IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL

PEPSICO, INC. & AFFILIATES,	)	
	)	
Petitioner,	)	
	)	
v.	)	Case Nos. 16 TT 82
	)	17 TT 16
ILLINOIS DEPARTMENT OF REVENUE,	)	
	)	Chief Judge James M. Conway
Respondent.	)	

ILLINOIS DEPARTMENT OF REVENUE'S SUR-REPLY IN RESPONSE TO PEPSICO, INC. & AFFILIATES' MOTION FOR SUMMARY JUDGMENT REPLY

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I. The Joint Stipulations of Fact Demonstrate that PGM LLC Did Not Have Economic Substance and Did Not Serve a Substantive Business Purpose

The Tribunal's November 16, 2020, Order directed that the Department address the issues in "PepsiCo's stipulation argument raised in its SJM Reply Memorandum." PepsiCo has argued in its Reply brief (p. 2-7) that the Department has "reneged" on the cross motions for Summary Judgment and has "distorted" the Joint Stipulations that had been painstakingly negotiated by the parties. The Tribunal proceeded to discuss the premise that the Department has "stipulated in opposition to its position taken in its Response Brief". In the sections that follow, the Department will demonstrate that it has used the Joint Stipulations as they were intended – as the factual universe of this matter – and has properly argued its legal position based on these stipulated facts. The Department has argued consistently throughout the years, even prior to this litigation, that PepsiCo Global Mobility LLC ("PGM LLC") and PepsiCo's expatriate program do not allow for the removal of FLNA from PepsiCo's Illinois combined return as an 80/20 company.

In its Response Brief, the Department has taken multiple, consistent positions. As addressed in Section II of this Sur Reply the Department must prevail on its statutory arguments that the expatriates are not the common law employees of PGM LLC, as well as that PGM LLC has not met its burden in showing that over 80% of FLNA's business activity is foreign based. Alternatively, the Department must also prevail based on PGM LLC's lack of economic substance, as the substance over form doctrine requires that compensation charged to PGM LLC must be disregarded for 80/20 Test purposes. In light of these legal arguments, the sham transaction doctrine raised at the November 16, 2020 status conference, which is related to the

substance over form doctrine, has not been the focus of the Department's arguments, but similarly requires that the expatriate compensation be disregarded for 80/20 Test purposes.

A. The "Conclusory" Factual Stipulations Were a Memorialization of PepsiCo's Stated Business Purpose and Actions PepsiCo Attributed to PGM LLC and Not a Stipulation to their Legal Validity or Substance

The Department has not taken any position in its Response brief that is inconsistent with the Joint Stipulations. One of the over-arching goals of both parties, in the drafting of the Joint Stipulations, was to create a full set of facts on which the parties would base their legal arguments. The stipulations were created based on documentation secured by the Department in discovery and on deposition testimony. They were negotiated against the backdrop of proceeding to trial and the additional witnesses PepsiCo would have to produce and the Department depose. Against that backdrop, certain stipulations were created based upon testimony that would have been introduced by Pepsi if the matter proceeded to a trial.

In its Reply brief, PepsiCo has not based its arguments relating to the Department's use of the Joint Stipulations on case law. Pepsi merely states that the parties are bound by their stipulations, citing *People v. Pablo*, 2018 IL App (3d) 150892 ("A stipulation signed by attorneys for both parties is binding."). The Department has not, up to this point, sought to rescind the Joint Stipulations and, to the contrary, has actively relied upon the factual stipulations in crafting its legal arguments.

Stipulations are to be construed like contracts or other legal agreements. Compass Group v. Illinois Worker's Compensation Commission, 2014 IL App (2d) 121283WC. The primary goal of the Tribunal is to ascertain the *intent* of the parties (emphasis added). See Id. In the instant case, when looking to the plain language of the stipulations, the Department has only stipulated to the creation of PGM LLC, as well as it being a party to the secondment agreements.

In the Department's Reply brief, the Department never distorts or reneges on any of the stipulations. It is PepsiCo that attempts to ascribe additional meaning to PGM LLC's mere paper existence.

The Department's clear and singular intent is to use the stipulations as "facts", as the parties always intended. The preamble to the Joint Stipulations addresses this issue in its preamble, as follows:

> **(a) The stipulations set forth below are true and may be accepted as facts but not as conclusions of law;**

Provision (a), above, clearly reiterates this position. A clear overview of how the Joint Stipulations must be viewed can be found in In re Halas, 104 IL 2d 83. In Halas, the Illinois Supreme Court stated in construing the trust agreement at issue in that case:

> The purpose of judicial construction of a trust instrument is to ascertain the intent of the settlor and carry it out and in so doing the instrument must be considered as a whole. The provisions of the instrument are not to be read in isolation, and in ascertaining intent, a court must not limit its consideration to the language of a particular paragraph, phrase, sentence or clause. Id.

Similarly, individual stipulations here must be read not in isolation but in conjunction with each other. The Department, in this matter, has always intended to argue that PGM LLC was a paper entity, with a lack of economic substance. This is supported by many of the stipulations in the Joint Stipulations (discussed more fully below), including but not limited to those found in paragraphs 32, 90, 91, 99, 129, 156. The plain language of the stipulations shows that PGM LLC has only a superficial existence. It would produce an absurd result, contrary to and in direct contradiction of the Department's intent, if the Tribunal found, at this stage of the litigation, that the Department had stipulated to the economic substance of PGM LLC, when the

Department had based its entire case on PGM LLC being a superficial, paper entity with a lack of economic substance, employees, property, and assets of any kind.

When viewing the stipulations in their entirety, as opposed to isolating a few stipulations, it is clear that both sides have facts in which they can make their arguments. The Tribunal must not look to a specific stipulation as providing evidence that PGM LLC is a viable entity. The Court must look at the totality of the stipulations, much as it would view the totality of a contract, giving the same force and weight to the stipulations that describe the limited existence of PGM LLC, as those that describe its intended business purpose. If this type of analysis is not done, the Joint Stipulations would be rendered meaningless for the Department, which spent a considerable amount of time negotiating all of the stipulations. It is plainly not reasonable to think that the Department would stipulate to the economic viability of PGM LLC, when the entirety of the Department's position is based on PGM LLC being a paper entity with no substance.

In order to illustrate the Department's position, it is instructive to look at the language of the US Tax Court. Rule 35.4.7.3 (08-11-2004), which although not binding here, in the absence of a binding Tribunal rule on point, provides guidance regarding the use and limitations imposed on factual stipulations:

> The facts should be stated clearly and concisely. Related facts should be grouped in short paragraphs, and each paragraph should be numbered serially. **Only facts should be stated; conclusions, arguments, and reasons should not be included.** Where the substance of a transaction is in dispute, the facts surrounding the transaction may be stipulated, but generally not their legal effect. Likewise, documents attached to the stipulation may generally not be characterized, as such documents speak for themselves. (Emphasis added) US. Tax Court Rules 35.4.7.3 (08-11-2004).

This relates closely to the present situation. The parties attempted to only include facts in the Joint Stipulations. This was the clear intent of the parties, as is stated in the preamble to the

Joint Stipulations. The language of the U.S. Tax Court Rules was used almost verbatim in section (a) of the preamble of the Joint Stipulations, "The stipulations set forth below are true and may be accepted as facts but not as conclusions of law." Joint Stipulation, page 1.

B. Exhibits were attached only as business records

Just as the parties intended to use the Joint Stipulations as a factual basis from which both sides could argue their legal theories, both parties intended to attach exhibits to provide the Tribunal with all the relevant documentation the parties may reference. The intent of the parties, as it related to the Exhibits, was to attach them and agree to treat them as business records, so that witnesses would not need to be called to testify for foundational purposes.

This is also set out in the preamble, letter (c), which treats the exhibits as "authentic" and admissible as "business records":

> (c) All exhibits attached hereto are incorporated into this stipulation and made a part hereof and such exhibits are authentic and are admissible as business records at any hearing or trial in the above-captioned matters;

It was never the intent of the Department to stipulate to the truth of the content contained in each and every Exhibit, but only to have them available as business records that either side could use to argue their position.

Looking again at IRS Tax Court Litigation Rule 35.4.7, which states "where a fact or facts are contained in a document, the stipulation should incorporate the entire document rather than a part or parts thereof." "The authenticity of petitioner's documents may be stipulated, but the attorney should not stipulate to the truth of their contents, or their interpretation." Id. It would defy logic and produce absurd results to believe that the intent of the Department was to admit voluminous records for the truth of everything stated in them. Neither party contemplated that type of a result. The parties anticipated attaching the Exhibits to the Joint Stipulations for

foundational purposes only, as opposed to for the truth of the contents contained therein. They were attached in order to make the resolution of the matter more efficient, as to not require any witness authentication of all the pertinent documents.

C. "Conclusory" Factual Stipulations – a listing of specific stipulations that can be seen, in isolation, to support a substantive purpose for PGM LLC.

PepsiCo, in their Reply brief raised specific examples of where they alleged that the Department has distorted the stipulation in our Response Brief. Without listing each and every stipulation that Pepsi addressed, a representative sample will be discussed:

> Stip. 58 – "After PGM LLC's formation, the PepsiCo Corporate Group utilized PGM LLC as the single Expatriate Program entity for foreign-based (non-U.S.) secondments."
>
> Stip. 62 – PGM LLC facilitates the secondment of high-performing expatriate executives, directors, managers, and analysts from PepsiCo Corporate Group affiliates/operating companies who fulfill temporary key roles with the objective of developing and retaining talent and expanding foreign business operations in established and emerging international (non-U.S.) markets.
>
> Stip. 67 – Having a single entity, like PGM LLC, be the counterparty to all of the Secondment Agreements for all outbound expatriate employees: (i) preserves seconded employees' continued participation in U.S. benefits plans (*e.g.*, pre-tax retirement contribution plans authorized under 26 U.S.C. § 401(k)); (ii) centralizes Permanent Establishment foreign tax exposure related to expatriates working abroad to a single legal entity; (iii) centralizes tax, business, and other government compliance requirements (including but not limited to: certificates of coverage, foreign country work permits, and simplifies the process of foreign assignments).

D. Application of Legal Rules Limits Conclusory Stipulations to PepsiCo's De Facto Business Practices Not a Stipulation as to Legal Validity of Such Business Practices

1. Stipulation 58

Looking at the plain language of these stipulations, they are factual in manner and illuminate the superficial existence of PGM LLC. The Department's use of stipulation 58 is based on PGM LLC being "created" and then being the entity that PepsiCo chose as a counter-party to secondment agreements for expatriates. This stipulation does not ascribe any more substance to PGM LLC than its mere paper existence (which the Department does not contest) and that secondment agreements were being signed in PGM LLC's name (See stipulations #63 – for each expatriate, a secondment agreement was executed and #100 – PepsiCo Corporate HR executed secondments).

