Statement of

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Before the

U.S. Senate Homeland Security and Governmental Affairs Committee
Permanent Subcommittee on Investigations

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Good morning Chairman Levin, Ranking Member McCain, and Members of the Subcommittee. Thank you for the opportunity to appear before you today. My name is Julie Lagacy, and I'm the Vice President of Caterpillar's Finance Services Division, which includes its tax and accounting functions. I am accompanied today by Caterpillar's Director of Global Tax & Trade, Robin Beran, a 24-year Caterpillar employee, and Rod Perkins, who retired in 2009 as one of Caterpillar's International Tax Managers after 35 years of service. We are proud to represent Caterpillar before you today.

Caterpillar is a great American company, and our reputation is one of our greatest assets.

Caterpillar complies with its legal obligations with respect to the payment of taxes. We are proud of what we do. We are proud of our men and women who make it possible. And we are equally proud of our U.S. and worldwide heritage.

Our average effective tax rate of 29 percent is one of the highest for a multinational manufacturing company, and 3 percentage points higher than the average effective income tax rate for U.S. corporations, according to the U.S. Department of the Treasury. This is particularly high when you consider that more than 65 percent of our sales and revenues are abroad. Over the last 15 years, we've increased U.S. jobs by 35 percent to nearly 52,000. And we've more than tripled our exports to $16 billion in 2013.

Over the last eight months, Caterpillar has responded to several Subcommittee questionnaires and other information requests, has produced roughly 2,000 pages of documents, has voluntarily permitted and facilitated 11 separate Subcommittee staff interviews of current and former personnel, and has sought to cooperate in every way possible with the Subcommittee's inquiry.

Background on Caterpillar

For nearly 90 years, Caterpillar has helped build the world, including the backbone of modern America. What began with two American inventors now employs over 118,000 people worldwide – and nearly 52,000 of those people are right here in the United States. When you consider our independent dealer and supplier networks, the worldwide reach of our company is even greater. At our roots, we are an American company. Our equipment was there to build the Golden Gate Bridge and create the interstate highway system. Caterpillar products, dealers and employees also show up after tragedy strikes. In Oklahoma City, at Hurricane Katrina and Ground Zero, we joined the first responders in cleaning up, powering up and paving the way for recovery.

We are proud that many of our products are "Made in America." Along the Illinois River in our East Peoria factories, we make the machine on which our company was founded – the track-type tractor, better known as the bulldozer. Just down the road in Decatur, Illinois, is the only place in the world where we make the world's largest mining truck, which stands two-and-a-half stories tall and can carry 400 tons. Eight out of ten large mining trucks made in Decatur are shipped outside the United States. There are other examples like this across the country – from engines rolling off the line in Texas, to the locomotives we are building in Indiana, or the excavators made in Georgia.

Our customers depend on Caterpillar's unmatched products, services, solutions, and the reliability of our machines. Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives. Throughout our history, we have always served worldwide customers, who turn to Caterpillar to help them develop infrastructure, energy and natural resource assets.

We grow and build near our customers worldwide, not only because it's what they demand but because remaining globally competitive helps create jobs right here at home. Growing where our business is means growing where our customers are located, not just in the United States but throughout the world. Most importantly, while more than 65 percent of our sales and revenues come from outside the United States, Caterpillar remains committed to our manufacturing roots here in America – that is why we continue to invest here at home with 69 facilities in 23 states and Caterpillar dealers from coast-to-coast.

In the past 15 years, we have added more than 13,000 U.S. jobs, growing from 38,000 in 1999 to nearly 52,000 in 2013. Many of these jobs came from our exports, which last year alone totaled $16 billion. We in Peoria thought we were doing exactly what the Congress was encouraging companies like us to do. Our effort to grow U.S. manufacturing jobs was highlighted by President Obama in his 2013 State of the Union address.

Caterpillar's Approach to Taxes

You have invited us here today to discuss taxes. We would like to explain very clearly how we view our responsibility with respect to taxes, what we do, and what we don't do. Caterpillar takes very seriously its obligation to comply with the tax laws enacted by the Congress, by the states, and by all of the many jurisdictions in which we conduct business.

Caterpillar's effective income tax rate averages about 29 percent, as Caterpillar has operations and customers worldwide. Considering that the average statutory corporate income tax rate among OECD countries is 25 percent, and the average effective income tax rate for U.S. corporations is 26 percent, a 29 percent effective tax rate is a relatively high blended rate.

Caterpillar in particular is proud to pay its fair share of taxes right here in the United States.

- For the last three years, Caterpillar's average Federal income tax liability has been approximately $600 million, for a three-year total of approximately $1.8 billion of Federal income taxes.
- Over the same period, Caterpillar also has incurred on average approximately $215 million in U.S. state and local income, property, and sales and use taxes, for a three-year total of approximately $645 million in U.S. state and local taxes paid.
- Caterpillar also has remitted on average nearly $1.8 billion in U.S. Federal and state employment taxes in each of the last three years, for a three-year total of over $5 billion, reflecting Caterpillar's commitment to creating and maintaining U.S. jobs.

We want to emphasize that Caterpillar has fully complied with U.S. tax law with respect to the restructuring and transactions that you have asked us to discuss today. These transactions

involve the purchase of replacement parts for Caterpillar machines and engines from our suppliers and the sale of those parts to our dealers.

Specifically, the supply chain that you have asked us to address relates to purchases of replacement parts for Caterpillar machines and engines from third-party suppliers and sales of those parts to independent dealers outside the United States. These purchases and sales are generally made by Caterpillar's non-U.S. affiliates. As such, the affiliates' income from these sales is subject to non-U.S. tax on a current basis, and is subject to U.S. tax on a deferred basis. This is a standard multinational business structure entirely consistent with the letter and spirit of U.S. tax law.

This also has nothing to do with Caterpillar's income from sales in the *U.S.* market or with Caterpillar Inc.'s income from export sales, all of which is subject to U.S. tax on a current basis. Caterpillar does not seek or obtain any benefit of lower foreign tax rates or deferral of U.S. taxes on this sales income. In addition, some of the benefit of lower foreign tax rates on Caterpillar's non-U.S. operations accrues not to Caterpillar but instead to the U.S. Treasury, in the form of reduced foreign tax credits on income that is subject to current-basis U.S. tax.

Business Context of the Supply Chain Restructuring

Caterpillar has four reportable business segments in which separate profitability is determined. The reportable segments include Construction Industries, Resource Industries, Energy & Transportation, and Financial Products. Each of the first three segments is led by a Group President accountable for the end-to-end businesses that they manage. That is, each aspect of the product included in that segment, from design, to manufacture, to sale, and to provision of replacement parts and servicing is determined by the Group President through appointed VPs and product managers assigned to the business in that segment. Replacement parts are a key facet of each of Caterpillar's machine and engine businesses, as Caterpillar equipment is built to last for decades.

Caterpillar reaches customers through a network of independent dealers and works closely with these dealers to deliver machines, engines, and parts to the market, and to ensure a high level of customer service.

Many sales of replacement parts into non-U.S. markets are made by a Caterpillar affiliate based in Geneva, Switzerland, known as Caterpillar Sarl, or CSARL. CSARL and its predecessor entity have had a large marketing and sales presence in Geneva for more than 50 years working with dealers located outside the United States. Geneva was initially chosen as an ideal base from which to serve European markets in the postwar era, and it continues to offer advantages of geographic location and access to the talented, multicultural, and multilingual workforce that Caterpillar needs to operate effectively in the region. CSARL is no mere shell, but rather a major operating company employing hundreds of personnel in Geneva, including many of the people who perform the strategically critical work of interfacing with dealers in non-U.S. markets.

