2020

Whistleblowing and Caterpillar Inc.'s Swiss Tax Strategy

Amy Lysak
Rowan University, lysak@rowan.edu

Richard Marmon
Rowan University, marmon@rowan.edu

Edward J. Schoen
Rowan University, schoen@rowan.edu

Recommended Citation

Amy Lysak, Richard Marmon, and Edward J. Schoen, "Whistleblowing and Caterpillar Inc.'s Swiss Tax Strategy," Journal of Business Ethics Education, Vol. 17, 2020, p. 237-250.

Journal of Business Ethics Education 17.
© 2020 NeilsonJournals Publishing. *GALLEY PROOF*

Whistleblowing and Caterpillar Inc.'s Swiss Tax Strategy

Amy Lysak, Richard Marmon, and Edward J. Schoen
Rohrer College of Business, Rowan University, USA

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

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

1. Introduction

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

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

2. Implementation of Caterpillar's Swiss Tax Strategy

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

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

and enabling Caterpillar to defer paying U.S. taxes on that income by keeping it offshore[2] (Subcommittee on Investigations Report 2014, p. 43).

Prior to the implementation of its Swiss tax strategy, Caterpillar purchased its replacement parts from third party manufacturers, many of whom were located in the U.S. in close proximity to Caterpillar, and then sold the parts to its foreign marketers, which in turn sold them to Caterpillar's independent dealers. Profits from those sales were included in Caterpillar's income and were taxable in the U.S. (Subcommittee on Investigations Report 2014, p. 47). Likewise, profits earned by Caterpillar's foreign marketers were also taxable in the U.S. as foreign base company sales income under Subpart F[3] whether it was repatriated to the U.S. or not (Subcommittee on Investigations Report 2014, p. 13). More particularly, if Caterpillar's foreign marketers, which sit in a tax haven, purchase the replacement parts from Caterpillar and then sell the goods in a third jurisdiction and retain the income resulting from the transaction, that income is nonetheless attributable to Caterpillar's U.S. operations under Subpart F (Subcommittee on Investigations Report 2014, pp. 13-14).

To implement the tax strategy, Caterpillar consolidated its leading Swiss affiliate, Caterpillar Overseas, S.A. (COSA), which acted as Caterpillar's lead marketing company for the Europe, Africa and Middle East (EAME) region, and several of its other Swiss affiliates, into a renamed Swiss entity, Caterpillar SARL (CSARL). CSARL is treated as a limited liability *corporation* for Swiss tax purposes, but as a limited liability *partnership* for U.S. tax purposes (Subcommittee on Investigations Report 2014; pp. 37-38, 48). CSARL created a new position for a Switzerland-based "Worldwide Parts Manager" that was charged with establishing an overall parts strategy in consultation with Caterpillar's Executive Office and acting as a liaison among Caterpillar's business units involved with parts management (Subcommittee on Investigations Report 2014, p. 39-40). While CSARL continues to perform the same marketing functions as COSA, including supporting Caterpillar's non-U.S. dealer network with respect to parts in the EAME region, CSARL was designated Caterpillar's "global purchaser" of PFRP. Through a series of licensing agreements, Caterpillar's highly profitable replacement part sales business was effectively transferred to CSARL for which they agreed to pay either a 4%or 6% royalty to Caterpillar. CSARL also agreed to pay Caterpillar's costs plus a 5% markup for

2. Notably, the Tax Cuts and Jobs Act of 2017 (TCJA) made sweeping changes to the international tax rules by shifting the U.S. tax system to a more territorial structure in an effort to align it with most other industrialized nations, whereby countries impose taxes only on income earned within their borders without regard to a taxpayer's residence status. Some of the provisions that have mitigated the advantages of Caterpillar's Swiss tax strategy include lower overall corporate rates, the mandatory transition tax on accumulated foreign earnings, the newly enacted participation exemption deduction and changes made to the foreign tax credit among others.
3. Subpart F was enacted in 1962 to deter U.S. taxpayers from using controlled foreign subsidiaries located in tax havens to accumulate earnings that should have been accumulated and taxed in the U.S.

maintaining the core functions of Caterpillar's worldwide replacement part operations, including managing the worldwide parts inventory, supervising suppliers, storing CSARL-owned parts in the U.S., supervising parts logistics, and forecasting parts demand, all of which CSARL was unable to perform (Subcommittee on Investigations Report 2014, pp. 38-39, 52-54). In addition, CSARL entered into "tolling agreements" with Caterpillar's principal European manufacturers in France and Belgium. These agreements shifted approximately 7% of French and Belgian affiliates' profits to Switzerland through a cost plus arrangement (Subcommittee on Investigations Report 2014, p. 51). The bottom line from these agreements was that Caterpillar was able to allocate 85% or more of the non-U.S. replacement parts profits to CSARL, instead of the 15% or less previously allocated to CSARL's predecessor, COSA (Subcommittee on Investigations Report 2014, p. 52).

