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 Conway
Respondent.	)	

ILLINOIS DEPARTMENT OF REVENUE'S RESPONSE BRIEF IN SUPPORT OF ITS CROSS MOTION FOR SUMMARY JUDGMENT – 80/20 ISSUE PENALTIES AND MOTION TO STRIKE THE CERTIFICATION OF CHARLES MUELLER

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SUMMARY

PepsiCo Inc. & Affiliates ("PepsiCo") argued in the Memorandum of Law supporting its Cross Motion for Summary Judgment that it satisfies the reasonable cause exception for abatement of 80/20 late payment penalties. PepsiCo, a very profitable company, used a shell company without substance to entirely eliminate its Illinois income tax liability and generate tens of millions of dollars of Illinois net losses starting in 2011 and continuing into subsequent tax years. PepsiCo's arguments that it demonstrated reasonable cause for abatement of penalties are directly contrary to both relevant facts and controlling law.

PepsiCo first argues that it has demonstrated reasonable cause because it has "maintained an excellent compliance" record with the Illinois Department of Revenue (the "Department"). In fact, for at least 13 consecutive years prior to 2011 PepsiCo was assessed penalties by the Department. Beginning in 2011, PepsiCo determined, contrary to Illinois law, that it *no longer had to pay any* Illinois income taxes, and was once again assessed penalties when the Department reversed this determination in its audit of PepsiCo's returns. PepsiCo's consistent history of penalties each year does not support reasonable cause for abatement of the penalties at issue.

PepsiCo next argues it has demonstrated reasonable cause because its application of the 80/20 Test to exclude Frito-Lay of North America, Inc. ("FLNA"), and its domestic income, from PepsiCo's unitary group based on foreign payroll charged to PepsiCo Global Mobility LLC ("PGM LLC"), a disregarded limited liability company owned by FLNA, was consistent with Illinois law. In fact, as the Tribunal ruled in addressing the parties cross-motions for summary judgment on the 80/20 issue, this exclusion was contrary to 85 years of substance over form case law. PepsiCo's

exclusion of FLNA, directly contrary to longstanding case law, does not support reasonable cause for abatement of penalties.

Finally, PepsiCo argues that its reliance on outside state tax advisors in taking its 80/20 filing position demonstrates reasonable cause. PepsiCo provides no documentary evidence of such reliance, and accordingly this bare assertion does not carry its burden of proof regarding such reliance. Even if PepsiCo had proved it relied on outside tax advisors in taking its filing position contrary to longstanding controlling law, Illinois and federal case law dictate PepsiCo, as a sophisticated taxpayer, could not rely on this advice in asserting reasonable cause. PepsiCo's alleged reliance on the advice of outside tax advisors in these circumstances does not support reasonable cause for abatement of penalties.

In sum, all of PepsiCo's arguments for reasonable cause for abatement of penalties fail. The 80/20 late payment penalties imposed against PepsiCo must be upheld.

ARGUMENT

I. Department Moves That The Tax Tribunal Strike The Certification of Charles Mueller As Failing to Comply With the Requirements of Illinois Supreme Court Rule 191 Because It Is Self- Serving, Unsupported by Documentary Evidence and Not Based on Personal Knowledge

In PepsiCo's Memorandum in Support of its Motion of Summary Judgment for Reasonable Cause Penalty Abatement, it has relied on the certification of Charles Mueller. This certification is attached in lieu of an affidavit, to support its motion for summary judgment, pursuant to 735 ILCS 5/1-109. Affidavits in support of a motion for summary judgment must comply with Illinois Supreme Court Rule 191. Woodling v. L & J Press Corp., 99 Ill. App. 3d 382, 384 (Ill. App., 1st Dist. 1981). Supreme Court 191 states in pertinent part:

> **(a) Requirements.** Motions for summary judgment under section 2-1005 of the Code of Civil Procedure [*735 ILCS 5/2-1005*] and motions for involuntary dismissal under section 2-619 of the Code of Civil Procedure [*735 ILCS 5/2-619*] must be filed before the last date, if any, set by the trial court for the filing of dispositive motions. Affidavits in support of and in opposition to a motion for summary judgment under section 2-1005 of the Code of Civil Procedure [*735 ILCS 5/2-1005*], affidavits submitted in connection with a motion for involuntary dismissal under section 2-619 of the Code of Civil Procedure [*735 ILCS 5/2-619*], and affidavits submitted in connection with a motion to contest jurisdiction over the person, as provided by section 2-301 of the Code of Civil Procedure [*735 ILCS 5/2-301*], **shall be made on the personal knowledge of the affiants; shall set forth with particularity the facts upon which the claim, counterclaim, or defense is based; shall have attached thereto sworn or certified copies of all documents upon which the affiant relies; shall not consist of conclusions but of facts admissible in evidence; and shall affirmatively show that the affiant, if sworn as a witness, can**

> **testify competently thereto**. If all of the facts to be shown are not within the personal knowledge of one person, two or more affidavits shall be used. (emphasis added)

The purpose of the affidavit is to demonstrate the testimony that would be offered at trial so that the court can determine whether such evidence, considered with the pleadings, would leave no material issues of fact for jury determination. Anderson v. Dorick, 28 Ill. App. 3d 225, 227 (Ill. App. 3rd Dist. 1975).