Stipulation #58 states that PGM LLC was used as the "single Expatriate Program entity". That term is never defined in the stipulations. The Department has never denied that PGM LLC was a validly created entity; that it was a party to secondment agreements; or that it had the expats on its payroll. However, the Department is not precluded from arguing that "PGM LLC" is unrelated to the actions of recruiting talent, developing talent or retaining talent. It has been stipulated that PGM LLC has no "employees" other than the expatriates (Stipulation #32) and also that PGM LLC has not reimbursed any entity for work performed in its name (Stipulation #91).

As can be seen when looking at the full context of this example, it is PepsiCo that may be distorting the factual stipulations by arguing that PGM LLC facilitates talent recruitment and talent development functions, which are not stipulated facts. The Department is refuting that allegation, by making arguments based on the stipulated facts that PGM LLC has no "employees" other than the expats. Based on this fact, the Department argues that PGM LLC cannot and did not take the actions that PepsiCo is ascribing to it.

2. Stipulation 62

In its Reply brief, Pepsi appears to take exception to the Department's use of the word "alleged". The Department does not dispute that PGM LLC is a party to the secondment contracts involved in this matter. This stipulation (62) simply states that PGM LLC facilitates the secondment of expatriates, but states nothing about how this business purpose is accomplished by PGM LLC. Stipulation 92 lays out what the "stated business activity" of PGM LLC was. Nowhere is it stipulated as to how it is performed by PGM LLC, other than the stipulation relating to the actions taken by PepsiCo Corporate HR members (See Stipulations #99 and 100).

The performance of these functions is what the Department takes great exception to in its brief. The Department has argued, in accordance with and supported by the stipulations, that PGM LLC did not have the ability to do what PepsiCo is alleging it has done. PGM LLC was a paper entity with no assets or employees and no one to administer aany of the actions that are being ascribed to it.

While the Department used the word "alleged" in its brief, it can be used interchangeably with the term "stated". The use of "alleged" does nothing to distort this stipulation. We are not challenging that PGM LLC has a stated business purpose of facilitating secondment of high performing executives. What the Department challenges is how PGM LLC did or did not go about fulfilling that stated business purpose. This can clearly be seen when viewing the full context of the Department's Response Brief, as well as in the Joint Stipulations.

3. Stipulation 67

The plain language of stipulation 67 says that execution of these agreements "preserved" the expatriates continued participation in U.S. benefit plans. The Department interprets this fact to mean that PepsiCo **permitted** the expatriates to continue on in these plans as PGM LLC employees. The Department would never stipulate that this treatment was legally valid (as that would be conclusory) and argues, based on the other stipulated facts, that PGM LLC was not the expatriates' common law employer.

Again, in its Reply brief, PepsiCo takes exception with the term, "asserts". The Department has used the term as a more persuasive word choice, instead of "states". The Department is not distorting the stipulation. The Department is drawing alternate inferences from the facts set out in stipulation 67 than the inferences that PepsiCo reaches. The Department does not take issue that the entity, PGM LLC, "centralizes Permanent Establishment foreign tax exposure related to expatriates working abroad to a single legal entity". However, the stipulation does not state that how this is accomplished or whether it would be successful/allowable as a strategy, but merely that the exposure is "centralized" in one entity. The stipulation appears to state that having a single entity accomplishes these benefits. The Department does not dispute that PGM LLC exists as an entity but does take issue as to whether its existence alone is enough to convey the benefits PepsiCo claims.

The Department reads this stipulation to state that PGM LLC, through its creation, replaced multiple expatriate entities, thereby "centralizing" issues abroad in one entity, by virtue of its mere existence. However, the Department has argued vigorously, based on other stipulated facts, that PGM LLC could not successfully insulate other entities because PGM LLC had no assets or other substantive business activities (See Stipulations #129, 156). If the Tribunal ultimately views this stipulation as conclusory, despite the intent of the parties to stipulate only

to facts, the stipulation should be stricken as not reflective of the mutual intent of the parties. The Department's intent was merely to stipulate that the facts contained in were taking place, not that they were proper.

During the drafting process, the Department was exceedingly careful not to stipulate to anything that was actively "done" by PGM LLC, as that is the crux of our position – that PGM LLC is a paper entity that is unable to take any actions on its own during the relevant time periods in this case. This premise can be seen clearly in stipulation 65 which states "One of the purposes of forming PGM LLC was to attempt to protect other U.S. entities . . . from having direct legal liability for . . . the seconded expatriates' actions." (EMPHASIS ADDED]. The Department stipulated that the stated goal of PepsiCo, in forming PGM LLC, was to protect other U.S. entities, but the stipulation stops short of agreeing that this goal was accomplished. The stipulation only sets out the agreed fact that it was "attempted" by PepsiCo.

E. Multiple Stipulations Support the Department's Position that PGM LLC has No Substance and Cannot Perform Any Actions

When looking at the full array of the Joint Stipulations and the arguments made in the Department's Response brief, the Department has taken the position, that while PepsiCo may have attempted to use the existence PGM LLC to provide certain benefits to the PepsiCo organization, the stipulated facts paint a different picture. A picture of a paper entity that has no assets and only a list of expatriates on its payroll that work for other entities.

Similarly, other stipulations, while illustrating some superficial "action" of PGM LLC, also support the Department's position that PGM LLC has no substance and is merely a paper entity. Examples of such stipulations are (#63) where PGM LLC "executed" a secondment

agreement, (#67) PGM LLC "preserves" expatriates US benefits, and (#112) where expatriates payroll "originate(s)" in PGM LLC's books and records.

While these stipulations can be used by PepsiCo to argue their legal theory, they are facts that are also used by the Department to support its position that PGM LLC has no real substance and is merely a paper entity. To this end, the Department can point to stipulation 63 and argue that the secondment agreements were executed by PepsiCo HR, not anyone on employed by PGM LLC, as PGM LLC had no one on its payroll except the expatriates (#100 and 32). Regarding stipulation 67, it merely supports the fact that PGM LLC exists, and offers no affirmation of any substance beyond mere existence. Finally, while payroll for the expatriates may originate in PGM LLC's books, this fact supports the Department's position that PGM LLC is strictly a paper entity. Payroll is handled by a third-party provider and the transaction is solely on paper (See Stipulations #111-113).

Conversely, there are numerous stipulations that support the Department's legal position PGM LLC lacks economic substance, which PepsiCo ignores in its Reply (See Section F, below).

F. The Factual Record Documents That PGM LLC Lacked Substance

The stipulations below underscore the Department's position that PGM LLC lacks economic substance and is merely a paper entity without the means or ability to take independent actions. These stipulations include, but are not limited to, the following:

Stipulation	Text
32.	The only people on the PGM LLC Payroll Reports (2011 – 2013) were expatriates.
74.	"Core" Senior Management Human Resource employees, (non-Global Mobility function personnel), spread amongst entities across the PepsiCo Corporate Group,

review Pepsi "talent" consisting of employees who have indicated in their profile they are willing to move to foreign countries and match employees with foreign subsidiaries for purposes of furthering their development as employees as well as providing foreign subsidiaries with talent needs.

76. PepsiCo Corporate Group management identifies and approves individuals for assignment to foreign host companies pursuant to its determination of the skill set and interest of each individual, and the business needs of the foreign host companies.

87. A foreign host company manager generally assesses the seconded expatriate's day-to-day performance and determines an annual performance rating reflective of these day-to-day services and submits this rating to the PepsiCo Corporate Group's Executive Compensation Team.

88. The PepsiCo Corporate Group's Executive Compensation Team evaluates the overall performance of all employees on the U.S. benefits plan (including all PepsiCo Corporate Group domestic U.S. employees and all expatriates seconded outside the U.S.) and makes all final compensation determinations.

90. There is no written agreement between PGM LLC, or any other PepsiCo Corporate Group entity, and PepsiCo, Inc. for human resource services provided to the entire PepsiCo Corporate Group.

91. No intercompany payment is made by or on behalf of PGM LLC, or any other PepsiCo Corporate Group entity, to reimburse PepsiCo, Inc. for human resource services provided to the entities within the PepsiCo Corporate Group.

99. The Expatriate Program is overseen in its entirety by a group of individuals within the PepsiCo Corporate Group's human resources function (the "PepsiCo Corporate Group HR Function").

100. More specifically, within the PepsiCo Corporate Group HR Function, there are approximately twenty individuals located throughout the world who execute employee transfers, relocations, and secondments throughout the PepsiCo Corporate Group in locations across the world ("Global Mobility HR Function"). *See* Exhibit 8 (Global Mobility HR Function Employee List (PEP00002531)).

122. Compensation paid to foreign expatriates is the only employee compensation reported by PGM LLC. PGM LLC claims no other employees for accounting, tax return reporting, or other purposes.

129. The reimbursement cross-charged to the foreign host companies, and credited to PGM LLC's general ledger as reimbursement, are on a cost basis, *i.e.*, there is no mark-up fee.

156. This stipulation illustrates that PGM LLC had no income during the tax years in question. See also Exhibit K, PGM LLC's *pro forma* return that shows no assets other than the reimbursement provided by the foreign hosts.

All the stipulations listed above clearly support the Department's position that PGM LLC, in and of itself, was unable to take any actions on its own accord due to its complete lack of assets, employees or income. For example, these stipulations reflect that PGM LLC has no one other than the expatriates on its payroll, that PepsiCo HR take all actions regarding the expatriates, that PGM LLC has no agreements with PepsiCo HR, makes no payments to Pepsi HR for their services, and charges no markup fees to the foreign hosts of the expatriates.

When viewed in their entirety, the stipulations are exactly what the parties intended them to be – a universe of the facts in this case that can be used by both sides to support their legal theories. It is misleading to view one stipulation, such as Stipulation58, in isolation, when the complete factual scenario is laid out over the full array of stipulations contained in the Joint Stipulations.

When crafting and negotiating the stipulations, the Department was careful to NOT ascribe any activity or actions to PGM LLC, other than being created (27), placed under FLNA (49), having only expats on its payroll (32), and being a party to the secondment agreements (62 and 67). This "passive" existence of PGM LLC is exemplified in Stipulation 65 where the Department insisted that the word "attempted" be included, as we would not agree that PGM LLC provided liability protection to other PepsiCo entities but only that was what PepsiCo had apparently intended by its creation of PGM LLC. Numerous other stipulations address how any "actions" of PGM LLC were taken by PepsiCo HR employees, how PGM LLC had no agreements for these services, did not pay for the services, and how PGM LLC had no employees of its own to administer any programs or take any actions.

The parties negotiated intensely over a significant period of time and attempted to craft stipulations that covered all the facts necessary to resolve the legal disputes. The stipulations were based on depositions taken, and potential trial testimony that would be offered. Throughout this process the Department was clear in its intention to argue that PGM LLC was a paper entity, unable to take the actions that PepsiCo was ascribing to it, as evidenced by the listed stipulations above.

