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 BRIEF IN RESPONSE TO PEPSICO, INC. & AFFILIATES' MOTION FOR SUMMARY JUDGMENT

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ILLINOIS DEPARTMENT OF REVENUE,	)	
	)	Chief Judge James Conway
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SUMMARY OF ARGUMENT

In this matter, PepsiCo Inc. and Affiliates ("PepsiCo") argues that it has followed the rules, and because it has followed the rules that it is entitled to exclude its wholly owned subsidiary, Frito-Lay North America, Inc. ("FLNA") from its Illinois combined unitary group as a corporation conducting its business primarily outside the United States (generically hereinafter an "80/20 Company") . The Department strongly opposes this position for multiple reasons that will be set out in full in the sections that follow. Based on the factual record, the Department will conclusively demonstrate that FLNA conducts business primarily within the United States and does not qualify as an 80/20 Company that conducts 80% of more of its business activities outside the United States. This matter involves a substantial monetary amount in dispute, there are numerous corporate entities involved, a corporate reorganization took place within PepsiCo, and expatriates were sent across the globe. However, the pertinent facts are remarkably simple, and are not disputed by the parties.

The crux of this case hinges on whether compensation paid certain expatriates working for PepsiCo foreign subsidiaries, and charged to PepsiCo Global Mobility, LLC ("PGM LLC"), a

disregarded limited liability company owned by FLNA, should be treated as FLNA foreign payroll that excludes FLNA from PepsiCo's unitary group as an 80/20 Company. The Department must prevail based on one, or a combination, of three main arguments. These legal arguments all require inclusion of FLNA in PepsiCo's Illinois unitary combined group in order to reflect the economic reality that both before and after formation of PGM LLC, FLNA continued to operate PepsiCo's domestic snack food business and conduct business primarily within the United States.

First, FLNA cannot be an 80/20 Company because the expatriates are not PGM LLC's common-law employees. The expatriates provide services exclusively to PepsiCo foreign subsidiaries, hereinafter referred to as the "Foreign Host Companies." The Foreign Host Companies' management directs and controls the expatriates' work as well as reviews and evaluates their work. PGM LLC exercises no oversight over the expatriates. PGM LLC cannot exercise oversight because it has no management employees. These economic realities dictate that the expatriates cannot be PGM LLC's common-law employees, and their compensation expense cannot be considered FLNA foreign payroll for purposes of treating FLNA as an 80/20 Company.

Second, even if the expatriates were PGM LLC common-law employees, PepsiCo has not met its burden of proving that FLNA conducted 80% or more of its business outside the United States. The facts clearly demonstrate that the expatriate compensation charged to PGM LLC does not represent substantive foreign business activities conducted by FLNA through PGM LLC. FLNA derives all of its profits from the purchase and resale of domestic snack products in the United States. The work of PGM LLC expatriates has absolutely no relation to FLNA's domestic snack foods profits, which PepsiCo is attempting to exclude from PepsiCo's Illinois combined return. The expatriates performed all their work under the direction and control, for the benefit of, and in generating income for the Foreign Host Companies. After PGM LLC's formation,

FLNA remained a company conducting business primarily and deriving its income within the United States. PepsiCo has not met its burden of proving otherwise.

Finally, it is abundantly clear, upon a review of all facts, that PGM has no economic substance and is a bare legal shell to which expatriate compensation is charged and Foreign Host Company reimbursement of this expense is credited. In form, PGM LLC is treated as the expatriates' employer for payroll tax and other compensation reporting purposes. However, in substance PGM LLC has no assets with which to conduct its alleged global employment business, and no employees to run this business. PGM LLC takes no steps to oversee or manage the expatriates. Human resource professionals employed by various PepsiCo entities, but not PGM LLC, take any and all actions for PGM LLC without a contract, or payment by PGM LLC, for these services. Economic substance, not form, controls for Illinois income tax purposes. Under the substance over form doctrine, the expatriate compensation cannot be treated as FLNA foreign payroll in characterizing FLNA as an 80/20 Company.