Mr. Mueller's certification contains fatal flaws. It is lacking in in several key aspects, including, but not limited to, that it contains conclusory statements and statements that Mr. Mueller could not testify to if this matter were to proceed to a hearing. Additionally, much of his testimony is self-serving and conclusory. Unsupported assertions, opinions, and self-serving or conclusory statements do not comply with Supreme Court Rule 191. Geary v. Telular Corp., 341 Ill. App. 3d 694, 699 (Ill. App. 1st Dist. 2003). The Department requests that this Tribunal strike the certification of Mr. Mueller in its entirety, or in the alternative, at least the portions that are not in compliance with Supreme Court Rule 191.

While this list is not exhaustive, the Department will illustrate that certain paragraphs of Mr. Mueller's certification are defective:

> 14 & 15: Discussion of "best practices" is conclusory, self-serving and lacking any support.
>
> 16 & 18: Discussion of PepsiCo's "compliance" record is conclusory, self-serving, and lacking in any foundation.
>
> 20, 22 & 26: Mr. Mueller makes unsupported opinions that are conclusory, self-serving, and lacking any foundation.
>
> 36: Discussion of PGM LLC that is conclusory, self-serving, and lacking any foundation. Additionally, this paragraph contradicts the findings of this Tribunal in that PGM was found to be a shell entity that could conduct no business on its own.
>
> 41 – 45: Mr. Mueller is offering conclusory, self-serving opinions that lack proper foundation. Additionally, these paragraphs contradict the findings of this Tribunal in that PGM was found to be a shell entity that could conduct no business on its own.
>
> 48 & 49: These paragraphs are conclusory and provide self-serving opinions. Additionally, these paragraphs contradict the findings of this Tribunal in that PGM was found to be a shell entity that could conduct no business on its own.
>
> 61 & 62: These paragraphs contain conclusory, self-serving opinions that lack proper foundation.
>
> 73 – 77: These paragraphs contain conclusory, self-serving opinions that lack proper foundation.

This listing of fatal defects in Mr. Mueller's certification is not exhaustive, as much of the proffered testimony is defective pursuant to Illinois Supreme Court Rule 191. His testimony in the certification contradicts the facts in the record, is conclusory, and is rife with self-serving opinions lacking in foundation. The Tribunal should strike the certification of Mr. Mueller in its entirety and analyze the motions for summary judgment based only on the evidence properly before the Tribunal.

II. PepsiCo's Record Does Not Support Abatement of Penalties for Reasonable Cause

PepsiCo states, quoting Illinois Income Tax Regulation §700.400, that the "most important factor to be considered in making a determination to a 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 to pay the proper liability **in a timely fashion**." PepsiCo's Memorandum in Support of Its Motion for Summary Judgment ("PepsiCo Memo") at p. 4. The Department's regulation states that a taxpayer's history of compliance is a "factor to be considered in determining whether the taxpayer acted in good faith in determining and paying" its proper tax liability. 86 Ill. Admin. Code §100.3100(b), 86 Ill. Admin. Code §100.3100(d). PepsiCo asserts it "maintained an excellent compliance record with the Department." PepsiCo Memo at p. 7 citing Mueller Cert.¶ 16. The only evidentiary support for this assertion is a certified statement attached to PepsiCo's Memo, executed by Charles F. Mueller attached to its cross-motion for summary judgment (hereinafter sometimes referenced as "Mueller Cert."). Mr. Mueller asserts in this certification that he was PepsiCo's Senior Director of State and Local Tax and then Vice President of State and Local Tax during the period at issue. Mueller Cert. ¶ 2. The certification states that PepsiCo has a "world class tax department" composed of "approximately 130 individuals" who implement "best business practices and procedures" to ensure the tax department "properly prepares and timely files all returns." Mueller Cert. at ¶¶ 11-14. Mr. Mueller then states based on adherence to such "practices and procedures" that "PepsiCo had **an excellent compliance record** with the State of Illinois for corporate income tax purposes throughout the duration of my tenure as Senior Director and then as Vice President of State and Local Tax." Id. at ¶ 16. (emphasis added). The certification does not provide any detail about PepsiCo's "excellent" Illinois corporate income tax compliance record. Furthermore, no documentary proof is attached to the certification to support its assertion of an "excellent" compliance record.

Illinois courts have repeatedly ruled that self-serving testimony by taxpayers, without supporting documentation, does not carry a taxpayer's burden of proof. For example, in Balla v. Dept. of Revenue, 96 Ill. App. 3d 293(1982) a taxpayer testified that she supported her children and was entitled to claim Illinois income tax personal exemptions for them. She did not produce any documentary proof to support this assertion. The court ruled that the taxpayer's self-serving conclusory testimony did not carry her burden of proof in demonstrating entitlement to the exemptions. Id. at 297. Similarly, in PPG Industries v. Illinois Department of Revenue, the Illinois 328 Ill. App. 3d 16 (2002) the taxpayer introduced as evidence only self-serving testimony, without supporting documentation, to support its legal position that sales to customers in other states should not be added back to the numerator of its sales apportionment factor under Illinois' sales throwback rule. The court ruled that this evidence did not carry the taxpayer's burden of proof in avoiding sales throwback. Id. at 34-36. As in these cases, PepsiCo's self-serving conclusory certification

that it maintained an "excellent" compliance record, without supporting documentation, should be rejected on its face as failing to carry PepsiCo's burden of proof in demonstrating such compliance.

