Caterpillar and Economic Substance: Tax Avoidance or Fraud

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Daniel Schlicksup, an accountant, worked for Caterpillar for 16 years. He previously worked for Arthur Andersen, moved to Peoria to work on the Caterpillar account for PWC, until he began working on the Caterpillar tax staff in 1992. Caterpillar is the world's largest builder of bulldozers and other construction equipment.

Caterpillar's main operations were in Peoria for many years with 85 percent of earnings allocated to the U.S. and 15 percent allocated to their Geneva, Switzerland office. Before a major reorganization, Caterpillar bought parts from third-party suppliers and then sold them to Geneva for overseas sales. They paid close to 35 percent on the U.S. earnings and 4 to 6 percent on the Swiss sales.

With encouragement from PWC, tax manager Robin Beran reorganized the Geneva's CSARL so that the parts' allocation to CSARL would be credited with 85 percent of the income from sales. PWC in a planning document said that "we are effectively more than doubling the profit on parts," since a customer spends two or three times on parts as on the machine. After the reorganization, CSARL bought parts from the suppliers, but the purchases were only on paper. Also, with approximately 400 Geneva employees, only 65 people worked on parts in Geneva and around 5,000 worked on parts in the U.S.

A 2014 report on CSARL by the Senate Permanent Subcommittee on Investigations indicated that Caterpillar kept two separate sets of books. Their internal "accountable profits" account maintained operating income of the divisions which was used to calculate employee bonuses. Their public ledger account showed most of the parts profit allocated to Geneva with the lower corporate rates. Most of the parts executives and employees were in the U.S. Most of the parts were designed, built, stored, and fulfilled in the U.S. The Senate committee said Caterpillar had avoided $2.4 billion of taxes on more than $8 billion in revenues over 13 years.

Whistleblower Daniel Schlicksup was adamant that the new scheme did not meet the tax laws. In an email to Robin Beran, Schlicksup said:

> There is a potential problem with the profit shifting strategy you along with PWC have created. The U.S. tax law requires corporate structure to have clear 'economic structure.' Under this doctrine an entity must show that any restructuring would have substantial impact on the entity's assets or pre-tax profits separate from tax burden. You have changed the tax structure without significantly altering the actual flow of parts. There seems to be no reason for CSARL to exist except to lower taxes, and the IRS will catch on to this activity.

Robin Beran responds as follows:

> Thank you for bringing this to my concern. However, I do not find this a problem because PWC and McDermott Will & Energy LLP helped recognize the Geneva operation as CSARL. I find an accounting firm along with a law firm is more knowledgeable than a single man. However, I do thank you for keeping an eye out for this great corporation.

Because of Schlicksup's activities, he alleged that his superiors retaliated against him for complaining. He provided a 137-page document showing how the company shifted the billions in profits to Geneva to avoid $2 billion of taxes. Schlicksup was transferred to the information technology department with a seven percent raise. He filed an IRS whistleblower complaint accusing Caterpillar of tax fraud, along with a complaint with the Occupational Safety and Health Administration. In 2012, his whistleblower lawsuit was settled for an undisclosed amount.

By 2013, the IRS declared the reorganization scheme to be an abusive tax strategy and gave the company a bill for $1 billion. If the IRS wins, Schlicksup could receive a whistleblower award as high as $600 million. The IRS is auditing more recent returns. On March 2, 2017, various enforcement agencies raided three Peoria-area Caterpillar facilities to collect documents and electronic evidence.

Dr. Leslie A. Robinson, an accounting professor at Dartmouth College, was commissioned by the government to prepare a report about the tax investigation into Caterpillar. In her 85-page report leaked to the *New York Times*, she said that "Caterpillar did not comply with either U.S. tax laws or U.S. financial reporting rules." Robinson stated "that the company's noncompliance with these rules was deliberate and primarily with the intention of maintaining a higher share price. These actions were fraudulent rather than negligent."

Companies are allowed to defer taxes on profits produced offshore until they bring the income back to the U.S. When the company brings this profit back to the U.S. (e.g., called repatriation), taxes are owed, reduced by overseas taxes paid. Professor Robinson estimated that Caterpillar had brought back $7.9 billion to the U.S. as structured loans beyond the income already taxed overseas. She asserted that the company failed to report these loans for accounting and tax purposes. The IRS could bring civil or criminal charges against Caterpillar and their executives. She spent 200 hours preparing the report and she indicated that PWC was paid $55 million to develop the tax strategy. Dr. Leslie Robinson was quoted by the *New York Times* as saying in her report that "I was provided with all documents available to the case agents assigned to the investigation."