CSARL's Geneva-based employees make pricing and discounting decisions, monitor dealer financial and customer service performance, and intervene as needed when dealer performance

issues arise. Over a period of decades, these Geneva-based employees have developed the network of independent dealers that comprise the Caterpillar marketing and distribution channel in Europe, Africa, and the Middle East. The same is true of the hundreds of Singapore-based CSARL branch employees who carry out these functions and have developed the dealer network for markets in the Asia-Pacific region. These employees perform strategically critical work in enabling Caterpillar to execute its business model around the world, and their functions could not be carried out effectively from the United States.

As part of a restructuring carried out in 1999 and the early 2000s, CSARL took on additional entrepreneurial functions related to the purchase and manufacture of machines, engines, and parts, including some functions that had previously been performed in other non-U.S. locations. Since this time, CSARL has purchased replacement parts that it sells to non-U.S. dealers from unrelated suppliers both within and outside the United States and has manufactured machinery and equipment through contract manufacturing arrangements. Prior to 1999, CSARL's predecessor purchased replacement parts from Caterpillar Inc. and then on-sold them to the dealers. The removal of Caterpillar Inc. from the transactional flow has produced a simpler supply chain that better reflects the reality that CSARL is a true entrepreneur for sales of machines, engines, and parts in its territories. Caterpillar's tax reporting consistently reflects the fact that CSARL is the entrepreneur for all of these transactions, regardless of whether the result is to report high margins, low margins, or losses on CSARL's transactions—there is no "cherry picking" of winners.

The fact that this adjustment to the supply chain also eliminated unnecessary related-party transactions that were accelerating U.S. taxation of the non-U.S. sales income under the "Subpart F" anti-deferral rules does not in any way render CSARL's purchases and sales suspect under long-established tax principles. Nor does the fact that some of CSARL's inventory is commingled in U.S. warehouses with physically identical inventory owned by Caterpillar Inc.—as U.S. tax law specifically allows and indeed encourages foreign ownership of inventory in the United States for subsequent export, as well as physically commingling this inventory with identical inventory owned by others, provided inventory ownership by each relevant entity is carefully tracked, as it has been in this case.

Application of Judicial Doctrines to the Restructuring and Subsequent Supply Chain Transactions

It is universally agreed that a transaction's form must be consistent with the transaction's substance in order to be respected for tax purposes. The relevant transactions in the present inquiry are the routine purchases and sales of parts by CSARL from and to unrelated suppliers and dealers—these are the transactions by which CSARL earns the relevant income, in the ordinary course of its business. As a matter of both form and substance, CSARL purchases and sells these parts in millions of transactions with entirely unrelated parties. CSARL obtains not only legal title to these parts, but also full beneficial and economic ownership in the sense of enjoying upside potential and bearing downside risk.

The "substance over form" case law and the recently codified economic substance doctrine provide absolutely no basis for recharacterizing third-party supply chain transactions of this nature—CSARL unquestionably is the purchaser and seller for tax purposes. The fact that

CSARL may not take physical possession of some of the products, and may rely on affiliates and third parties to perform some ancillary purchasing and logistics services, does not undermine CSARL's status as purchaser, beneficial owner, and seller of the parts for tax purposes—there is ample case law establishing this proposition. Incidentally, this would be true even if CSARL did not have hundreds of employees carrying out strategically important functions directly contributing to the earning of the income in question—CSARL actually has much more "substance" than is necessary for its supply chain transactions to be respected for tax purposes.

None of the various judicial doctrines, including the economic substance doctrine, apply to disregard CSARL or recharacterize its transactions. Again, the relevant transactions are the millions of purchases and sales of parts by CSARL from and to unrelated parties, and these transactions are unquestionably respected for tax purposes.

The change in Caterpillar's contracting practices in 1999 to remove Caterpillar Inc. from the CSARL purchase-and-sale chain for foreign-bound parts is not, in and of itself, an income-generating transaction and thus is not the proper focus of any "substance" analysis under the various judicial doctrines. Case law has long established that the mere decision to pursue a business opportunity through a foreign subsidiary rather than through a U.S. entity is not subject to examination under the economic substance doctrine.

This is so because the law provides specific rules addressing the tax policy issues presented by the pursuit of business opportunities by foreign subsidiaries of U.S. corporations—the anti-deferral rules of Subpart F, and the transfer pricing rules of Code section 482 and the regulations thereunder. Thus, even if it were stipulated that the changes made in 1999 were motivated primarily by tax considerations and generated primarily tax effects, the economic substance doctrine still would not apply.

The economic substance doctrine prevents taxpayers from engaging in unnecessarily complicated transactions in order to accomplish tax results that could not be specifically foreseen by tax policy makers due to the unpredictable interactions between various tax rules as applied to a particular highly engineered set of transactions. It does not prohibit corporations from engaging in bona fide, economically based business transactions.

When relevant, the doctrine requires some demonstration of a meaningful change in economic position due to the various steps of a transaction and/or a non-tax business purpose for the various steps. The doctrine is not relevant to supply chain restructurings that actually simplify the relevant transaction flows and produce no tax savings other than those specifically contemplated and controlled by detailed tax rules. The doctrine is not relevant in determining whether a business should use a domestic or foreign corporation to pursue foreign markets. *Sam Siegel v. Commissioner*, 45 T.C. 566 (1966), *acq*. 1966-2 C.B. 7. Instead, the transfer pricing and Subpart F rules govern the allocation and deferral of income resulting from these basic supply chain arrangements.

The Congress explicitly confirmed this point when it codified the economic substance doctrine. *See* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10 (Mar. 21, 2010), at 152-53 (noting that, "under longstanding

judicial and administrative practice," certain basic business decisions are respected even if "largely or entirely based on comparative tax advantages," including "a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment" and "the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of [Code] section 482 and other applicable concepts are satisfied"); *see also* Internal Revenue Service, LB&I Directive for Industry Directors, *et al.* regarding Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (LB&I-4-0711-015), July 15, 2011 (confirming same). In other words, decisions of this nature generally are not subject to second-guessing under the economic substance doctrine, even if based primarily on tax considerations, because the resulting structures are already policed by other highly developed legal regimes (*i.e.*, the Subpart F and transfer pricing rules).

Moreover, courts have explicitly interpreted, and the Congress has endorsed, the economic substance doctrine to mean that businesses are allowed to structure and restructure their foreign operations, even when motivated primarily by tax considerations and resulting primarily in tax benefits. In *United Parcel Service of America* ("*UPS*") *v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), the taxpayer restructured its business by transferring its package insurance program to a Bermuda affiliate and then distributing the shares of that entity in a taxable dividend to the UPS shareholders. Even though the Bermuda company had no facilities or employees in Bermuda, the 11th Circuit concluded that the arrangement did not violate the economic substance doctrine. In reaching this conclusion, the court focused on the millions of transactions engaged in by the Bermuda company being challenged by the IRS, and not on the business restructuring that preceded them.

The appropriate analysis is whether CSARL's post-restructuring transactions had substance. Applying *UPS*, CSARL and its transactions had more than ample substance. CSARL has and had several hundred employees, numerous warehouses to hold inventory for sale to its dealers, and office facilities in Geneva. Significantly, CSARL engaged in millions of transactions with third parties by purchasing replacement parts from third party suppliers and manufacturers, and selling the parts to third party dealers.

