In the

ORIGINAL

Supreme Court of the United States

CHICAGO BRIDGE & IRON COMPANY,

Appellant,

v.

CATERPILLAR TRACTOR CO., ET AL.

No. 81-349

Washington, D. C.

Monday, April 19, 1982

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Monday, April 19, 1982

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 2:12 o'clock p.m.

APPEARANCES:

WILLIAM P. SUTTER, ESQ., Chicago, Illinois; on behalf of the Appellant.

STUART A. SMITH, ESQ., Office of the Solicitor General, Department of Justice, Washington, D. C.; on behalf of the United States as amicus curiae.

DON S. HARNACK, ESQ., Chicago, Illinois; on behalf of the Appellee.

JOHN D. WHITENACK, ESQ., Special Assistant Attorney General of Illinois, Chicago, Illinois; on behalf of Illinois.

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C O N T E N T S

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P R O C E E D I N G S

CHIEF JUSTICE BURGER: We will hear arguments next in Chicago Bridge and Iron Company against Caterpillar Tractor.

Mr. Sutter, you may proceed whenever you are ready.

ORAL ARGUMENT OF WILLIAM P. SUTTER, ESQ.,

ON BEHALF OF THE APPELLANT

MR. SUTTER: Mr. Chief Justice, may it please the Court, although this case, the Chicago Bridge and Iron case, is of great international significance, it is a case which I submit presents a much simpler questionn than the two cases which immediately preceded it.

QUESTION: Is there not an underlying question, too, as to whether there is any case at all? I assume you will address that.

MR. SUTTER: I will indeed, Your Honor. I will address that right at the moment, if you would like, sir.

QUESTION: In your own time.

MR. SUTTER: Illinois has a statute permitting intervention. In this particular instance, the litigation began between Caterpillar and the State of Illinois. However, the client which I represent, believing that the issue of the constitutionality of

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worldwide combined reporting, would not be presented in that controversy, because both sides assumed the constitutionality of worldwide combined reporting, sought leave to intervene. That intervention was granted, and was affirmed by all of the Illinois courts.

Under the Illinois statute, an intervenor has all of the rights of an original party, including the right to oppose both of the original parties or to take an appeal from which neither -- from a decision which neither of the original parties chose to appeal. That is what has happened in this case.

All of the parties appealed as the case moved through the Illinois courts, but when it reached the Illinois Supreme Court, the decision there was appealed by neither the state nor by Caterpillar, but it was appealed by Chicago Bridge and Iron.

QUESTION: Well, Caterpillar didn't appeal from the intermediate court of appeals to the Supreme Court of Illinois, did it?

MR. SUTTER: I believe that they did not, Your Honor. They appealed to the appellate court, and the state appealed all the way, but on issues totally unrelated to the issue that is before this Court today.

The issue that is before this Court today is whether the foreign commerce clause precludes the use of

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worldwide combination by a state in any and all instances. This is not a case where the Court needs to grapple with the difficult problem of what constitutes a unitary business. It is conceded by everybody that the Caterpillar companies that are involved in this case did constitute a unitary business.

The question, however, is whether the State of Illinois or any other state can impose or permit the use of a method, worldwide combined reporting, if that method is in conflict with and opposed to the method which is internationally accepted by the United States and all of its trading partners.

QUESTION: Is the precise question before us whether the Illinois Tax Commission can impose on Caterpillar the type of reporting and the type of income tax that it did?

MR. SUTTER: No, the precise question is whether the Department of Revenue can impose combined reporting on any taxpayer. That was the decision of the Illinois Supreme Court. When Chicago Bridge and Iron intervened and became a party plaintiff, it was asserting on its own behalf that worldwide combined reporting could not be applied to it. The decision of the Supreme Court was that where you have a unitary business, worldwide combined reporting must be applied

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to any and all taxpayers.

QUESTION: But --

MR. SUTTER: And it is from that that Chicago Bridge and Iron is appealing.

QUESTION: And it is just that abstract question then that is before us, not its application on any particular set of returns.

MR. SUTTER: I think that is essentially correct, Your Honor.

QUESTION: Do you suggest there is not a case or controversy in the constitutional sense?

MR. SUTTER: No, I do not, Your Honor.

QUESTION: I would suppose that the state isn't making any bones about it. It threatens to and would and will impose this system on the Appellant here, Chicago Bridge and Iron.

MR. SUTTER: That is precisely the case. They have already --

QUESTION: And so there is a case or controversy.

MR. SUTTER: I submit there is a case and controversy, case or controversy. The state in its briefs to this Court has so indicated as well.

QUESTION: Just as though instead of intervening they brought a separate suit against the

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state to enjoin them from applying what seems to be the Illinois law.

MR. SUTTER: Precisely, Your Honor.

QUESTION: Is that in the nature of a declaratory judgment then?

MR. SUTTER: No, that was argued to the Illinois Supreme Court, because the Illinois Supreme Court does not render declaratory judgments in tax matters, and the Illinois Supreme Court held that this was not a declaratory judgment, that our intervention procedure permits an intervenor to raise a question of law which is common to it and to the case in chief.

QUESTION: But hasn't an assessment been --

MR. SUTTER: Indeed, an assessment has been made against Chicago Bridge and Iron. It has been held in abeyance, without further hearings, because of the progress of this case through the courts.

QUESTION: But you didn't put any record in, did you?

MR. SUTTER: We were not permitted to put anything into the record.

QUESTION: Well, isn't this a strange case where you are arguing a case where you don't have a record?