The Tax Cuts and Jobs Act altered the U.S. approach to taxing corporations from the worldwide system to a territorial system after 2017. This shift to the territorial system aligns the U.S. approach to taxing international transactions with the territorial system used by most other countries. Under both the territorial and worldwide systems the U.S. collects tax revenue on taxable income that has some territorial connection to the U.S. Under the worldwide system, the U.S. also will collect tax revenue on taxable income that is transferred from, in this case, CSARL, to Caterpillar's U.S. parent company.

Thus, both the worldwide and territorial systems can encourage companies like Caterpillar to attempt to shift income from the U.S. parent company to CSARL, since the new 21% tax on corporations is still above the 6% tax rate paid by CSARL to Switzerland. However, only the worldwide system motivates the short-term financing arrangement between CSARL and the U.S. parent to avoid the U.S. tax on taxable income transferred from CSARL to Caterpillar's U.S. parent company. For example, had the U.S. maintained a worldwide system, then taxable income transferred from CSARL to Caterpillar's U.S. parent company would be taxed at 15% by the U.S., so that the total tax paid on taxable income is 21% (6% Swiss tax + 15% U.S. tax). The financing arrangement between CSARL and the U.S. parent allowed Caterpillar to avoid the 15% tax that would have been imposed by the U.S., but is now mostly irrelevant under the new territorial system after 2017. The new tax code has a provision where foreign profits must face at least a 10% tax rate in a foreign jurisdiction, or the taxable income will be partially taxed by the U.S. The residual tax companies face under the worldwide system is why the worldwide system has been criticized as promoting companies engaged in international tax planning to trap the cash from foreign subsidiaries in overseas operations.

On March 8, 2017, Americans for Limited Government complained that the government was illegally outsourcing parts of the tax investigation to an outside source. The group argues that it is illegal for the federal government to outsource tax investigations to non-governmental personnel due to the highly confidential nature of tax records. Section 7701 (a) (11) (b) indicates that although the Secretary has broad powers to delegate authorities, any delegation is limited to an "officer, employee, or agency of the Treasury Department" unless Congress expressly grants broader authority.

A valuable addition to a forensic accounting or fraud course is a mock trail near the end of the semester. The facts in the Caterpillar situation is an excellent topic for a mock trial. The dispute includes possible "cooking the books," new tax laws, outsourcing, economic substance test, whistleblowing, civil v. criminal aspects, structured loans, fraud, negligence, IRS using expert consultants/witnesses, and much more.

Our students have engaged in mock trials on numerous occasions. We break the students into three or four-member teams. We prefer student groups to prepare for more than one trial, so they do not cheat and fall over each other while researching. Since you need both a prosecuting team (criminal) or plaintiff (civil), and a defense, if you have 24 students there is a need for 3 disputes (24/8). Thus, for a 16-group class, there would be a need for two disputes (16/8). We prefer 3-person teams rather than 5-person teams. Four-person teams work also.

Keep in mind that one student can play more than one part (e.g., a fact witness and an expert witness). Students will wear wigs, different hats, mustaches, etc. In general, each team needs one or two attorneys, at least one fact witness, and one expert witness. While two teams are engaged in a trial, the other students can be jurors, bailiff, investigative reporter, etc. We bring in a lawyer for the judge, and we use the courtroom at LSU's law school. We prefer a mock trial dealing with an accounting, auditing, or taxation subject. In a three-hour night class, we can get in at least two trials, and possibly have the other teams give their opening and closing arguments. We randomly select the trial topic minutes before the night class. If you want only one sample trial, the first time we used the facts in J.T. Reisch, "Brodnax Minerals Company: A Case Study for Auditors" Responsibility: *Issues in Accounting Education*, Vol. 14, No. 4, November 1999, pp. 601-612. We handed out a copy of the article to the class.

From the Internet and other sources, prepare answers for these questions:

1. What are the major steps in conducting a mock trial?
2. Explain the economic substance test. Did Caterpillar fail this test? Find the appropriate Internal Revenue Code sections.
3. Which alternative courts could Caterpillar select to fight the current $2 billion in income penalties the IRS is seeking? What are the differences between civil v. criminal charges?
4. How can accountants help attorneys? What are the various roles they can play in litigation services?
5. What motion is used by the opposing attorney to eliminate an expert witness? Discuss Daubert and *Frye* challenges against expert witnesses.
6. Can the IRS outsource part of their tax investigation? Take a position.
7. Prepare a three-to-four paragraph opening statement for the prosecution (plaintiff) in a Caterpillar mock trial.

