**IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL**

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

# PEPSICO, INC. AND AFFILIATES' RESPONSE TO THE ILLINOIS DEPARTMENT OF REVENUE'S CROSS-MOTION FOR SUMMARY JUDGMENT TO UPHOLD LATE-PAYMENT PENALTIES


THEODORE R. BOTS
DAVID A. HEMMINGS
BAKER & MCKENZIE LLP
300 E. Randolph Street, Ste. 5000
Chicago, IL 60601
Telephone: (312) 861-8845
Fax: (312) 698-2004
theodore.bots@bakermckenzie.com
drew.hemmings@bakermckenzie.com

GEORGE M. CLARKE
BAKER & MCKENZIE LLP
815 Connecticut Avenue, NW
Washington, DC 20006
Telephone: (202) 835-6184
Fax: (202) 416-7184
george.clarke@bakermckenzie.com


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*Attorneys for Petitioner,*
*PepsiCo, Inc. and Affiliates*

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**PEPSICO'S RESPONSE TO THE DEPARTMENT'S CROSS-MOTION FOR SUMMARY JUDGMENT TO UPHOLD LATE-PAYMENT PENALTIES**

Petitioner, PepsiCo, Inc. and Affiliates ("PepsiCo"), and Respondent, the Illinois Department of Revenue (the "Department"), filed cross-motions for summary judgment on Count X (Case No. 16 TT 82) and Count XV (Case No. 17 TT 16) regarding PepsiCo's petition for reasonable cause abatement of late-payment penalties assessed in connection with PepsiCo's exclusion of Frito-Lay North America, Inc. ("FLNA") from its Illinois combined group as an "80/20 Company" for the 2011 - 2013 tax years. The Department moves to uphold its penalty assessment, raising three discrete arguments against PepsiCo's claim for reasonable cause abatement, each of which must be denied in full.

First, the Department distorts the plain language of the reasonable cause penalty abatement regulation, which looks exclusively at whether the taxpayer made a good faith effort to report its proper tax liability in accordance with the law as it existed at the time the returns were filed. Second, the Department obfuscates the clear, mechanical 80/20 Company calculation with vague, extrastatutory standards to maximize the amount of income reported on the Illinois return. Contrary to the Department's claim, Illinois 80/20 calculations are neither informed by, nor contingent on, the resulting Illinois tax liability. Further, as agreed by the parties, the underlying

tax dispute hinges exclusively on the narrow legal issue of "whether the expatriates were PGM LLC's common law employees under case law interpreting this term for federal income and withholding tax purposes." The Department's Brief In Support of Its Cross-Motion for Summary Judgment ("Dept. MSJ Br."), Page 5 (Mar. 17, 2022). This legal issue is governed by a federal common law employer-employee analysis, which the Illinois "80/20 Rule" incorporates by reference. Again, contrary to the Department's claim, pursuant to U.S. Supreme Court precedent neither the purpose / intent of the Illinois 80/20 rule, nor PepsiCo's resulting Illinois income tax liability, have any relevance or bearing on the determination of whether the expatriates were PGM LLC's common law employees. As a result, these issues have no relevance or bearing on whether the subject penalties should be abated for reasonable cause. Third, the Department's attempt to characterize PGM LLC as a company formed solely for tax avoidance purposes is in direct conflict with the stipulated record. The undisputed facts unequivocally set forth the valid non-tax business purpose and objectives of PGM LLC. Finally, the Illinois and federal case law relied upon by the Department directly supports PepsiCo's penalty abatement request and/or is clearly distinguishable from the facts at issue here. For these reasons, the Department's motion for summary judgment must be denied, PepsiCo's motion for summary judgment must be granted, and the subject penalties abated accordingly.

## I. <u>The Department's Regulation Mandates Abatement of Penalties</u>

The key factor in the Department's penalty abatement regulation is whether PepsiCo acted reasonably to determine its proper tax liability at the time its tax returns were filed. *See* 86 Ill. Admin. Code § 700.400(b) ("The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine the proper tax liability and to file returns and pay the proper liability in a timely

fashion."). In this case, the Department has agreed that PepsiCo accurately computed FLNA's property and payroll factors for 80/20 Company purposes. *See* Joint Stip. ¶¶ 146-147. Applying these amounts to Illinois's mechanical test, PepsiCo determined that FLNA was an 80/20 Company and, thus, must be excluded from the Illinois combined group in accordance with 35 ILCS 5/1501(a)(27)(A) and 86 Ill. Admin. Code § 100.9700(c)(2)(b). This determination was consistent with Illinois case law existing at the time the returns were filed. *See Zebra Tech. Corp. v. Ill. Dept. of Revenue*, 344 Ill. App. 3d 474, 484 (1st Dist. 2003) (requiring all property / payroll be included within the 80/20 calculation).