MR. SUTTER: It is perhaps an unusual

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procedure, the Illinois intervention procedure, Your Honor.

QUESTION: It is unusual.

MR. SUTTER: But we are fully a party. If the Court were to dismiss this case, the question of the constitutionality of combined reporting as applied to Chicago Bridge and Iron would be res judicata. We could not raise it in Illinois in a later proceeding against us. Of course, some other taxpayer in some other case might ultimately persuade this Court that it was unconstitutional and we would benefit from that.

QUESTION: But you created that problem.

MR. SUTTER: No, Your Honor, we did not create the problem.

QUESTION: You didn't have to intervene, did you?

MR. SUTTER: No, we did not have to intervene, but we were concerned that this case would wend its way through the Illinois courts dealing with peripheral issues, and everybody assuming the constitutionality of combined reporting, and in addition to which there was a statutory construction argument, which of course does not concern this Court. If those issues reached the Supreme Court without being controverted, the decision would have said, the way to compute the tax for

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Caterpillar under combined reporting is such and such. It would have not precluded us from raising these issues at a later time, but it would have made the job much more difficult.

Since we have a statute which permits us to become a party, which permits us to participate fully in the appeal procedure, in the argument procedure, in the briefing procedure, as an original party, and to oppose both of the original parties as we are in fact opposing both of the original parties on this issue, it seemed to us that that was the appropriate and efficient method of proceeding. We do have the problem, we do have an assessment against us. The State of Illinois has not asserted, as you might expect that it would, since if this case were dismissed it would win, that there is no case or controversy.

The state has recognized that there is one, that Caterpillar will receive a very large refund based entirely on the decision of the Illinois Supreme Court that worldwide combined reporting is constitutional.

QUESTION: And you will have lost your claim of unconstitutionality.

MR. SUTTER: And we will have lost our claim of unconstitutionality.

QUESTION: Mr. Sutter, do you contend that it

is unconstitutional for the state to tax on a worldwide combined reporting basis a taxpayer who requests its use?

MR. SUTTER: No. The statute in Illinois permits a taxpayer to apply for relief from any tax that the Illinois tax authorities develop, and I suppose that they could work up a method that as applied to them they thought was all right, and there would be nobody raising any issue about it. They would settle the case on an ad hoc basis. It is the imposition of the tax which I submit is unconstitutional because it contravenes all principles of international law.

QUESTION: Well, if there was a settlement between the state and -- if the taxpayer just came in and chose to report on this basis and the state accepted it, the impact on foreign commerce would be the same.

MR. SUTTER: No, I think not, Your Honor, because nobody would be objecting then. If the foreign subsidiary of the taxpayer is not being penalized because they have concluded that they will come out better in a particular fashion, I submit that it is not really a selection of an unconstitutional method. It is simply an agreement on how much tax you are going to pay.

QUESTION: Well, if a state has a rule that this is the way you do it, and somebody just doesn't object to it, in that case it is quite all right.

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MR. SUTTER: I think I misunderstood you. If the state has a rule --

QUESTION: Yes.

MR. SUTTER: -- that this is how you do it.

QUESTION: And the taxpayer says, okay, I will do it that way.

MR. SUTTER: I am submitting that the rule is unconstitutional. What the taxpayer can settle his own tax liability for, I think, is not a constitutional issue. The rule is unconstitutional.

QUESTION: All right.

QUESTION: Would a reversal here prevent the Supreme Court of Illinois' decision from being carried out as between the State of Illinois and Caterpillar?

MR. SUTTER: Yes, it would, Your Honor.

QUESTION: Well, then, I really am at a loss, because I had thought you said that what parties consented to or didn't take an appeal from was between them.

MR. SUTTER: Well, it would prevent it from being carried out unless the State of Illinois and Caterpillar then, looking at the arm's length income of Caterpillar, said, this is too much, we must find a method of apportioning or allocating or changing the factors that will permit a reduction in your total

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liability and they mirabile dictu arrived at the same dollar figures. That might happen. It would prevent Caterpillar from compelling the state to pay this refund. The state and Caterpillar would have to work it out under the relief provisions.

QUESTION: Even though Caterpillar is perfectly content with the result below.

MR. SUTTER: Yes. I should say that Caterpillar -- this case bore a strong resemblance to the two cases you previously heard at the time it arose administratively. Caterpillar was being taxed on dividends from its foreign subsidiaries. Caterpillar felt that that tax was excessive, very much as ASARCO and Woolworth did, and sought to have the foreign factors included in some fashion to ameliorate that. That was sought under the relief provision of the Illinois Act.

Alternatively, they said, treat us as worldwide combined, and we will come out a little better, and that is what we wish. So that it could have gone off in the other direction, and I submit that in cases where worldwide combined reporting would be unconstitutional, as it would, because it contravenes the law of nations and therefore contravenes this Court's decision in Japan Line, it might very well be

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that some form of taxation of dividends along the lines suggested by ASARCO and Woolworth, with the proper recognition of foreign factors, would be the solution for the states, but that is not for me to determine. That is a possibility.

Simply put, worldwide combined reporting is followed by no responsible nation in the world today of which I am aware. It has been recognized by all of the authorities and by the United States government, and the United States government will tell you today that for us to permit a state to interfere with the system that has been worked out through the treaties that the United States has with all foreign nations -- most foreign -- major foreign nations, with the system that the United Nations group of experts recommended for treaties with undeveloped nations as well, the arm's length method would be to throw a spanner into the works of American diplomacy in the area of international trade, and that is precisely the problem that was presented to this Court in the Japan Line case.