UNDISPUTED MATERIAL FACTS

The Department incorporates the entire Joint Stipulation, including exhibits, into its Response to PepsiCo's Motion for Summary Judgment. PepsiCo has provided a detailed summary of the facts that it wished to emphasize. The Department, in the paragraphs that follow, will highlight the facts that are most pertinent to the undecided issues in this matter.

A. PepsiCo's and FLNA's Profitability

PepsiCo is one of the pre-eminent soft drink and snack manufacturers in both the United States and globally. PepsiCo, both before and during the 2011 through 2013 tax years at issue, was a very profitable company. PepsiCo's 2013 Annual Report states that PepsiCo's "net revenue compound annual growth rate was 9% …" and "in the last 10 years, earnings per share

grew at an 8% compound annual growth rate." This report also states that "[t]he PepsiCo Corporate Group's Cumulative Total Shareholder Return has outpaced the S&P 500 on an annualized basis by 170 basis points since 2000." Joint Stip. ¶ 8. Both before and after PGM LLCs' formation, FLNA's "gross sales … during the Tax Years at Issue remained relatively constant at: $8,064,542,579 (2010);$8,532,030,618 (2011); $8,570,477,304 (2012); and $8,719,295,267 (2013)." Joint Stip. ¶ 18.

FLNA's gross sales during the period 2010-2013 were almost exclusively sales of snack food products to, and for distribution by, Rolling Frito-Lay Sales, L.P. ("RFLS"). Joint Stip. ¶ 19. The Frito-Lay North America division, "which includes FLNA, … generated more operating profits than any of the other five individual business segments in 2010, 2011, 2012 and 2013," as can be seen in the chart below. Joint Stip. ¶¶ 22 and 23.

Divisions	**2010**	**2011**	**2012**	**2013**
Frito-Lay North America	$3,376	$3,621	$3,646	$3,877
Quaker Foods North America	$741	$797	$695	$617
Latin American Foods	$1,004	$1,078	$1,059	$1,242
PepsiCo Americas Beverages	$2,776	$3,273	$2,937	$2,955
Europe	$1,054	$1,210	$1,330	$1,293
Asia, Middle East, and Africa	$708	$887	$747	$1,174
Total Division Operating Profits	$9,659	$10,866	$10,414	$11,158

The income and tax effects of PepsiCo excluding FLNA, as an 80/20 Company, from PepsiCo's 2011, 2012 and 2013 Illinois Combined Tax Returns as compared to 2010, the year prior to such exclusion, are summarized in the chart below. 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

A review of the above chart discloses that consistently with PepsiCo's sustained financial reporting profitability, for federal consolidated income tax purposes from 2010 through 2013 PepsiCo regularly reported consolidated federal taxable income ranging from $1.4 to $1.6 billion per year (row 1). By contrast, while PepsiCo commenced its computation of Illinois combined income with federal consolidated taxable income of $1.4 billion in 2010, after PGM LLC's formation, commencing in 2011 PepsiCo computed Illinois combined income based on *pro forma* federal

consolidated losses, ranging from ($.8) billion to ($1.4) billion per year (row 3) as a result of PepsiCo's exclusion of FLNA (row 2) as an 80/20 Company.

B. FLNA

The FLNA domestic snack food business management team is employed by and operates out of FLNA, at FLNA's Texas offices. FLNA owns the domestic rights to PepsiCo's snack food business, which includes Lay's, Doritos, Tostitos, Cheetos, Rold Gold Pretzels, Funyuns, Grandma's Cookies, SunChips, Fritos, Ruffles, and Crackerjack. Joint Stip. ¶¶11 and 12. FLNA contracts with two other wholly owned PepsiCo subsidiaries, Frito-Lay, Inc. ("FLI"), for the manufacture of its snack-foods products, and RFLS, for the distribution and sale of the snack-foods products. Joint Stip. ¶¶ 15 and 16. FLNA generates its income by developing and operating the PepsiCo domestic snack foods business. Joint Stip. ¶ 17. All of FLNA's gross sales during the period 2011 - 2013 were United States sales of snack food products, with the exception of approximately $230 million per year in foreign sales from the United States shipped abroad. Joint Stip. ¶ 20.