G. Potential Remedies and/or Solutions for this Issue

Based on the Tribunal's concern with the Department's use of the Joint Stipulations, the Department suggests potential remedies for the issue:

1. The expected outcome from the Department's perspective is for the Tribunal to view the Joint Stipulations in their totality, both those that support PepsiCo and those that support the Department, and then decide the case on the merits. As has been pointed out by both parties, these stipulations have been crafted with pain-staking detail over a long period of time, between sophisticated counsel on both sides. The stipulations are based on information found in documents, information gleaned during discovery, and information that would have been proffered had the matter gone forward to trial. Both sides agreed that the Joint Stipulations represented a factual universe that would allow this Tribunal to decide the case on its merits.
2. If the Court determines that the intent of the parties is not reflected in the stipulations, case law permits amendment of the at issue stipulations. See Brink v Industrial Commission, 368 Ill. 607 (1938). This alternative would allow the parties

to decide the case on the merits, as opposed to with stipulations that do not reflect the intent of the Department.

3. If after reviewing the stipulations in their entirety, the Court determines that certain stipulations are conclusory or in conflict with other stipulations – (i.e. some appear to say that PGM LLC has substance, others that indicate that it does not), this Tribunal should rule that there are material issues of fact that must be decided at hearing, either partial or in full. This would produce a result that would effectuate the intent of the parties to have the case decided on its merits. The Department never intended to stipulate that PGM LLC had economic substance.

Despite the allegations of PepsiCo, the Department has not distorted any of the stipulations in our legal arguments. The Department has taken the stipulated facts and properly made inferences from the facts to craft our legal arguments. The Stipulations contain a full factual record and, based on that record, summary judgment would be appropriately granted in favor of the Department.

II. PGM LLC's Lack of Economic Substance Requires That FLNA Continue to Be Included in the PepsiCo Illinois Combined Return

The Tribunal's November 16, 2021 Order directed that the Department, in addition to replying to the stipulation argument addressed in the first section of this reply, otherwise reply "to the points raised" at the status conference that day. This section responds to assertions made by PepsiCo's counsel that economic substance is a "bankrupt" doctrine that has no bearing on FLNA's exclusion from PepsiCo's Illinois combined return. It is not this doctrine, but instead PepsiCo's misinterpretation and misapplication of the doctrine that is "bankrupt." Petitioner in PepsiCo , Inc. and Affiliates' Reply Memorandum In Support of Its Motion for Summary

Judgment ("PepsiCo's Reply Memorandum" or "Reply Memorandum") attempts to argue that PGM LLC's lack of economic substance is irrelevant in determining whether FLNA is excluded from PepsiCo's Illinois combined return. It is not.

Payroll charged to PGM LLC cannot exclude FLNA from PepsiCo's combined return due to PGM LLC's lack of economic substance. Lack of economic substance is a determining factor in concluding: i) as a matter of statutory interpretation of 35 ILCS 5/101 et seq. ("IITA") Section 1501(a)(27) that the expatriates were not PGM LLC employees; ii) PepsiCo failed to satisfy its burden of proving that 80% or more of FLNA's business activities were conducted outside the United States; and iii) the judicial substance over form doctrine applies to require FLNA's inclusion in PepsiCo's Illinois combined return. In making its legal arguments, PepsiCo has wrongly asserted that United States Supreme Court precedent on which the Department relied in the Illinois Department of Revenue's Brief In Response To PepsiCo, Inc. & Affiliates' Motion For Summary Judgment (the "Department's Initial Brief" or "Initial Brief") for the relevancy of economic substance in common-law employer-employee determinations, has been overruled. It has not. This Tribunal must reject PepsiCo's misstatement of controlling law and rule, as a matter of summary judgment in favor of the Department, that PGM LLC and its single member, FLNA, must be included in PepsiCo's Illinois combined return.

A. Lack of Economic Substance Attendant to PGM LLC's Relationship With the Expatriates Requires A Ruling That The Expatriates Are Not PGM LLC's Employees

1. PepsiCo Argues For An Interpretation Of The 80/20 Test That Is Contrary to Economic Substance And Legislative Purpose of Excluding Foreign Source Income from Illinois Combined Returns

By way of brief review, the 80/20 Test contained in 35 ILCS 5/101 et seq. ("IITA") Section 1501(a)(27) excludes corporations, 80% or more of whose business activities are conducted outside the United States, from combined returns. The 80/20 Test measures business activities outside the United States by averaging payroll and property factors, defined in IITA Section 304(a), as modified to divide property and payroll within the U.S. by property and payroll everywhere. IITA § 1501(a)(27). The payroll factor at issue here divides compensation paid in the United States over total worldwide compensation. Compensation is defined to mean "wages, salaries, commissions and any other form of remuneration paid to **employees** for personal services." IITA § 1501(a)(3) (emphasis added). The IITA does not adopt a statutory definition of "employees" for this purpose, although for undefined terms it does adopt the meaning of terms as used in a comparable context in the Internal Revenue Code. IITA § 102. Illinois by regulation, at 86 Ill. Admin. Code Section 100.3100, adopts the federal income tax definition of the employer-employee legal relationship contained in Internal Revenue Code, 26 USC 101 *et. seq*. ("IRC") Code Section 3401(c) and 26 CFR ("Treas. Reg.") 31.3401(c)-(1). Under federal income tax law, an employer-employee relationship exists under common-law tests when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work. but also, as to the details and means by which that result is accomplished. Treas. Reg. 3401(c)-(1)(b).

Prior to the formation of PGM LLC, PepsiCo annually reported approximately $1.5 billion of base income for apportionment to Illinois. PGM LLC was organized as a single member limited liability wholly owned by FLNA that is disregarded for federal and state income tax purposes. PepsiCo argues that PGM LLC, a limited liability company with essentially no

assets to which expatriate compensation is charged at cost for work expatriates perform for PepsiCo foreign subsidiaries, excludes FLNA from PepsiCo's combined return under the 80/20 Test.

FLNA is a corporation recognizing all of its profits and conducting its business activities in the United States. As explained in detail in the Department's Initial Brief (pages 11-16), the Illinois General Assembly's purpose in enacting the 80/20 Test was to exclude foreign source income from Illinois combined returns. The application of the 80/20 Test for which PepsiCo argues accomplishes just the opposite result by excluding FLNA's domestic source income from PepsiCo's combined return. This transforms Federal Consolidated Income reported on Line 1 of PepsiCo's Illinois return from average annual income in excess of $1.4 billion dollars to average annual losses in excess of $1.2 billion dollars, as illustrated by the following chart contained in Joint Stip. ¶ 131:

Row	**Tax Year**	**IL 1120 Line**	**2010**	**2011**	**2012**	**2013**
1.	**Federal Consolidated Income - Per Audit**	1	$1,438,691,738	$1,395,652,666	$1,397,889,650	$1,574,642,751
2.	**PepsiCo's Exclusion of FLNA Income from Federal Consolidated Income under the 80/20 test.**	N/A	N/A	($2,743,739,901)	($2,822,348,294)	($2,374,671,181)
3.	**Federal Consolidated Income – Per PepsiCo's Original Return.**	1	**$1,438,691,738**	**($1,348,087,235)**	**(1,424,458,644)**	**(800,028,430)**
	*********		*********	************	**********	**********

4.	**Total Net Income and Replacement Taxes - Per Audit**	52	$ 6,251,010	$ 4,696,736	$ 3,355,864	$ 2,623,354
5.	**Total Net Income and Replacement Taxes – Per PepsiCo's Original Return**	52	$ 5,350,035	$0	$0	$0

(emphasis added).

The interpretation and application of the 80/20 Test for which PepsiCo argues, is directly contrary to the legislative purpose for enactment of this test, which was to exclude foreign source income from Illinois combined returns. Application of the test to exclude FLNA and its domestic income could only occur by ignoring economic realities surrounding PGM LLC, and the expatriate compensation PepsiCo charges to PGM LLC. PepsiCo's counsel argued on November 16th that economic substance is a "bankrupt" doctrine that does not affect the interpretation and application of the 80/20 Test. This argument, based on the legal analysis contained in PepsiCo's Reply Memorandum, is fatally flawed and contrary to longstanding federal and state income tax law.

2. Economic Substance Governs Tax Determinations

One of the basic tenets of income tax law interpretation is that economic realities govern tax consequences. The United States Supreme Court, 100 years ago in U.S. v. Phellis, 257 U.S. 156,168 (1921) first recognized "the importance of regarding matters of substance and

disregarding forms in applying the provisions of the Sixteenth Amendment[1] and income tax laws enacted thereunder." Economic substance has long been considered by courts as "a cornerstone of sound taxation" when interpreting the Internal Revenue Code. Estate of Weinert v. Comm'r 294 F.2d 750, 755 (5th Cir. 1961). In 2010, Congress codified the substance over form doctrine, when it enacted IRC Section 7701 (o) which defines a "transaction as having economic substance only if (A)the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B)the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." (emphasis added).

3. The United States Supreme Court Has Not Ruled that Economic Substance Is Irrelevant in Making Common-Law Employer-Employee Determinations

The Department's Initial Brief addressed a long line of case law, which began with two U. S. Supreme Court decisions, United States v. Silk, 331 U.S. 704 (1947) ("Silk") and Bartels v. Birmingham, 332 U.S. 126 (1947) ("Bartels") and included numerous lower court decisions such as the Tax Court's decision in Professional & Executive Leasing, Inc. v. Commissioner of Internal Revenue, ("PEL") 89 T.C. 225 (1987) aff'd. 852 F2d. 751 (9th Cir.) (1988), in which the Courts ruled that the legal existence of common-law employer-employee relationships must be determined based on economic realities. PepsiCo argues, beginning at page 14 of its Reply Memorandum, that the "U.S. Supreme Court expressly abandoned the antiquated 'economic realities' common law employer-employee analysis/factors in its decisions: *Community for Creative Non-Violence v. Reid*, 490 U.S. 730 (1989) ("CCNV"); and *Nationwide Mut. Ins. Co. v.*

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[1] Enacted in 1909 this Amendment states that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived."

Darden 503 U.S. 318 (1992) ("Darden")." Contrary to PepsiCo's assertion, a close examination of the Supreme Court decisions and subsequent jurisprudence clearly illustrates that economic realities continue to be the measuring stick by which common-law employer-employee determinations are made.