8. Prepare a three-to-four paragraph closing statement for the defense in a Caterpillar mock trial.
9. What does Leslie Robinson mean when she indicates that Caterpillar did not comply with “U.S. financial reporting rules?”
10. Was there a transfer pricing problem after Caterpillar’s reorganization?
11. Are there any problems with the many short-term loans which Caterpillar received from the Swiss controlled entity? Be sure to look at I.R.C. Sections 951 and 956 and appropriate Regulations.

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Instructor's Notes

1. The typical steps in a mock trial are as follows:
    a. Pre-trial preparation of information gathered from different sources by students.
    b. Courtroom participants: Judge, attorneys, witnesses, jurors, plaintiff, defendant, and a bailiff.
    c. Beginning the trial, the bailiff announces:" All rise. The Court of the _____ is now in session; the Honorable Judge _____ is presiding." Everyone remains standing until the judge enters and takes the bench. The judge asks the bailiff to call the day's calendar, and the bailiff says, "Your Honor, today's case is _____ vs. _____." The judge asks the attorneys for each side if they are ready to begin the trial.
    d. The Trial. Each attorney introduces him/herself: "May it please the court and members of the jury, my name is _____, counsel for _____ in this action."
    e. Attorneys for the plaintiff (first) and the defense (second) deliver their opening statements prepared from studying the facts of the dispute.
    f. Plaintiff calls each witness until finished calling witnesses and conducts direct examination for each one (direct examination).
    g. Defense cross-examines the witnesses called by the plaintiff before each witness steps down.
    h. The defense calls witnesses after the plaintiff rests the case (direct). Plaintiff's attorney may cross-examine witnesses called by the defense before each witness steps down.
    i. Defense rests. Preparation of closing arguments.
    j. Closing arguments in a trial: Plaintiff's (or Prosecutor) attorney first, then defense.
    k. Jury instructions if a jury trial, but only in a District Court. Jury's verdict. This verdict must be unanimous in a criminal trial, but not in a civil trial.
    l. The sentence. The judge decides the punishment: jail, money, and/or time of volunteer service in a criminal trial.

2. The economic substance doctrine is defined in I.R.C. § 7701 (o) (5) (A) as the common-law doctrine that disallows tax benefits if the transaction lacks economic substance or a business purpose. Notice 2014-58 indicates that "a transaction has economic substance if: (1) the transaction changes in a meaningful (apart from federal income tax effects) the taxpayer's economic position; and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction." The term transaction includes a series of transactions. Further, IRC § 6662 (b)(6) imposes a penalty on an underpayment attributable to tax benefits that are disallowed because of a lack of economic substance.

Whether the reorganization meets economic substance depends upon what action the IRS takes with respect to a lawsuit and the ultimate outcome of any lawsuit against Caterpillar.

In his deposition, Rodney Perkins, senior tax manager in Caterpillar's tax department was asked this question:

Q: Was there any business advantage to Caterpillar, Inc., to have this arrangement put in place other than the avoidance or deferral of income taxation at higher rates?

A: No, there was not.

Caterpillar counsel then said, "Let's take a break."

More discussion of this question can be found in Senate Permanent Subcommittee on Investigations, Carl Levin, Chairman, Caterpillar's Offshore Tax Strategy, April 1, 2014 Hearing, pp. 69-73. There is a statement by Daniel Schlicksup that the reorganization lacked economic substance. Also, Leslie Robertson's report reached the same conclusion.

3. Caterpillar would have three choices to fight the proposed IRS $2 billion deficiency: U.S. Tax Court, U.S. District Court, or U.S. Court of Federal Claims. Apparently, the investigation is being undertaken by the U.S. Attorney's Office for the Central District of Illinois, the IRS, and the Inspector General of the F.D.I.C.

   Caterpillar would have to select the U.S. District Court that has jurisdiction if they go that route. In the District Courts there is one judge, and there can be a jury trial (rather than a bench trial).