C. 2010 Corporate Restructuring

In 2010, Pepsi underwent a corporate restructuring. Joint Stip. ¶ 48. As part of the 2010 PepsiCo Corporate Group global restructuring, FLNA employees were realigned with their organizational function:

- Manufacturing, research, and development employees were relocated to FLI;
- Information Technology employees, who provide shared services to all of PepsiCo, Inc. and affiliates, were transferred to PepsiCo, Inc.;
- Procurement, supply chain, and transformation and strategy groups were relocated to FLI;
- Human resources employees were relocated to FLI; and
- Sales and local marketing related employees were relocated to RFLS.

Joint Stip. ¶ 52.

D. PGM LLC

Contemporaneously with the 2010 corporate restructuring, PGM LLC was formed on June 23, 2010 as a Delaware single member limited liability company, which PepsiCo elected to treat as a disregarded entity for federal and state income tax purposes. Joint Stip. ¶ 27. After PGM LLC's formation, the PepsiCo Corporate Group utilized PGM LLC in connection with its program of assigning domestic executives to work in foreign countries (generically hereinafter the "expatriate Global Mobility program" or "expatriate program") as the single entity connected with such foreign-based (non-U.S.) secondments. Joint Stip. ¶ 58. The PepsiCo Corporate Group identified approximately $14 million dollars per year in total tax savings in 13 states by creating PGM LLC as a division of FLNA. Joint Stip. ¶ 59.

The only compensation claimed by PGM LLC as "payroll" and reported as such on PGM LLC Payroll Reports (2011 – 2013) was compensation paid employees (hereinafter generically "expatriates") who were assigned to work for and under the direction and control of Foreign Host Companies. Joint Stip. ¶¶ 32 and 122. PGM LLC's books and records were debited to record expatriate compensation expense, and credited to record as "other income" Foreign Host Company dollar-for-dollar reimbursement of this expense. Joint Stip. ¶ 113. No mark-up was charged on this reimbursement and PGM LLC accordingly earned no profits. Id. PGM LLC claimed no other employees for accounting, tax return reporting, or other purposes. Joint Stip. ¶¶ 32 and 122. PGM LLC owned no tangible or real property, nor did it maintain an office during any of the tax years at issue. Joint Stip. ¶ ¶ 147 and 151.

E. Expatriates and Foreign Host Companies

During the tax years at issue, the following number of expats were listed on the PGM LLC Payroll Reports: 151 (2011); 165 (2012); and 184 (2013). Joint Stip. ¶ 30. The expatriates were assigned to Foreign Host Companies in various non-U.S. locations around the world, including (but not limited to): China, Ireland, Japan, Mexico, Poland, Russia, Spain, Switzerland, Thailand, the United Arab Emirates, and the United Kingdom. Joint Stip. ¶ 69. The PepsiCo Corporate Group has two different forms of global mobility practices for transferring individuals outside the U.S.: (1) permanent transfers, *e.g.*, a U.S. citizen's employment is transferred indefinitely/permanently from a U.S. PepsiCo Corporate Group entity to a foreign (non-U.S.) PepsiCo Corporate Group entity; and (2) temporary assignments, *e.g.*, a U.S. citizen is temporarily assigned to a foreign host company conditioned upon repatriation. Joint Stip. ¶ 72. PGM LLC *does not* identify and approve individuals for assignment to Foreign Host Companies, but instead PepsiCo Corporate Group management performs this key function based on its review and determination of the skill set and interest of each individual, and the business needs of the Foreign Host Companies. Joint Stip. ¶ 76.

The expatriates signed Letters of Understanding and Secondment Agreements that set out the framework of their foreign assignments, under which the expatriates provide services exclusively for and to the Foreign Host Companies. Joint Stip. ¶ 94 and Exhibits 25 and 26. PGM LLC cedes to the Foreign Host Companies the right to direct, control, and supervise the day-to-day services performed by the seconded expatriate; during the assignment, the seconded expatriates are subject to the full direction, control, and supervision of the assigned Foreign Host Company while the expatriate provides the agreed upon services; and PGM LLC does not exercise any direction, control, or supervision over the seconded expatriates of any day-to-day duties for

the Foreign Host Company performed under the Secondment Agreement. See Joint Stip. ¶ 84. 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. Joint Stip. ¶ 87.