Even if the unsupported assertions in Mr. Mueller's certification did constitute acceptable proof of compliance, his claim that PepsiCo had an "excellent" Illinois corporate income tax compliance record is *directly* contrary to the facts. The Department annually assessed penalties against PepsiCo from at least as early as 1998 through 2015. <u>See</u> Exhibit A – Affidavit of Joe Myers, Revenue Audit Supervisor, Illinois Department of Revenue. Beginning in 2011, based on expatriate compensation charged to PGM LLC, a shell company owned by FLNA, PepsiCo determined that it should exclude FLNA, and its billions of domestic profits from its Illinois income tax return under the 80/20 Test. Based on this exclusion, PepsiCo in 2011 began annually reporting no Illinois income tax liability, and instead millions of dollars of net losses each year. The Department assessed penalties against PepsiCo for 2011 through 2015, which were overwhelmingly attributable to PepsiCo's 80/20 exclusion of FLNA and its domestic income from PepsiCo's unitary group. <u>Id.</u>

Contrary to Mr. Mueller's assertion of an "excellent" Illinois compliance record, these facts demonstrate just the opposite. PepsiCo has annually been subject to penalties since at least as early as 1998. PepsiCo's record of annual penalties does not support abatement of 80/20 late payment penalties for reasonable cause. PepsiCo's course of conduct since as early as at least 1998, demonstrates that it has not made a good faith effort to determine its proper Illinois tax liability, and therefore does not satisfy reasonable cause for abatement of penalties.

III. PepsiCo Did Not Exercise Ordinary Business Care and Prudence Constituting Reasonable Cause for Abatement Because Its Classification of FLNA As An 80/20 Company Was Clearly Contrary to Illinois Law

PepsiCo next argues it has reasonable cause for abatement of 80/20 penalties because its application of the 80/20 rule to exclude FLNA from its unitary group *was consistent with Illinois law*:

> PepsiCo made a "good faith effort" to investigate the mechanics of the 80/20 Rule and evaluate corresponding 80/20 case law. <u>PepsiCo's 80/20 calculation and exclusion of FLNA was consistent with Illinois law and existing interpretations. Nothing in the law of interpretations would have alerted PepsiCo to alter its 80/20 calculations or exclusion of FLNA</u>.

PepsiCo Memo at p. 8. (emphasis added). PepsiCo's treatment of FLNA as an 80/20 Company was *directly contrary* to Illinois law. The parties and the Tribunal all agree that Illinois law adopts the federal income tax common law definition of an employer-employee relationship. The Tribunal held that PGM LLC had no economic substance and in particular no employees that exercised control over the expatriates. Tribunal May 4, 2021 Decision On Summary Judgment Motions ("Tribunal 80/20 Decision") at p. 34. The Tribunal further held, based on longstanding federal income tax case law -- dictating the determination of employer-employee relationships is

based on economic realities -- that PGM LLC was not the expatriates' employer and they were not its employees. Id. at p. 35 ("PGM LLC must be disregarded as it has no economic substance. Similarly, it cannot be considered the employer of the expatriates.") The Tribunal accordingly ruled that expatriate compensation was not PGM LLC foreign payroll, and FLNA was therefore not excludible from PepsiCo's unitary group as an 80/20 Company. Id. PepsiCo's assertion that "nothing in the law" would have alerted it to alter its 80/20 calculations ignores the Tribunal's contrary ruling rejecting this assertion, and accordingly does not support reasonable cause for abatement of penalties.

A. The Clear Legislative Purpose of the 80/20 Rule, to Exclude Foreign Income from Illinois Combined Returns, Is Directly Contrary to PepsiCo's Use of This Rule to Exclude Domestic Income from Its Illinois Combined Returns and Therefore The Legislative Purpose of this Rule Does Not Support Reasonable Cause for Abatement

In support of its conclusion that FLNA's exclusion from the PepsiCo unitary group as an 80/20 Company was consistent with Illinois law, PepsiCo argues that this exclusion was consistent with the legislative purpose of the 80/20 exemption. PepsiCo asserts the exemption's purpose was to provide certainty and stability important in determining which companies are excluded from unitary groups, and in furtherance of this purpose adopted an 80/20 Test which consisted of "straight-forward, mechanical measurements involving the property and payroll factors." PepsiCo loses sight of the forest for the trees when it asserts that the legislative purpose of the 80/20 regime was to adopt a straightforward mechanical 80/20 Test for excluding 80/20 companies from unitary business groups. The Tribunal noted that the legislative purpose of this test was to exclude foreign income from Illinois combined returns. Tribunal 80/20 Decision at pp. 11-12. PepsiCo has never argued, and there are no facts that would even support the assertion, that FLNA's income was foreign income. As the Tribunal found, PepsiCo by establishing PGM LLC as a shell company and charging expatriate compensation to it latched on to the 80/20 Test for tax avoidance purposes to exclude FLNA's *domestic income* from PepsiCo's combined return. The Tribunal rejected PepsiCo's attempt to subvert the 80/20 Test in this fashion:

> . . . in enacting the 80/20 test the Illinois legislature **did not create a tax avoidance** vehicle that lacked economic substance . . . The clear and concise language of 35 ILCS 1501(a)(27) states that the 80/20 test is to be used to measure a unitary business group's business activity within the United States and to exclude from such a group "those members whose business activity outside the United States is 80% or more of any such member's total business activity…" Id. The very use of the term "business activity" in Illinois' 80/20 statute necessarily refers to determining the economic reality of a business by **looking [at] the true substance of its business operations and by marking that economic reality by a defined measuring stick, in this case, the 80/20 formula**.