   The U.S. Tax Court normally has 19 regular judges, but only one judge would hear the dispute. Only in the Tax Court does the $2 billion deficiency not have to be paid before trial. The Tax Court hears only tax cases; whereas the District Court and Court of Federal Claims hear nontax disputes. An appeal from Tax Court and District Court is to the appropriate U.S. Court of Appeals. If Caterpillar were to lose in the District Court (and there is no appeal), the deficiency must be paid with interest.

   The third alternative is the Court of Federal Claims, which may be more favorable for issues having an equitable or pro-business orientation (and for those requiring extensive discovery of evidence). The Court of Federal Claims meets more often in Washington, D.C.

   In a civil trial the dispute is over money, and a party needs only around 51 percent of the evidence to win (e.g., preponderance of the evidence). However, in a criminal trial about 95 percent of the evidence must prove the party is guilty (e.g., beyond a reasonable doubt). A criminal trial may result in a prison term.

   If a special agent of the IRS recommends a criminal trial and if the Department of Justice Tax Division accepts the investigation for prosecution, the case is tried under IRC § 7201 (civil trial under § 6663). There is no statute of limitations for a civil tax fraud case, but for criminal tax fraud the statute of limitations is normally three years.

   4. A quote from a Second Circuit Court of Appeals decision indicates why lawyers need both accounting consultants and expert witnesses. "Accounting concepts are a foreign language to some lawyers in most cases, and to almost all lawyers in some cases." Hal Rosenthal argues that "a lawsuit is like a parachute jump; you have to get it right the first time." The party who has

command of the paper and electronic trails most often controls in the courtroom, and the accountants understand both the paper and electronic trails.

An accountant may be used in the courtroom as a fact witness to provide the court with relevant facts related to a dispute. No specialized training is necessary. The accountant or anyone can testify if he or she has information relevant to the case, and the testimony is not prejudicial or unnecessarily duplicative of evidence already presented. All documents referred to by the fact witness must already be in evidence, and the accountant can not testify about hearsay evidence. Their payment is a small, daily statutory fee. If called in a future trial, Daniel Schlicksup would probably be a fact witness.

An accountant may be hired as a consultant to help the attorney with accounting matters. If Leslie Robinson had been hired by the IRS as a consultant, her research report would not have been discoverable by Caterpillar (her research was leaked to the *New York Times*). A consultant may eventually turn into an expert witness, and her/his work would be discoverable by the other side.

If Dr. Robinson has been hired (or will be used) as an expert witness, she will help the court or trier-of-the-facts (jurors) to understand technical issues. As a consultant or expert witness Dr. Robinson is entitled to a reasonable hourly rate, and an expert witness can testify about hearsay evidence if it is something normally relied upon by experts in that field (e.g., accounting). An expert witness can testify about documents that have not been entered into evidence (if they are of the type normally relied on by experts in that field to form an opinion). The judge determines if the expert has the qualifications, and the testimony must be relevant and not unnecessarily duplicate or prejudicial.

The court can appoint someone pre-trial, during trial, or post-trial to oversee certain aspects of the dispute. Often called special masters, appellate courts generally believe that special masters are reserved for special matters or unique circumstances, and they can be subject to Daubert challenges. Special masters have aided federal tax disputes for more than 90 years, especially in District Courts.

On occasions, a person may act as a summary witness to avoid calling many fact witnesses. They are used to efficiently and effectively present voluminous and complex data in the courtroom.

5. An attorney can make a motion of *limine* to exclude certain information before trial, such as an expert witness and his/her report. The judge will rule on the motion after a hearing. The hearing with the judge and lawyers can be simple or complex. A complex challenge can involve multiple days with live witnesses, both challenging experts and rebuttal experts.

In federal courts and many state courts there are *Daubert* challenges. Some state courts still follow the *Frye* rule. The Supreme Court in *Daubert v. Merrill Dow Pharmaceuticals, Inc.* established a gatekeeping rule for federal courts so trial judges have a special responsibility to ensure that scientific testimony is not only relevant, but also reliable. In *Kumho Tire Company,*

Ltd. v. Carmichael, the Supreme Court decided that a judge's "gatekeeping" obligation applies not only to scientific testimony, but to all expert testimony.

The Daubert five factors used to exclude expert witnesses are as follows:

1) Whether the theory or technique used by the expert can be, and has been, tested;
2) Whether the theory or technique has been subjected to peer review and publication;
3) The known or potential rate of error of the method used; and
4) The degree of the method's or conclusion's acceptance within the relevant community.
5) Are there standards controlling methodology and principles?