Finally, the expatriate Global Mobility 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"), and not by any person employed by PGM LLC. Joint Stip. ¶ 99. Specifically, within the PepsiCo Corporate Group HR Function, there are approximately twenty individuals employed predominantly by PepsiCo foreign affiliates throughout the world who execute the Letters of Understanding and Secondment Agreements in the name of PGM LLC . Joint Stip. ¶ 100.

ISSUE IN DISPUTE

The issue in dispute is whether FLNA is excludible from PepsiCo's Illinois unitary combined group under 35 ILCS 5/101 et seq. ("IITA") Section 1501(a)(27) as an 80/20 Company conducting 80% or more of its business activities outside the United States. [1]

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[1] PepsiCo's Motion for Summary Judgment mistakenly asserts that the parties have agreed that the issue of whether FLNA is excluded from PepsiCo's Illinois unitary combined group as an 80/20 Company "is purely a question of law." Petitioner PepsiCo. Inc. and Affiliates' Motion for Summary Judgment ¶ 5. The Department does not agree to this characterization of the issue. This issue is clearly a mixed question of law and fact. Whether FLNA is excluded from PepsiCo's Illinois unitary group as an 80/20 Company requires evaluation of stipulated facts in assessing their relevance and importance in determining whether FLNA was an 80/20 Company as defined in IITA Section 1501(a)(27). See e.g. JI Aviation v. Department of Revenue, 335 Ill. App. 3d 905, 914 (2002) (court ruled based on fully stipulated factual record that determination of whether aircraft was subject to Illinois use tax was a mixed question of law and fact which required evaluation of stipulated facts in determining their legal effect). Whether an issue is a purely a question of law or a mixed question of law and fact determines the standard of Appellate Court review under the Illinois Administrative Review Law. Id. at 910. This standard of review is not at issue here because the Tribunal is making the final administrative decision in place of the Department. Illinois Independent Tax Tribunal Act of 2012, 35 ILCS 1010/1-5. Regardless, PepsiCo's mistaken characterization of the issue as "purely a question of law" perfectly illustrates why the legal analysis in PepsiCo's brief is fatally flawed. PepsiCo's legal analysis ignores controlling facts and economic realities. Both before and after PGM LLC's formation, FLNA continued to operate PepsiCo's domestic snack food business, and derive its income, within the United States. PGM LLC is a

ARGUMENT

I. FLNA Is Not Excluded from PepsiCo Combined Group Under the 80/20 Test Because the Expatriates Are Not Its Employees

Illinois adopts the water's edge combined apportionment method. This apportionment method excludes from Illinois combined returns corporations conducting 80% or more of their business activities outside the United States. IITA §1501(a)(27). For this purpose, business activity is measured under the so-called "80/20 Test" by averaging payroll and property factors comparing United States payroll and property to worldwide payroll and property. Id. Under this test, corporations with 80% or more of their business activity *outside* the United States, or put another way 20% or less of their business activity *within* the United States, are excluded from an Illinois unitary combined return.

PepsiCo is attempting to apply the 80/20 Test to exclude FLNA and its approximately $2.5 billion in annual profits from domestic sales of iconic United States snack foods from PepsiCo's combined return. PepsiCo does this by treating as FLNA foreign payroll, expatriate compensation charged to PGM LLC that is wholly unrelated to FLNA's domestic snack food business. PGM LLC is not the expatriates' employer and their compensation should not be included in FLNA's payroll factor calculations. The expatriates' compensation does not reflect FLNA foreign business activity. PepsiCo's application of the 80/20 Test to exclude FLNA from PepsiCo's combined return is contrary to the plain statutory language of this test and economic realities. FLNA remains a domestic corporation conducting business primarily within the United States.

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paper company with no office, no property, no management, or other means to accomplish any business purpose. PGM LLC lacks any economic substance. As addressed in this brief, applicable law as well as simple logic, dictates that PGM LLC, a company without economic substance, cannot transform FLNA, a dominant company in the United States snack foods industry, into a corporation conducting 80% or more of its business outside the United States.