I am not suggesting that worldwide combination is a bad system per se. It might be all right, if we were starting with a tabula rosa. We are not. We are dealing with a world in which the complexities of international trade have established one fundamental

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premise, and that is that where a company has a subsidiary situated within its borders, that income of that subsidiary taxable by that country must be determined on an arm's length basis so that no games can be played, but not on a mechanical, mathematical basis, as worldwide apportionment.

Worldwide apportionment makes it impossible for there to be a loss in any company that is a member of a unitary business if the unitary business has a profit.

QUESTION: You are arguing about, you say, an international unitary company. It is the kind of an organization that if it were all domestic, everybody would agree it was a unitary business.

MR. SUTTER: Yes, sir --

QUESTION: Part of it happens to be conducted abroad. Even though otherwise it might be a unitary business, you say that part of it must be dealt with arm's length.

MR. SUTTER: That is correct, because of the treaty network, Your Honor.

QUESTION: Right.

MR. SUTTER: Domestically, that is an entirely different story. We have raised the due process argument domestically where the unitary business falls

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short of the kind of control that ASARCO was talking about this morning. There are definitions of unitary that talk about contribute to, and Your Honor mentioned some of those situations. We would submit that there, even domestically, to combine where there isn't integration --

QUESTION: Yes.

MR. SUTTER: -- is unconstitutional due process-wise, but getting over that hurdle, and assuming that you have a truly integrated business, nevertheless, to impose this on an international basis violates the foreign commerce clause.

QUESTION: All right.

MR. SUTTER: I would like to reserve some time and defer now to the Solicitor.

CHIEF JUSTICE BURGER: Mr. Smith.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF THE UNITED STATES AS AMICUS CURIAE

MR. SMITH: Mr. Chief Justice, and may it please the Court, Mr. Sutter has ably put forth a preliminary case on behalf of the Appellant in support of reversal of the judgment below. He has graciously ceded a limited amount of time to the United States in order that I might inform the Court as to the special concerns of the United States with respect to this case.

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Our analysis here likewise proceeds on the foundation of this Court's seminal decision three years ago in Japan Line versus County of Los Angeles. There, the Court struck down a California ad valorem tax on shipping containers owned by a Japanese company. There, as here, the states contended that its apportionment formula met the requirements developed by this Court for domestic interstate commerce clause scrutiny, but this Court disagreed, observing that when construing Congress's power to regulate commerce with foreign nations, a more extensive constitutional inquiry is required.

This more extensive constitutional inquiry brings two additional considerations into play: first, as the Court said, the enhanced risk of multiple international taxation, and second, the need for federal uniformity in the conduct of international relations and foreign trade.

In the limited time I have available, I would like to focus on the second requirement adverted to by the Court in Japan Line. That is, whether the Illinois tax prevents the federal government from speaking with one voice in regulating foreign trade. We submit that the Illinois worldwide apportionment formula places serious impediments before our nation's conduct of its

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foreign relations.

The United States and our major trading partners use the arm's length method of allocating income among related corporations. Now, what is this arm's length method of allocating income? The arm's length method requires that controlled subsidiaries of multinational corporations are to be treated for tax purposes as independent legal entities doing business with the rest of the enterprise on an independent or arm's length basis. That is, it requires that transfer prices for goods and services exchanged between related corporations be set at the same price that would have been acceptable to an independent party dealing with each other at arm's length. This is a common system. The Internal Revenue Service uses it in Section 482 of the Internal Revenue Code, and there is a highly developed set of regulations that the Internal Revenue Service uses, but the international acceptance of the arm's length standard cannot be disputed. It is based upon a League of Nations adoption in 1928 of a Model Bilateral Tax Convention.

QUESTION: Why should that force it on the states, just because it has been accepted by a number of nations?

MR. SMITH: It should force it on the states,

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Mr. Justice Rehnquist, we believe, because the United States, the federal government, pursuant to Article II of the Constitution, is charged with the responsibility of conducting foreign relations, and in our view, the state's adoption of a method which is undisputedly at loggerheads with this federal method, which is the law and custom of nations, necessarily interferes with and places impediments before the conduct of the nation's foreign relations.

QUESTION: Well, is it contrary to any particular treaty?

MR. SMITH: It is not contrary to -- the method here does not violate any provision of any particular treaty, but I would suggest to the Court that the entire relationships between ourselves and our trading partners is based upon this arm's length method --

QUESTION: Well, then, I take it if this is such a fundamental facet of your dealings, of the United States' dealing with other countries, it can be awfully easy to amend the treaties and to make sure that the -- so that the treaty would announce the supreme law of the land.

QUESTION: Or to ask Congress to do something about it.

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MR. SMITH: Well, the treaties do not use the term "arm's length", but I would suggest to the Court that the treaty in Japan Line did not -- the customs convention that the Court relied upon did not specifically outlaw the taxation by the County of Los Angeles of the tax on the containers, but the Court nevertheless found that the local tax in question violated, was contrary to the nation's policy, and that is the nation's foreign policy, and its posture vis-a-vis our foreign trading partners.

QUESTION: Well, it found that it violated the foreign commerce clause of the United States Constitution, didn't it?

MR. SMITH: Yes. Yes, it found --

QUESTION: And you say that this -- the Illinois provision for the type of taxation they impose, if imposed on anyone at all, would violate the federal commerce clause of the Constitution?