Even though a substantial amount of replacement parts sales was transferred to CSARL, the number of employees working for CSARL was modest. As of 2012, Caterpillar indicated there were 8,300 employees worldwide associated to its overall "purchase, storage, movement, and sales of replacement parts." Of the 8,300 employees, 66 were located in Switzerland. Of the 66 Swiss employees, only 10 were involved with "parts pricing" and 56 employees worked for its EAME division (Subcommittee on Investigations Report 2014, p. 40).

Over the next thirteen years, the Swiss tax strategy permitted Caterpillar to shift billions in sales outside the United States and defer or avoid paying billions in federal income taxes (Subcommittee on Investigations Report 2014, p. 2; Gruley *et al.* 2017). These tax savings dwarfed the $55 million fee Caterpillar paid PwC to develop and implement the tax strategy (Subcommittee on Investigations Report 2014; p. 2, 4, 6, 46).

3. Caterpillar's Swiss Tax Strategy and Genuine Economic Substance

Taxpayers are permitted to structure their business transactions to reduce or avoid taxation; however, those efforts will be unsuccessful if the transactions lack "economic substance." This requirement stems from the United States Supreme Court decision in *Gregory v. Helvering*,[4] in which a woman who owned one company, transferred its stock to a newly created, second company, and received in return shares in the second company. Three days later she dissolved the second company, took back the shares in the first company and sold them. She claimed her tax-free corporate reorganizations increased the cost of the first company shares thereby reducing her taxable gain. The Supreme Court decided that her transactions lacked any economic substance other than tax avoidance and ruled in favor of the IRS.[5] In 2010, the economic substance doctrine was codified in 26

4. *Gregory v. Helvering*, 293 U.S. 465 (1935).
5. Ibid.

U.S.C. § 7701(o), which establishes a two-part test to determine whether a transaction has economic substance: (1) the transaction must alter the taxpayers' economic position in a meaningful way, and (2) the transaction must have a substantial non-tax purpose.

Although Caterpillar's Swiss tax strategy changed their economic position in a meaningful way, whether there was a substantial non-tax purpose in implementing that strategy requires the consideration of several issues: (1) whether the terms of the transfer pricing agreements between Caterpillar and CSARL are the equivalent to terms parties would agree to in an arms-length transaction, (2) whether Caterpillar received sufficient compensation for its transfer of its replacement parts business to CSARL and replaced an 85/15% profit split with a 15/85% profit split on sales of non-U.S. parts, (3) whether severing the high-profit-margin replacement parts business from the low-profit-margin sales of Caterpillar equipment is an equitable distribution of profits, (4) whether Caterpillar is adequately compensated for continuing to perform key functions (parts design, parts forecasting, inventory management, supplier oversight, quality control, and parts pricing, storage and delivery) supporting the replacement parts sales business, and (5) whether the virtual inventory system establishes CSARL partnership activity on U.S. soil, triggering taxation of replacement part sales profits in the U.S. (Subcommittee on Investigations Report 2014, pp. 80-86).

According to the Permanent Subcommittee on Investigations, the quick answers to these questions are as follows: (1) it is highly doubtful parties in an arms-length transaction would transfer a highly profitable replacement parts business producing 85% of its profits without receiving some compensation for the decades Caterpillar devoted to developing its replacement part business; (2) Caterpillar received no compensation for its dramatic and lopsided switch in the profit split between Caterpillar and CSARL and no compensation for the millions of Caterpillar machines in the field that continually need replacement parts; (3) Caterpillar received no compensation for severing the highly profitable replacement parts business that produced a years-long income stream from the machine sales business and transferring it to CSARL while remaining responsible for the design, manufacture and sales of Caterpillar machines; (4) the cost plus a 5% markup produced only limited income to Caterpillar in return for its obligation to maintain normal operations in support of the parts sales business and to bear the ultimate economic risk for the replacement parts business; and (5) the virtual inventory system permits the commingling of parts without any regard to ownership, accommodates flash titling, and allows intercompany borrowing and assigning of parts ownership after sales are made, and demonstrates that Caterpillar and CSARL have a common inventory pool managed by both parties for their mutual benefit, suggesting the existence of a de facto U.S. partnership between Caterpillar and CSARL (Subcommittee on Investigations Report 2014; p. 2, 4, 6, 46).