A. Excluding FLNA's Domestic Profits from Combined Income Under the 80/20 Test Is Directly Contrary to the Purpose of Illinois' Waters Edge Combined Apportionment

1. Overview – IITA Section 1501(a)(27) Requires Fair Determination of Illinois Income With Exclusion of Foreign Source Income

The Illinois General Assembly enacted the 80/20 Test in 1982, the year after the Illinois Supreme Court issued its landmark decision in Caterpillar Tractor Co. v. Lenckos, 84 Ill 2d. 102 (1981). The 80/20 Test responded to the Caterpillar court's ruling that fair determination of income from Illinois business activity required that it interpret the IITA as authorizing worldwide combined apportionment. The General Assembly adopted the 80/20 Test in recognition that business and tax policy considerations required a retreat from worldwide combined apportionment to water's edge combined apportionment, which excluded foreign income from combined income. PepsiCo's application of the 80/20 Test is contrary to the purpose of water's edge combined apportionment because it: i) *does not fairly* determine income, but instead only attributes losses to PepsiCo's Illinois business activities; and ii) reaches this result by using the 80/20 Test to exclude billions of dollars in profits from PepsiCo's iconic and very profitable *domestic snack foods business* from PepsiCo combined income.

2. In Caterpillar the Illinois Supreme Court Ruled That The IITA Authorized Use of Worldwide Combined Apportionment In Order to Fairly Determine Income Attributable to Illinois Business Activities

The Illinois Supreme Court in Caterpillar interpreted the IITA for the first time in determining whether it dictated that multinational affiliated corporate groups must use combined apportionment in order to fairly determine that portion of their income attributable to Illinois business activities. Caterpillar Inc. and its affiliates were a worldwide commonly owned, managed and economically integrated (hereinafter generically "unitary") group of corporations.

From the enactment of the IITA, effective August 1, 1969, Caterpillar had filed tax returns for each Caterpillar corporate affiliate with Illinois taxable nexus, which determined Illinois taxable income by apportioning each corporation's base income to Illinois by means of the IITA's three-factor apportionment formula.[2] This formula compared the corporation's Illinois sales, property and payroll to total property, payroll and sales (hereinafter generically "*separate apportionment*"). Caterpillar subsequently filed refund claims on a worldwide *unitary combined apportionment* basis for 1970 through 1974, under which each corporation with Illinois nexus determined Illinois base income by apportioning combined base income of the unitary members to Illinois based on each corporation's payroll, property, and sales over total combined payroll property and sales of the unitary group.

The court observed that Caterpillar and its subsidiaries were a classic illustration of a unitary business. Id. at 116. They formed a worldwide network of companies whose combined operations constituted the world's largest construction and earth-moving manufacturer. Id. The court noted that courts in other states had ruled that their income apportionment provisions, which like Illinois' were based on the model Uniform Division of Income for Tax Purposes Act ("UDITPA"), authorized use of combined apportionment by unitary corporate groups. The Caterpillar court noted that combined apportionment was necessary because unitary corporate group business activities were so interrelated that it was impossible to determine income generated by a particular corporation within a state under separate apportionment. Id. The court held with respect to combined apportionment:

> [t]he purpose of this method . . . is to permit the fair determination of the portion of business income that is attributable to business activity by the reporting member of the unitary group. The concern, it is emphasized, is in making a fair determination of tax liability.

[2] Effective for tax years ending on or after December 31, 2000, Illinois adopted its current single sales factor in place of its former three-factor apportionment formula. IITA § 304(h)(3).

Id. at 121. The Caterpillar court ruled that in order to most fairly determine income attributable to Caterpillar's Illinois business activity, the IITA required application of the worldwide combined apportionment formula against Caterpillar's worldwide unitary business income.

3. The Illinois General Assembly Enacted the 80/20 Test to Limit Combined Income Apportionment to the United States Water's Edge

In 1982, the year immediately following the Caterpillar decision, the General Assembly attempted to overrule this decision by enacting legislation rejecting world-wide combined apportionment in favor of separate apportionment. This legislation was the subject of an amendatory veto by then Governor Thompson. Worldwide combined apportionment at this time faced significant political opposition. Worldwide Unitary Taxation Working Group, Chairman's Report and Supplemental Reviews, August 1984, p.2. This opposition is memorialized in a report published in 1984 by the Worldwide Unitary Taxation Working Group appointed by President Ronald Reagan to make recommendations to state legislators for a replacement of worldwide combined apportionment. Id. at August 31, 1984 Letter Transmitting Final Report by United States Treasury Secretary Donald T. Regan.