Experts may be excluded for other reasons such as

1) The older, more liberal *Frye* challenge is used in a few state courts.
2) Does not qualify as an expert by skill, knowledge, experience, education, and training (SKEET).
3) Requires a valid connection to the pertinent inquiry as a precondition to admission.
4) Courts remain vigilant against the admission of legal conclusions.
5) Side-taking or result-oriented work (especially the U.S. Tax Court).
6) Conflict of interest.
7) Ghost-written report.
8) Spoliation.
9) Name not disclosed within time limit.
10) Improper expert witness designation.

6. Once Dr. Leslie Robertson's 85-page IRS report was leaked to the *New York Times*, Americans for Limited Government published a report by Natalia Casto indicating that critical taxpayer information and records should only be handled by the government agencies which are dedicated to the American people's trust. She points out that since May 2014, the IRS has hired outside firms to assist in income tax audits and investigations. The IRS paid the Quinn Emanuel law firm $2.2 million to perform duties that IRS normally handled privately (charging up to $1,000 an hour). Apparently, the law firm did not list taxes as one of its 32 practice areas.

Casto points to 26 U.S. Code 6103 which allows non-employees to handle paperwork only "to the extent necessary about the processing, storage, transmission, and reproduction of such returns and return information, the programming, maintenance repair, testing, and procurement of equipment, and the providing of other services, for purposes of tax administration." The IRS, according to Casto, manipulated a law about photocopying and issued Temporary Regulation § 301,7602-1T. This temporary regulation gives the IRS possibly illegal power to allow non-employees to "receive and examine books, papers, records, or other data produced in compliance with the summons and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of the witness summoned by the IRS to provide testimony under oath." Likewise, IRC §6103 prohibits officers and employees of the IRS from disclosing taxpayer information, except in limited circumstances.

Senator Orrin Hatch sent a letter to the IRS Commissioner reminding him that the IRS has more than 36,000 employees, and the IRS will need an Act of Congress to hire private contractors. Further, he said:

> In a tax system based on voluntary compliance, the integrity of the tax administration process and protection of taxpayer rights is of paramount importance. To those ends, Congress put in place specific restrictions on government action in the examination process.

Is Dr. Robinson a private contractor? What documents was she given? We do not have a copy of her 85-page report. The authors believe the IRS has overstepped its powers.

7. May it please the court and members of the jury, my name is Don Crumb, counsel for the Department of Justice in this action. Today's tax trial involves Caterpillar, Inc., the world's largest builder of bulldozers and other heavy equipment. Caterpillar's management felt that their 34% tax rate was too high. They saw Apple, Verizon, Pfizer, Merck, and other companies reducing their tax rates by transferring intellectual properties and other intangible assets to foreign tax havens. How could a builder of machinery use such a scheme?

So, Caterpillar hired a magician, PwC, for $55 million to pull a rabbit out of a black top hat. The magician suggested moving the parts division to a Swiss subsidiary (with a 4 to 6% tax rate) so the income would be taxed at the much lower rate. Before the magic trick 85 percent of profits were taxed in the U.S. and 15 percent in Switzerland. After the rabbit is pulled from the hat, the Swiss unit bought parts from the suppliers, but the purchases were only on paper. In reality, only 65 employees in Switzerland (out of 400) worked on parts, but 5,000 employees worked on parts in the U.S.

For the period 2000 to 2012, Caterpillar moved at least $7.9 billion in revenue to the Swiss subsidiary (a controlled unit) and reduced their federal taxes by at least $2.4 billion.

Caterpillar's bright yellow machines only can be maintained and repaired with Caterpillar parts, and these parts are manufactured mostly by companies in the U.S. and shipped around the world. Almost 80 percent of the R&D expenditures to design the machines and parts occurs in the U.S. The $525 million worth of parts are stored in the U.S., and few, if any, are stored in Switzerland.

As a juror, would you have paid PwC (the magician) $55 million for this scheme? Probably not. But Caterpillar still had a problem, because much of the cash was in Switzerland. If Caterpillar brings the cash back to the U.S. (called repatriation), it will be taxed. So, PwC (magician) suggested to cover the obvious cash shortages in the U.S., have the Swiss office send 30-day short-term loans to Caterpillar USA. Each of these many short-term loans are paid back from more and more short-term loans from Switzerland. Although, the company had economic use of these funds, they did not pay taxes on it. I ask you, if some foreign company gave you $7.9 billion of rolling, short-term loans, would that be worth something to you? Maybe invest it or buy a couple of Lamborghinis. Or buy a dozen bulldozers at wholesale and resale them. Our expert, Dr. Leslie Robinson, will testify that Caterpillar has brought back $7.9 billion to the U.S. as structured loans beyond the

income already taxed overseas. She will testify that Caterpillar kept two sets of books. She will testify that Caterpillar's non-compliance with financial reporting rules was deliberate and primarily with the intention to maintain a high share price. I quote: "These actions were fraudulent rather than negligent."