Despite PepsiCo's belief that FLNA was properly excluded as an 80/20 Company under Illinois law, the Department subsequently challenged PepsiCo's classification of FLNA by raising a good faith legal dispute regarding the classification of expatriates as "employees" of PGM LLC. The answer to this narrow legal question is governed by federal common law and requires an analysis of the unique facts-and-circumstances of each case. This narrow legal issue is a matter of first impression before the Tax Tribunal. A good faith legal dispute alone is sufficient to demonstrate reasonable cause. *See*, *e.g.*, 86 Ill. Admin. Code § 700.400(c) ("A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation …"); *Horsehead Corp. v. Ill. Dept. of Revenue*, 2019 IL 124155, ¶ 51 (abating penalties where "there was no case law that Horsehead could have turned to for guidance …"); and *Security Life of Denver Insurance Company v. Ill. Dept. of Revenue*, 14 TT 89 (Apr. 11, 2016) ("Penalties are not imposed where a taxpayer is unable to ascertain a clear legal standard through no fault of its own.").

PepsiCo exercised ordinary business care and prudence in classifying FLNA as an 80/20 Company given the lack of guidance and clarification regarding the narrow legal issue presented

here. The lack of express guidance and clarification are evidenced by the statutory language and existing authorities, as well as the parties' protracted litigation. Contrary to the Department's claim, a subsequent adverse decision on a narrow legal issue of first impression does not serve to defeat a claim to reasonable cause. *See* 86 Ill. Admin. Code § 700.400(c). The Department's repeated reliance on the Tax Tribunal's determination in an effort to retroactively support its imposition of penalties on a return filed more than a decade earlier is misplaced and inappropriate.

## II. PepsiCo Reported Its "Proper Tax Liability" In Accordance With Governing Law and Applicable Authorities

PepsiCo computed its "proper tax liability" in accordance with controlling legal authorities existing at the time PepsiCo filed its returns for the 2011 - 2013 tax years. *See* Dept. MSJ Br., Pages 10-14. The Department's claim that a taxpayer's "proper tax liability" requires looking beyond the undisputed 80/20 Company statute and applicable authorities is without merit. Neither the Illinois 80/20 Company statute, nor the incorporated federal common law employer analysis, contain the after-the-fact, undefined, results-driven, self-serving criteria relied upon by the Department in support of its claim to uphold penalties here.

### A. PepsiCo Computed Its "Proper Tax Liability" Through Required 80/20 Rule Property and Payroll Computations

The Illinois 80/20 Rule is construed in accordance with its clear statutory language. *See PepsiCo, Inc. v. Ill. Dept. of Revenue*, Case Nos. 16 TT 82 and 17 TT 16, Order on Count I - Motion for Summary Judgment, Page 12 (May 4, 2021) ("PepsiCo [was] correct that the 80/20 statute mandates straightforward mathematical calculations."). PepsiCo's tax department evaluated the available and clear statutory language and administrative guidance and, consistent with these authorities, reasonably determined that FLNA was an 80/20 Company based on mechanically accurate property and payroll calculations. *See* Joint Stip. ¶¶ 146-147 (where the

parties agree PepsiCo accurately computed the amount recorded as FLNA property and payroll; it is only the classification of reported PGM LLC payroll as "compensation" that is in dispute); and *Zebra*, 344 Ill. App. 3d at 484.

While the mechanics of the 80/20 Company statute are clear and undisputed, the Department asserts that determining PepsiCo's "proper tax liability" requires something beyond the clear statutory language of the Illinois Income Tax Act ("IITA") generally and the 80/20 Rule specifically. *See* Dept. MSJ Br., Pages 3-4, 10, 13, 15. The Department's claim is in complete conflict with Illinois law and, at best, represents an undefined, unsupportable, and subjective extrastatutory standard. *See* Dept. MSJ Br., Pages 3-4, 10, 13, 15. To this end, there is no equitable reallocation provision in the 80/20 Rule, while equitable adjustments made under IITA Sections 304(f) and 404 are permitted in narrow circumstances, none of those circumstances apply here. And even under those provisions, the Department must promulgate a formal regulation providing specific methods and standards for equitable adjustments to apportionment or income.