Id. at pp. 19-20 (emphasis added). The Tribunal held based on longstanding case law that PGM LLC was a shell corporation without economic reality that must be disregarded as such. See Tribunal 80/20 Decision at pp. 27 et seq. *discussing* United States v. Silk, 331 U.S. 704 (1947); Bartels v. Birmingham, 332 U.S. 126 (1947); E.E.O.C. v. North Knox School Corp., 154 F.3d 744

(1998); and Professional and Executive Leasing, Inc. v. C.I.R., 89 T.C. 225 (1987). Clearly, the Tribunal did not agree with PepsiCo conclusion that PepsiCo's exclusion of FLNA from the PepsiCo unitary group was consistent with Illinois law and met the legislative purpose of the 80/20 Test. Accordingly, PepsiCo cannot rely on the legislative purpose of the 80/20 Test – which was to exclude foreign income from Illinois unitary business groups – to support its claim of reasonable cause for abatement of penalties.

B. PepsiCo's Alleged Application of Best Business Practices and Alleged Reliance on Outside Counsel Does Not Demonstrate Reasonable Cause for Abatement In Light of PepsiCo's Tax Avoidance Motives Coupled With PGM LLC's Lack of Economic Substance

PepsiCo next argues that it has demonstrated reasonable cause for abatement because its "tax department utilizes various best business practices and procedures for purposes of preparing and filing its corporate income tax returns" and making the determination here that FLNA was an 80/20 Company. PepsiCo Memo at p. 9. In support of this argument, it states that "the FLNA 80/20 analysis was done in accordance with the tax department's procedures and protocols," and that senior members of PepsiCo's tax department participated in conducting this analysis and determining that FLNA was an 80/20 Company. Id. PepsiCo also asserts that it relied on "outside state advisors" who supported PepsiCo's conclusion that FLNA was an 80/20 Company, and that "reliance on the advice of a professional is a factor for considering reasonable cause penalty abatement under Department Regulation §700.400." Id. These assertions are fatally flawed. They are once again contrary to relevant facts and controlling Illinois law.

PepsiCo's assertions that it applied best business practices and procedures in concluding that FLNA was an 80/20 company, and that it received confirmation of this conclusion from outside tax advisors do not constitute reasonable cause for abatement. PepsiCo provides no detail regarding the advice it received from outside tax advisors. Even more importantly, the only documentation of these assertions it provides is a self-serving certification signed by one of its employees. It provides no correspondence, memoranda, opinion letters, nor other written documentation to support this assertion. As addressed in Section II. of this brief, Illinois courts have repeatedly ruled that self-serving testimony by taxpayers, without supporting documentation, does not carry a taxpayer's burden of factual proof. Balla v. Dept. of Revenue, 96 Ill. App. 3d 293(1982); and PPG Industries v. Illinois Department of Revenue, the Illinois 328 Ill. App. 3d 16 (2002). Accordingly, PepsiCo's reliance on Mr. Mueller's documentarily unsupported certification does not carry its burden of proof that it relied on outside tax advisors.

Even if PepsiCo's undocumented self-serving assertion did prove it relied on the advice of outside tax advisors in concluding that FLNA was an 80/20 company, this still would not constitute reasonable cause for abatement of penalties. Illinois courts have rejected taxpayer assertions of reliance on outside tax advisors as evidence of reasonable cause, where given the sophistication of the taxpayer and their advisors they should have understood that controlling law simply did not support the taxpayer's filing position. For example, in Hollinger Int'l. Inc. v. Bower, 363 Ill. App.

3d 313 (2005), the Illinois Appellate Court rejected a taxpayer's assertion of reasonable cause for abatement of late estimated tax payment penalties based on its reliance on a safe harbor from estimated tax payments equal to tax shown due on the taxpayer's previous year's Illinois tax return. The taxpayer did not qualify for this safe harbor because it had not filed a tax return in Illinois the previous year. The court found that the taxpayer was a "multinational unitary business," and was "a sophisticated taxpayer with a high degree of experience, knowledge, and education." Id. at 327. As such, the court found that given the taxpayer's sophistication and knowledge in tax matters, it should have been aware of the fact that the Illinois estimated tax safe harbor did not apply to it, regardless of the contrary advice it received from its outside accountant. Id. at 328. Accordingly, the court ruled that reasonable cause for abatement of estimated tax penalties had not been proved by the taxpayer. Id.