MR. SMITH: We so submit, and indeed, foreign governments have so protested to the United States.

QUESTION: Well, we don't usually rely on foreign governments to tell us what violates the commerce clause, do we?

MR. SMITH: That is true, but I think that in conducting the foreign relations of the United States,

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the United States government necessarily has to take into account that a particular state method of taxation which is undisputably at loggerheads and quite different and based on completely different theoretical assumptions than the international norm necessarily introduces an irritant to the conduct of our foreign relations that the government can feel is sufficiently serious to impede the conduct of our foreign policy and thereby create a foreign commerce clause problem. I think that was the basis of the Court's --

QUESTION: Do you think your trading partners would really object if the states applied this method to American parents with subs abroad but didn't apply this method to the United States subs of foreign parents?

MR. SMITH: I cannot speculate --

QUESTION: I suppose the latter is what really worries the --

MR. SMITH: I cannot speculate as to what foreign governments would or would not find objectionable. It is true that the state and many of its supporting amici seek to minimize the seriousness of the diplomatic protest that we adverted to, and which the other amici advert to by emphasizing that they address the case of a foreign parent with a domestic subsidiary, and I -- to be sure, the United States views

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the case of a foreign parent with particular and special concern, because of the burdensome record-keeping in conformity with the U.S. dollar accounting principles --

QUESTION: Mr. Smith, do you make the same argument even when you have a domestic parent who requests the use of this type of taxation?

MR. SMITH: I think that Mr. Sutter -- I think that the unconstitutionality of the method for federal -- the uniformity purposes is when the method is imposed upon someone against their will. I think as Mr. Sutter pointed out --

QUESTION: But with regard to --

MR. SMITH: -- a taxpayer could arrange to settle a case on any ad hoc method, and there wouldn't be anyone to complain about it, but it is the imposition of the method across the board to as a rule of state law that for us creates the --

QUESTION: We heard this afternoon about, for instance, New Mexico, who gives the taxpayers the option. Would you argue that that is an unconstitutional option for New Mexico, to offer --

MR. SMITH: I would say that for New Mexico to give a taxpayer an option and to have that available would create the same sort of problems. It would necessarily as a theoretical matter create the same sort

of problems of federal uniformity, because what would happen would be at the foreign end of the spectrum, somebody else's ox would necessarily be gored.

The problem as we see it is that the arm's length method is the international norm and custom of nations, and that the worldwide unitary method, which doesn' take into account separate entities, which is based upon an aggregation of everyone's income into a common pot, and the application of factors, necessarily is at complete variance with this arm's length method, and if the custom of nations which the United States government is obliged to represent ourselves beyond the water's edge is to mean anything, it means essentially that it is only -- it is the United States government that conducts foreign relations and not the states.

The Court made that clear, it seems to us, in Japan Lines, and it seems to us that this case necessarily proceeds on that basis.

QUESTION: Except that the party in interest is not interested.

MR. SMITH: The party in interest, the Caterpillar Company would prefer that --

QUESTION: Wouldn't you be better off if they were here instead --

MR. SMITH: Yes, but the party -- the party in

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interest here is really fickle in the sense that it wanted to apply this method for all years except 1969. The party in interest is simply interested in minimizing its tax liability, and would take any opportunity to do it. Our concern here on behalf of the United States is that the adoption of this method as a rule of law imposed across the board creates -- impairs uniformity in the conduct of foreign relations.

Now, before this digression, I was addressing the question of the foreign parent. I simply want to say that the United States views the foreign parent with particular and special concern because of the record-keeping examples, and while we talk about in our brief cases that might arise, let me simply close by saying that such cases are not a figment of our imagination, but in fact have arised. There are two cases now pending in the district court in California involving foreign parents in which the California Franchise Tax Board is trying to impose a worldwide unitary method, and create income where local losses exist. Those cases are the Shell Oil Company case and the EMI case, which was before the Court.

QUESTION: Mr. Smith, what is the status of the EMI case which you advised us about back in --

MR. SMITH: Yes. That case is now back in the

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district court in California, the northern district of California, because the Ninth Circuit has just ruled that Section 1341 was not applicable. That is, that the case could be heard in federal court because the foreign parent did not have a plain, speedy, and efficient remedy within the meaning of 28 USC 1341.

QUESTION: So it is back in district court again.

MR. SMITH: Exactly.

Thank you.

CHIEF JUSTICE BURGER: Mr. Harnack.

ORAL ARGUMENT OF DON S. HARNACK, ESQ.,

ON BEHALF OF THE APPELLEE

MR. HARNACK: Mr. Chief Justice, and may it please the Court, Justice Marshal, as counsel for that fickle taxpayer, Caterpillar, I wish to assure you that we are very interested in the outcome of this case.

QUESTION: But you didn't appeal.

MR. HARNACK: We did not appeeal, Your Honor, because we are convinced that the Supreme Court of Illinois came to the right result in affirming the imposition of combination in this case. As this case originally arose, the state insisted that only separate reporting was proper.

QUESTION: All I say is, if you had filed an

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appeal, I would have no problem. If you didn't, I have problems.

MR. HARNACK: Both the Solicitor General and counsel for the Appellant have referred to, although I don't see it cited anywhere in their brief, the law and custom of nations. It seems about as amorphous as the definition of what constitutes a unitary enterprise on a worldwide basis. There is no specific definition, and yet in this case when you see a unitary operation such as Caterpillar, the world's largest earth-moving equipment company, you can be sure that you have the unitary operation.