As a result, the Illinois 80/20 calculation is neither informed, nor governed, by the amount of PepsiCo's resulting Illinois tax liability. The Department's claim that the purpose and intent of the 80/20 statute is to exclude "foreign income" from the Illinois return is overly simplistic, self-serving, and most importantly in conflict with the clear statutory language, legislative history, and logic. *See* Dept. MSJ Br., Page 13. Rather, the intent of the 80/20 Rule was to exclude foreign "business activity" through "clear statutory language" with "clearly defined provisions" to "provide the certainty and stability so important to businesses." *See* Letter from Governor James R. Thompson to the Illinois House of Representatives regarding House Bill 2588 (1982).[1]

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[1] In contrast, "[i]n many of the other States which apply combined reporting, these definitions are not spelled out and taxation decisions may be arbitrary and may be based on factors other than business activity." *Id.*

The Department's reference to a taxpayer's "proper tax liability" solely based on equities is exactly what the legislature sought to avoid when it defined "unitary business group" through exclusion of "those members whose business activity without the United States is 80 percent or more of any such member's total business activity," measured by the "property and payroll factor computations." 35 ILCS 5/1501(a)(27)(A). The Department's subjective, after-the-fact inquiry to re-determine the amount of income or loss reported on the Illinois return is in conflict with the applicable statutory language and legislative history. Nowhere in the language of the 80/20 statute / regulations, or the IITA for that matter, is the term "proper tax liability" defined to mean anything other than a taxpayer's liability computed in accordance with existing Illinois law and related authorities. The Department's claim that PepsiCo had some additional unarticulated burden to prove entitlement to classifying FLNA as an 80/20 Company is completely unfounded. *See, e.g.*, Dept. MSJ Br., Page 10 ("PepsiCo has never argued, nor has it introduced any evidence, that application of the 80/20 Test to exclude FLNA and its domestic profits from its combined return better reflected its 'proper tax liability.'").

As required under Illinois law and applicable authorities, FLNA was classified as an 80/20 Company through agreed upon and accurate property and payroll factor computations. The Department's subjective, results-driven quest to determine some undefined, "know it when you see it," "proper tax liability" does not exist in Illinois law or authorities. Indeed, just the opposite. PepsiCo followed and complied with Illinois law and authorities by excluding FLNA as an 80/20 Company. As such, penalties must be abated for reasonable cause. *See Hartney Fuel Oil Co. v. Hamer*, 376 Ill. Dec. 294 (2013) (the Department must abate penalties where the taxpayer complies with Illinois guidance, even when the transaction is structured to minimize tax due); and the Taxpayers' Bill of Rights Act, 20 ILCS 2520/2 ("The General Assembly further finds that the

Illinois tax system is based largely on self-assessment, and the development of understandable tax laws and taxpayers informed of those laws will both improve self-assessment and the relationship between taxpayers and government. It is the further intent of the General Assembly to promote improved taxpayer self-assessment by improving the clarity of tax laws and efforts to inform the public of the proper application of those laws.").

B. The Federal Common Law Employer-Employee Determination Is Made Without Regard to Resulting Tax Due

Despite devoting a significant portion of its brief to equitable "proper tax liability" claims, these arguments are irrelevant to the penalty abatement issue presently before the Tax Tribunal. In fact, the Department concedes that the sole issue in dispute is "whether the expatriates were PGM LLC's common law employees under case law interpreting this term for federal income and withholding tax purposes." *See* Dept. MSJ Br., Page 5. Therefore, as agreed, the federal common law employer-employee analysis controls. This analysis neither considers, nor turns on, PepsiCo's Illinois 80/20 Company calculation or resulting Illinois tax liability. The Department's claim that late-payment penalties must be upheld as a result of "decades of well-established case law" illustrates its misunderstanding of applicable law. *See* Dept. MSJ Br., Page 13 (citing *United States v. Silk*, 331 U.S. 704 (1947) and *Equal Employment Opportunity Comm'n v. N. Knox School Corp.*, 154 F.3d 744 (7th Cir. 1998)).