4. The Darden Court Affirmed Applicability of the Common-Law Test for Employees in Making Employer-Employee Determinations for Federal Income, Unemployment and Social Security Tax Purposes

PepsiCo's mistaken conclusion that economic realities are irrelevant in making common-law employer-employee determinations appears to be attributable to its cursory reading of the CCNV and Darden decisions, coupled with a lack of understanding of the legislative and judicial context of these decisions. A careful review of CCNV and Darden illustrates that the Court did not rule that economic realities are irrelevant in making common law employer-employee determinations for federal income, unemployment, and Social Security tax purposes. Instead, the Court reaffirmed the common-law test as controlling for these determinations. In the aftermath of these decisions courts continue, based on Silk and its progeny, to apply the common-law employer test based on economic realities.

a. Silk and Bartels Courts Applied Common-Law Test Based on Economic Realities

To understand the CCNV and Darden decisions, it is necessary to briefly review both Silk and Bartels and their immediate aftermath. In Silk, the Court ruled individuals hired by a coal company to unload coal from railroad cars, were employees and not independent contractors of a coal company. It also ruled that truckers hired to deliver coal were independent contractors. In reaching these conclusions the Court noted that there was no simple uniform or easily appliable test in the Internal Revenue Code for determining whether the unloaders or truckers

were employees. The Court examined, based on economic realities, common-law employer test factors, including: the degree of control exercised by the coal company over the workers; the workers' opportunities for profit and loss; the workers' investment in facilities; and the permanency of the coal company's relationship with the workers. Id. at 716. For instance, the Court held that economic realities demonstrated the coal company exercised little control over the truckers, who had significant opportunities for profit or loss. The truckers hired their own assistants, provided their own trucks, and otherwise paid their own expenses, and could maximize profits by minimizing these expenses. By contrast, the Court held that economic realities demonstrated that the coal company exercised significant control over the unloaders: i) the coal company exercised "all necessary supervision" over their "simple tasks;" and ii) the workers had little opportunity to profit from their relationship – they were paid a set price per ton for coal they unloaded. Similarly, in Bartels the Court ruled that bandleaders, not ballroom operators, employed band musicians. The Court disregarded employment contracts identifying ballroom operators as the employer because economic realities demonstrated that the bandleaders controlled the musicians' work. The bandleaders employed and discharged the musicians, as well as paid the musicians and all their expenses. Bartels at 128.

b. Silk and Bartels Also Interpreted "Employee" Consistently With Legislative Purpose To Extend Social Security Coverage to Workers Economically Dependent on Their Hirer

The Silk Court also stated that that it was construing the term "employee" in "light of the mischief to be corrected and the end to be attained." Silk. at 713-714. (emphasis added). Specifically, the Court construed the term "employee" in light of the legislative purpose of the Social Security Act to eliminate labor disputes and industrial strife by extending Social Security benefits to the unloaders. Id. The Bartels Court similarly held that "control is characteristically

associated with the employer-employee relationship but in the application of social legislation employees are those who as a matter of economic reality are dependent upon the business to which they render service." Bartels at 130 (emphasis added).

After the Court issued its decisions in Silk and Bartels, there was confusion in both Congress and at the Internal Revenue Service ("IRS") whether these decisions continued to apply the common-law test, or adopted a whole new test, which has come to be known as the "economic dependence test," but also is sometimes less accurately referred to as the "economic realities test." Under the economic dependence test a worker is an employee if economically dependent on its hirer for continued employment. What Is An Employee? The Answer Depends on the Federal Law, Monthly Labor Review January 2002 at p.7.[2] The IRS proposed new regulations based on the "economic dependence test" dramatically expanding the scope of the term "employee" and thereby expanding coverage for Social Security purposes. See General Rules Determining the Employment Relationship Under Social Security Laws: After Twenty Years An Unsolved Problem, Temple Law Quarterly, Vol. 33 No. 4, p 382, Summer 1960.

In reaction to the Services' proposed regulation, Congress passed a Status Quo Resolution which stated its intent to maintain the status quo regarding application of employment taxes and social security benefits. Specifically, the resolution, effective October 1, 1948, amended the Social Security Act to treat individuals as "employees" only if they are employees under the "common-law" test. 1948-2 C.B. 317 (I.R.,S.) HJRES 296, 1948 WL 60525. The Truman Administration estimated that application of the common-law test under the Status Quo

[2] This article notes that the economic dependence test, which as discussed in the text is substantially more encompassing than the common-law test, is not used in interpreting the term "employee" in federal *tax* statutes. However, the economic dependence test is used in the interpretation of "employee in federal statutes typically providing some benefit or protection to the hirer, such as the Fair Labor Standards Act, Age Discrimination in Employment Act, American with Disabilities Act, etc. Id. at pp. 6-7.

Resolution, as compared to the economic dependence test, would result in a reduction to the Social Security rolls of up to three-quarters of a million people. See Temple Law Quarterly, Vol. 33 No. 4, p 384, Summer 1960. The current Internal Revenue Code provisions defining employer-employee relationships are derived from the Status Quo Resolution. Determination of Employer -Employee Relationship, 37 A.L R. Fed. 95, F.N. 3. These provisions include IRC Section 3121(d)(2) which states "(d) . . . 'employee' means – (2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of employee;" See also 3306(i)(referencing definition of employee in IRC Section 3121(d)(2).[3] In reaffirming applicability of the common-law test, Congress rejected the economic dependence test for Social Security, federal income and other tax purposes, but it did not reject the relevance of economic substance in applying the common- law test. The cases cited in the Department's Initial Brief, such as Professional & Executive Leasing, Inc. v. C.I.R., 89 T.C. 225 (1987) aff'd. 862 F.2d 751 (9th Cir. Ct App. 1988) , applied the common-law test in the context of economic realities, focusing in particular on control:

> To determine the existence of an employer-employee relationship we must look to common law concepts . . .Among the factors to which the courts have looked in determining the existence of an employment relationship are the following: (1) the degree of control exercised over the details of the work . . . opportunity for profit or loss . . . the transactions embodied in the [Contract of Employment] and [Personnel Lease Contract] lack objective economic substance and are not controlling for tax purposes . . . we hold that the Workers are not common-law employees of petitioner.

Id. at 231-235. In summary, after Congress adopted the Status Quo Resolution courts continued to apply the common-law employer test based on economic realities.

[3] This statutory change reaffirming applicability of the common-law test is the statutory change referenced in PepsiCo's Shepardization of the Silk and Bartels decision attached as Exhibits H and I to its Reply Memorandum. See Donovan v. Agnew, 712 F2d 1509,1514 (1st Cir. 1983) (identifies Status Quo Resolution as Congress' directive after Bartels and Silk that common-law employer test controls for Social Security Act purposes). As discussed in the text of this memorandum, this statutory change had no effect on importance attributed to economic realities in applying the common-law test in the case law cited in the Department's Initial Brief.

c. CCNV and Darden Reaffirmed that the Common-Law Test Controls In Employer-Employee Determinations for Federal Laws That Do Not Contain a Clear Definition of Employee

The Court reaffirmed in Darden applicability of the common-law employer test in applying Social Security, income withholding and other federal laws that do not have a clear definition of the term "employee." With this reaffirmation economic realities remained controlling in applying the common-law test. The Court **did not**, as PepsiCo argues, rule that in applying the common law test economic realities are irrelevant.

In CCNV, the Community for Creative Non-Violence ("CCNV") hired a sculptor ("Reid") to produce a statue. At issue was whether CCNV or Reid held copyright ownership of the statute. Determination of this issue was based on the federal Copyright Act of 1976, U.S.C. § 101 et seq. (the "Act"). If the Court ruled that Reid was CCNV's "employee," as that term was used in the Act, then CCNV held copyright ownership of the statute as a "work for hire." If, on the other hand, the Court ruled that Reid was an independent contractor, then Reid held copyright ownership. The Court held because there was no statutory definition of employee that the common-law test must apply here:

> . . . the Act nowhere defines "employee," "employment," or related terms, it must be inferred that Congress meant them in their settled, common-law sense, since nothing in the text of the work for hire provisions indicates that those terms are used to describe anything other than the conventional relation of employer and employee.

CCNV 490 U.S. at 731. The Court then ruled in applying the common-law test that Reid was an independent contractor based on the lack of control CCNV exercised over Reid. He had complete discretion in deciding when and how long to work on the sculpture and had total discretion in hiring and paying assistants. Id.

Darden involved a determination of whether an insurance company agent was an independent contractor or employee of Nationwide Mutual Insurance Company. If the Court ruled that he was an employee of Nationwide, then he would be entitled to pension benefits from Nationwide under the Employment Retirement Income Security Act ("ERISA"). The Darden Court noted that it had often been asked to construe the meaning of the term "employee" in the context of a federal statute using, but not helpfully defining, the term "employee." The Court cited CCNV as authority for the position that in such instances the common-law test for control must apply. 503 U.S. at 322-324. The Court ruled that the common-law test controlled here since ERISA's "nominal definition" of "employee" as "any individual employed by an employer" was "completely circular and explains nothing." Id. at 323.

Based on its determination that the common-law test was controlling, the Court proceeded to overrule the 4th Circuit Court of Appeals decision below, which *rejected* the common-law test as controlling for ERISA purposes. The Court of Appeals had held that under the common-law test Darden "most probably" would not be an employee of Nationwide. Id. at 321. Nonetheless, the Court of Appeals ruled that Darden *was an employee for ERISA purposes*, because it found application of the common-law test "inconsistent with the 'declared policy and purposes' of ERISA," which included improving the equitable character of such plans. As the Supreme Court noted, under the Court of Appeals expanded definition a worker would be an employee "simply" by demonstrating that he (1) had a reasonable expectation of receiving pension benefits (2) relied on this expectation and (3) lacked economic bargaining power to contract out of pension plan forfeit provisions. As support for this expansive interpretation of the term "employee" under ERISA, the Court of Appeals cited Silk for "the proposition that the

content of the term 'employee' in the context of a particular federal statute is to be construed in the light of the mischief to be corrected and the end to be attained." Id.

The Court rejected the Court of Appeals' expansive interpretation of "employee," holding that Silk, which interpreted the term "employee" as used Social Security Act, is a feeble precedent for "unmooring the term [employee] from the common law" Id. at 324. The Court noted that while its decision in Silk could be read to "imply something broader than the common-law definition" of employee, after this decision was issued "Congress amended the statute so construed to demonstrate that the usual common-law principles were the keys to meaning." Id. at 324-25. That is, Congress' Status Quo Resolution, addressed above, made clear Congress' intent that the common-law test applied for Social Security Act and other tax purposes. Accordingly, the Court rejected the Court of Appeals' expansion of "employee" beyond the common-law test. Because the Court of Appeals had not definitively ruled, based on the common-law test, whether Darden was a Nationwide employee, the Court remanded the case back to the Court of Appeals for a ruling on this issue.

5. Common-Law Test After CCNV and Darden Continues to Be Applied Based on Economic Realities

This careful and considered review of the Court's decision in Darden makes clear that this decision had no impact on Silk's application of the *common-law test* based on economic realities. Indeed, in Darden the Court, citing Silk, held in applying the common-law test that because it "contains no shorthand formula for determining who is an 'employee' all of the incidents of the employment relationship must be assessed and weighed with no one factor being decisive . . . ." Id. at 324. (emphasis added). It would be an illogical application of the common-law test, as well as directly contrary to this holding, if courts after Darden considered

"all incidents" of an employment relationship except economic realities. Subsequent jurisprudence makes clear that not only is economic substance relevant in applying the common-law test, but that Silk, Bartels and PEL are cited as leading authorities in this regard at every federal level, including by the Internal Revenue Service, United States Tax Court and Federal Courts of Appeal.