Both the Solicitor General and counsel for Appellant tell us that the application of combination to Caterpillar in this case and in Chicago Bridge and Iron will result and create tensions in the international -- and disrupt our foreign relations, and I think we should look at the facts in this case and ponder how the application of combination in accordance with the Illinois court will create those tensions.

Why tensions? Well, let's look at Caterpillar first. Caterpillar has 25 subsidiary corporations operating throughout the world, but with a nerve center, with a headquarters in Peoria, and if you have had the opportunity to look at a very lengthy record, you have

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seen where Caterpillar has demonstrated that it is basically one operation. Yes, it has 25 subsidiary operations, but they could be equally 25 divisions throughout the world, and those 25 divisions would constitute permanent establishments throughout the world, and the treaties that have been alluded to would apply to those permanent establishments, and the foreign countries which would tax those permanent establishments would determine the amount of the income taxable in the foreign countries on a separate reporting basis.

And, yes, of course, Illinois could apportion on a formulary basis the worldwide income of one corporation with 25 divisions precisely as it now chooses to apportion the worldwide income of a parent corporation with 25 corporations, and yet, over the past years, with our multitude of multinational corporations, having many divisions, we have not heard the government, the Solicitor General, raise the question as to why the imposition of formulary apportionment to a multinational, single corporate multidivision corporation imposes upon or violates the law and custom of nations, and yet no one would deny that our treaties cover both divisional operations and subsidiary operations. As a matter of fact, the treaties specifically state that they will both be handled in

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precisely the same manner.

Now, who cares whether or not Illinois apportions income in Illinois based upon the worldwide income of Caterpillar? Does Caterpillar U.K. or does the U.K. government have some concern about that? You have had the opportunity to look at the diplomatic correspondence which was furnished to the Court, and as we have pointed out in our brief, that correspondence flows only in one direction. Yes, there are tensions. We don't deny there are tensions. But the tensions are whether or not Illinois or other states such as California can or may impose worldwide combination on a foreign controlled group.

The U.K. raises it, Sony raises it, the amicus briefs raise it. But do we have the same tensions in the case of combination being imposed on the domestic controlled group, and insofar as I have been able to ascertain in my study of all the diplomatic correspondence, the question was not raised, not even inferentially raised, and as a matter of fact in the testimony that was submitted to this Court in the appendix, as I recall --

QUESTION: Well, is there any suggestion that the states will treat the two groups differently?

MR. HARNACK: None, Justice White. As a

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matter of fact, I think there is a suggestion, if we look at California, that the state will not treat both differently. In fact, California has asserted combination against foreign control groups. That was a matter of quite a bit of debate at the time the recent U.K. treaty was adopted. There was an effort to preclude California from doing that specifically. That effort failed.

We cannot deny that that tension exists. We would suggest, however, that this Court is not in any way constrained to consider these two separate questions as the same question. Now, throughout the briefs and throughout the arguments you have been told that this is a violation of our foreign relations. It creates tension. In fact, domestic combination does not create tension. In fact, combination of foreign control groups probably does create tension. I can't deny that. We have all read the diplomatic correspondence. However, if this Court were to determine that issue as being violative of a commerce clause provision, it would not, as inferred or argued by Appellant, result, if you will, in a Fourteenth Amendment violation to taxpayers in this country.

This Court decided in the Matson Line that a discrimination in state taxation required by the

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commerce clause cannot be held to violate the equal protection clause of the Fourteenth Amendment. What that says is, if there is in fact a commerce clause problem, and I don't for a moment concede that there is a commerce clause problem as it applies to foreign controlled groups, this Court would be in a position to find that problem and resolve that problem, but I would certainly argue strenuously that insofar as Caterpillar is concerned, the domestic corporate groups are concerned, we don't have a commerce clause problem.

Now, Appellant also would argue that, well, there are other tensions created. What about the minority shareholder of the U.K. corporation? Isn't he losing inadvertently some equity in the U.K. corporation? And the answer is, of course not. What are we attempting to do with combination? We are not taxing income earned in the U.K. or India or South Africa or anywhere else. What we are attempting to do is to determine how much income is properly apportionable from this unitary operation and its operations in Illinois.

Caterpillar U.K. assembles a tractor. It gets the engine from Peoria. The tractor is sold through Caterpillar overseas to a customer in Arabia. It is financed by Caterpillar Credit Corporation, overseas

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credit corporation in this case. It is served by Caterpillar France. The pamphlet that goes along to handle the warranty is probably printed again in Peoria. There are inventory stations throughout the world. Caterpillar's tractors are built to the same specification throughout the world. If we need a part in Arabia, the part may be built in the U.K., it may be built in the U.S., it may be built in Australia. They are precisely the same. Where it comes from depends upon the supply in that particular inventory. How do we determine the amount of income specifically or separately sourced to Caterpillar France, Caterpillar U.K., Caterpillar Australia, and the answer is pragmatically, we cannot.

The reason that we were able to establish to the State of Illinois that combination was the proper method to determine the amount of income properly apportionable to Illinois was not because we assumed that a dollar of sales in China had the same value as a dollar of sales in the U.K. It was because we could determine that there was no way to determine the relative amount of income produced by a specific transaction in this big amalgamation of transactions throughout the world on a separate return sourcing basis.

QUESTION: So as far as you are concerned, the

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so-called arm's length approach is just impossible?