In connection with the Subcommittee's inquiry, Caterpillar sought and received an independent review of the CSARL restructuring. Professor John Steines, a professor of tax law at New York University, reached the same conclusions that the various judicial doctrines, including the economic substance doctrine, do not apply to the restructuring. Professor Steines's report is attached to this testimony.

If any well-advised business decided to expand today from serving purely domestic markets to serving global markets, it would establish a structure that looks like the current CSARL structure. It would conduct its foreign business through a foreign entity, and that entity would pay its U.S. parent fees for services and licensed intellectual property. The foreign entity, not the U.S. parent, would purchase whatever the entity needed in terms of inventory and other material inputs. Courts would respect this arrangement so long as the foreign corporation engaged in bona fide, economically based transactions (*Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506 (7th Cir. 1997)). This result is clearly contemplated in the case law (*e.g., UPS, Sam Siegel*) and the codification of the economic substance doctrine.

The various judicial doctrines, including the economic substance doctrine, simply do not apply to the CSARL restructuring and subsequent supply chain transactions.

Application of Transfer Pricing Regulations to the Restructuring and Subsequent Intercompany Transactions

U.S. tax law, like the tax laws of most U.S. trade and investment partners, requires that related parties price their transactions as if they were unrelated parties dealing at arm's length. The lengthy and complex transfer pricing regulations under Code section 482 set forth the methods that a taxpayer must use in determining the appropriate price for a related-party transaction. The regulations require that a taxpayer adopt the "best method" by using the method that provides the most reliable measure of an arm's length result under the facts and circumstances. A taxpayer is required to document its related-party transactions at the time of filing of the tax return in order to avoid exposure to penalties under Code section 6662, and the IRS routinely requests this documentation at the beginning of an audit. Similarly, the country where the other related party is located generally requires documentation for the same transaction. These rules apply to transactions between entities in high-tax countries (*e.g.*, United States and France), as well as in transactions between a U.S. entity and an entity in a low-tax jurisdiction.

Unlike the judicial doctrines discussed above, the transfer pricing rules obviously did and continue to apply to the transactions that the Subcommittee has asked Caterpillar to address in this hearing. The provision of intangible property rights and services to CSARL by Caterpillar Inc. is subject to the arm's length standard. Any possibility that income might be inappropriately shifted from Caterpillar Inc. to CSARL through these license and services transactions is addressed by the requirement that the royalties and service fees comply with the arm's length standard. Caterpillar has executed, documented, and priced these intercompany transactions in a manner that fully complies with the arm's length standard.

As all transfers of property rights and services are accounted for under these pricing arrangements, U.S. law does not require any separate charge or "exit fee" for the mere decision to allow CSARL to pursue a business opportunity that was previously pursued by Caterpillar Inc. Moreover, since CSARL did not purchase these property rights outright, it pays a royalty to Caterpillar Inc. and will continue to do so until the license either expires or is terminated. Although there are OECD projects and U.S. legislative proposals circulating that would impose exit fees in a wider range of circumstances, these proposals are not present law (and Caterpillar certainly could not have been expected in 1999 to foresee and apply such proposals to its own transactions).

The inapplicability of the "substance over form" and economic substance doctrines to the situation at hand represents no loophole or unintended outcome—any income-shifting concerns that structures like this could possibly present are anticipated and addressed by the transfer pricing rules and the related documentation requirement.

Application of Subpart F Law and Policy to the Restructured Supply Chain

The CSARL parts transactions also fully comply with the letter and spirit of the Subpart F anti-deferral rules.

As explained above, the sales income at issue is earned by CSARL from the purchase of parts from unrelated suppliers and the sale of these parts to unrelated foreign dealers. CSARL legally contracts with the suppliers for the purchase of parts, and the suppliers transfer to CSARL legal title, risk of loss, and other commercial risks relating to the parts in millions of routine third-party commercial transactions. CSARL markets and sells these parts to unrelated foreign dealers, with CSARL directly carrying out strategically critical marketing and selling functions through CSARL's workforce of hundreds of employees, who have developed this dealer network over the course of several decades. CSARL takes entrepreneurial risks and is exposed to entrepreneurial upside and downside. CSARL obtains important intangible property rights and services from related parties, and CSARL remunerates these related parties with substantial intercompany royalties and service fees that comport with the arm's length standard.

Since 1962, it has been perfectly clear under Subpart F that a foreign subsidiary's income from the sale of personal property cannot be Subpart F foreign base company sales income if the subsidiary, acting on its own behalf, both purchases the personal property from an unrelated person and sells the personal property to an unrelated person, as is the case for CSARL's purchases and sales of the parts at issue in today's hearing.

Subpart F provides that other factors, such as location of the manufacturing of the property, or the location where the property will be used, may be relevant to the application of Subpart F, but only in situations in which the foreign subsidiary makes the related-party purchase or sale of property necessary to implicate the Subpart F sales rules in the first place. Subpart F does not require any inquiry whatsoever into the location of manufacture, the identity of the manufacturer, or the location of the customer markets in situations involving unrelated-to-unrelated purchases and sales of inventory. Simply stated, the Congress quite clearly provided that "unrelated-to-unrelated" purchases and sales of personal property do not give rise to Subpart F income, even if the foreign subsidiary in question has nothing at all to do with the production of the property and is organized in a country other than the country of manufacture and the country of sale and ultimate use of the property. Subpart F thus imposes no requirement that CSARL employees carry out any particular activities in dealing with its suppliers, or indeed any activities at all—the fact that hundreds of CSARL employees do in fact carry out activities that are strategically important to the earning of CSARL's income means that CSARL has much more substance than Subpart F requires.

Nothing about the CSARL replacement parts supply chain or tax result offends any Subpart F policy, in view of the unmistakable clarity with which the Congress has provided that unrelated-to-unrelated purchase and sale structures do not give rise to Subpart F income, not to mention the fact that the activities directly performed by CSARL employees with respect to the marketing and sale of the products in question are far more substantial than is the case for other structures commonly observed in the marketplace (and considered without any substance-over-form objections in various court cases). If CSARL stands out among the hundreds of large multinational structures prevalent in the marketplace, it would be for the unusually *high* degree of business substance in the buying and selling entity, when in fact the law requires very little in this regard.

Subpart F also specifically envisions that a foreign subsidiary might own inventory in U.S. warehouses, for export to foreign markets. Code section 956(c)(2)(B) provides an export

property exception, establishing that a foreign subsidiary's mere ownership of inventory located in the United States does not constitute a taxable investment in U.S. property by the subsidiary, provided the property is held for export to or use in foreign markets. To do otherwise would discourage engaging U.S. suppliers in the export markets. Thus, CSARL's ownership of parts located in the United States is also entirely consistent with the law and policy of Subpart F.

Caterpillar's Use of External and Internal Tax Expertise

In planning and implementing the restructuring, Caterpillar relied on the advice of two of the world's leading tax advisory firms, as well as on the experience and judgment of its own tax department.

Suggesting that Caterpillar did not properly manage tax risk based on a reading of materials generated as part of Caterpillar's brief experiment with a so-called "guardrails" format for quantifying and describing tax risk, marketed by management consultants, would be incorrect. Caterpillar's in-house tax professionals and outside advisors manage tax risk every day, and all remain convinced that the restructuring and subsequent transactions comply with the tax code and case law dealing with the need for transactional form to comport with transactional substance. Caterpillar has never had any reservation about any fundamental "substance" issue relating to CSARL's purchases and sales of replacement parts, and nothing in the guardrails reflects any such concern.