4. Schlicksup's Early Career with Caterpillar

Shortly after joining Caterpillar's tax department, Schlicksup was assigned to Brussels and Geneva from 1996 to 2005 to give him greater exposure to international tax law and to establish its first overseas tax department. In 2005, Schlicksup returned to the United States to take the position of global tax strategy manager and was charged with assisting tax risk management and improving the company's global tax practices (Subcommittee on Investigations Report 2014, p. 64). He lived with his wife and two sons in a three-bedroom home on 17 wooded acres in Dunlap, near Peoria. He reported to Beran, who in turn reported to the then CFO, David Burritt, and developed a reputation for competently handling complex projects with aplomb and earned strong and complimentary job performance reviews. He also displayed a somewhat prickly personality, sending detailed, badgering e-mails to colleagues complaining about a variety of accounting and earnings issues both before and after meetings (Gruley *et al.* 2017).

Shortly after his appointment to his new position, Schlicksup developed a "Tax Risk Guard Rails" (TRGR) risk management tool to evaluate Caterpillar's tax position. TRGR assessed a variety of factors: technical, operational, compliance, financial statement, management, and reputational. These factors, in turn, were broken down into 19 "indicative criteria," such as industry practice, magnitude of cash impact, legal advice, and impact on financial statements. Each of the 19 criteria was scored using a rating system of 1 to 5, with 5 being the highest risk (Subcommittee on Investigations Report 2014, pp. 64-65). Once specific tax positions were evaluated and scored, they were plotted on a graph showing whether the risk was high, medium or low, and presented to company executives (Subcommittee on Investigations Report 2014, p. 65). In 2006, when TRGR was applied to the Swiss tax strategy, two areas were singled out as possessing high risk: the bundled royalty rate CSARL paid to Caterpillar and the virtual inventory system which transposed Caterpillar's parts sales into CSARL's parts sales (Subcommittee on Investigations Report 2014, p. 66). Caterpillar continued to employ the TRGR tax position rating system through 2008 and reviewed the risk ratings twice each year. The risk assigned to the Swiss tax strategy remained high throughout those years (Subcommittee on Investigations Report 2014, p. 68). That Caterpillar recognized the high risk of its Swiss tax strategy is also confirmed by its setting aside a substantial "tax reserve" equal to half of CSARL's profits should the IRS challenge the Swiss tax strategy.[6]

---

6. GAAP requires companies to account for and disclose uncertain tax positions. An uncertain tax positions is a tax position taken by a company that may or may not be sustainable upon reviewed by a taxing authority. The accounting standards require that any positions that are not "more-likely-than-not" defendable against federal, state or local tax review be estimated and accounted for as a liability in the financial statements.

5. Schlicksup's Internal Complaints about the Swiss Tax Strategy

In 2006, Beran assigned Schlicksup to work with companies lobbying Congress about the "economic substance" requirement. His research convinced him that Caterpillar and CSARL's agreement violated the requirement. Although Schlicksup was not involved in setting up the Swiss tax strategy, he made his misgivings about the strategy known to Beran, Burritt and other Caterpillar executives in a series of e-mail messages. Beran and Burritt asked Schlicksup not to debate the economic substance issue via e-mail and informed him no change would be made to the CSARL arrangement. Changes began to appear, however, in Schlicksup's performance evaluation which contained negative comments on his 2007 review, causing Schlicksup to fear losing his job (Gruley *et al.* 2017).