PepsiCo touts the immense investment and effort it has made in establishing a "world class tax department, capable of handling complex U.S. federal, state/local, and international tax compliance requirements," which is "comprised of approximately 130 individuals, including accountants and attorneys who are well-versed in tax laws and corresponding compliance requirements." PepsiCo Memo p. 6. Surely such a sophisticated "world-class" tax department should have been aware of 85 years of substance over form case law which dictated that PGM LLC, a shell company, was not the expatriates' employer and accordingly that FLNA was not an excludible 80/20 company. This is particularly true in that PepsiCo's exclusion of FLNA did not just have a modest effect on its Illinois income tax liability. This exclusion from 2011 forward eliminated PepsiCo's Illinois income tax liability and has annually generated tens of millions of annual Illinois income tax losses, despite the fact that PepsiCo is a very profitable multinational corporation that during this period has reported billions of dollars of income for financial and federal income tax purposes. Under the Appellate Court's decision in Hollinger, based on PepsiCo's obvious tax sophistication it would not qualify for reasonable cause for abatement of late payment penalties, even if it had carried its burden of proof that it relied on the advice of outside state tax advisors in excluding FLNA from its unitary group.

Finally, as addressed in the Brief in Support of the Department's Motion for Summary Judgment – 80/20 Penalties ("Dept. Br. 80/20 Penalties") while Illinois case law has not yet addressed a taxpayer's attempt to argue reasonable cause for abatement of penalties by relying on the advice of an outside tax advisor with respect to a transaction wholly lacking in economic substance, federal courts in these circumstances have repeatedly addressed and rejected this argument. Dept. Br. 80/20 Penalties at pp. 14-15. For example, in Stobie Creek Invs. LLC v. United States, 608 F.3d 1366 (2010) the United States Court of Appeals for the Federal Circuit applied the economic substance doctrine to disregard a taxpayer's attempt to step up the basis of capital assets with a series of paper transactions and thereby avoid payment of tax on a sale of the assets. The court observed that 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. The court stated that "[u]nder

that doctrine, a court disregards the tax consequences of transactions that comply with the literal terms of the tax code, but nonetheless lack economic reality." The court noted that here the taxpayer was clearly interested in generating tax benefits rather than pursuing a legitimate business purpose with these paper transactions. Id. at 1380. Accordingly, the court disregarded the paper transactions in which the taxpayer attempted to step up its basis in the stock and upheld the $ 4 million tax assessment against the taxpayer. In upholding the Internal Revenue Service's imposition of penalties, the court stated that the taxpayer did not act reasonably because ". . . the taxpayer knew or should have known that the transaction was too good to be true, based on all the circumstances . . . " and that this was true despite the fact that the taxpayer in taking its filing position had relied on the advice of outside tax experts. Id. at 1381. See also Superior Trading LLC v. Comm'r. 728 F3d 676 (7th Cir. 2013) (court upheld penalty against taxpayer engaging in sham transaction without any substance despite reliance on outside tax experts); and Sugarloaf Fund LLC 911 F 3d. 854 (7th Cir. 2018) (same). This federal case law confirms the conclusion that 80/20 penalties here cannot be abated based on PGM LLC's lack of economic substance, even though PepsiCo makes the evidentiarily unsupported assertion that it relied on the advice of outside tax experts in reaching this conclusion.

C. The Illinois Appellate Court's Decision in Zebra Tech. v. Ill. Dept. of Revenue Does Not Support PepsiCo's 80/20 Exclusion of FLNA from Its Unitary Group, Nor Reasonable Cause for Abatement

PepsiCo next argues that it has demonstrated reasonable cause for abatement by further attempting to relitigate the 80/20 issue decided against PepsiCo by the Tribunal. PepsiCo claims based on the Illinois Appellate Court's decision in Zebra Technologies v. Ill. Dept. of Revenue, 344 Ill. App. 3d 474, that "the inclusion of PGM LLC and the expatriate payroll in the 80/20 Company calculation was not only fully supported – but was required – by *Zebra*." PepsiCo Memo at p. 12. (emphasis added). In Zebra, the Illinois Appellate Court ruled that two Bermuda based intellectual property investment companies ("PICs") were not excludible as 80/20 companies from a unitary group formed by United States based Zebra Technologies and its subsidiaries. Zebra transferred its patents to the PICs, which licensed and earned royalty income on the patents. Zebra excluded the PICs from its unitary group as 80/20 companies on the basis of payroll paid to Bermuda-based administrative part-time employee, and rent (annualized as property at 8 times annual rent) paid on Bermuda office space that housed the employee. The court ruled that Zebra did not meet its burden of proof in demonstrating the PICs were 80/20 companies. The court determined that whether the PICs qualified as 80/20 companies required "a look at substance over form." Zebra Technologies 344 Ill. App. 3d 483 as referenced in Tribunal's 80/20 Decision at p.15 . The court noted that the PICs' Bermuda employee had absolutely no experience in the essential function of protecting and maintaining the patents. Instead, individuals who performed this function remained employees of Zebra and continued to perform this work in the United States. There was no evidence of a contract between Zebra and the PICs for the PICs' purchase of their services from Zebra. Id. The court ruled that Zebra, by failing to account for the services of its United States based intellectual property employees, failed to meet its burden of proof in

demonstrating that the PICs in substance conducted 80% or more of their business activities outside the United States. Id. Similarly, looking here at substance rather than form, the Tribunal found that PGM LLC, without any management employees that directed and controlled the expatriates or any other substantive business activities, must be disregarded as a shell company. Tribunal 80/20 Decision at p.35. The Tribunal accordingly ruled as a matter of substance over form that the expatriates were not PGM LLC employees, and their compensation charged to PGM LLC was not PGM LLC foreign payroll that excluded it and FLNA from the PepsiCo unitary group. Id.