Caterpillar further notes that the restructuring was in no way a tax shelter and was not originated as an idea by PricewaterhouseCoopers. In addition, the fact that Caterpillar's audit firm, PricewaterhouseCoopers, advised on these matters violated no law, regulation, or ethical standard, either before or after the enactment of Sarbanes-Oxley years after the restructuring.

Conclusion

In sum, 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. The entity in question has considerable business substance and is fully entrepreneurial as a matter of both functional reality and contractual form. CSARL and its predecessor developed the dealer networks in much of the world outside the United States. The amount of income and eligibility for deferral of U.S. tax are well policed by existing transfer pricing and Subpart F rules. The structure complies with existing law and offends no U.S. tax policy. Caterpillar stands by this structure.

We look forward to an open dialogue with the Subcommittee and will be happy to answer your questions. Thank you.

United States Senate
Committee on Homeland Security and Governmental Affairs
Permanent Subcommittee on Investigations

In the Matter of

Caterpillar Inc.

Expert Witness Report

of

John P. Steines, Jr.
Professor of Law
New York University

March 7, 2014

Introduction

I am Professor of Law at New York University School of Law. My specialty is U.S. income taxation.

I have been a full-time faculty member at New York University for thirty-five years and have taught a wide variety of courses in the LL.M. program in Taxation, concentrating in those covering domestic and international aspects of corporate and partnership taxation, including the particular issues addressed in this report. I am a former editor-in-chief of the *Tax Law Review.* I have authored a casebook on international aspects of U.S. taxation, which includes chapters on subpart F, transfer pricing, and accumulated offshore funds, and articles on various international, corporate, and partnership tax issues. I have also spoken on most of these subjects at professional conferences. I am Counsel to the law firm of Cooley LLP, where my practice generally involves the same areas of specialization.[1] Prior to affiliating with Cooley, I was a consultant to Deloitte & Touche from 2001 to 2004 and Counsel to the law firm of Weil, Gotshal & Manges LLP from 1984 to 2001. A copy of my curriculum vitae is appended, which includes a list of my publications and other engagements in which I have served as an expert witness.

I have been engaged by counsel to Caterpillar Inc. ("Caterpillar") to report to the Permanent Subcommittee on Investigations ("Subcommittee") as an expert witness in taxation on behalf of Caterpillar. Specifically, I have been asked to address the Subcommittee staff's concern that Caterpillar's supply chain restructuring executed in 1999 through the early 2000's, pursuant to which its Swiss affiliate, Caterpillar SARL ("CSARL"), purchases finished replacement parts from unrelated U.S. suppliers and sells them to unrelated dealers and customers abroad, may have lacked sufficient economic substance. I understand that the Subcommittee may have other areas of inquiry, but I do not address those here.

The opinions expressed in the report are based upon my specialized professional knowledge. I confirm that I have included in the report all matters within my knowledge and expertise relevant to the matters on which I have been asked to report. I have made all the

[1] Cooley does not represent Caterpillar, nor did it have any involvement in the restructuring that is the subject of this report. In filing this report, I am acting only in my capacity as Professor of Law, not on behalf of Cooley. My role as expert in this matter is not a conflict of interest.

inquiries that I believe are appropriate and no matters of significance that I regard as relevant have, to my knowledge, been withheld from me or the report.

The report comprises three parts: a summary of conclusions; a statement of facts; and an analysis of the issues I was asked to report on.

Summary of Conclusions

As elaborated below, in my professional judgment, it is extremely unlikely that Caterpillar's supply chain restructuring and the countless ensuing sales conducted pursuant to the restructuring are vulnerable to attack for lack of economic substance.

Summary of Essential Facts

The report is based on my understanding of the essential elements of the supply chain restructuring described below. This understanding is drawn primarily from information provided by Caterpillar to the Subcommittee at its request and, to a lesser degree, on conversations with Caterpillar and its counsel.

The Parties

Caterpillar is the parent company of the Caterpillar group. Where relevant, references to Caterpillar include references to Caterpillar's affiliated U.S. subsidiary companies. CSARL is a limited liability company organized under Swiss law in 1997 as the successor to a Caterpillar company that had conducted overseas operations for decades. CSARL is treated as a partnership for U.S. tax purposes and is owned directly or indirectly (through disregarded entities) by controlled foreign corporations that are directly or indirectly owned by Caterpillar.

Pre-Restructuring Supply Chain in Brief

Before the restructuring, Caterpillar purchased replacement parts for its various products—purchased finished replacement parts ("PFRP")—from unrelated suppliers located in the United States and sold a portion of them to CSARL ("outbound PFRP"), which in turn sold them to unrelated dealers and customers in foreign markets. Caterpillar's profits from outbound

PFRP sales were taxable in the United States. CSARL's profits were also taxable in the United States as foreign base company sales income (under Section 954(d) of subpart F).

Post-Restructuring Supply Chain in Brief

After the restructuring, CSARL purchased outbound PFRP directly from the unrelated U.S. suppliers and sold them to unrelated dealers and customers in foreign markets. The restructuring simply removed Caterpillar from the outbound PFRP supply chain. As a result, Caterpillar earned no profits (other than royalties and fees paid by CSARL described below) from outbound PFRP sales, and CSARL's profits were no longer taxable under subpart F because there was no longer a related party (Caterpillar under the old structure) in the supply chain, which Section 954(d) requires as a condition of foreign base company sales income.

Elements of the Restructuring

Since at least 1960, Caterpillar's primary non-U.S. marketing center has been located in Switzerland. For several decades, CSARL (and its predecessor) have had several hundred employees in Switzerland, currently approximately 400, engaged in activities involved in manufacturing, marketing, sales, and support of Caterpillar machines, engines, and parts. Swiss-based managers have been instrumental in Caterpillar's international expansion. As the Asia Pacific market developed, CSARL developed a similar regional center in Hong Kong, which was later relocated to Singapore and currently is home to approximately 400 employees and the site of Caterpillar's Asia-Pacific aftermarket distribution center and remanufacturing facility. Presently, roughly 70 percent of the Caterpillar group's sales are to foreign dealers and customers.

The restructuring entailed a broad realignment of many of the Caterpillar group's various functions in foreign markets. An important objective was to facilitate CSARL's functioning as the principal in contract (toll) manufacturing arrangements. Another objective was to remove Caterpillar from the outbound PFRP supply chain in order to eliminate an unnecessary middleman between the supplier and customer and in the process to eliminate unnecessary subpart F income.

Prior to the restructuring, outbound PFRP functions were divided. Caterpillar employees located in the U.S. engaged with U.S. suppliers on design, production, and pricing matters, whereas marketing to foreign customers was carried out by CSARL employees in Switzerland or Singapore. CSARL, operating as a distributor with limited exposure to market risk, earned a relatively small gross profit (approximately four percent of sales revenue).