More specifically, the Department's suggestion that the common law employer-employee determination is informed / controlled by the underlying impact on the 80/20 Rule is in direct conflict with U.S. Supreme Court precedent. To this end, common law employer-employee determinations are made without regard to the policy / purpose of the underlying statute referencing the term "employee." *See Daughtrey v. Honeywell*, 3 F.3d 1488, FN 16 (3rd Cir. 1993) ("*Darden* rejected the directive announced in *United States v. Silk* … that the scope of [the term]

‘employee’ should depend on the statutory purpose.”). Furthermore, the *Knox* case cited by the Department clarifies that the “‘economic realities’ test” “calls for ***application of general principles of the law of agency*** to undisputed or established facts.” *See Knox*, 154 F.3d 744 (7th Cir. 1998) (citing *Darden*) (emphasis added). When applying the “general principles of the law of agency” to a federal common law employer analysis, the amorphous “policy or purpose” of the underlying statute (ADEA, ERISA, the 80/20 Rule, etc.) -- which uses the word “employee” -- has no bearing whatsoever on the determination of whether an individual is (or is not) an “employee.” *See Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 325 (1992).

Consistent with this clear and unmistakable framework, PepsiCo’s tax department followed the proper protocols by extensively investigating FLNA’s qualifications as an Illinois 80/20 Company, which necessarily included the classification of PGM LLC as the common law employer of the expatriate employees. With respect to the latter, PepsiCo’s tax department reasonably relied upon extrinsic evidence including Form W-2 wage reports, Federal Insurance Contributions Act (“FICA”) Form 941 tax returns filed with the IRS, federal income tax withheld, as well as the advice and determinations of subject matter experts in expatriate global mobility. *See* Joint Stip. ¶¶ 114-116; and C. Mueller Cert. ¶¶ 43, 72-74. PepsiCo’s determination that FLNA qualified as an 80/20 Company was completely reasonable and consistent with these factors. The Department’s assertion that the common law employer determination is made through the “policy or purpose” of the 80/20 Rule to maximize income reported on the Illinois return is expressly forbidden by controlling case law and cannot be used as a basis to defeat PepsiCo’s case for reasonable cause penalty abatement.

## III. PGM LLC Was Created and Continues to Exist for Non-Tax Business Reasons

The Department's suggestion that PGM LLC was created simply to avoid tax is directly contradicted by the stipulated factual record. *See* Dept. MSJ Br., Pages 10, 14. PGM LLC serves the entire PepsiCo Corporate Group for legitimate, non-tax business reasons. As stipulated by the parties, and detailed in Charles F. Mueller's certification, PepsiCo did not determine PGM LLC qualified as the common law employer in a vacuum; rather, PepsiCo's tax department -- in consultation with subject matter experts in expatriate global mobility -- made this determination by evaluating the federal employment tax treatment of PGM LLC (issuing Form W-2, withholding FICA taxes, etc.). *See* Joint Stip. ¶¶ 114-116; and C. Mueller Cert. ¶¶ 43, 72-74. Furthermore, PGM LLC was formed for legitimate business reasons, including, but not limited to: the limitation of U.S. entity legal liability; to minimize permanent establishment exposure; ease tax, business, and other government compliance requirements; employ expatriates in one centralized entity; and to support high performing executives sent outside the U.S. to perform temporary key services for foreign subsidiaries. *See* Joint Stip. ¶¶ 7, 26, 65, 67, 73, 81-82, and 92. These operations were fulfilled by authorized personnel throughout PepsiCo's corporate structure who worked together to provide management and support functions for PGM LLC and its expatriates. *See* Joint Stip. ¶¶ 74, 100-110, 103, 158 (Exhibits 4-9, 25, and 26).

The Department selectively ignores all of these facts in its attempt to uphold its penalty assessment. While one can dispute the level or amount of substantive operations required to support classification as a common law employer, the stipulated record unequivocally proves PGM LLC was formed for valid business reasons -- separate and apart from FLNA's classification as Illinois 80/20 Company. The Department's mischaracterization of these critical facts cannot serve as a basis to uphold late-payment penalties.