During the Spring 2008 meeting of Caterpillar finance executives at the Peoria Civic Center, a few blocks from Caterpillar's headquarters, Eugene Fife, the chair of the audit committee, reminded those present that they were the stewards of Caterpillar's reputation, noted that the actions of only one or two "wayward stewards" could bring disaster to a company as colossal as Caterpillar, and urged anyone aware of financial misstatements to report them immediately. CEO Jim Owens underscored Fife's comments by stating he "slept well," because it was unimaginable to him that the financial improprieties discovered in the Enron scandal could occur at Caterpillar. These comments caused Schlicksup to believe his "economic substance" warnings had not been passed on to the CEO. Schlicksup returned to his office and sent an e-mail to two group presidents (with the subject line "Ethics issues important to you, the Board and Cat Shareholders") in which he referred to his misgivings about the tax strategy, described the methodical campaign to mute his concerns, and complained he was the victim of retaliation by his superiors. The next morning, Schlicksup sent 137 pages of additional documents to the two group presidents explaining how Caterpillar and PwC shifted billions in sales to Switzerland to avoid paying U.S. taxes (Gruley *et al.* 2017).

6. Schlicksup Blows the Whistle

While Schlicksup's e-mail failed to change Caterpillar's tax strategy, it torpedoed his career. Four months later, John Heller, Caterpillar's Chief Information Office, and Alice Barbour, a human resources manager, advised Schlicksup that his position had been eliminated, and he would be transferred to the information technology division. When his objections to the transfer failed, Schlicksup reluctantly accepted the new position (and the 7% increase in salary that came with it). Four months later he filed an IRS whistleblower complaint accusing Caterpillar of tax fraud, and in June 2009, he filed a retaliation lawsuit in federal district court in Peoria against Caterpillar. Schlicksup remained at Caterpillar as he pursued his retaliation claim, taking unpaid leave for depositions, becoming increasingly miserable as his professional career crumbled, and receiving treatment for stress from three physicians and a physical therapist. Schlicksup's retaliation claim survived Caterpillar's first motion to dismiss, and, while the second motion to dismiss was pending, he and Caterpillar reached a settlement, the terms of which were not disclosed (Gruley *et al.* 2017).

Schlicksup continued to work with the IRS on his whistleblower claim. Armed with extensive documentation provided by Schlicksup, the IRS in December 2013 accused Caterpillar of concocting an abusive tax strategy and understating its U.S. income by more than $3 billion during the period 2007 through 2009 (Gruley *et al.* 2017). Hearings by the Permanent Subcommittee on Investigations followed. In a 2011 deposition, Schlicksup defended his whistleblowing activity by claiming that "[i]t is absolutely in the shareholder's best interests to have the most accurate financial statements they can have," and, echoing CEO Jim Owens, said "I don't think that the shareholders of Enron would think it would have been such a bad deal if somebody would have caught that before it bankrupted the company and they lost everything they had" (Gruley *et al.* 2017).

7. Retaliation Protection of IRS Whistleblowers

In 2006, when Congress overhauled the IRS whistleblower program, the U.S. Treasury Inspector General for Tax Administration recommended that Congress include anti-retaliation protection for IRS whistleblowers, but Congress declined to do so. Hence the IRS whistleblowing program provides little retaliation protection to IRS whistleblowers other than a weak commitment by the IRS to keep the identity of the whistleblower confidential. The only way IRS whistleblowers can get protection against retaliation is to combine their IRS whistleblowing complaint with another whistleblowing program that provides protection against whistleblowing, such as the Sarbanes-Oxley Act, 18 U.S.C. § 1514A, The False Claims Act, 31 U.S.C. § 3730(h), or the Fair Labor Standards Act, 29 U.S.C. § 215(a)(3). Hence IRS whistleblowers can be protected when there is an overlap between the IRS whistleblower disclosure and, for example, misstated financial records or shortcomings in internal controls (Sarbanes-Oxley), or health care fraud or medical kickbacks for Medicare or Medicaid referrals (False Claims Act), or failure to pay workers for compensable commute time (Fair Labor Standards Act) (Law360 2012).

The many federal whistleblowing regulations mentioned above that protect whistleblowers from retaliation strongly advocate on behalf of the duty owed to society and the potential harm that would be caused by allowing financial improprieties to go unchallenged. Those regulations advocate in favor of protecting the whistleblower over the economic harm that may be suffered by a company over a species claim, especially in a situation such as Caterpillar, where the financial burden of a significant tax obligation maybe ultimately borne by the society as a whole. That the IRS's whistleblowing regulations do not otherwise provide for similar protections may be perceived to add a level of credibility to claims made under their disclosure program.