For example, in Bealor v. C.I.R. , T.C. Memo. 1996-435 (1996), issued 4 years after Darden, the Tax Court ruled at *39, citing Professional & Executive Leasing, Inc. v. Commissioner of Internal Revenue, ("PEL") 89 T.C. 225 (1987) *aff'd.* 852 F2d. 751 (9th Cir.) (1988), that despite employee leasing agreements and pension plan documents that characterized employee lessor partnerships as an employer, based on economic realities the employee lessee, Machise Interstate Transportation Co., Inc. ("Machise"), remained the employer of its workers. Id. at *41. The Tax Court held that "there was no instance in which the partnerships undertook to 'control or direct the performance of the services of the individuals,' despite the explicit reservation of the right to do so" in each of the employee leasing agreements. Instead, the court found that despite these leasing agreements, Machise continued to act, as it had before entering these agreements, as employer in directing the activities of the employees. Id. at *39.

Similarly, in Technical Advice Memorandum ("TAM") 199918056 (1999), 1999 WL 283129, which was issued 7 years after Darden, the Internal Revenue Service cited Bartels, PEL and Burnetta v. Commissioner, 68 T. C. 387 (1977), also addressed in the Department's Initial Brief, as setting the standard for "the determination of which of two potential employers is treated as the employer for employment tax purposes . . . " Id. at p. 5. The IRS stated that it addressed here factual circumstances similar to those at issue in PEL and Burnetta. Id. at p. 7. The Taxpayer's business was facilitating compliance with collective bargaining agreements

entered between industry Operating Companies and various unions. At the start of the Taxpayer's involvement in an industry project, the Taxpayer would enter a Standard Contract with an Operating Company in which the Taxpayer was designated as employer of workers needed for a project. Contrary to these contracts, the IRS noted that many factors demonstrated Operating Company direction and control over the workers. The Operating Companies hired the workers, determined their compensation, provided any training, and determined their hours and location of work. Operating Companies reimbursed the Taxpayer for the workers' pay and benefits. Like PepsiCo is arguing here, the Taxpayer asserted that employer status turns on the right to direct and control workers, and not on actual direction and control, and that under the Contract, it merely delegated a portion of its right to direct and control to the Operating Companies. In response the IRS noted, as in PEL and Burnetta, as a matter of economic reality, the Taxpayer did not screen workers for their qualifications, place them with the Operating Company, set their compensation or determine how long they would be employed, and accordingly the Operating Company, not the Taxpayer, retained the right to control the workers and therefore was their employer. Finally, like PepsiCo here, the Taxpayer argued "that the provision of employee benefits is the overriding criterion for determining employer status and that taxpayer is therefore the employer." However, the IRS rejected this argument stating that "as PEL clearly proves, merely providing benefits is not enough to establish an employment relationship."

In Newhouse v. C.I.R., T.C. Summ. Op. 2002-18 (2002), the court's decision made clear that Silk and PEL not only remain valid, but represent controlling law in determining whether an employer-employee relationship exists based on economic realities. In Newhouse, the Tax Court considered whether the petitioner, a junior college professor, was an independent

contractor or an employee of junior colleges where he worked. The court cited Darden, Silk and PEL for the legal principle that whether the professor was an employee was a factual question examined based on common law principles. Id. at *2. It then cited Silk for the legal principle that various common-law factors, particularly control, determined the "substance of an employment relationship." Id. The court ruled that the junior colleges as a practical matter "exercised sufficient control over petitioner's teaching assignments to support a finding that he was an employee of the colleges."

In Stahl vs. U.S., 626 F.3d 520 (2010) at issue was whether a corporation president was an employee of a religious organization. If he were, his medical and meal expenses would be deductible by the organization. The Ninth Circuit Court of Appeals held under Darden that this determination was made based on general common-law principles. The court stated that in PEL, 862 F.2d. at 753. it had applied common-law factors, such as control, in making this determination. Id. at 523, F.N. 4. The court noted in PEL the taxpayer was in the business of leasing professionals to businesses and at issue was whether the professionals were employees of the taxpayer. Id. at 525. The court further noted that in PEL, regardless of the fact that the professionals' employment contracts identified them as employees of PEL, the court in that case "looked to the true substance of the relationship, and determined that they were not [PEL] employees." Id. (emphasis added). The court in Stahl went on to rule that in contrast to PEL the true substance of the president's relationship with the corporation at issue agreed with its form (corporate bylaws) and accordingly that the president was an employee of the corporation.[4]

[4] It should be noted that PEL was also cited in Striker v. C.I.R., T.C. Memo. 2015-248 at *4 (2015), a decision on which PepsiCo heavily relies on in its memoranda, for the principle that whether a worker is an "employee" is a question of fact, the crucial test for which is the control which the employer exercises over the worker.

Most recently on June 17, 2020 the Tax Court issued its decision in Santos v. C.I.R., 119 T.C.M. (CCH) 1589 (2020). In this case the Tax Court ruled for employment tax purposes that workers were not employees of a cleaning service, Campos Cleaning. Campos Cleaning maintained commercial liability and worker's compensation insurance, which apparently identified the workers as employees of Campos Cleaning. The court concluded that these contracts did not evidence Campos Cleaning's control over the workers that would make them its employees. In support of this conclusion the Tax Court cited at *6 PEL as follows for the principle that economic realities, not contracts, govern common-law employee determinations: "Prof'l & Exec. Leasing Inc. v. Commissioner, 89 T.C. 225, 233 (1987) ("A contract purporting to create an employer-employee relationship will not control where the common law factors (as applied to the facts and circumstances) establish that the relationship does not exist"), aff'd, 862 f.2d 751 (9th Cir. 1988)."

In summary, PepsiCo has misinterpreted the Court's decision in Darden. The Court in that decision rejected a reading of Silk that would adopt, in place of the common-law test, *a more expansive* test for employees known as the economic dependence test. The Department did not argue in its Initial Brief for a more *expansive* test for employees. It has always argued that the common-law test for employees applies here. The case law it has cited, including Silk, Bartels, Burnetta and PEL remain, after Darden, leading authorities on the application of the common-law test based on economic realities, which as addressed in the authorities summarized above are consistent with, and indeed implement the Darden decision. See e. g. Newhouse T.C. Summ. Op. 2002-18 at *2 .

6. Applying the Common-Law Test Based on Economic Realities Requires a Ruling that the Expatriates are Not PGM LLC's Employees

PepsiCo devotes approximately the first 20 pages of its Reply Memorandum to the mistaken argument, debunked above, that economic realities have no bearing on application of the common-law test in ascertaining employment relationships. PepsiCo then devotes the next 25 pages of its Reply Memorandum to the equally mistaken alternative argument that despite the fact PGM LLC has no tangible assets, no real property assets, negative capitalization, maintains no office, and has no management nor administrative support employees, it has sufficient economic substance to require a ruling that the expatriates were its employees, and that PGM LLC had an annual average foreign payroll of over $100 million. For emphasis, these figures are summarized as follows:

	2011	2012	2013
Total Tangible and Real Property	$ 0	$ 0	$ 0
PGM LLC Total Assets	$ 0	$ 2,586	$236,260
PGM LLC Shareholder's Equity	(45,335)	$ 0	(109,451)
*****************	*************	***********	**********
PGM LLC Administrative & Management Employees Payroll	$ 0	$ 0	$ 0
Expatriate Compensation PepsiCo is Attempting to Include in FLNA 80/20 Test as PGM LLC Foreign Payroll	$93,463,835	$100,439,232	$116,263,196

Jt. Stip. Exhibit K (PGM LLC Pro Forma U.S. Corporation Income Tax Return, Schedule L – Balance Sheet, PEP00002536,PEP 00002548 and PEP00002559); and Jt. Stip. ¶ 147. The Department

debunked this assertion at length in its Initial Brief, and in the interests of brevity will not generally repeat all those arguments here, but instead will rely on its Initial Brief (pages 18-35), to refute arguments raised in PepsiCo's Reply Memorandum (pages 20-45). The Department instead will focus here on the principal factor that precludes PGM LLC from being considered the expatriates' employer -- PGM LLC's lack of substantive control over the expatriates.

a. **Contracts Do Not Govern Employer-Employee Determinations Where Such a Relationship is Unsupported By Economic Realities**

PepsiCo asserts at page 19 of its Reply Memorandum that the Department "improperly disregards binding PGM LLC secondment agreements and contracts of employment" in reaching its legal conclusion that the expatriates were not PGM LLC common-law employees. PepsiCo asserts that the underlying contract is the most reliable mechanism for companies to figure out who their employees' are and what, by extension, their pension fund obligations will be, along with many employment benefits with real life consequences, e.g. , healthcare plans, savings plans, etc.

PepsiCo's assertion that contracts invariably control the determination of employment relationships is simply contrary to governing law, which dictates that contracts do not control when they do not reflect economic realities. The Tax Court recognized this principal most recently in Santos v. C.I.R., 119 T.C.M. (CCH) 1589 (2020) at *6 in citing Prof'l & Exec. Leasing Inc. v. Commissioner, 89 T.C. 225, 233 (1987), aff'd, 862 F.2d 751 (9th Cir. 1988) for the principle that a ". . . contract purporting to create an employer-employee relationship will not control where the common law factors (as applied to the facts and circumstances) establish that the relationship does not exist." See also Bartels v. Birmingham, 332 U.S. 126 (1947) (Court ruled that bandmembers were not employees of ballroom operators, even though identified as

such in employment contracts, but instead employees of bandleaders based on all relevant facts and circumstances demonstrating bandleaders' control over their employment) and TAM 199918056 (1999), 1999 WL 283129 (IRS ruled that workers were employees of operating companies despite contracts identifying them as employees of taxpayer that facilitated their operating company employment).[5] Non-arm's length contracts between affiliated legal entities – for example, such as here where there is no arm's length charge by PGM LLC to the Foreign Host Companies – are subject to particular scrutiny. See e. g. IRC Section 482 (authorizing the IRS to override for federal income tax purposes non-arms-length contracts between affiliated entities); and IITA Section 404 (similarly authorizing the Department to adjust for the effect of non-arm's length transactions among affiliated entities).

b. PGM LLC Does Not Control the Expatriates and Therefore It Is Not Their Common-Law Employer

Pertinent facts and circumstances do not support contractual characterization of PGM LLC as the expatriates' common-law employer. The expatriates perform services for the host companies under the direction, and for the benefit, of the host companies. Jt. Stip. ¶ 94. A Foreign Host Company manager assesses the expatriates' day-to-day performance and determines an annual performance rating that is used to determine the expatriates' compensation. PGM LLC has no management or administrative employees. Jt. Stip. ¶¶ 87 and 88. All Global Mobility human resource functions associated with PGM LLC are performed by human resource

[5] PepsiCo cites Revenue Ruling 75-41, 1975-1 C.B. 323 as legal authority for its argument that contractual characterization as an employment relationship governs this determination for tax purposes. However, review of this Revenue Ruling reveals it is based on factual circumstances nothing like those here or at issue in the decisions cited by the Department. In Revenue Ruling 75-41 facts and circumstances supported a determination that a physical professional service corporation was the employer of secretaries, nurses, dental hygienists assigned to medical and dental professionals. The professional service corporations screened and hired the workers, set work hours and duties, and evaluated worker performance.

professional employees of other PepsiCo entities. Jt. Stip. ¶ 74 and ¶¶ 99-102. There is no written agreement regarding, nor intercompany payment made by PGM LLC for, the services of human resource personnel employed by its affiliates. Jt. Stip. ¶¶ 90-91.