The report noted that opponents of worldwide combined apportionment included domestic and foreign-based multinationals, which contended that to lump together income earned in numerous profit centers throughout the world and then divide the result on a formula basis distorts the attribution of income to any particular source or state since in some centers losses were incurred, while in others profits result. Id. at p.2. The report also found that: i) many U.S. based multinationals contended that this method distorted income because no deduction was allowed for foreign taxes or other payments to foreign governments; and ii) many foreign-based multinationals contended that the method imposed substantial administrative burdens by requiring them to

translate accounts of their entire foreign operations into U.S. currency and to conform income computation to U.S. and state accounting rules, and that they were not required to do this by any other country. Id. The Task Force unanimously recommended that in lieu of worldwide combined reporting states adopt water's edge combined apportionment, which excludes foreign income from combined income. Id. at August 31, 1984 Letter Transmitting Final Report by United States Treasury Secretary Donald T. Regan and at p. 9.

While the Task Force's final report postdated Illinois' adoption of water's edge apportionment, Governor Thompson in issuing his amendatory veto was clearly aware of the arguments against worldwide combined reporting memorialized in this report. Governor Thompson's amendatory veto observed that worldwide combined reporting caused "concern to many businesses because it mixes foreign operations with domestic activities, a mix many believe is unfair based on the differences between United States taxing and accounting methods, profit factors, and payroll cost, and those in effect in foreign countries. Businesses headquartered in foreign countries are particularly sensitive to this problem." Governor Thompson Amendatory Veto, Illinois Senate Journal at p. 3756 (November 19, 1982). At the same time, in rejecting the General Assembly's attempt to re-institute separate apportionment, the amendatory veto stated that domestic combination could prove to be of significant benefit to corporations conducting business in Illinois:

> Companies operating an economic enterprise throughout the various states may, for a variety of reasons, choose to organize themselves as separate corporations rather than as branches or divisions of a single corporation. The business structure should not be the determining factor in taxation. Domestic combined reporting allows firms to more clearly reflect the income attributable to Illinois. For these reasons, I am recommending combined reporting for domestic members of a unitary group.

Id. at p. 3757. (emphasis added). The amendatory veto further advised that domestic combination have a provision, the 80/20 Test, clearly identifying those corporations excluded from the unitary group. Id. at pp. 3756-3757. The 80/20 Test recommended by Governor Thompson, and now contained in IITA Section 1501(a)(27), excluded from combined returns those corporations that primarily conduct business outside the United States:

> The group will not include those members whose business activity without the United States is 80 percent or more of any such member's total business activity; for purposes of this paragraph . . . business activity within the United States shall be measured . . . [by] the results of the property and payroll factor computations divided by two . . .

Id. at p. 3760 (emphasis added). In other words, the basis for excluding a corporation from the water's edge combined returns was that it conducted 80% or more of its business activities outside the United States. The 80/20 Test, using payroll and property factors, was adopted as a clear and concise test for measuring business activity.

4. PepsiCo's Application of the 80/20 Test Is Directly Contrary To The Purposes Underlying Illinois' Water's Edge Combined Apportionment

In its recitation of the legislative history of the 80/20 Test, the PepsiCo brief focuses exclusively on Governor Thompson's recommendation that domestic combination have clearly defined provisions. PepsiCo's Br. 17. PepsiCo's Brief then asserts that that the 80/20 Test is a straightforward mechanical rule and that application of this straightforward mechanical rule excludes FLNA from the PepsiCo water's edge combined return. PepsiCo's Br. p. 18. PepsiCo's Brief ignores the purpose of water's edge combined apportionment. Examining the facts surrounding PepsiCo's application of the 80/20 Test, it is clear this application is directly contrary to the true purpose of water's edge apportionment, which is to **fairly determine income**

apportionable to Illinois while excluding from this determination income from predominantly foreign business activities.