PepsiCo's attempt to turn Zebra on its head in claiming, contrary to the Tribunal's 80/20 Decision, that Zebra dictates that expatriate compensation charged to PGM LLC excludes FLNA from PepsiCo's unitary group, clearly fails. PepsiCo claims that FLNA had substantial property and payroll and that gave this sufficient substance under Zebra to be treated as an 80/20 company. PepsiCo Memo at p.11. PepsiCo further argues that the Department cannot "'cherry pick' activities for purposes of the 80/20 calculation in an effort to achieve a particular result." Id. The Department is not "cherry picking" activities for challenge here. FLNA's United States business operations were substantive and significant with management employees based out of its corporate headquarters in Texas and gross annual domestic sales of over $8 billion. Joint Stip. ¶¶ 11 and 18. The Department simply asserted that the approximately $100 million per year in expatriate compensation charged to PGM LLC, a shell company, did not represent substantive foreign business activities, conducted through PGM LLC, which excluded PGM LLC and FLNA from the PepsiCo unitary group under the 80/20 exemption. Based on 85 years of substance over form case law the Tribunal agreed with the Department that this compensation did not represent substantive PGM LLC foreign business activities that excluded FLNA from PepsiCo's unitary group. Tribunal 80/20 Decision at p. 35. PepsiCo cannot now change that result with its arguments, nor do its arguments, already rejected by the Tribunal, constitute reasonable cause for abatement of late payment penalties.

Finally, PepsiCo argues that The Tax Tribunal's "determination on the 80/20 Company Issue is the first to exclude business activities/factors for Illinois 80/20 Company purposes." PepsiCo's Memo at p. 12. It then asserts that due to a lack of legal guidance on this point that this exclusion is a resolution of a novel legal issue comparable to the Tribunal's decision in Security Life of Denver, 14 TT 89 and the Illinois Supreme Court's decision in Horsehead Corporation v. Dep't of Revenue, 441 Ill. Dec. 532, 157 N.E.3d 453 (Ill. Sup. Ct. 2019). It specifically references as support for this assertion the court's statement in Horsehead that reasonable cause for abatement of penalties was justified because "there was no case law that Horsehead could have turned to for guidance . . . " These decisions have already been addressed and distinguished in Dept. Br. 80/20 Penalties at p. 12. However, just to briefly reiterate what was stated there, unlike these decisions there was no novel interpretation of law at issue here. The only novel thing at issue here was PepsiCo's attempt to use Illinois' 80/20 Test to exclude FLNA's *domestic income* from PepsiCo's unitary group by charging expatriate compensation to PGM LLC, a shell company. PepsiCo does not get a free pass on penalties just because it is the first taxpayer since the 80/20 exemption was

enacted 40 years ago to attempt to use it in this fashion to exclude *domestic income rather than foreign income* from a combined return. As the Tribunal held, controlling substance over form case law has been out there for all to see for over 85 years. Tribunal 80/20 Decision at pp. 27 et seq. PepsiCo accordingly has not proved reasonable cause for abatement of penalties based on a novel issue of law pursuant to the Security Life and Horsehead decisions. Because controlling substantive law here was clear and well-established, penalties assessed do not qualify for abatement for reasonable cause. PPG Industries v. Dep't. of Revenue 328 Ill. App 3d 16, 28 (2002) Kroger Co. v. Department of Revenue 284 Ill. App. 3d 473 (1996); and Tyson v. Illinois Dep't of Revenue, 312 Ill. App. 3d 64 (1996).

IV. PepsiCo Did Not Exercise Ordinary Business Care and Prudence Constituting Reasonable Cause for Abatement When Contrary to Controlling Law, It Treated Expatriate Compensation Charged to PGM LLC as Foreign Payroll That Excluded FLNA from the PepsiCo Unitary Group Under Illinois' 80/20 Test

PepsiCo next argues it has demonstrated reasonable cause for abatement of penalties by once again attempting to re-litigate the 80/20 issue, this time claiming that federal income tax law defining the common law employer-employee relationship fails to support the Tribunal's determination that the expatriates were not PGM LLC employees. PepsiCo acknowledges that Illinois law incorporates federal income tax common law principles in defining an employer-employee relationship. Id. at 16. It asserts that classification of expatriate compensation as PGM LLC payroll is completely consistent with federal employment tax law and U.S. Supreme Court caselaw:

> . . . the classification of the expatriate compensation as PGM LLC's payroll/'wages" for federal purposes is consistent with controlling federal employment tax authorities and U.S. Supreme Court precedent, which are expressly incorporated into Illinois 80/20 Rule.

Id. at 13. PepsiCo points to PGM LLC's retention in expatriate secondment agreements of the contractual right to direct and control the expatriates as dictating that PGM LLC be treated as the expatriates' employer, citing the United States Supreme Court's decision in Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318 (1992) in support of this conclusion. Id. at 16. PepsiCo asserts that there is "nothing in federal/Illinois guidance that would have alerted PepsiCo's tax department to a different conclusion when it determined FLNA was an 80/20 Company for Illinois income tax purposes." Id. at p. 17.