Even if the human resource functions performed by employees of other PepsiCo affiliates constituted control for purposes of the common-law test, this would still not make the expatriates PGM LLC's employees. PepsiCo at page 27 of its Reply Memorandum describes the activities of these human resource professionals employed by PepsiCo entities as "PGM LLC's management and support functions." PepsiCo then asserts that "[t]here is no legal requirement for these individuals to be employed directly by PGM LLC" nor that there be another other legal tie between PGM LLC and these individuals such as an intercompany agreement requiring that PGM LLC pay for their services.

First, it is PepsiCo's burden of proof to cite legal authority supporting its position that it can attribute services of human resource personnel employed by other affiliates to PGM LLC, for which PGM LLC does not contract or pay. In Zebra Technologies Corp. v. Topinka, 344 Ill. App. 3d 474, 484 (2003) the court ruled that because the 80/20 test is an exemption from tax: i) taxpayer has "the burden of proving clearly that it comes within the statutory exemption"; and ii) "[s]uch exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation." PepsiCo has not me this burden of proof by citing any legal authority to support its assertion that the human resource personnel constitute PGM LLC's management and support function thereby making the expatriates PGM LLC's employees.

Second, PepsiCo wants to have "its cake and eat it too." On the one hand, PepsiCo demands that PGM LLC's legal form be respected for purposes of treating payroll compensation

charged to it – for work expatriates perform exclusively for and at the direction of Foreign Host Companies --- as PGM LLC foreign payroll. On the other hand, PepsiCo asks that PGM LLC's legal form be disregarded for purposes of attributing to PGM LLC, "management and support" functions, *performed by employees of other PepsiCo entities*, necessary to make PGM LLC the expatriates' employer.

A corporation that choses a particular corporate form to conduct its business may not disregard that form just to gain a tax advantage. Cf. Burnet v. Clark, 287 U.S. 410, 415 (1932), and Moline Props., Inc. v. Commissioner, 319 U.S. 436, 439 (1943). PepsiCo established the form at issue here, organizing PGM LLC as a single member limited liability company of FLNA with the important tax effect that if the expatriates are considered PGM LLC's employees, FLNA and its billions of dollars of income would be statutorily excluded from PepsiCo's Illinois return. PepsiCo cannot then disregard PGM LLC's legal form in order to treat human resource employees of other affiliates as PGM LLC's "management and support function." Id.

Certainly, the courts in the Bartels, PEL and other cases discussed above, in determining which of unrelated businesses was an employer, did not attribute control exercised by one business to an unaffiliated business for this purpose. For example, the court in PEL ruled that PEL was not an employer because PEL lacked the expertise to supervise the professional workers at issue. The court did not impute the supervisory expertise of the businesses for which the professionals worked to PEL for purposes of making them PEL's employees.

PepsiCo has failed to cite legal authority for imputing the activities of human resource personnel employed by affiliates to PGM LLC for purposes of establishing PGM LLC's control over the expatriates. PepsiCo's failure to cite such authority must be resolved under Zebra in favor of taxation by disregarding these activities. PGM LLC has no management and support

employees of its own. Under Bartels, PEL and other case law addressed above, PGM LLC lacks control over the expatriates and therefore cannot be their employer. Accordingly, compensation received by the expatriates is not PGM LLC foreign payroll that excludes FLNA from PepsiCo's combined return under the 80/20 Test.

B. PepsiCo Has Not Met Its Burden of Proving That 80% or More of FLNA's Property and Payroll Are Outside the United States

PepsiCo's Reply Memorandum at pages 44-49 asserts, in contrast to the facts at issue in the Zebra and IBM v. Department of Revenue, 14 TT 229 decisions, that PepsiCo has met its burden of proof that FLNA conducts 80% or more of its business activities outside the United States based on what it contends is extensive discovery in this case. However, the amount of discovery is not what determines whether PepsiCo has met its burden of proof, but rather what this discovery does or does not document. Contrary to PepsiCo's assertion otherwise, it has not documented that FLNA is unitary with PGM LLC, nor even if they are unitary that the expatriate compensation represents substantive foreign business conducted by PGM LLC, which excludes PGM LLC and FLNA from PepsiCo's combined return. For purposes of brevity, we refer to and reiterate the arguments made at pages 37-50 of the Department's Initial Brief addressing PepsiCo's failure to meet its burden of proof in demonstrating that FLNA conducts more than 80% of its substantive business activities outside the United States. This includes PepsiCo's failure to prove that FLNA and PGM LLC are unitary under 86 Ill. Admin. Code Sec. 100.3010(b)(3), and specifically: i) its failure to cite any legal authority for its position that FLNA and PGM LLC are centrally managed where the majority of the employees, who constitute what PepsiCo has referred to as PGM LLC's "management and support function," are employed by foreign subsidiaries that are not included in PepsiCo' Illinois unitary group (Joint

Stip.¶ 74 and Exhibit 8); and ii) similarly PepsiCo's failure to cite *any* legal authority that supports PepsiCo's assertion that PGM LLC's human resource function associated with expatriates assigned to foreign subsidiaries is in the same line of business or a step in a vertical process with FLNA's domestic snack food business. Jt. Stip. ¶¶ 11, 12 and 92.

Finally, PepsiCo has failed to sustain its burden of proving that expatriate compensation charged to PGM LLC represents substantive business activities conducted by PGM LLC outside the United States. As detailed above, and in the Department's Initial Brief, day-to-day business activities of the expatriates are managed by and their services are performed exclusively for foreign subsidiary company management. PGM LLC has no management or support employees of its own. Human resource services that facilitate expatriates' secondment are performed by employees of other foreign subsidiaries without charge to PGM LLC. The expatriates are contractually precluded from performing any business activities on behalf of PGM LLC in attempting to avoid establishing a Permanent Establishment in a foreign country that could subject FLNA to foreign tax exposure. Jt. Stip. ¶¶ 65 and 86. PepsiCo has cited no legal authority that supports the conclusion under these facts that PGM LLC is conducting substantive business activities outside the United States for purposes of the 80/20 Test. In summary, PepsiCo has not met its burden of proof for excluding PGM LLC and FLNA from PepsiCo's Illinois combined return under the 80/20 Test.

C. Application of the Substance Over Form Doctrine Requires a Ruling that PGM LLC Does Not Exclude FLNA from PepsiCo's Illinois Combined Return

1. PGM LLC Is A Conduit for Expatriate Compensation

PepsiCo asserts at pages 49-50 of its Reply Memorandum that the substance over form doctrine is inapplicable here, stating that "PGM LLC's standing as a viable business enterprise" is "established by the factual record here and cannot be seriously debated." It does not there provide an accepted definition for "viable business enterprise" in support of this assertion. Although "viable business enterprise" is not a legal term *per se*, it does have a generally accepted meaning. Most such definitions focus in determining whether a business is viable on whether it is a "going concern" that is able to survive, succeed and make a profit from year to year – i. e. has more money coming in that going out. In this regard, viability also considers the adequacy of funds invested in the business for purposes of assuring its long-term survival and profitability. See e. g. Market Business News, What is viable? Definition and examples https://marketbusinessnews.com/financial-glossary/viable/ ("A viable business . . .When we use the term to describe a company, it means that it is able to survive and succeed. In other words, the business continues making a profit year after year – it is profitable . . . "; and Small Businessify.com, What is viable? Definition and examples, https://smallbusinessify.com/what-does-viability-mean-in-business/. (" Initial Funding Stability . . . You need to be able to afford day-to-day operations for a while on your own, without expecting to be able to use any sort of income. . . ") . PGM LLC certainly does not meet this definition of viable business. PGM LLC's contracts with foreign subsidiaries guarantees that it will never make a profit, in that that they reimburse it on a dollar-for-dollar basis for expatriate compensation, and nothing more or nothing less. Neither is PGM LLC a viable business entity in the sense that it has the necessary economic substance to accomplish its business purpose. PGM LLC neither contracts with, nor employs, human resource personnel necessary to accomplish its business purpose. See e. g. Talbots, Inc. v. Commissioner of Revenue, 79 Mass. App. Ct. 159, 163 (2011) (court refused to

recognize as viable business entity a passive investment company that did not have employees necessary to conduct its business). Neither does PGM LLC have any tangible or real assets to conduct business, and during the years at issue it generally had a negative capitalization. PGM LLC is a conduit, whose general ledger is debited for expatriate compensation and then credited for foreign subsidiary dollar-for-dollar reimbursement of these amounts.

2. PepsiCo's Arguments That Substance Over Form Doctrine Is Inapplicable To PGM LLC Are Supported By Neither Facts Nor Law

Before turning to a discussion of why relevant law, contrary to PepsiCo's arguments otherwise, requires that PGM LLC be disregarded as a conduit, this reply will briefly rebut two meritless arguments PepsiCo makes commencing at page 51 of its Reply Memorandum.

a. The Hartney Fuel Oil Decision is Not Relevant Because the Taxpayer Bill of Rights On Which This Decision is Based Is Inapplicable Here

Exactly what PepsiCo is arguing at pages 51 -52 of its Reply Memorandum based on Hartney Fuel Oil 376 Ill. Dec. 294 (2013) is unclear. PepsiCo seems to be arguing, based on the Taxpayer Bill of Rights, that since Hartney Oil abated the taxpayer's tax liability because that liability was based on the taxpayer's reliance on an invalid regulation, that PGM LLC is entitled to similar relief. PepsiCo argues that the "Department is attempting to improperly expand the scope of the 80/20 rule without a regulation." This argument has no support in either Hartney Oil or the Taxpayer Bill of Rights Act on which this decision is based. The Taxpayer Bill of Rights directs the Department to "abate taxes and penalties assessed based upon erroneous written information or advice given by the Department." 20 ILCS 2520/4(c) (West 2008). Hartney Oil abated tax assessed against a taxpayer because the assessed sales tax resulted from

the taxpayer's reliance on a Department regulation that invalidly sourced sales based solely on place of sales order acceptance. Id. at 314. The Department has never provided erroneous written information or advice to PepsiCo that expatriate compensation charged to a shell entity would be respected as foreign payroll for 80/20 Test purposes. Accordingly, Hartney Oil and the Taxpayer Bill of Rights Act on which it is based are irrelevant here.

b. Summa Holdings Is Inapplicable Because the 80/20 Test Is Not a State of Illinois Sanctioned Tax Avoidance Scheme

At pages 52 and 53 of its Reply Memorandum, PepsiCo returns to the arguments made in its initial memorandum that Summa Holding Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2017) precludes the Department from even raising a substance over form argument. It asserts the factual and legal distinctions made by the Department in its Initial Brief dismissing applicability of Summa are irrelevant. But they are not. The court in Summa held that the Internal Revenue Service could not challenge under the substance over form doctrine the taxpayer's use of a Domestic International Sales Corporation, which is a shell corporation and accepted as such by Internal Revenue Code Section 991 for purposes of exempting foreign source income from tax. As much as PepsiCo would like to similarly consider the 80/20 Test an Illinois sanctioned tax avoidance scheme, it is not. The 80/20 Test, set forth in IITA Section 1501(a)(27), is a substantive provision, as discussed in the Department's Initial Brief (pages 11-16), designed to exclude foreign source income from Illinois combined returns based on practical and policy reasons. PepsiCo's attempt to use this test to exclude billions of dollars of income from FLNA's domestic snack foods business from PepsiCo's Illinois combined return is neither contemplated

nor authorized by IITA Section 1501(a)(27). The Summa Holdings decision has no relevance here.