MR. HARNACK: Justice White, insofar as absolutely separately sourcing the income is concerned for Caterpillar, the answer is yes, but we must come up with a number. The treaties require for federal purposes and for foreign national purposes that we have a number, so obviously you come up with a number, but that does not mean it is the right number.

QUESTION: Well, it may not be, but if you say that this just is an omnipresence in the sky, this international law rule, but how do -- how would you suggest the foreign parent would go about allocating its income among all of its American subs, if what you say is so impossible?

MR. HARNACK: Well, I would suggest, Justice White, that the efficacy of combination, the formulary apportionment is based upon the fact that it is literally impossible to separately source. Now, that has never stopped anybody from separately sourcing, but for accurate apportionment of income, you cannot separately source. Now, if you assume you can't separately source, then formulary apportionment should be applied to the foreign controlled parent, too.

Part of the problem in the dialogue that has gone on before this Court for years now is that

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everybody assumes the assumption. If you assume that you can't separately source, of course combination is applicable. If you assume you can separately source, as the Appellant assumes, then who needs combination? But the answer is, combination and formulary apportionment has developed because of that great difficulty of attempting to separately source.

QUESTION: Well --

QUESTION: Mr. Harnack --

QUESTION: Excuse me. Go ahead, sir.

QUESTION: -- is Caterpillar consistent in this respect in every state in which it does business?

MR. HARNACK: It files on a separate basis in a number of states, Your Honor. It has only had the ability to file on a combined basis in several states. Now, does that mean it is consistent? The answer is obviously not. It is not consistent, but also, the answer is that in terms of the factors involved in each state, in some instances it is really -- it doesn't make enough difference to go to the effort of filing on a combined basis.

QUESTION: But in some states using that basis, it might be disadvantage -- disadvantageous to Caterpillar, might it not?

MR. HARNACK: It could be both

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disadvantageous, Your Honor, and it could be advantageous, in all candor.

QUESTION: Well, you -- on a combined basis, you saved a little money in Illinois, didn't you?

MR. HARNACK: On a combined basis we save a lot of money, Your Honor, in Illinois.

(General laughter.)

MR. HARNACK: And if it had turned out the other way, you might have been able to come up with a figure.

(General laughter.)

MR. HARNACK: If it had been the other way, Your Honor, I might very well have appealed, in accordance with Justice Marshal's concerns. But let me ask this question, if I may, and then attempt to answer it. What impact would a reversal of this case have, both on Caterpillar and on the prior decisions of this Court?

On Caterpillar, we have -- we originally went in and asked for relief under Section 18 of UDITPA. We said separate apportionment does not truly reflect our income. Let us demonstrate to you a method that will. That was combination. We demonstrated that to the satisfaction of the hearing officer, and he found, as a matter of fact, based on an extensive record, that no

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other method would fairly apportion our income to Illinois. Now, if you would reverse this case, I don't know precisely what I would do at that point, already having proven on the basis of the clear and cogent rule that no other method but combination clearly reflects our income.

QUESTION: As the case comes here, is it true, I thought it was, that the Illinois courts had decided this is the method that must be used.

MR. HARNACK: The Illinois court has decided that Section 304(a) of our Income Tax Act provides that combination will be imposed in every case where there is a unitary business. It then provides --

QUESTION: Well, so that -- but that is all -- if the case were reversed, what you would reverse is the imposition of this method. I suppose you could still settle with Illinois on this method.

MR. HARNACK: I would hope that in the event this Court was of that mind --

QUESTION: Wouldn't that be true?

MR. HARNACK: I don't know that that would necessarily follow. I would think that they should be -- I would think that the court below would still be controlled by the finding that the only method that clearly reflects our income is the unitary method,

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unless this Court determined that on a constitutional basis under no circumstances could that be utilized.

QUESTION: Would you care to suggest what would be the consequence of dismissing the appeal?

MR. HARNACK: I think the consequences of dismissing the appeal would be that this Court would be called upon to consider this issue again in the very near future.

QUESTION: When they levied a tax on you, for example.

MR. HARNACK: Not when they levied a tax on us. I believe there is already a case that this Court has before it where you have indicated jurisdiction, Container Corporation, and the same issue is present in that case. I would also suggest to this Court --

QUESTION: On a developed record.

MR. HARNACK: I beg your pardon?

QUESTION: On a record that is far better developed than this one.

MR. HARNACK: Justice Blackmun, I don't believe you could find a better developed record than this one. You have it --

QUESTION: Well, we don't have the record. We are not interested in the record between Caterpillar and Illinois, I take it, because certainly we are not going

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to let Chicago Bridge and Iron litigate Caterpillar's rights.

MR. HARNACK: Well, Chicago Bridge and Iron chose to bring this case up on our record, Your Honor, and that would indicate that they are stuck, if you will, with our facts. As I was answering the question, though, what would this do, this would reverse, if you will, Bass, Ratcliff. This would seriously erode your decision in Mobil Oil, and I do believe that it would also limit UDITPA to a water's edge concept.

Thank you.

CHIEF JUSTICE BURGER: Mr. Whitenack.

ORAL ARGUMENT OF JOHN D. WHITENACK, ESQ.,
ON BEHALF OF ILLINOIS

MR. WHITENACK: Mr. Chief Justice, and may it please the Court, the issue before you today is really whether some corporations should enjoy profound tax advantages over other corporations. These tax advantages, we are told, can be obtained in two ways, first, by separately incorporating the branch offices, even though the home office will continue to enjoy the same control that they enjoyed before incorporating that branch office into a separate subsidiary corporation, and second, by inventing a water's edge cutoff.