The restructuring added to CSARL's exposure to market risk by essentially placing it in the position previously occupied by Caterpillar—the entrepreneur between suppliers and customers. In order to take on purchasing functions previously discharged by Caterpillar, CSARL needed continuing support from Caterpillar and the right to use Caterpillar's intellectual property necessary to engage with suppliers and customers (*i.e.*, production technology and trade name). To that end, CSARL entered into a licensing agreement with Caterpillar entitling CSARL to use relevant Caterpillar intellectual property, pursuant to which CSARL pays annual royalties to Caterpillar equal to four to six percent of sales revenue. In addition, CSARL reimburses Caterpillar, at cost plus a five to seven percent mark-up, for various engineering and logistical services provided by Caterpillar personnel located in the United States involved in engaging with suppliers and storing and managing inventory in U.S.-situs warehouses. The adequacy of these royalties and fees is subject to normal audit review under the arm's length principles and rules of Section 482's transfer pricing regime. Although CSARL hired or reassigned two high-level purchasing managers located in Switzerland after the restructuring, much of the purchasing and logistical functions relating to outbound PFRP continued after the restructuring to be carried out by Caterpillar personnel located in the United States.

After the restructuring, some outbound PFRP was shipped directly from suppliers to customers or through unrelated packagers. The balance was stored, intermingled with Caterpillar's goods, in Caterpillar's U.S. warehouses. As a mutual accommodation, if CSARL's or Caterpillar's inventory ran out, the inventory control system ("ITAS") permitted the short party to use the other's inventory and later replenish it from future purchases. Also, because U.S. suppliers did not want to deal with more than one purchaser, CSARL purchased not only outbound PFRP but also goods destined for U.S. dealers and customers. In order to accomplish such inbound sales, CSARL would transfer title ("flash title") to Caterpillar at no mark-up, enabling Caterpillar to close sales to U.S. dealers and customers.

The net U.S. tax effect of the restructuring on outbound PFRP profits, taking into account royalty and service agreement payments made by CSARL to Caterpillar, was to convert some percentage, which varies year-by-year, of the profits from income subject to current U.S. income taxation (either because Caterpillar earned it or it was subpart F income to CSARL) to CSARL's income subject to deferred U.S. taxation.

Economic Substance Requirements

I understand that some members of the Subcommittee staff may be of the view that continued storage of outbound PFRP in the United States (perhaps aggravated by the inventory warehousing features discussed above), combined with continued supplier engagement and inventory warehousing being conducted by Caterpillar personnel located in the United States, means that the restructuring did not accomplish a sufficient change in economic substance to be respected for U.S. income tax purposes. The staff's view may be premised on one or both of two related judicial doctrines: the doctrine that substance prevails over form; and the economic substance doctrine. I will address both doctrines as well as relevant historical policies behind present law, concluding that the restructured outbound PFRP supply chain offends neither the case law nor the relevant underlying statutory purposes.

Substance over Form and Economic Substance in General

The various doctrines employed by courts to police what is perceived as overly aggressive tax planning are somewhat overlapping and draw common support from the bedrock notions that substance generally prevails over form where they conflict and, in addition, economically meaningless transactions devoid of business purpose other than tax avoidance are generally not respected.[2] Given the potential breadth of these principles, however, it is important to remember that many routine transactions that may superficially seem suspect, such as issuing debt instead of equity in order to obtain an interest deduction or forming a subsidiary to conduct activity instead of operating in branch form or acquiring a target company for stock in a tax-free

[2] See *Gregory v. Helvering*, 293 U.S. 465 (1935); *Knetsch v. United States*, 364 U.S. 361 (1960); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

reorganization instead of purchasing it for cash in a taxable transaction, are unquestionably above reproach in the vast majority of situations.[3]

Therefore, in order to put Caterpillar's restructuring in proper perspective, in the following pages I begin with indisputable economic substance principles established by the courts and Congress, then describe cases countenancing legitimate international tax planning, and, finally, catalog some of the transactions that courts of late have unabashedly struck down as objectionable under either the substance-over form doctrine, which holds that economic substance trumps inconsistent formalism, or the economic substance doctrine, which holds that a taxpayer must have a nontax business purpose for entering into a transaction (the "subjective" factor) and/or the transaction must exhibit economic effects other than tax savings (the "objective" factor).[4] I provide only enough detail to show the contrast between transactions condemned by courts and Caterpillar's restructuring.

Indisputable Judicial Principle Respecting Separateness of Corporation and Shareholder

Seventy years ago, in *Moline Properties*,[5] the Supreme Court, rejecting the taxpayer's argument that his wholly owned corporation was merely his *alter ego*, established that a corporation cannot be ignored if it engages in even minimal economic activity. The corporation in that case owned real property formerly owned by the shareholder and transferred to the corporation at the insistence of creditors. The corporation sold the property at a gain, which the taxpayer unsuccessfully argued was taxable to him, not the corporation.

From that point on, courts refused to ignore the separate existence of a corporation, even though tax-motivated, unless it was a sham, engaged in no economic activity, or represented itself to be merely an agent. For example, in the *Siegel* case, cited with approval by the Joint

[3] See, e.g., *Kraft Foods Co. v. Comm'r*., 232 F.2d 118 (2d Cir. 1956); Joint Comm. on Tax'n, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10 (Mar. 21, 2010), at 152-53.

[4] The recently codified economic substance doctrine, enacted in 2010, requires a taxpayer to show both a meaningful change in its economic position as a result of the transaction in question and a non-tax business purpose for it. I.R.C. § 7701(o). Pre-codification doctrine, depending on the circuit in which the case arose, sometimes required taxpayers to make both showings, sometimes only one, and sometimes fused the two prongs into one. See David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 Tax L. Rev. 29 (2006), Martin J. McMahon, *Living with the Codified Economic Substance Doctrine*, 128 Tax Notes 731 (2010); JCX-18-10, *supra* note 3, at 153-54.

[5] *Moline Properties, Inc. v. Comm'r*, 319 U.S. 436 (1943).

Committee on Taxation as beyond attack under the economic substance doctrine,[6] the Tax Court rejected the government's argument that the taxpayer's wholly owned Panamanian corporation, which entered into a farming joint venture in Cuba, where the taxpayer operated as a food broker, should be ignored for lack of economic substance simply because the arrangement deferred U.S. tax, provided the taxpayer had some non-tax reason for using the corporate form (*e.g.*, insulation from liability to creditors, protection of licenses and reputation).[7] Another oft-cited example is *Northern Indiana Public Service Company*,[8] where the Court of Appeals refused to ignore the separate existence of a U.S. parent corporation's Netherlands-Antilles subsidiary, which had borrowed funds in the Eurobond market and on-loaned them at a slightly greater rate of interest to the parent company. The subsidiary's retention of the interest rate spread and the need to employ such a structure in order to reduce borrowing costs (by not having to pay increased interest to cover the U.S. withholding tax that would have been due had the parent borrowed directly from the Eurobond market) was enough business justification to fend off an economic substance challenge.

Legislative History

Congress has been equally respectful of the separateness of corporation and shareholder. When subpart F was enacted in 1962, with the approach that only certain types of income ("subpart F income") earned by a controlled foreign corporation would be currently taxable to its U.S. shareholders, it was obvious that other kinds of income could not also be rendered currently taxable through the expedient of simply ignoring the separate existence of the controlled foreign corporation on substance-over-form or related grounds. Legislative history of the codification of the economic substance doctrine in 2010 restates this reality unambiguously:

> "The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are . . . a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment . . . and . . . the choice to

[6] See JCX-18-10, *supra* note 3, at 153.
[7] *Siegel v. Comm'r*, 45 T.C. 566 (1966).
[8] *Northern Indiana Public Service Co. v. Comm'r*, 115 F.3d 506 (7th Cir. 1997).

> utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied."[9]

Also noteworthy is Congress's decision not to trigger taxation under subpart F merely because a controlled foreign corporation holds goods in the United States that are destined for export.[10] This exception to the definition of "United States property" in Section 956, which dates back to the initial enactment in 1962, was justified by Congress as follows:

> "Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them. The exceptions . . . , however, are believed to be normal commercial transactions without intention to permit the funds to remain in the United States indefinitely . . ."[11]

Taxpayer Victories in International Tax Planning Cases

Consistent with the foregoing principles, taxpayers have prevailed in cases exhibiting considerable international tax planning.

Relocation of Business Offshore

The most germane of these cases involved United Parcel Service's transfer of its package insurance business to a foreign affiliate. UPS, which had previously conducted the business itself, moved the business (and resulting profit) to its Bermuda sister corporation (which it had formed and spun off to shareholders) by engaging an independent insurance company to accept the insurance risk, in exchange for premiums collected by UPS from customers, followed by a reinsurance agreement between the insurer and the Bermuda sister that passed the premiums and risk on to the Bermuda sister (less a fee for the insurer). The government challenged the arrangement on economic substance grounds, complaining that nothing in substance had changed (UPS continued to administer customer claims) except that UPS's profits were now earned by the Bermuda sister. The court disagreed, finding that the restructuring of an existing, bona fide business with involvement of an independent third-party insurer satisfied the economic substance doctrine, notwithstanding the tax avoidance motive.[12]

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[9] JCX-18-10, *supra* note 2, at 152-53.
[10] See I.R.C. § 956(c)(2)(B).
[11] Sen. Rep. No. 1881, 87th Cong., 2d Sess., at 794.
[12] *United Parcel Service of America, Inc. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001).

Of all the cases mentioned in this report, the one closest to the Caterpillar restructuring is *UPS*. Like the Caterpillar restructuring, it involved dealings between the taxpayer and independent parties (the insurer in *UPS* and unrelated suppliers and customers in this case), and it was a restructuring of an existing, mature business, as opposed to a one-time adventure into unfamiliar terrain motivated exclusively by a desire to generate tax benefits in order to shelter tax on unrelated income.

Hybrid Financing Arrangements

Two recent cases illustrate the degree of international planning permitted under the substance-versus-form doctrine, each involving cross-border tax arbitrage (inconsistent classification by two countries of either an entity or a financial instrument, resulting to some degree in income being taxed in neither country). In the first, a formal debt instrument issued by a domestic reverse hybrid entity (a corporation for U.S. tax purposes), which, if respected, would have resulted in a U.S. interest deduction but little or no taxation in the U.K. due to the issuer's status as a partnership for U.K. purposes, was indeed respected as debt, contrary to the government's argument.[13] In the second, a hybrid instrument issued by a Dutch subsidiary to its U.S. parent was treated as equity for U.S. purposes, notwithstanding that it was treated as debt for Dutch purposes, resulting in an interest deduction in the Netherlands but asymmetrical tax treatment in the United States (*e.g.*, return of stock basis or dividend sheltered by foreign tax credits).[14]

Government Victories in Economic Substance and Substance-Over-Form Cases

In contrast to instances of tax planning sanctioned by the courts and Congress, transactions too heavily freighted with tax-avoidance have been stuck down. These cases demonstrate that, wherever the line drawn by the substance-over-form and economic substance doctrines may be, the Caterpillar restructuring falls easily on the safe side.

SILO/LILO Transactions

Sale-in-lease-out ("SILO) and lease-in-lease-out ("LILO") transactions typically involve a lease (head lease) of a public or quasi-public facility (*e.g.*, a municipal railroad or sewage system or hydroelectric plant) by a U.S. taxpayer from a tax-indifferent user (*e.g.*, a foreign or

[13] *NA General Partnership v. Comm'r*, T.C. Memo. 2012-172.
[14] *PepsiCo Puerto Rico v. Comm'r*, T.C. Memo. 2012-269.

U.S. municipality) that historically operated the facility, followed by a lease of the facility back (sublease) to the user for continued operation, but for a term shorter than the head lease. Upon expiration of the sublease, the user is generally economically compelled, though not for absolute certain, to exercise an option to reacquire the facility from the taxpayer. The taxpayer has no business interest or acumen in the facility and plays no role in its operation. Rent on the head lease is prepaid, funded approximately one fifth by the taxpayer's equity and four fifths by nonrecourse financing taken out by the taxpayer. Aside from a fee retained by the user to enter into the transaction, the prepaid rent is set aside in special-purpose ("defeasance") accounts dedicated, via rental payments on the sublease, to servicing the taxpayer's nonrecourse financing and to fund the repurchase option, meaning that the taxpayer's equity (net of the user's fee) is returned, the loan is repaid, and ownership of the facility reverts to the user. Because rent on the head lease is prepaid, giving rise (prior to certain changes in the Code) to an immediate deduction for rent (LILO) or a depreciation stream (SILO), there is a timing advantage due to the relatively deferred inclusions of rental income (net of interest deductions on the loan) from the sublease. As an economic matter, the tax benefit from this deferral is offset by the user's fee and transaction expenses.

Courts have consistently denied the tax benefits of SILOs and LILOs on substance-over-form grounds, more particularly that the taxpayer did not acquire the economic benefits and burdens of ownership, and in some cases for lack of economic substance as well.[15]

The chasm separating Caterpillar's restructuring from SILO/LILO transactions is obvious. Outbound PFRP is central to Caterpillar's business, there was no use of an indifferent financier to accommodate the restructuring, and the restructuring made permanent economic changes in the relationships among Caterpillar affiliates.

Foreign Tax Credit Generators

"Foreign tax generators" come in many varieties and can be exceedingly complicated.[16] Although there are variations, most generators are duplicate-benefit financing transactions in

[15] *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008); *Altria Group, Inc. v. United States*, 658 F.3d 276 (2d Cir. 2011); *Wells Fargo & Co. v. United States*, 641 F.3d 1319 (Fed. Cir. 2011); *Consol. Edison Co. of N.Y., Inc. & Subs. v. United States*, 703 F.3d 1367 (Fed. Cir. 2013); *AWG Leasing Trust v. United States*, 592 F. Supp.2d 953 (N.D. Ohio 2008); *John Hancock Life Insurance Co. (USA) v. Comm'r*, 141 T.C. No. 1 (Aug. 5, 2013).

[16] Yaron Z. Reich, *International Arbitrage Transactions Involving Creditable Taxes*, 85 Taxes 53 (2007); Gregory May, *Getting Realistic About International Tax Arbitrage*, 85 Taxes 37 (2007).

which a U.S. corporation, usually a financial institution (acting either as borrower or lender), holds a security issued by a foreign special purpose entity ("SPV") through which the loan proceeds pass and which incurs foreign tax on profits from investment of the loan proceeds (usually a loan to an affiliate of the SPV). Securities issued by the SPV are also owned by a foreign counterparty to the deal, and, with the help of inconsistent classification or ownership of the securities by the United States and the foreign counterparty's home country, the tax incurred by the SPV is effectively reversed (where the counterparty is the borrower) or is a substitute for tax that the counterparty would have incurred in a straightforward loan (where it is the lender). That being the case, the counterparty is willing to bear, through the pricing of the securities and various associated deals (*e.g.*, interest rate and currency swaps), most of the economic burden of the tax incurred by the SPV. The U.S. corporation obtains a credit for avoidable tax economically borne by the counterparty. In these transactions, it can be demonstrated, by comparison to a straightforward loan, how the U.S. corporation and foreign counterparty (and usually the counterparty's home country) all benefit at the expense of the U.S. treasury. In result, foreign tax generators are open to attack as a tax shelter in the sense that two parties trade disparate tax positions for their mutual after-tax benefit at the expense of the fisc with virtually no risk.