3. Under The Substance Over Form Doctrine Expatriate Compensation Charged to PGM LLC Should Be Disregarded for 80/20 Test Purposes Because PGM LLC Is Acting Merely As A Conduit

Turning back to PepsiCo's assertion that the Illinois Appellate Court's decision in JI Aviation v. Department of Revenue, 335 Ill. App. 3d 905 (1st Dist. 2002) is inapplicable here, this assertion is based on a misreading of JI Aviation as well as misapplication of the substance over form doctrine.

a. Application of the Substance Over Form Doctrine Is Required to Insure The 80/20 Test Is Applied Consistently With Legislative Intent To Exclude Foreign Source Income From Combined Returns

The substance over form doctrine is a tool of statutory interpretation. Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 23 (1st Cir. 2016) (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 581 n.16, (1978)). It does not "tak[e] a transaction entirely outside its statutory framework," but instead "helps courts read tax statutes in a way that makes their technical language conform more precisely" with legislative intent. Dewees v. Comm'r, 870 F.2d 21, 35 (1st Cir. 1989). Under the doctrine, a taxpayer's transaction "must be viewed as a whole," Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945), to determine whether "the transaction upon its face lies outside the plain intent of the statute." Gregory v. Helvering, 293 U.S. 465, 470 (1935). In this way, courts "look[ ] to the objective economic realities of a transaction rather than to the particular form the parties employed." Frank Lyon Co., 435 U.S. at

573. Courts use the substance over form doctrine when a more wooden application of the Code would "deprive the statutory provision in question of all serious purpose" and would thereby "exalt artifice above reality." Gregory, 293 U.S. at 470. Accordingly, courts begin a substance over form analysis by first "determining the plain intent of the statutory provisions underpinning the taxpayers' transaction." Benenson v. Commissioner of Internal Revenue, 887 F.3d 511, 517 (1st Cir. 2018).

As addressed in detail in the Department's Initial Brief (pages 11-16), the purpose of the 80/20 Test is to exclude foreign source income from Illinois combined returns, due to problems attributable to otherwise including foreign source income in Illinois combined returns. For U.S. based multinationals, these problems include income distortion from not allowing deductibility of foreign taxes. For foreign multinationals, these problems include those associated with translating accounts of their entire foreign operations into U.S. currency and conforming income computation to U.S. and state accounting rules. The application of the 80/20 Test PepsiCo argues for generates billions of dollars of losses on its Illinois combined returns, whereas for federal consolidated return and financial reporting purposes PepsiCo reports billions of dollars of income. PepsiCo accomplishes this by excluding FLNA, and billions of dollars of income from its domestic snack foods business, from PepsiCo's Illinois combined return. This application of the 80/20 Test is not just inconsistent with legislative intent it is *directly contrary to legislative intent* by excluding *domestic*, not foreign, income from PepsiCo's Illinois combined return.

b. PepsiCo Misstates the Substance Over Form Doctrine Which Requires Demonstration of Economic Substance and Business Purpose to Avoid Application of the Doctrine

In JI Aviation, passage of title to a Gulfstream II from a seller through a conduit, Nationsbanc, *a retailer* of aircraft, was ignored. and JI Aviation was treated under the substance over form doctrine as acquiring the Gulfstream directly from the seller, a *nonretailer*. Accordingly, JI Aviation's purchase was free of use tax. Passage of title to the Gulfstream II through Nationsbanc was necessary under IRC Code Section 1031 to accommodate the seller's federal income tax deferral on a like exchange of the Gulfstream II for title to a Gulfstream IV passed on to it by Nationsbanc. PepsiCo at pages 50-51 of its Reply Memorandum attempts to distinguish the facts at issue here by asserting that ". . . unlike Nationsbanc in JI Aviation, PGM LLC has [1] economic substance and [2] business purpose . . . "

PepsiCo further asserts in footnote 12 at page 58 of its Reply Memorandum that whether a transaction has economic substance, for purposes of avoiding application of the substance over form doctrine, is based on a two-part analysis – economic substance and business purpose -- in which the two parts are interrelated. It then incorrectly asserts, citing case law, that PGM LLC will be respected for Illinois income tax purposes if it satisfies *either* part. Contrary to this latter assertion, current law requires that PGM LLC satisfy both parts of this test.

Prior to 2010, there was a split in the federal circuits as to whether economic substance and business purpose were both necessary to avoid application of the substance over form doctrine. Compare Dow Chemical Co. v. United States, 435 F3d. 594 (6th Cir. 2006) (requiring economic substance and business purpose) with Kirchman v. Comm'r. 862 F2d 1486 (11th Cir. 1989) (requiring economic substance or business purpose). In 2010, Congress codified the substance over form doctrine, which adopted the *conjunctive* version of this test. The codification at IRC Section 7701(o) states that a transaction will avoid application of the doctrine ". . . only if (A) the transaction changes in a meaningful way (apart from Federal income tax

effects) the taxpayer's economic position, and (B)the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." (emphasis added). The conjunctive test, requiring both economic substance and business purpose, is now applied by courts in making substance over from doctrine determinations. See e. g. Feldman v. C.I.R., 779 F.3d 448, 455 (7th Cir. 2015) ("transaction has economic substance (and thus will be respected for tax purposes) if it 'changes in a meaningful way ... the taxpayer's economic position' and the taxpayer has a valid nontax business purpose for entering into it.")

The first prong – the objective economic substance prong – is a codification of longstanding case law that requires a determination whether "the transaction has any practical economic effects other than the creation of income tax losses." (emphasis added). If and only if this question is answered in the affirmative, then the second prong – the subjective business purpose prong – requires an examination whether the taxpayer engaged in the transaction for any legitimate nontax business purpose. ACM P'shp v. Comm'r, 73 T.C.M. 2189, 1997 WL 93314 at *36, aff'd in part , rev'd. in part, ACM P'shp v. CIR 157 F.3d 231 (3d Cir. 1998).

c. **PGM LLC Fails to Satisfy The Economic Substance Prong**

Courts have long required that to satisfy the objective *economic substance* prong– *i. e.* have *a non-tax economic effect* – that the transaction must offer "a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." Portland Golf Club v. Comm'r., 497 U.S. 165, 169 n.19 (1990) (quoting Gefen v. Comm'r, 87 T.C. 1471, 1490 (1986); and Rice's Toyota World, Inc. v. C.I.R., 752 F.2d 89, 91 (4th Cir.1985). For example, in Rice's Toyota World the Tax Court applied the substance over form doctrine to disregard a sale-leaseback transaction where it held that an "objective analysis of the transaction showed that petitioner

could not have had a realistic hope of profit." Id. This interpretation continues to apply, subsequent to the codification of the substance over form doctrine in IRC Section 7701(o), for both federal and state income tax purposes. See e. g. Feldman v. C.I.R., 779 F.3d 448, 455 (7th Cir. 2015) ("transaction has economic substance (and thus will be respected for tax purposes) if it 'changes in a meaningful way ... the taxpayer's economic position''); and Elmer v. Indiana Department of Revenue, 42 N.E.3d 185, 191 (Tax Ct. Ind. 2015) (interpreting IRC Section 7701(o)'s first prong the Indiana Tax Court asked, citing Rice's Toyota "did the transactions lack economic substance because no reasonable possibility of a profit existed (the economic substance test)."

PGM LLC has no tangible or real assets, and during the years at issue generally had a negative capitalization. PGM LLC has no management or support personnel to oversee the expatriates that PepsiCo asserts are its common-law employees. The human resource personnel who signed Secondment Agreements and Letters of Understanding with Foreign Host Companies setting the terms and scope of the expatriates' employment were employees of other PepsiCo subsidiaries. PGM LLC will never have any opportunity for profit and loss since the amounts paid by foreign subsidiaries credited to it exactly offset the expatriate compensation charged to it. Applying the judicial interpretation of economic substance now codified in IRC Section 7701, PGM LLC has no economic substance because it has no opportunity for profit. The flow of expatriate compensation through PGM LLC as a mere conduit must accordingly be ignored for Illinois 80/20 Test purposes under the substance over form doctrine. See Aiken Industries v. Commissioner, 56 T.C. 925 (1971) (flow of funds from United States company through Honduran corporation to Ecquadoran corporation, for purposes of securing exemption from federal income tax withholding offered under U.S.\Honduran treaty, disregarded because

Honduran corporation served merely as a conduit). Accordingly, based on this application of the substance over form doctrine compensation charged to PGM LLC must be ignored and FLNA can therefore not be excluded from PepsiCo's Illinois combined return.[6]

PepsiCo relies at pages 55-58 of its Reply Memorandum on the Massachusetts Supreme Court's decision in Sherwin Williams Co. v. Commissioner of Rev. 438 Mass. 71 (2002) in support of its argument that expatriate compensation charged to PGM LLC should not be disregarded under the substance over form doctrine. PepsiCo asserts that like the intellectual property passive investment company ("PIC") at issue in Sherwin Williams, PGM LLC conducted substantial business activity that avoids application of the substance over form doctrine. Contrary to this assertion, there were crucial factual differences in Sherwin Williams,

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[6] Because of PGM LLC's lack of economic substance, it is not necessary for the Department to reach the second business prong in order to disregard expatriate compensation under the substance over form doctrine. It should be noted, however, that PGM LLC fails to meet this prong also because PGM LLC lacks the economic substance to accomplish its business purposes. In Comptroller of the Treasury v. SYL Inc., 375 Md. 78, 87-88 (2003) the Maryland Supreme Court addressed whether royalties paid to an intellectual property passive investment company ("PIC") should be ignored under the sham transaction doctrine. The court in SYL found that although the PIC had a stated business purpose of maintenance and management of intellectual property, it relied on employees of affiliates to accomplish this business purpose for it:

> Although the business purpose alleged for the formation of SYL was the "maintenance and management of valuable intangible assets," the license agreement between Syms and SYL *88 authorized Syms to take charge of such maintenance and management. It stated: "Licensor [SYL] shall have the right (but not the obligation) to take charge of the defense of any [infringement] claim, action or proceeding.... If licensor declines ... to defend any such claim, action or proceeding, licensee may do so." The license agreement did impose some affirmative duties upon **405 SYL, as licensor, in the area of quality control of the trademarks. Nevertheless, there is no indication in the record that Edward Jones, SYL's sole "employee," performed any of these duties. Nor are the quality control duties mentioned in the letter memorializing the services that Mr. Jones was to provide to Syms or SYL. Instead, according to the testimony, these duties were assumed by Syms' officers when they were wearing their SYL "hats.