Both of these techniques would allow the

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Appellant, Chicago Bridge and Iron, and their amici, to turn back time back to when unitary apportionment and multinational operations were exceptions instead of commonplace. This would once more permit the use of separate geographical accounting, in spite of all your decisions that separate geographical accounting is not constitutionally required.

When it comes to separately incorporating branch offices, the Solicitor General's duties compelled him to agree that mere incorporation cannot change the underlying economic realities. The advantages of functional integration, the advantages of centralized management, economies of scale remains the same whether you have a branch office or a separately incorporated subdivision, subsidiary.

While the Solicitor General agrees that combined apportionment is permissible within the United States, both he and Chicago Bridge and Iron would cut off that permission at the water's edge, and reverse Bass, Ratcliff. To justify this cutoff of the unitary stream of income with a hypothetical example that some day there may be a corporation that is operating in the United States at a loss or at a lower profit margin, and so then they say that any state which taxes or uses the combine unitary apportionmen method could be taxing the

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profits of the controlled foreign subsidiary of that domestic parent.

This is circular reasoning. It uses separate accounting to conclude that the domestic parent is losing money in the United States, and that the foreign controlled subsidiary is making money overseas. Having already begun with the premise of separating inseparable unitary income, they then come full circle and say that this is proof that separate geographical accounting is necessary to keep this unofficially separated, unitary income free from tax. The premise assumes the answer.

The hypothetical example is also a clear parallel of the facts in Butler Brothers. On a separate accounting basis, in Butler Brothers, they demonstrated that they were losing money in California, and that the claim to any tax in California would be actually taxing their income earned outside of California. This Court rejected that argument in Butler Brothers, and decided that separate geogprahical accounting cannot be misused to prove a lost inside one state, California, and prove that untaxable income, unitary income was being earned outside of California, yet if Butler Brothers had had an office in California, and another office in London, the opponents of unitary apportionment today would have this Court reverse Butler Brothers.

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Instead of unitary losses being offset against unitary profits, as they must be when you have a single business unit, the separate accounting proposed by Chicago Bridge and Iron and the Solicitor General at the water's edge does not permit such an offset, since it assumes, contrary to your decision in Mobil, that all business income has a clear identifiable source in either London or in California even though it arises from the business as a whole.

When we leave the hypothetical example and go to the actual facts of this appeal, your decision in Butler Brothers, in Mobil, have even more impact. As you know, Illinois is a state that has two conflicting groups. It is a home state of two conflicting groups of multinational corporations. One group wants combined unitary apportionment, and the other group wants separate accounting.

There is no way that Illinois can allow both unitary apportionment up to the water's edge and then separate accounting everywhere else. This would discriminate against the domestic corporation. It would effectively reverse the Uniform Act upon which the Illinois Act is based. It would cause tax losses to Illinois of tens of millions of dollars. We've got $40 million at stake right now, and it would arbitrarily

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include only the domestic members of the worldwide single business unit. That would deny the economic reality of combination, of combined single unit corporations.

The water's edge travesty would also cut the business into four different ways. There would be separate accounting between the unitary domestic corporation, separate accounting between the unitary foreign corporation. There would also be separate accounting between the Peoria, Illinois, headquarters and its branch offices, not its subsidiaries, its branch offices overseas.

Caterpillar Tractor Company, Caterpillar Finance Company, Caterpillar Credit Corporation, Caterpillar Americas Corporation are not only unitary with their foreign subsidiaries, but each one of the Peoria-based corporations also have their own branch offices in several foreign nations as well. Thus, the Bass, Ratcliff decision affirmed by this Court in Mobil would be squarely at issue in this appeal. The result of some form of crippled combined unitary apportionment only up to the water's edge would require outright reversal of Bass, Ratcliff, and give rise to a whole new generation of tax cases in its wake.

It would utterly disregard the fact that

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Caterpillar Finance Company is not only worldwide in its own operations, with branch offices abroad, but also has the purpose of borrowing foreign currency and then reloaning the foreign currency that it borrows to its unitary foreign subsidiaries. It would disregard the fact that this very appeal shows that worldwide unitary income method is completely neutral. It does not inevitably cause extraterritorial taxation, but takes into account all of the underlying economic realities.

Thus, this appeal is the very opposite of the decision in Japan Lines relied upon so heavily by Chicago Bridge and Iron and the Solicitor General. In Japan Lines, there is actual multiple taxation. In this appeal, there is an actual tax reduction. In Japan Lines, we are dealing with property taxes. Here we are dealing with income taxes. There is no relief clause in Japan Line to prevent extraterritorial taxation.

In Caterpillar, the very combined unitary method that we are using is meant to prevent multiple taxation by taking into account the reality of how Caterpillar is operated. There may be some extraordinary cases where extraterritorial taxation could conceivably arise, but if it does happen, then we have a relief clause adopted from Section 18 of the Uniform Act which doubly ensures against such taxation.

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For this reason, Chicago Bridge and Iron and its amici have retreated to the untenable position that our U.S. treaties somehow create a national policy which requires states to disregard Mobil, to disregard Exxon, to disregard Butler Brother and Bass, Rafclitt. In Japan Lines, there was a precise custom convention protecting containers, an instrumentality of foreign commerce.

In this appeal, Chicago Bridge and Iron and the Solicitor General have admitted to you that we are not vioating any United States treaty. It is very hard to believe that any foreign nation will care how Illinois computes the Illinois income of an Illinois corporation doing business in Illinois.