Would the Swiss branch do the same for another company—say General Motors? Give G.M. $7.9 billion in loans, and during the next month loan more to G.M. so they could pay back the first loan. In other words, G.M. would always have $7.9 billion to use. Of course not. There would be no benefit of repatriating money to G.M.

By necessity we will talk about some tax terms, such as the economic substance doctrine. For the magician to pull the revenue (rabbit) out of the hat, an economic substance test must be met to keep it from being an abusive tax shelter. Mr. Daniel Schlicksup, as a tax employee, warned management that the new scheme did not meet the tax laws. He will tell you that the only reason for the new Swiss scheme to exist was to lower overall taxes—which is not a business reason for such a reorganization.

Another term is transfer pricing. Now transfer pricing is not illegal, but when dealing with a foreign subsidiary, a parent must use arms-length pricing (or uncontrolled pricing). Caterpillar does not use arms-length pricing when they transfer the parts, know-how, and accounting to the Swiss unit. Our expert will show that a one percent increase in cross-border, intra-firm transfers leads to only .38 percent decrease in U.S. pretax income. Caterpillar is reducing its tax rate from 34 percent to 4 to 6 percent.

We will show that the magician, PwC, sold for $55 million an abusive tax shelter to Caterpillar. Even some of Caterpillar's employees told management that the scheme did not meet the tax laws. An e-mail between two PwC partners shows that the slight-of-hand magic trick did not meet the transfer pricing tax rules. We will show that the massive short-term loans gave Caterpillar economic repatriation which should be taxable income to Caterpillar USA.

This subterfuge of Caterpillar and PwC brings to mind a tax adage. Pigs get fed; hogs get slaughtered.

Keep an open mind as you hear the evidence. Remember, when corporations do not pay their fair share of taxes, your tax bill is higher, and government benefits are reduced or eliminated.

Thank you.

8. May it please the court and members of the jury, my is Christa Cheep, counsel for Caterpillar Corporation. This dispute is simple. Did my client engage in legal tax avoidance or tax evasion? We have clearly shown that Caterpillar merely engaged in effective and legal tax avoidance – not fraud or evasion.

Most accounting and law students are familiar with the classic words of Judge Learned Hand in *Commissioner v. Newman* illustrating the value of tax avoidance:

> Over and over again courts have said there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.

Tax avoidance is merely tax minimization through legal techniques allowable by the Internal Revenue Code. Tax avoidance is the proper objective of a large corporation or you. Remember you are not obligated to make voluntary contributions to federal, state, or local governments. I suspect that each of you and your accountant try to reduce your taxes by taking advantage of each of the available provisions in the tax laws.

The prosecution harps on this vague economic substance doctrine. Caterpillar's restructuring was necessary and appropriate because part sales grew globally, and the company had to invest in facilities and warehouses in many other countries. We have clearly shown that the Swiss unit was running the foreign business from Geneva regardless where the parts were made or stored. Obviously, this constitutes the required economic substance under the tax laws.

There is the argument about the short-term loans from Switzerland to Caterpillar USA. Have you ever been short of cash? Have you borrowed money from your parent, children, bank, or on your credit cards? If so, you do not have to show that as taxable income. Besides, there is a 30-day short-term loan exception. The loans from Switzerland were short-term loans that were repaid.

With the high tax rates on corporations in the U.S., Caterpillar must continually adapt to the way their business is run, and that is what my client does. They did not invent an artificial tax structure. Do not punish my client for engaging in tax avoidance like most other corporations do in the U.S. and around the world. Caterpillar, based upon testimony from our witnesses, merely tries to minimize their taxes legally, and they do not evade taxes. These allegations against Caterpillar are gross misconceptions and misinterpretations of the complicated tax laws.