Because it does not appear that Schlicksup combined his IRS whistleblower claim with another whistleblower program that provides whistleblower protection, for instance disclosure to the company's audit committee of the board of directors under the procedures authorized by the Sarbanes-Oxley Act, Schlicksup lacked protection against retaliation. Nonetheless, perhaps seeking to avoid a charge of retaliation, Caterpillar did not terminate Schlicksup's employment, but rather transferred him to the information technology division with a 7% salary increase.

8. Schlicksup's Potential Whistleblower Award

The Internal Revenue Service provides two levels of whistleblower awards based on the amount of taxes, penalties, interest and any additions to tax collected from the taxpayer and the taxpayer's gross income. For tax deficiencies less than $2 million or in cases where the gross income of the taxpayers does not exceed $200,000, the maximum award is 15% of the amount collected up to a maximum of $10 million. Under IRC §7623, tax deficiencies and gross income exceeding these amounts require the IRS to pay 15% to 30% of the amount collected (Whistleblower – Informant Award 2017). In the event the IRS is successful in assessing and collecting $2 billion in taxes from Caterpillar, Schlicksup may be entitled to receive up to $600 million under the whistleblowing statute depending upon how valuable the IRS views Schlicksup's contribution to the IRS's claim against Caterpillar. Based on the Permanent Subcommittee on Investigations' Report, that contribution was significant. Schlicksup's name frequently appears in the Subcommittee's report in various capacities: his interviews with the Subcommittee; his role as an employee of Caterpillar; his repeated warnings about the economic substance of the Swiss tax strategy; numerous depositions taken during his litigation against Caterpillar; and multiple e-mail messages sent to and from Schlicksup assembled in the record. Indeed, Schlicksup's whistleblowing award might grow larger, as additional tax years during which Caterpillar employed the Swiss tax strategy are added to the IRS's audit of Caterpillar.

9. Caterpillar's 2017 Annual Report Disclosure

In its 2017 annual report Caterpillar, filed with the SEC,[7] made the following disclosure about the status of the IRS proposal to attribute the replacement part business profits earned by CSARL to Caterpillar and to tax those profits in U.S.:

> For tax years 2007 to 2012 including the impact of a loss carryback to 2005, the IRS has proposed to tax in the United States profits earned from certain parts transactions by CSARL based on the IRS examination team's application of "substance-over-form" or "assignment-of-income" judicial doctrines. We are vigorously contesting the proposed increases to tax and penalties for these years of approximately $2.3 billion. We believe that the relevant transactions complied with applicable tax laws and did not violate judicial doctrines. The purchase of parts by CSARL from unrelated parties and the subsequent sale of those parts to unrelated dealers outside the United States have substantial legal, commercial, and economic consequences for the parties involved. We have filed U.S. income tax returns on this same basis for years after 2012. Therefore, we have concluded that the largest amount of benefit that is more likely than not to be sustained related to this position is the entire benefit. As a result, no amount related to these IRS adjustments is reflected in unrecognized tax benefits. We have filed U.S. income tax returns on this basis for years after 2012. We currently believe the ultimate disposition of this matter will not have a material adverse effect on our consolidated financial position, liquidity or results of operations (Caterpillar Form 10-K 2017, pp. 59-60 of the Management's Discussion and Analysis ("MD&A")).

10. Caterpillar's Defense of Its Swiss Tax Strategy

During the hearings before the Subcommittee on Investigations, several witnesses testified in favor of Caterpillar's contention that its agreement with CSARL possessed economic substance and addressed a business purpose other than reducing taxes. New York University School of Law Professor John Steines opined that the CSARL transaction complied with the economic substance test. He claimed that removing Caterpillar as the "middleman" between supplier and customer was a sensible business decision and was supported by case law. "[I]t was highly unlikely," he stated, "that a court adjudicating with fidelity to the law presented in [his] report would find that the restructuring or the countless ensuing

---

7. In addition to the reporting requirements mandated by the SEC for US public registrants, on a periodic basis, correspondence between the SEC and regulated companies occur whereby the SEC provides a letter to management detailing questions regarding disclosures and accounting issues. During the periods affected by Caterpillar's Swiss Tax Strategy, the SEC had provided management comments specific to the tax accounting disclosures and accruals related to Caterpillar's offshore investments and operations and included questions regarding various tax disclosures for CSARL all of which were sufficiently resolved by Caterpillar's management without adjustment to the financial statements.

outbound PFRP transaction offend the doctrines or substance over form or economic substance" (Subcommittee on Investigations Report 2014; p. 79, 154).

