucrative IRS whistleblowing lawsuit and the Permanent Subcommittee on Investigations' report (Gruley *et al.* 2017).

2. Implementation of Caterpillar's Swiss Tax Strategy

Following the recommendations of its independent auditor, PwC, and law firm, McDermott Will & Emery LLP, Caterpillar's tax manager, Robin Beran, implemented its Swiss tax strategy. In 1998, Caterpillar and PwC's tax consulting group agreed that PwC would undertake a comprehensive review of Caterpillar's tax practices at the state, national and international levels in order to identify operational changes that might lower its overall tax payments. PwC was Caterpillar's longtime auditor, providing audit services since the 1920s. In the 1990s, the audit firm extended its services to include tax consulting services to assist with identifying strategies to reduce global taxes.[1] PwC conducted that review of Caterpillar's existing tax practices and, starting in 1999, Caterpillar began implementing PwC's recommendations over the next four years as approved by its executive steering committee (Subcommittee on Investigations Report 2014, p. 42). One of the key recommendations PwC made was to remove Caterpillar from the chain of title for purchased finished replacement parts (PFRP) supplied by U.S. or foreign parts manufacturers and sold to foreign

1. A majority of the tax services related to the Swiss tax strategy were provided to Caterpillar prior to the enactment of the Sarbanes-Oxley Act of 2002 (SOX). SOX resulted in stricter rules surrounding the types of consulting and tax services that can be provided by an audit firm to its client. Prior to SOX, there were few restrictions on providing both auditing and tax consulting services simultaneously to a client. After SOX was enacted, any tax services performed by the auditor required pre-approval from its client's audit committee. The PCAOB's Rule 3522 specifically states that an audit firm would not be independent of its client if it provides services related to marketing, planning or opining in favor of a tax treatment involving an "aggressive tax position" transaction (Subcommittee on Investigations Report 2014, p. 45).