The Tribunal's 80/20 Decision held that PepsiCo's exclusion of FLNA was directly contrary to Illinois and the federal law it incorporates. The Tribunal ruled that whether the expatriates were PGM LLC employees, and therefore their compensation was included in FLNA's computation of the 80/20 Test, was based on the common law employer-employee test applied for federal income tax purposes as incorporated by Illinois income tax law. Illinois Income Tax

Regulation §100.3100(b), 86 Ill. Admin. Code §100.3100(b). The Tribunal ruled in favor of the Department that economic substance determines whether the expatriates were PGM LLC's common law employees. As the Tribunal observed in its decision, the seminal tax case which first enunciated the substance over form doctrine was the United States Supreme Court decision over 85 years ago in Gregory v. Helvering, 293 U.S. 465 (1935). The Tribunal's decision quoted the Court in Gregory, which ruled that substance, not form, must govern tax determinations because "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Tribunal 80/20 Decision p. 15 quoting Gregory 293 U.S. 470. This is precisely what has PepsiCo attempted to do, exalt artifice over reality in depriving the 80/20 Test of all serious purpose here. In fact, PepsiCo has ignored controlling law to turn the 80/20 Test on its head by using it to exclude FLNA's *domestic* rather than foreign income from PepsiCo's Illinois combined returns.

Unlike the novel legal determination in Horsehead Corporation – which addressed never previously interpreted statutory language -- the Tribunal's ruling that the expatriates were not PGM LLC common law employees was based on many decades of well-established case law. See Tribunal 80/20 Decision pp. 27 et seq. *discussing* United States v. Silk, 331 U.S. 704 (1947); Bartels v. Birmingham, 332 U.S. 126 (1947); E.E.O.C. v. North Knox School Corp., 154 F.3d 744 (1998); and Professional and Executive Leasing, Inc. v. C.I.R., 89 T.C. 225 (1987). PepsiCo's exclusion of FLNA, based on expatriate compensation charged to PGM LLC, was directly contrary to longstanding case law. PepsiCo had notice that it should not rely on expatriate compensation charged to PGM LLC, a shell company without substance, to exclude FLNA as an 80/20 company from the PepsiCo unitary group. Accordingly, PepsiCo has not demonstrated federal employment tax law and U.S. Supreme Court case law support abatement of late payment penalties for reasonable cause.

V. PepsiCo's Argument That Imposition of Penalties Against It Violates The Illinois Constitution's Equal Protection Clause Fails for Lack of Proof And Furthermore Is Without Merit Because the Illinois Tax Law Imposes Penalties Against All Taxpayers That Pay Taxes Late

PepsiCo has alleged a violation of the equal protection clause of the Illinois constitution. PepsiCo contends that it is being treated differently than the taxpayer in the Zebra decision, 344 Ill. App. 3d 474, based upon the Department enforcing a late payment penalty in the current case. PepsiCo's Memo at p. 12. PepsiCo alleges that the Department did not seek to enforce penalties in the Zebra case. This naked allegation by PepsiCo is raised with no context, no supporting caselaw, and no factual analysis.

The Illinois Supreme Court addressed interpreted Illinois' equal protection clause in Goldberg v. Johnson, 117 Ill. 2d 493 (1987). In Goldberg, various long-distance telephone carriers challenged a section of the Telecommunications Excise Tax Act (Ill. Rev. Stat. 1985, ch. 120, par. 2004) as unconstitutional. The plaintiffs argued that the tax favored telecommunications originating in Illinois but paid for in other States, such as collect telephone calls, or those telecommunications billed to service addresses located in other States, such as credit-card

telephone calls. Id. at 505. The Illinois Supreme Court found that the tax was constitutional under the equal protection clause because it was "a **rational exercise of the state's authority to tax**." (emphasis added) Id. The Court reasoned that it is well settled that a tax will be upheld, for purposes of equal protection, if there is any set of circumstances under which the legislative classification is, in fact, a rational exercise of the State's authority to tax. Id. The Goldberg Court reasoned that the State of Illinois had a rational basis to tax calls paid for in Illinois, or billed to Illinois, as these calls were likely to be made by residents of the state, as opposed to calls paid for or billed in another state. Id. at 506.

In this case, PepsiCo has made no allegation that the provisions of the Uniform Penalty and Interest Act ("UPIA") treat PepsiCo any differently than any other taxpayer in Illinois. There is also no allegation that the state did not have a rational basis in enacting the applicable statutory penalty provisions. PepsiCo has merely insinuated, with no factual basis, that the Department did not assess penalties against the taxpayer in Zebra. This allegation appears to be based on dicta in the Zebra opinion, which contained no legal discussion or analysis of the penalty issue. Zebra at 480. Indeed, PepsiCo itself appears to treat this as a "throw away" argument in that it devotes one two-sentence paragraph to this constitutional challenge of the penalties at issue here.

Section (b-20) of the UPIA imposes a mandatory 20% penalty against a taxpayer that fails to pay the amount owed before the date the Department has initiated an audit or investigation of the taxpayer. 35 ILCS 735/3-3 (b-20). The Department followed the provisions of the UPIA as required and assessed the prescribed penalty. PepsiCo's mere mention that penalties were not assessed in in the Zebra matter contains no factual support whatsoever and is wholly irrelevant. In this matter, PepsiCo's allegations of violation of the Illinois equal protection clause are without merit and must be disregarded.