Thomas F. Quinn, the PwC Tax Consulting Partner who originally proposed the Swiss tax strategy, testified that Caterpillar's assigning the PFRP sales operations to CSARL was part of Caterpillar's global reorganization and simply did for part sales what Caterpillar previously did for equipment, namely to delegate responsibility for sales outside the U.S. to a company outside the U.S. The agreement, Quinn insisted, has tangible economic benefit, because CSARL became a "risk-bearing entrepreneurial company [whose] margins increased consistent with the increase of functions and risks (Subcommittee on Investigations Report Hearing Transcript 2014, p. 124). As a result of the reorganization, CSARL purchased finished parts directly from third-party suppliers and sold them to third-party dealers, and the profits earned on those sales is foreign based income, the tax on which is deferred until the income is remitted to Caterpillar in the U.S. (Subcommittee on Investigations Report Hearing Transcript 2014, p. 124). Quinn also noted that PwC annually tested the arrangements between Caterpillar and CSARL to confirm that they conformed to the IRS transfer pricing rules under the relevant transfer pricing methods prescribed by the Treasury regulations, and that their analysis confirmed the arrangement complied with the arm's-length requirements of related-party pricing (Subcommittee on Investigations Report Hearing Transcript 2014; pp. 28-29, 125-126).

Julie A. Lagacy, Vice President of Finance Services for Caterpillar, testified that "Caterpillar has fully complied with U.S. tax law." She explained that Caterpillar assigned the PFRP operation to CSARL in order to remain competitive and increase exports, and to remove Caterpillar as an unnecessary middleman which bought parts from independent suppliers and then sold them to dealers outside the United States. "The removal of Caterpillar from the transactional flow has resulted in 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" (Subcommittee on Investigations Report Hearing Transcript 2014; pp. 59-60, 131, 133). When it planned and implemented the restructuring, she noted, Caterpillar relied on the advice of PwC and its law firm. CSARL, she claimed, paid Caterpillar an arms-length royalty for the intangible property made available to CSARL by Caterpillar and an arms-length service fee for Caterpillar's activities to support the part sales activities (Subcommittee on Investigations Report Hearing Transcript 2014; p. 60, 136, 138).

11. Conclusion

This case describes Caterpillar Inc.'s "Swiss tax strategy", which was recommended by its independent auditor, PwC, and designed to transfer the profits earned on its sales of purchased finished replacement parts to foreign marketers to a Swiss entity. This strategy enabled Caterpillar to shift $8 billion in replacement parts sales and approximately 85% or more of its profits to Switzerland and to avoid or defer paying U.S. taxes on that income by keeping it offshore. Daniel Schlicksup, a member of Caterpillar's tax staff, persistently complained the Swiss tax strategy failed to meet the "economic substance" test and was illegal. According to Schlicksup's testimony, his complaints resulted in negative performance reviews and his ultimate transfer to the corporation's information technology division. It was at this point that Schlicksup felt a moral obligation to report his findings to the IRS notwithstanding the potential impact it might have had on his career. Schlicksup ultimately filed employment retaliation and IRS whistleblower complaints against Caterpillar and began to provide the IRS and the Subcommittee on Investigations with extensive documentation which provided the foundation for the IRS's claim Caterpillar owed $2 billion in back taxes and penalties and the Subcommittee on Investigations' report accusing Caterpillar of tax fraud. If Caterpillar is ultimately required to pay the estimated $2 billion assessed by the IRS, Schlicksup may be entitled to a huge whistleblower award ranging from $300 to $600 million. This case facilitates student discussion and enhances student understanding of the wisdom and morality of Schlicksup's whistleblowing activities. It is intended to provide a framework for students to evaluate the available facts and explore arguments either for or against the whistleblower's claims.

Discussion Questions

1. Are you satisfied that the justifications Daniel Schlicksup provided in his deposition testimony for blowing the whistle on Caterpillar's Swiss tax strategy are sufficient and convincing?

2. Decide whether Caterpillar's Swiss tax strategy possesses genuine "economic substance." Briefly explain your decision.