This company is proud to be a symbol of a lawful, legitimate business for almost a century. The government has failed to prove that my client did not follow the letter of the tax laws. It is absurd to believe that Caterpillar has done what the government claims. Consider the motives of their witnesses. One is a disgruntled employee who expects to receive a $600 million whistleblower award if the IRS wins. An expert was paid at least $250 an hour for 200 hours of work, or at least $50,000. How do you expect them to testify?

While the prosecutor is critical of Caterpillar's international tax planning and financing schemes, there is an important legal, alternate perspective. First, the Scholes and Wolfson's framework[1] suggests that companies' tax planning schemes are amoral. The paradigm that companies' tax planning schemes are amoral comes from the economic perspective that companies must take all actions necessary to remain viable in competitive operating environments. The globalization of competition highlights

[1]Scholes, M.S. and M.A. Wolfson. 1992. Taxes and Business Strategy: A Global Planning Approach, Pearson.

the importance of minimizing costs. There are any number of U.S. based manufacturing examples (e.g., televisions, steel, etc.) that have moved to other countries due to lower costs of production which highlight the importance of minimizing costs in competitive environments.

Second, do you want to pay more for the products you purchase? Economists frequently suggest that companies do not pay taxes, but instead pass these costs onto consumers, in the form of higher product prices, or onto employees, in the form of lower salaries. Some companies announced that they would pay employees bonuses or higher wages following the passage of the Tax Cuts and Jobs Act. These bonus payments and higher wage announcements support the economists' suggestion that companies pass the cost of taxes onto their employees in the form of lower salaries and consumers in the form of higher prices.

Finally, I want you to contemplate the real effects that the U.S. international tax system has on all corporate decisions. To minimize taxable income in the U.S., companies frequently try to move their valuable intellectual property overseas, before it has a significant value. By moving their valuable intellectual property overseas, profits can be shifted to foreign subsidiaries as these foreign subsidiaries charge their U.S. parent company for the use of these intellectual property rights. The question is whether the U.S. international tax system should promote companies to move these valuable assets to overseas subsidiaries, particularly since the U.S. is continuing to transition to a largely service based economy. The real effect is that, long-standing, profitable U.S. based companies who cannot shift profitable intellectual property rights, such as Caterpillar prior to the development of the CSARL strategy, are punished by the high U.S. tax system as they try to compete against global competitors whose profit centers are in lower tax jurisdictions.

Another troubling real effect is that newer, growth companies, that could help the U.S. GDP continue to expand, are often motivated to shift their valuable assets, and thus profit growth, to foreign subsidiaries well before any profits are made from their operations. Another troubling trend that is motivated by the U.S. international tax system, is the trend for large, long-standing profitable companies to engage in inversions, where a merger and acquisition transaction results in the newly formed company choosing to locate their parent company in a foreign jurisdiction that has lower tax rates. Should the U.S. international tax system promote these types of real effects on corporate decisions?

Read very carefully the jury instructions about fraud. Use common sense in your deliberations. Disagreement with the IRS is not a crime. Just because a taxpayer is audited is not a sign a taxpayer owes taxes. There are many grey areas in the tax laws, and experts can disagree about a word or phrase in the tax law.

Do not punish Caterpillar for merely engaging in tax avoidance, which is not tax evasion.

Thank you.

9. The SEC also raised questions with respect to whether Caterpillar's financial reporting of taxes were appropriate. The SEC requested documents particularly with respect to Caterpillar's loans and product

shipments between the U.S. parent and CSARL. While the SEC ultimately declined to pursue enforcement action,[2] we speculate on two financial reporting items that the SEC may be considering.

Financial reporting and tax rules require parity between inventory valuation methods. For example, a company must use LIFO for both financial reporting and tax reporting purposes. Given the transfer of parts from the U.S. parent to CSARL, the SEC may have been investigating whether Caterpillar's financial reporting of inventory on these transferred parts matched the tax reporting.

More importantly, companies must recognize deferred tax liabilities on their balance sheets for tax liabilities that they reasonably expect to incur at some point. Financial reporting rules, however, permit companies to avoid recognizing deferred tax liabilities for what are commonly referred to as permanently reinvested earnings.[3] Permanently reinvested earnings are foreign earnings earned by a foreign subsidiary that are not expected to be sent back to the U.S. parent. In the case of Caterpillar, the lending arrangement between CSARL and the U.S. parent may have violated the concept of permanently reinvested earnings, as the loans, were in effect, a return of the foreign earnings from CSARL to the U.S. parent. The SEC may have been evaluating whether Caterpillar recorded a deferred tax liability with respect to CSARL's profits. Had Caterpillar not recorded a deferred tax liability because they considered CSARL's profits to be permanently reinvested earnings, then the SEC likely would have investigated whether this lending arrangement between CSARL and the U.S. parent violated the permanently reinvested earnings concept.