a. PepsiCo's Application of the 80/20 Test Grossly Distorts Income Attributable to PepsiCo's Illinois Business Activities

PepsiCo's domestic and foreign business operations are both extremely profitable. Over the decade preceding and encompassing the years at issue here, PepsiCo's net revenues grew at a rate of 9% and its earnings per share grew at a compound rate of 8%. Joint Stip. ¶ 8. PepsiCo's operating margin of 15% was in the top tier of the food and beverage industry. Id. PepsiCo's net revenues and assets were evenly spread between the U.S. and foreign countries. Joint Stip. ¶ 9. All of PepsiCo's 6 divisions were profitable, with Total Division Operating Profits increasing from $9.7 billion in 2010 to $11.1 billion in 2013. Joint Stip. ¶ 23. Frito-Lay North America, the division of which FLNA is a part, was PepsiCo's most profitable division during this time period. Id. In 2010, the year prior to PepsiCo's application of the 80/20 Test excluding FLNA from its Illinois unitary group, PepsiCo reported $1.4 billion of federal consolidated income on its Illinois combined return, which when apportioned to Illinois generated $6.3 million of Illinois income taxes. Joint Stip. ¶ 131. PepsiCo similarly reported federal consolidated income ranging from $1.4 to $1.6 billion in 2011 through 2013. Id. However, application of the 80/20 Test to exclude FLNA income of from $2.4 billion to $2.7 billion in 2011 through 2013 generated net operating losses of between ($800) million and ($1.4) billion on PepsiCo's Illinois combined returns for these years and no Illinois income taxes for these years. Id. The 80/20 Test as applied here grossly distorts income attributable to PepsiCo's Illinois business activities.

b. PepsiCo's Application of the 80/20 Test Excludes Domestic Source Income from PepsiCo's Illinois Combined Return

The purpose of the 80/20 Test is to eliminate foreign source income from Illinois combined income. This exclusion was necessary due to the multitude of problems attendant to worldwide combined reporting, which mixed income from "foreign operations with domestic activities." Governor Thomson Amendatory Veto, Illinois Senate Journal at p. 3756 (November 19, 1982). PepsiCo's application of the 80/20 Test excludes FLNA's profits from **its domestic** snack foods business from Illinois combined income. Stip. ¶¶ 10-12,15-19 and 131. This exclusion is directly contrary to the purpose of Illinois' water's edge combined apportionment, which was to exclude foreign income from combined income. The exclusion of domestic profits accounts for the gross distortion of income attributable to Illinois business activities on PepsiCo's Illinois combined returns.

B. PGM LLC is Not the Expatriates' Common-Law Employer And Accordingly Expatriates' Compensation Charged to PGM LLC Is Not Included in FLNA's 80/20 Test

As summarized above, PepsiCo's application of the 80/20 Test is directly contrary to its purpose of fairly apportioning income to Illinois while excluding predominantly foreign income from this computation. As detailed below, PepsiCo's application of this test is also directly contrary to the plain language of the 80/20 Test as interpreted under controlling legal authority.

1. 80/20 Test Payroll Factor Adopts Internal Revenue Code's Common-Law Employer Test

The 80/20 Test is based on the average of 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 compares 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 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). A similar common-law definition applies for purposes of requiring employers to withhold and pay social security taxes on their employees' wages, as well as meet requirements for gaining beneficial qualified federal income tax treatment of employee retirement plans. IRC § 3121 and Treas. Reg. 31.3121(d).

2. PGM LLC Is Not the Expatriates' Common-Law Employer Based on the Interpretation of This Statutory Term In Light of Economic Realities

a. Common-Law Employer Determinations Arise In a Variety of Tax Contexts

The determination whether a common-law employer-employee relationship exists between a business and an individual commonly arises in the context of determining whether individuals are independent contractors or employees of a business to whom the individuals provide services. If the individual is an employee, the business has payroll tax collection, reporting and payment

responsibilities for that employee. If the individual is an independent contractor, the business does not. The issue of whether a business is a common-law employer also arises when two businesses benefit from services provided by the same individual, in which instance courts must determine which of the two businesses is the common-law employer with payroll tax obligations for that employee. Finally, the issue also commonly arises in determining which of two businesses are the employer of individuals for purposes of testing whether the employer meets pension plan coverage requirements.