CONCLUSION

PepsiCo has failed to demonstrate that it qualifies for the reasonable cause exception from the assessed penalties in this case. Its Illinois state income tax compliance record before, during and after the years at issue has been filled with consistent penalties since as early as 1998 and continued until at least 2015 and does not constitute reasonable cause for abatement. There is no legal support for excluding FLNA as an 80/20 Company based on expatriate compensation charged to the shell company PGM LLC. Neither has PepsiCo proved that imposition of penalties violated Illinois' equal protection clause. PepsiCo has not demonstrated that it qualifies for the reasonable cause exception from imposition of late payment penalties. The Department's imposition of these penalties against PepsiCo must be upheld.

Respectfully submitted,

Illinois Department of Revenue

By:/s/Alan V. Lindquist

Attorney for Respondent

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Exhibit A

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 Conway
Respondent.	)	

CERTIFICATION OF RECORDS

It is hereby certified under authority provided by Illinois Compiled Statutes, that the attached documents, records and/or memoranda, offered herein for the purpose of proving the determination of the Department of Revenue which is at issue, are true, correct and exact photographic reproductions of documents, records and/or memoranda made, kept and maintained on file by the Department in the ordinary course of its business.

To the extent such documents or records included herein consist of computer-generated data, it is further certified that such information is a true and exact representation of records properly entered into standard electronic computer equipment in the regular course of the Department's business, at or reasonably near the time of occurrence of the facts recorded, from trustworthy and reliable information.

DAVID HARRIS, DIRECTOR
ILLINOIS DEPARTMENT OF REVENUE

Dated: 4/21/2022

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 Conway
Respondent.	)	

AFFIDAVIT OF JOE MYERS

I, Joe Myers, having personal knowledge of the matters set forth herein, do solemnly swear and state upon oath, the following:

1. My name is Joe Myers. I am the Revenue Audit Supervisor for the Illinois Department of Revenue. I have been with the Department from January 1998 and began with the Audit Bureau in November of 2005.

2. I have reviewed the Certification of Charles Mueller.

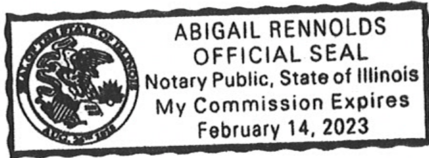
3. In his Certification, Mr. Mueller makes multiple references to the lack of penalties assessed to PepsiCo, as well as the "excellent compliance record" of PepsiCo.

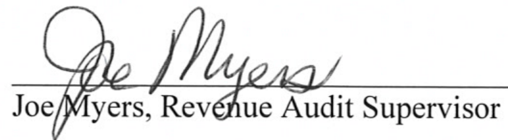
4. I have reviewed the tax compliance record of PepsiCo with the Illinois Department of Revenue for the years 1998 through 2015.

5. Based upon my review of the Department's records, I have determined that PepsiCo has been assessed penalties in every year from 1998 through 2015. PepsiCo Affidavit Supplement is attached as Exhibit 1.

6. I have personal knowledge of the facts stated herein and if called upon, could and would competently testify thereto.

FURTHER AFFIANT SAYETH NOT

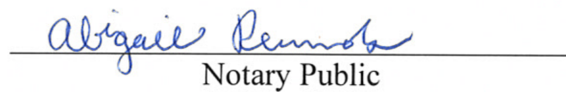




Joe Myers, Revenue Audit Supervisor

Subscribed to and sworn to before me this

21 day of April, 2022.



Notary Public

Exhibit 1

Pepsico FEIN ---13-1584302

Penalty Analysis by Joe Myers, Revenue Audit Supervisor

Period	Penalty Assessed	
31-Dec-1998	Yes	
31-Dec-1999	Yes	
31-Dec-2000	Yes	
31-Dec-2001	Yes	
31-Dec-2002	Yes	
31-Dec-2003	Yes	
31-Dec-2004	Yes	
31-Dec-2005	Yes	
31-Dec-2006	Yes	
31-Dec-2007	Yes	
31-Dec-2008	Yes	
31-Dec-2009	Yes	
31-Dec-2010	Yes	
31-Dec-2011	Yes	
31-Dec-2012	Yes	
31-Dec-2013	Yes	
31-Dec-2014	Yes	
31-Dec-2015	Yes	

CERTIFICATE OF SERVICE

The undersigned counsel of record certifies that a copy of the **ILLINOIS DEPARTMENT OF REVENUE'S RESPONSE BRIEF IN SUPPORT OF THE DEPARTMENT'S CROSS MOTION FOR SUMMARY JUDGMENT – 80/20 ISSUE PENALTIES AND MOTION TO STRIKE THE CERTIFICATION OF CHARLES MUELLER** was served on April 21, 2022 on the following persons:

Judge James M. Conway Chief Administrative Law Judge Illinois Independent Tax Tribunal 160 N. LaSalle Street, Room N506 Chicago, IL 60601 James.Conway@illinois.gov	**David A. Hemmings** BAKER & MCKENZIE LLP 300 E. Randolph Street, Ste. 5000 Chicago, IL 60601 drew.hemmings@bakermckenzie.com
Theodore R. Bots BAKER & MCKENZIE LLP 300 E. Randolph Street, Ste. 5000 Chicago, IL 60601 theodore.bots@bakermckenzie.com	**George M. Clarke** BAKER & MCKENZIE LLP 815 Connecticut Avenue, NW Washington, DC 20006 george.clarke@bakermckenzie.com

/s/ Joseph T. Kasiak
Attorney for Respondent,