Regulations invalidating credits for taxes incurred in generator transactions were issued in temporary form in 2008 and finalized in 2011.[17] The government challenged deals pre-dating the regulations in court on several grounds, including substance-over-form and economic substance. Several cases have been decided, all but one in favor of the government, mostly on economic substance grounds.[18]

Similar to the comparison with SILO/LILO transactions, the differences between generator transactions and the Caterpillar restructuring are stark. Nothing in the restructuring smacks of a U.S. taxpayer contracting with a tax-indifferent foreign counterparty to their mutual

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[17] T.D. 9416, 2008-2 C.B. 1142; Treas. Reg. § 1.901-2(e)(5)(iv).

[18] *Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011) (economic substance and partnership anti-abuse grounds); *Hewlett-Packard Co. v. Comm'r*, 103 T.C.M. (CCH) 1736 (2012) (debt-equity grounds, finding that HP's investment in Dutch SPV was debt, destroying its claim to indirect credits); *Bank of New York Mellon Corp. v. Comm'r*, 140 T.C. No. 2 (2013) (economic substance grounds); *Salem Financial, Inc. v. United States*, 112 Fed. Cl. 543 (2013) (economic substance grounds); *American Int'l Group, Inc. v. United States*, 2013-1 USTC ¶ 50,255 (S.D. NY 2013) (rejected taxpayer's motion for summary judgment on economic substance grounds). But see *Santander Holdings USA, Inc. v. United States*, 2013-2 USTC ¶ 50,564 (D. Mass. 2013) (granting taxpayer's motion for summary judgment on profit element of economic substance).

advantage to deprive the United States of revenue it would have earned in a straightforward substitute transaction.

Structured Partnership Financings

Subject to the requirement that partnership allocations must have substantial economic effect (Section 704(b)), partnerships offer the potential for taxable partners to deflect income to tax-indifferent partners and, conversely, for tax-indifferent partners to transfer tax benefits to taxable partners. In structured partnership financing transactions, as a general proposition, the accommodating partner earns a debt-like return on its contribution to the partnership with very little economic risk or upside potential beyond a fixed return. The return is somewhat above market where the accommodating partner is tax-indifferent and absorbs income deflected by the taxable partner and somewhat below market where the accommodating partner is allocated a valuable tax benefit deflected by a tax-indifferent partner.

The first wave of these transactions invalidated by the courts on economic substance grounds involved partnerships of U.S. and foreign parties (often banks) where the partnership purchased and sold securities with little economic gain or loss and employed peculiar basis recovery rules (under the installment method of accounting) to allocate gain to tax-indifferent foreign partners followed by an offsetting allocation of loss to taxable partners.[19]

Next came a series of two lower court decisions in favor of General Electric and two reversals by the Court of Appeals involving a partnership among GE and foreign banks.[20] GE contributed low-basis airplanes to the partnership, and allocations to the banks of rental income from the planes and largely offsetting amounts of book depreciation had the effect of temporarily shifting gain inherent in the airplanes from GE to the foreign banks. The two appellate decisions, sounding a blend of substance-over-form and economic substance criteria, rested on the finding that the lower court erred in rejecting the government's claim that the foreign banks were not bona fide equity partners.

A recent case in which a Dow Chemical Company affiliate formed a partnership with foreign banks reveals a similar pattern.[21] Dow contributed low-basis patents and operating

[19] See, e.g., *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998). Several subsequent cases with similar facts were also won by the government.
[20] *TIFD III-E, Inc. v. United States*, 342 F.Supp.2d 94 (D. Conn. 2004); *rev'd and rem'd*, 459 F.3d 220 (2d Cir. 2006); 660 F.Supp.2d 367 (D. Conn. 2009); *rev'd*, 666 F.3d 836 (2d Cir. 2012).
[21] *Chemtech Royalty Associates, L.P. v. United States*, 2013-1 U.S.T.C. ¶50,204 (M.D. La. 2013).

facilities to the partnership and paid royalties and rents to the partnership in order to retain use of the assets. Dow deducted the royalty and rent payments, but partnership royalty income from the patents was disproportionately allocated to the banks and partnership rental income from the facilities allocated to Dow was sheltered by a special partnership basis adjustment (under Section 734(b)). Finding that the transaction had no purpose other than tax avoidance, the court invalidated the arrangement on economic substance grounds and on the finding that the banks were not bona fide equity partners. Finally, a partnership between an arm of the State of New Jersey and Pitney Bowes, where Pitney Bowes earned a low, relatively fixed return on its contribution to the partnership but was allocated virtually all of the partnership's historic rehabilitation credits, was invalidated on the ground that Pitney Bowes was not a bona fide equity partner.[22]

The gulf between the Caterpillar restructuring and the foregoing structured partnership financing arrangements resembles the differences noted above regarding SILO/LILO transactions and foreign tax credit generators. Here too, the Caterpillar restructuring exhibits none of the fatal features condemned by the courts.

Repatriation Strategies

Strategies to repatriate earnings and profits from controlled foreign corporations without imposition of residual U.S. tax failed in two recent cases. In the first, Schering-Plough entered into an interest rate swap and sold the receivables leg of the swap to its foreign subsidiary in exchange for a lump sum payment, which would effectively be repaid to the subsidiary as Schering-Plough made payments on the pay leg of the swap to its counterparty (a foreign bank), which in turn would make payments on the receivables leg to the foreign subsidiary. Had the foreign subsidiary simply loaned funds to Schering-Plough, Schering-Plough would have been taxable under Section 956 (investments in U.S. property by a controlled foreign corporation), which the structure was designed to avoid. The lower court treated the transaction as a loan by the subsidiary to Schering-Plough on substance-over-form grounds and also held that the

[22] *Historic Boardwalk Hall, LLC v. Comm'r*, 694 F.3d 425 (3d Cir. 2012), *rev'g*, 136 T.C. 1 (2011), *cert. denied*, 186 L.Ed.2d 192 (2013).

transaction violated the economic substance doctrine. The Court of Appeals affirmed only on substance-over-form grounds.[23]

In the second case, one controlled foreign corporation (*A*) transferred cash to an affiliated, newly formed controlled foreign corporation (*B*) in exchange for stock of the transferee (*B*), and the transferee (*B*) then transferred the cash and its own stock to a newly formed U.S. sister corporation (*C*) in exchange for the sister's stock. The sister (*C*) then loaned the funds to the U.S. parent company (*D*). The taxpayer took the position, based on a revenue ruling, that *B*'s basis in the *C* stock was zero and, therefore, *B* had not made a taxable investment in U.S. property under Section 956. The court, employing substance-over-form criteria, concluded that transferring the cash from *A* to *D* through *B* and *C* had no business purpose and, consequently, characterized the series of transactions as a dividend from *A* to *D*.[24]

These attempts at tax-free repatriations were recharacterized because, as the courts assessed the transactions, they employed complicated arrangements to accomplish through a multitude of steps the simple (and taxable) act of paying dividends to the U.S. parent companies. There is no such use of numerous transactions in substitution of a simpler, single transaction in the Caterpillar restructuring. Indeed, the restructuring simplified Caterpillar's business by removing a redundant middleman.