## IV. **The Cases Cited By the Department Are Clearly Distinguishable and Otherwise Support Penalty Abatement**

The Department's motion cites federal and Illinois case law in an effort to support its assertion of late-payment penalties. In every instance, the cases cited by the Department are clearly distinguishable from the facts at issue here and/or expressly support reasonable cause penalty abatement. For instance, the Department resorts to inapposite reasonable cause penalty abatement cases where taxpayers took untenable filing positions directly in conflict with existing law. *See Kroger Co. v. Ill. Dept. of Revenue*, 284 Ill. App. 3d 473, 477 (1st Dist. 1996); *PPG Industries v. Ill. Dept. of Revenue*, 328 Ill. App. 3d 16 (1st Dist. 2002); and *Tyson Foods, Inc. v. Ill. Dept. of Revenue*, 312 Ill. App. 3d 64 (1st Dist. 2000). Unlike those cases, PepsiCo's classification of FLNA as an 80/20 company was consistent with existing case law. Additionally, the federal cases cited by the Department fit perfectly within PepsiCo's penalty abatement framework. *See, e.g.*, *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366 (Fed. Cir. 2010) ("The economic substance doctrine seeks to distinguish between structuring a real transaction in a particular way to obtain a tax benefit, which is legitimate, and *creating* a transaction to generate a tax benefit, which is illegitimate." (emphasis in the original)). PGM LLC exists for non-tax business reasons; FLNA's subsequent corporate reorganization was a legitimate transaction, structured in a tax-efficient manner. In sum, none of these cases support enforcement of penalties over a dispute that hinges on a federal common law employer-employee determination incorporated by reference into the 80/20 Company payroll calculation.

Finally, it is worth noting that the Department conveniently omits the Illinois Appellate Court's ruling in *Zebra Tech. Corp.* from its list of cases. 344 Ill. App. 3d 474. While the Department may technically be correct that no Illinois court has decided reasonable cause penalty abatement in context of a similar 80/20 Company dispute (Dept. MSJ Br., Page 14), the

Department clearly has as evidenced in the *Zebra* decision. *Id.* at 480, 484-485. There, the Department abated penalties despite challenging the business purpose and substance of the applicable 80/20 Companies in question. *Id.* If penalties were improper in *Zebra*, certainly they are improper here under a significantly more developed factual record, and the parties' good faith dispute over a narrow legal issue of first impression.

## CONCLUSION

PepsiCo made a good faith effort to determine its proper Illinois tax liability for the 2011 - 2013 tax years in accordance with authorities existing at the time the returns were filed. The plain language of the reasonable cause penalty abatement regulation requires abatement of penalties in such circumstances. The Department disregards the clear mechanics of the 80/20 Company statute and controlling federal common law employer authority, both of which are written without regard to resulting tax due. Furthermore, PGM LLC was formed for legitimate, non-tax business reasons. For the reasons discussed herein, penalty abatement is proper, PepsiCo's motion for summary judgment should be granted, and the Department's motion for summary judgment must be denied.

Respectfully submitted,

**PepsiCo, Inc. and Affiliates**

Dated: April 21, 2022

By: */s/ Theodore R. Bots*
Attorney for Petitioner

Theodore R. Bots (ARDC No. 6224515)
David A. Hemmings (ARDC No. 6307850)
BAKER & MCKENZIE LLP
300 E. Randolph Street, Ste. 5000
Chicago, IL 60601
Telephone: (312) 861-8845
Fax: (312) 698-2004
theodore.bots@bakermckenzie.com
drew.hemmings@bakermckenzie.com

George M. Clarke (ARDC No. 6331046)
BAKER & MCKENZIE LLP
815 Connecticut Avenue, NW
Washington, DC 20006
Telephone: (202) 835-6184
Fax: (202) 416-7184
george.clarke@bakermckenzie.com

*Attorneys for Petitioner,*
*PepsiCo, Inc. and Affiliates*

<u>**CERTIFICATE OF SERVICE**</u>

The undersigned counsel of record certifies that a copy of **PEPSICO, INC. AND AFFILIATES' RESPONSE TO THE ILLINOIS DEPARTMENT OF REVENUE'S CROSS-MOTION FOR SUMMARY JUDGMENT TO UPHOLD LATE-PAYMENT PENALTIES** was served on April 21, 2022 to the following persons:

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| **Judge James M. Conway**<br>Chief Administrative Law Judge<br>Illinois Independent Tax Tribunal<br>160 N. LaSalle Street, Room N506<br>Chicago, IL 60601<br>James.Conway@illinois.gov | **Alan V. Lindquist**<br>Illinois Department of Revenue<br>Special Assistant Attorney General<br>100 W. Randolph Street, 7th Floor<br>Chicago, IL 60601<br>Alan.Lindquist@illinois.gov |
| **Joseph T. Kasiak**<br>Illinois Department of Revenue<br>100 W. Randolph Street, Ste. 7-900<br>Chicago, IL 60601<br>Joeseph.Kasiak@illinois.gov | **Rebecca Kulekowskis**<br>Illinois Department of Revenue<br>100 W. Randolph Street, Ste. 7-900<br>Chicago, IL 60601<br>Rebecca.Kulekowskis@illinois.gov |

*/s/ Theodore R. Bots*
Attorney for Petitioner,
PepsiCo, Inc. and Affiliates