Moreover, the standard created by these treaties is anything but precise. The general accounting report which is an appendix to our brief shows that the Internal Revenue Service itself has great difficulty in defining arm's length pricing system and resort to unitary apportionment to make that idea work.

QUESTION: Mr. Attorney General, do you want us to dismiss or affirm?

MR. WHITENACK: I beg your pardon, Your Honor?

QUESTION: Do you want us to dismiss the appeal, or do you want us to affirm the judgment?

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MR. WHITENACK: We wish, Your Honor, that this Court will affirm in its entirety the decision of the Illinois Supreme Court that combined unitary method is an appropriate method for a state to use worldwide.

I think that there are two points that I need to make before the time goes out. This very question has been raised in Congress for decades, of whether or not states ought to be limited and prevented from using the combined unitary method. Congress has not been silent. Congress has debated it and decided not to limit the states. In the celebrated United Kingdom-U.S. Treaties Debate before the United States Senate, the Senate decided not to limit the states, and here we have the United States Treasury Department acting through the Solicitor General asking this Court to set the very policy that the United States Senate declined to set. The appropriate forum for those who oppose the combined unitary method is in Congress and not before the Court.

Finally, there is one fact that seems to get lost in this appeal, and that fact is that no state, least of all Illinois, compels any corporation to enter into a unitary relationship with any other corporation. The way corporations manage their business is soley their choice, not our choice. If they don't feel -- if they feel that combined unitary apportionment is worth

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avoiding, they can simply make their subsidiaries autonomous, and by doing that, the combined unitary method no longer applies, but they cannot come to this Court and ask this Court to separate the income that they decided to make inseparable.

I think I will make that point again, that they can't separate -- they can't ask this Court to make that income separated, when they themselves have made that income inseparable by making it a business as a whole.

Thank you very much.

CHIEF JUSTICE BURGER: Mr. Sutter, do you have anything further?

ORAL ARGUMENT OF WILLIAM P. SUTTER, ESQ.,

ON BEHALF OF THE APPELLANT - REBUTTAL

MR. SUTTER: I have two brief points, Your Honor. First, it should be clearly understood that we do not advocate the reversal or overruling of Bass, Ratcliff. This is not a case where a branch is involved. There are substantial differences in this than admitting that the Court said in Mobil that where a branch and the subsidiary concerned is frequently the same. That is true so far as repatriated money is concerned. It is quite a different thing to tax a parent on money which is not repatriated than it is to

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tax a parent on dividends that are received.

In the treaty sense, and we must bear in mind that our entire case here is based on the law of nations, which does not recognize combined reporting for subsidiaries, the treaties upon which we rely to demonstrate what the United States has chosen as its modus operandi vis-a-vis its foreign trading partners recognize that there can be double taxation of branches. The branch abroad must be treated there on an arm's length basis, but the treaties recognize that the United States as the domiciliary nation can tax all of the income, including the branch income.

They preclude that where it isn't a branch that is abroad, but a subsidiary that is abroad. The rule can be different. I submit that it is entirely consistent with Bass, Ratcliff to sustain our position in this case based on the law of nations relative to foreign subsidiaries of American companies or to domestic subsidiaries of foreign companies.

Secondly, on the question of the Congressional intent, this Court has already recognized in the Japan Line case and more recently in another case which at this moment I cannot recall that it is not necessary where the national interest is involved for there to be Congressional action to find that the commerce clause

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has been violated. The commerce clause can be violated by state action which is contrary to the national interest, regardless of whether Congress has acted.

On the British Treaty, the facts are that in point of fact the reservation, the provision which would have precluded some limited amount of worldwide combination did carry by a majority vote of the Senate. It did not carry by the necessary two-thirds vote. That is the only vote of any kind on this matter of which I am aware. After that was done, the Treaty was amended, and that went out. The Treaty was then passed.

The British were so distressed by that fact that before they would reapprove the Treaty, they demanded a protocol which permitted expanded taxation of American oil companies doing business in the North Sea, and the Assistant Secretary of the Treasury, Mr. Lubeck at the time, wrote to one of the Senators stating that the United States acquiesced in that expansion of British taxing power because they recognized that they would demand a concession in return for having given up the protection that prohibition against worldwide combination would have given them.

We have here a situation which goes further than that in Japan Line. We have a situation in which the first overt act of retaliation, if you will, has

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already occurred. In Japan Line, this Court was concerned that if California were permitted to tax property which was subject to tax somewhere else, there might be retaliation. Here, we are dealing with income. Income is clearly a form of intangible property. The state says it is not taxing foreign income, it is only determining the proper income in Illinois. That is a conceptual argument.

But when the foreign country determines income on a totally different basis, a basis which is incommensurate, theoretically incompatible with combined reporting, as is arm's length reporting, then it is precisely the same situation. That property, that income is taxed by the foreign country in accordance with the law of nations, as was the property by Japan in Japan Line.

If, then, a different theory finds that some of that property is really U.S. property, and really subject to tax here, really subject to income tax here, there is the same duplication of tax that there was in the Japan Line case. The two systems, as this Court said in Mobil, allocation and apportionment, are incommensurate, and if apportionment is constitutionally preferred it must be sustained, and if the other, the other.

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Thank you, Your Honor.

CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

(Whereupon, at 3:13 o'clock p.m., the case in the above-entitled matter was submitted.)

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