Application of Principles to Caterpillar Restructuring

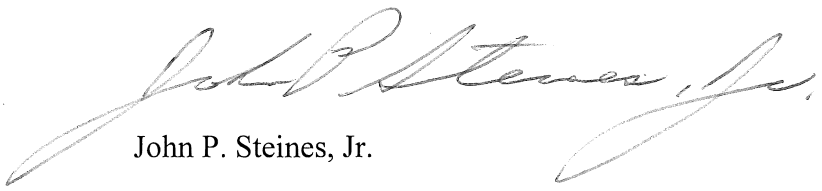
Legislative history of the codification of the economic substance doctrine makes clear that the decision to remove Caterpillar from the outbound PFRP supply chain did not violate the economic substance doctrine. And case law interpreting the substance-over-form and economic substance doctrines reveals that they are primarily reserved for highly engineered transactions, frequently unrelated to the taxpayer's core business and involving tax-indifferent parties with no stake in the outcome other than a fixed return, that Congress would not have countenanced as consistent with the purpose of the statutes it enacted—in other words, transactions that most impartial tax professionals would concede are tax shelters.

[23] *Schering-Plough Corp. v. United States*, 651 F.Supp. 219 (D. N.J. 2009), *aff'd sub. nom., Merck & Co., Inc. v. United States*, 652 F.3d 475 (3d Cir. 2011).
[24] *Barnes Group, Inc. v. Comm'r*, T.C. Memo 2013-109.

Caterpillar's restructuring is of an entirely different realm—a sensible business decision to remove a redundant middleman between supplier and customer, fully within the text and spirit of subpart F, notwithstanding that it deferred some U.S. tax. The inventory accommodation and flash title features of Caterpillar's inventory control system are pragmatic business solutions to normal business problems and do not approach what would raise a problem under the case law digested above.

In my professional judgment, it is extremely unlikely that a court adjudicating with fidelity to the law presented in this report would find that the restructuring or the countless ensuing outbound PFRP transactions offend the doctrines of substance over form or economic substance.

Respectfully submitted,



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Leiden University, International Tax Center, LL.M. program—teaching course in international aspects of U.S. tax law (May 2012).

NYU/KPMG Lecture Series, Outbound Transfers of Intangibles (April 2012).

International Fiscal Association (New York), International Tax Reform (December 2011).

Vienna University of Economics and Business Administration, Postgraduate International Tax Law—teaching course in international aspects of U.S. tax law (December 2011).

NYU/IRS CLE Program, Foreign Tax Credit (Winter, 2011).

NYU/IRS CLE Program, Dual Consolidated Loss and Foreign Currency Issues (Spring, 2010).

NYU/IRS CLE Program, Cross-Border Acquisitions and Reorganizations (Winter, 2010).

NYU/IRS CLE Program, Foreign Tax Credit and Subpart F (Fall, 2009).

Vienna University of Economics and Business Administration, Postgraduate International Tax Law—teaching course in international aspects of U.S. tax law (February 2009).

NYU/Univ. Conn. EC Tax Policy Conference, European Tax Policy in a Global Context (Spring 2008).

NYU/IRS CLE Program, Cross-Border Reorganizations and Foreign Currency Issues (Spring, 2008).

NYU/IRS CLE Program, Foreign Tax Credit and Subpart F (Fall, 2007).

NYU/IRS CLE Program, Taxation of Inbound Transactions (Fall, 2006).

NYU Wallace-Lyon Graduate Tax Workshop, International Tax Developments (May, 2006).

1st Annual NYU/IBA International Tax Law Conference, President's Advisory Panel on Federal Tax Reform (December, 2005).

NYU National Tax Workshop, International Taxation (February, 2005)

ABA/IBA Second International Tax Institute, Optimizing Tax, Financial Accounting, and Cash Management in Multinational Operations (June 2004).

NYU National Tax Workshop, International Taxation (February, 2004)

NYU Seminar for Government, Foreign Tax Credit Reform (February, 2003).

KPMG/NYU Panel Discussion on Electronic Commerce (October, 2000).

NYU Graduate Tax Workshop, International Transactions (February, 2000).

NYU/Tax Analysts Seminar for Government, Deferral and Subpart F (February, 2000).

NYU/IRS CLE Program, Selected Issues in the Substantive Law and Federal Income Tax Treatment of Intangible Property (Autumn, 1999).

Deloitte Touche & Tohmatsu Training Conference on Outbound Mergers, Acquisitions, and Restructurings (July, 1998).

NYU/IRS CLE Program, International Joint Ventures (Autumn, 1997).

State Bar of Michigan, Taxation Section, Summer Tax Conference: Replicating a Corporation Through a Partnership; Cross-Border Transactions After NAFTA (June, 1995).

Tax Law Review, Colloquium on NAFTA and Taxation (September, 1994).

NYU/IRS CLE Program, Seminar on International Joint Ventures (Fall, 1993).

NYU/IRS CLE Program, Partnership Taxation (Spring, 1992).

Tax Law Review, Colloquium on Partnership Taxation (June, 1991).

NYU Graduate Tax Workshop, Restructuring Insolvent Corporations (June, 1991).

NYU Inst. on Fed Tax'n, Partnerships and S Corporations -- Workouts and Bankruptcy (July, 1990).

NYU Graduate Tax Workshop, Restructuring Insolvent Corporations (May, 1990).

NYU Inst. on Fed Tax'n, Corporate Acquisitions (April, 1990).

NYU Seminar for Government, Asset Tracing (March, 1990).

Corporate Tax Planning for Today (NYU) (San Francisco), Restructuring Insolvent Corporations (October, 1989).

NYU Graduate Tax Workshop, Restructuring Insolvent Corporations (June, 1989).

NYU/IRS CLE Program, Partnership Taxation (Summer, 1988).

NYU Graduate Tax Workshop, Partnership Taxation -- Passive Loss and Investment Interest Limitations (June, 1988).

NYU Graduate Tax Workshop, Partnership Taxation -- Debt and Risk-Sharing Issues (August, 1986).

NYU/IRS CLE Program, Seminar on Partnership Taxation Issues (June, 1986).

NYU Graduate Tax Workshop (San Francisco), Partnership Allocations Attributable to Contributed Property (October, 1985).

NYU Graduate Tax Workshop, Partnership Allocations Attributable to Contributed Property (August, 1985).

Advanced Tax Techniques in Real Estate Transactions (NYU), Partnership and Corporate Strategies (May, 1985).

NYU Graduate Tax Workshop (San Francisco), Partnership Taxation Issues (February, 1985).

NYU Graduate Tax Workshop, Partnership Taxation After the Tax Reform Act of 1984 August, 1984).

Advanced Tax Techniques in Real Estate Transactions (NYU), Corporate Entities -- Problems and Pitfalls (June, 1984).

NYU Graduate Tax Workshop, Changes in the Treatment of Corporate Distributions (August, 1983).

NYU Graduate Tax Workshop, Tax Shelter Problems (August, 1982).

NYU Seminar for Government, Marital Breakups -- Legislative Proposals (May, 1982).

Practising Law Institute, Organization of the Corporation and Tax Benefits of Doing Business as a Corporation (April, 1982).

NYU Graduate Tax Workshop, Tax Planning in Divorce and Separation (August, 1981).

NYU Graduate Tax Workshop, Debt versus Equity Characterization (August, 1980).

NYU Graduate Tax Workshop, Corporate Liquidations (August, 1979).