10. Research shows that significant gains accrue to shareholders of firms that engage in cross-border, intra-firm transfers. "Estimation results show that a one percent increase in intra-company, inter-geographic area transfers leads to approximately 0.38 percent decrease in U.S. pretax income. Caterpillar's tax rate of around 35 percent of revenue went to 4 to 6 percent." See K.O. Olibe et al., "The Impact of Intra-firm Transfer Pricing on Firm Value, Taxes, and Earnings: International Financial and Tax Fraud, *J. of Forensic & Investigative Accounting*, Vol. 9, Issue 1, Jan. – June 2017.

PwC's webpage indicates that they have over 3,100 transfer pricing professionals in more than 90 countries. They indicated three major risks with transfer pricing arrangements.

1) Large local tax reassessments – with significant penalties and interest on overdue tax – and double taxation on income when relief under tax treaties is not available.
2) Uncertainty about worldwide tax burden, and expensive, time-consuming conflicts with regulatory authorities.
3) Damage to reputation and corporate brand if seen as a bad corporate citizen.

As a juror, would you have paid PwC $55 million for the tax schemes?

[2]Tangel, Andrew and Michael Rapoport. 2018. "What New Law? Caterpillar Fights to Protect Its Swiss Made Profits, Wall Street Journal, January. http://www.foxbusiness.com/features/2018/01/01/what-new-tax-law-caterpillar-fights-to-protect-2.html

[3]Edwards, Alexander, Todd Kravet, and Ryan Wilson. 2015. Trapped Cash and the Profitability of Foreign Acquisitions, *Contemporary Accounting Research,* Vol. 33, Issue 1, Spring, pp. 44-77.

After the reorganization, there was a transfer miss-pricing problem. An e-mail exchange between two PwC transfer pricing partners recognized this problem and the solution:

> Steven Williams (PwC Managing Director: "[J]ust curious – say they [Caterpillar] decide PMs [Product Managers] stay in U.S. How do we retain CSARL parts profits if those 'US entrepreneurs' claim both machine AND parts profit?"
>
> Thomas Quinn, PwC Tax Partner, designer of CSARL scheme responded: "PMs in U.S. will put some pressure on the parts profit model. These guys are really bought into the PM [Production Management] is king concept. We are going to have to create a story that will put some distance between them [product managers] and parts (e.g., all the parts that are non-current) to retain the benefit. Get ready to do some dancing."
>
> Steven Williams replied: "What the heck. We'll all be retired when this audit comes up to audit. [Edward] Bodnam and [C]hris Dunn will have to solve it. Baby boomers have their fun, and leave it to the kids to pay for it."

U.S. corporate income tax rates are the highest among Organization of Economic Development countries, which drives U.S. multinationals to use transfer pricing to reduce their overall taxes. Switching income from a 35 percent regime to a 4 to 6 percent country is obviously beneficial.

In general, transfers of tangible goods, intangible property, and services must be done under an arm's length standard (as if Caterpillar is dealing with an uncontrolled party). Reg. §1.482-1(b)(1) indicates that a transaction is consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

If a taxpayer fails to prepare and maintain contemporaneous documentations, there can be 20 or 40 percent tax adjustments. There are various transfer pricing methods for tangible goods, intangible property, and services, such as resale price, cost plus, comparable uncontrolled price, and others. There is not enough information to know which method Caterpillar used. However, with only 65 parts employees out of 400 in Switzerland and 5,000 in the USA, the impression is Caterpillar did not meet the transfer pricing rules.

11. The IRA LB&I International Practice Service Transaction Unit discusses this technique by some companies that use short-term loans (30 days) from the foreign entity to obtain economic repatriation of the foreign earnings. In general, under IRC Sections 951 and 956, Caterpillar, as a shareholder, must include in income an average amount of U.S. property held by the Swiss entity (Controlled Foreign Corporation). There is a short-term loan limited exception that can be used to avoid taxation, but the IRS looks at a situation where a series of short-term loans is being used to circumvent taxation under IRC Section 951. To meet the exception, the substance of the obligation must match its form, and the obligation must not be one step in a series of related steps in a united transaction. If so, multiple obligations may be collapsed into a single obligation.