The court therefore disregarded the PIC's stated business purpose, and under the sham transaction doctrine, which applies when a legal entity has neither economic substance nor business purpose, disregarded for state income tax purposes royalty payments made to the PIC. Id. at 107. This decision is consistent with other state tax decisions that have disregarded royalties under the sham transaction doctrine. See. e.g. Syms v. Commissioner of Rev. 436 Mass. 505, 511 (2002); Kimberly-Clark Corp. v. Commissioner of Revenue, 83 Mass. App. Ct. 65 (2013); and Talbots, Inc. v. Commissioner, 79 Mass. App. Ct. 159, (2010). Similarly, application of the sham transaction doctrine here to disregard expatriate compensation is appropriate because PGM LLC lacks the economic substance necessary to achieve its business purpose.

which PepsiCo's Reply Memorandum fails to address, that only underscore why the two PICs in that case conducted substantial business activity and *PGM LLC does not* for purposes of avoiding application of the substance over form doctrine.

Intellectual property PICs, such as those in the Sherwin Williams decision, are typically set up in a jurisdiction, that either does not impose corporate income taxes or, like Delaware, adopts a specific tax exemption for passive investment income. Parent operating companies transfer intellectual property, such as trademarks, to the PIC. The parent pays the PIC a royalty, which the parent uses to reduce state taxable income. There is typically a circular flow of funds in that the PIC either returns money to the parent by tax-exempt dividend or repayment of the parent's intercompany loan used to capitalize the PIC. The PIC also typically hires an employee, who performs ministerial tasks, but no activities related to maintenance of the PIC's intellectual property. Delaware: An Onshore Tax Haven, December 10, 2015, https://itep.org/delaware-an-onshore-tax-haven/.

The Massachusetts Department of Revenue attacked the deductibility of the royalties in Sherwin Williams under the sham transaction theory. Unlike the substance over form doctrine, codified in IRC Section 7701(o), which requires the Illinois Department of Revenue to demonstrate either a lack of economic substance or business purpose in order to prevail, in order to succeed under its sham transaction theory, the Massachusetts Department of Revenue was required to demonstrate both a lack of economic substance and business purpose in order to prevail. Id. at 84-85 (citing Rice's Toyota World, Inc v. C.I.R., 752 F.2d 89 (4th Cir. 1985)). As PepsiCo observes at pages 55-56 of its Reply Memorandum, the court concluded that the PIC did not have a (nontax) business purpose, so the focus of the court's inquiry turned to whether the PIC had economic substance. The court held that in contrast to the PIC in its earlier decision in

Syms Corp. v. Commissioner of Rev., 436 Mass. 505, 511 (2002), in which the court disregarded royalty payments under the sham transaction doctrine, Sherwin Williams PICs' factual circumstances were distinguishable in four key respects. Review of these four factors illustrates why PGM LLC does not have economic substance. The court stated that after their formation the PICs "operated as ongoing businesses" (Sherwin Williams 438 Mass. at 78) as evidenced by the following facts.

1. **Enjoyed Benefits and Bore Burdens of Business It Conducted**. The court held that the benefits and burdens of owning the intellectual property rested in the Sherwin Williams PICs. The PICs retained and invested the royalties received. They paid expenses associated with filing and trademark proceedings necessary to maintain trademarks, as well as for quality control testing of Sherwin Williams' use of the trademarks in its products. By contrast, PGM LLC was a pure conduit. Its books were debited for expatriate compensation expenses and credited for foreign host company reimbursement. PGM LLC did not incur any human resource or other expenses associated with identifying, placing, overseeing, repatriating, or terminating the expatriates.

2. **Conducted Business With Unrelated Third Parties**. The PICs licensed the marks to unrelated third parties. By contrast, although PepsiCo touts PGM LLC as a "global employment company" all expatriates were placed with PepsiCo affiliates, and none were placed with unrelated third parties.

3. **Engaged In Profitmaking Activities Independent of Affiliates.** The PICs engaged in profit making activities independent of their affiliates. Besides generating royalties by licensing marks to third parties, the PICs retained and invested the royalties received under investment policies established by the PICs, which earned a rate of return greater than earned on comparable funds invested by its parent. Between them the PICs had over $60 million invested in short-term investment instruments that generated over $1.3 million of annual investment income. By contrast, PGM LLC engaged in no profitmaking activities at all. PGM LLC's contracts with Foreign Host Companies simply required that they reimburse PGM LLC dollar-for-dollar for expatiate compensation.

4. **Meticulously Observed Corporate Formalities in Incurring and Paying For Substantial Services of Third Parties in Conducting Its Business** . "All corporate formalities were meticulously observed" by the PICs. Id. To assist them with the filings necessary to maintain trademarks the PICs "contracted with Sherwin-Williams and paid market rates on periodic invoices for the services they received." The PICs also hired and paid professionals to conduct quality control testing, and hired and paid

> outside lawyers to represent them in trademark proceedings. By contrast, PGM LLC did not retain any outside third parties to help facilitate the placement and management of expatriates. All expatriate identification, placement, oversight and re-patriation activities were performed by employees of other PepsiCo affiliates. Corporate formalities were not observed. PGM LLC neither contracted, nor paid, for the performance of these services.

In a subsequent decision, the Massachusetts Appellate Court in Talbots, Inc. v. Commissioner, 79 Mass. App. Ct. 159 (2011) ruled based on the four factors identified in Sherwin Williams that royalty payments must be disregarded under the sham transaction doctrine where a PIC conducted "business in form only" because it: i) served merely as a conduit for royalties received, by repaying almost all royalties (ninety-six percent) to its parent; ii) entered no license agreements with unrelated third parties; iii) distributed most royalty payments, instead of investing them in its business, and earned only minimal interest at an annual rate of 0.21 percent on the limited royalties it retained; and iv) did not have employees who made licensing or other decisions on its behalf, nor did it otherwise contract or pay for such services. Id. at 163-164.

In summary, while PepsiCo asserts its pertinent facts are like those in Sherwin Williams, they are effectively indistinguishable from those at issue in Talbots. A close examination of PGM LLC's facts based on the Sherwin Williams and Talbots decisions demonstrates that PGM LLC does not possess economic substance because PGM LLC: i) does not enjoy the benefits nor bear the burdens of the expatriate business, but simply serves as a conduit for expatriate compensation; ii) does not conduct any business with third parties iii) does not engage in any profitmaking activity; and iv) does not employ individuals to manage the expatriate business, and does not contract with and pay third parties to manage this business. PGM LLC is a conduit for the expatriate compensation which lacks economic substance and accordingly the expatriate compensation charged to PGM LLC must be disregarded under the substance over from doctrine.

JI Aviation v. Department of Revenue, 335 Ill. App. 3d 905 (1st Dist. 2002); Sherwin Williams Co. v. Commissioner of Rev. 438 Mass. 71 (2002); and Talbots, Inc. v. Commissioner, 79 Mass. App. Ct. 159 (2011).

D. Conclusion: PGM LLC's Lack of Economic Substance is Fatal to PepsiCo's Assertion that Expatriate Compensation Excludes FLNA from the PepsiCo Illinois Combined Return Under the 80/20 Test

Contrary to the assertion by PepsiCo's legal counsel that economic substance is a "bankrupt" consideration with no applicability here, PGM LLC's utter lack of economic substance is controlling in requiring for 80/20 Test purposes the conclusion that: i) the expatriates are not PGM LLC's employees; ii) PepsiCo has not met its burden of demonstrating that 80% of more of PGM LLC's substantive business activities are conducted outside the United States; and iii) application of the substance over form doctrine applies to require that expatriate compensation charged to PGM LLC be disregarded. Accordingly, based on this application of the 80/20 Test, FLNA does not conduct 80% or more of its business activities outside the United States, and is not excluded from PepsiCo's Illinois combined return.

III. Conclusion

The Department has demonstrated that it has used the Joint Stipulations as they were intended – as the factual universe of this matter – and has properly argued its legal position based upon these stipulated facts. The Department's position that PGM LLC is a paper entity without economic substance, unable to take any actions on its own, is supported by the Stipulations, when the Joint Stipulations are viewed in their entirety. The Tribunal must honor the intent of

the parties, that the Joint Stipulations are the factual basis for which the parties to base their arguments. All of the positions taken by the Department, in this brief and in its Response, have been consistent with the Joint Stipulations. However, if this Tribunal finds that the Joint Stipulation of Facts do not represent the intent of the parties, then the Joint Stipulations of Fact should be read as intended by the parties, certain stipulations should be revised or deleted, or a trial or hearing on the contested facts should be conducted.

Substantively, the thrust of the Department's argument is that FLNA does not, and cannot, qualify as an 80/20 company, as payroll charged to PGM LLC must not exclude FLNA from PepsiCo's combined return due to PGM LLC's lack of economic substance. PepsiCo has failed to prove that the expatriates were PGM LLC employees. PepsiCo has failed to prove, and cannot prove, that 80% or more of FLNA's business activities were conducted outside the United States. The facts contained in the Joint Stipulations, when viewed in totality, clearly illustrates just how inappropriate PepsiCo's legal position really is. PGM LLC lacks any semblance of economic substance and it would be a travesty to remove FLNA (one of the largest domestic snack food providers) from the Illinois combined return as an 80/20 company.

For the reasons stated in the Department's Response Brief and Surreply, summary judgment should be granted in its favor.

Respectfully submitted,

Illinois Department of Revenue

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IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL

PEPSICO, INC. & AFFILIATES,	)
	)
Petitioner,	)
	)
v.	) Case Nos. 16 TT 82
	) 17 TT 16
ILLINOIS DEPARTMENT OF REVENUE,	)
	) Chief Judge James M. Conway
Respondent.	)

CERTIFICATE OF SERVICE

The undersigned counsel of record certifies that a copy of **Illinois Department of Revenue's Sur-Reply in Response to PepsiCo, Inc. & Affiliates' Motion for Summary Judgment Reply** was served on January 6, 2021, to the following persons:

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