3. Briefly describe the generally accepted preconditions to engagement in internal and external whistleblowing.

4. Explain whether or not the generally accepted preconditions to internal and external whistleblowing were properly fulfilled before Daniel Schlicksup engaged in whistleblowing, thereby making his whistleblowing actions morally permissible and morally obligatory.

5. Assess the morality of Daniel Schlicksup's *internal* whistleblowing activities under Act Utilitarianism, Rule Utilitarianism. Kant's Categorical Imperatives and Rawls' Veil of Ignorance Theory?

6. Assess the morality of Daniel Schlicksup's *external* whistleblowing activities with the Permanent Subcommittee on Investigations and the IRS under Act Utilitarianism, Rule Utilitarianism, Kant's Categorical Imperatives and Rawls' Veil of Ignorance Theory?

References:

De George, R. T. (2010), *Business Ethics* (7th ed., pp. 298-318). New York: Prentice Hall.

Dividend.com (n.d.), "Dow 30 Dividend Stocks". Retrieved from http://www.dividend.com/dividend-stocks/dow-30-dividend-stocks.php

Douglas, Danielle (2014, March 31), "Caterpillar skirted $2.4 billion in taxes, Senate Report says". *The Washington Post*. Retrieved from https://www.washingtonpost.com/business/economy/caterpillar-skirted-24-billion-in-taxes-senate-report-says/2014/03/31/36d2bc3a-b8ee-11e3-899e-bb708e3539dd_story.html?utm_term=.9273deea7263

Gruley, B, Voreaco, D., & Deauz, J. (2017, June 1), "The Whistleblower Behind Caterpillar's Massive Tax Headache Could Make $600 Million", *Bloomberg Businessweek*. Retrieved from https://www.bloomberg.com/news/features/2017-06-01/the-whistleblower-behind-caterpillar-s-massive-tax-headache-could-make-600-million

Internal Revenue Service (2017, March 21), "Whistleblower – Informant Award". Retrieved from https://www.irs.gov/uac/whistleblower-informant-award

Hoffman, W. & Schwartz, M. (2015), "The Morality of Whistleblowing: A Commentary on Richard T. De George", *Journal of Business Ethics127*: pp. 771-781, https://doi.org/10.1007/s10551-014-2186-8.

Law360 (2012, November 29), "Retaliation Protection Rests On How The Whistle Is Blown". Retrieved from https://www.law360.com/articles/394855/retaliation-protection-rests-on-how-the-whistle-is-blown

United States Securities and Exchange Commission (2012), Caterpillar Form 10-K for fiscal year ended December 21, 2012. Retrieved from https://www.sec.gov/Archives/edgar/data/18230/000001823013000075/cat_10-kx12312012.htm

United States Securities and Exchange Commission (2013), Caterpillar Form 10-K for fiscal year ended December 31, 2013. Retrieved from https://www.sec.gov/Archives/edgar/data/18230/000001823014000058/final10k2013pdfwithexhibits.pdf

United States Securities and Exchange Commission (2014), Caterpillar Form 10-K for fiscal year ended December 31, 2014. Retrieved from https://www.sec.gov/Archives/edgar/data/18230/000001823015000061/cat_10-kx12312014.htm

United States Securities and Exchange Commission (2015), Caterpillar Form 10-K for fiscal year ended December 31, 2015. Retrieved from https://www.sec.gov/Archives/edgar/data/18230/000001823016000410/cat_10-kx12312015.htm#s502fdc508bd14e5da17e09789051f4f0

United States Securities and Exchange Commission (2016), Caterpillar Form 10-K for fiscal year ended December 31, 2016. Retrieved from http://www.caterpillar.com/en/investors/financialInfo/proxy-statement/general-and-financial-information-proxy-appendix.html

United States Senate Permanent Subcommittee on Investigations (2014), Caterpillar's Offshore Tax Strategy. Retrieved https://www.hsgac.senate.gov/subcommittees/investigations/hearings/caterpillars-offshore-tax-strategy

United States Senate Permanent Subcommittee on Investigations (2014), Caterpillar's Offshore Tax Strategy Hearing Transcript. Retrieved from https://www.gpo.gov/fdsys/pkg/CHRG-113shrg89523/pdf/CHRG-113shrg89523.pdf