b. Economic Realities Govern the Determination of Common-Law Employer Relationships

The United States Supreme Court's 1947 decisions in United States v. Silk, 331 U.S. 704 (1947) and Bartels v. Birmingham, 332 U.S. 126 (1947) are seminal cases in defining the common-law employer-employee relationship for federal payroll tax purposes. The Court in Silk ruled that independent truckers were independent contractors rather than employees of a Chicago based trucking business. The Court observed in its ruling that the differentiation between independent contractor and employee status had become much more consequential as a result of the social legislation enacted in the 1930's, which provided worker benefits, such as social security and unemployment compensation benefits, as well as worker rights in labor disputes. Id. at 713. The Court emphasized that the term "employee" was not a term of art defined by this legislation by "some simple, uniform and easily applicable test," but instead was a general common-law test that must be construed to remedy the social ills that were the focus of this legislation. The Court held that the term must include "workers who were such as a matter of economic reality." Id. (emphasis added). In Silk, the Court further held the following factors were critical in determining the economic realities of a true employer-employee relationship between a business and worker:

i) business control of the worker; ii) business investment in facilities used by the worker; iii) business opportunities for profit or loss from services provided by the worker; and iv) the worker's skill level and permanency of the worker's relationship with the business. Id. at 716. The Court ruled based on these factors that truckers were independent contractors and not employees of a trucking business, in particular focusing on the truckers' ability to profit from their relationship rather than the trucking business' opportunity to profit from their services. Id.

In Bartels v. Birmingham, 332 U.S. 126 (1947), the Court addressed whether bandleaders or ballroom operators were the common-law employers of band members and therefore liable for collection and payment of federal social security taxes due on the employees' wages. The bandleaders entered contracts with ballroom operators under which the operators paid the bandleader for their band's performance at the ballrooms, and the bandleader paid the band members from these proceeds. The *contracts stated* that the *ballroom operator was the employer* of the band members and their leader. The contracts further stated that the operators had the right to control and direct the musicians' work. The payroll tax collectors relied on these provisions to treat the ballroom operators as the band members' employer liable for payroll taxes. The Court discounted these contractual provisions and assigned them no evidentiary weight. The Court noted that District Court below had found that the contracts were *not* entered into as a matter of "fair negotiation" between the band leaders and ballroom operators, but instead were a standardized contract, used by bandleaders, that had been drafted by the musicians' union to shift payroll tax collection responsibilities from the band leaders to the ballroom operators. Id. at 129. The contract had no practical effect on the relations between the musicians, band leader, and ballroom operator. Id. The Court held that it was the "total situation that controls" the determination of an employer-employee relationship. Id. at 130. The Court held that as a practical matter it was the bandleader

that controlled the band members' work because the band leaders provided them with sheet music arrangements, uniforms, employed and discharged the musicians, and paid them, and their expenses. The Court ruled based on these economic realities that the band leaders, not the ballroom operators, were the musicians' common-law employers. Id at 132.

The Tax Court has repeatedly relied on the United States Supreme Court's decisions in Silk and Bartels to rule that economic realities determine if there is a common-law employer-employee relationship. For example, in Burnetta v. Commissioner of Internal Revenue, 68 T.C. 387 (1977) the court ruled that economic realities dictated that individuals were common-law employees of professional service corporations, Crockett and Burnetta, to which they provided administrative support services. Crockett and Burnetta, were run respectively by an ophthalmologist and optometrist. They each retained the services of Staff Employees, Inc. ("Staff Inc.") to supply bookkeeping, office manager and other staff personnel. Staff Inc. had an employee, Robert Williams, that served as its chief executive officer, and another employee Louise Moulder, who was its manager of daily business operations. Staff Inc. allegedly selected, hired, trained, instructed, and contracted out the employees to Crocket and Burnetta and other customers. The court noted that Staff Inc. in actual practice did not have a sufficient number of personnel to conduct its own screenings. Staff Inc.'s customers instead performed these functions. Id. at 391. Staff Inc. never hired an employee without already having a position for him to fill with a customer. Staff Inc., as employer, issued all payroll checks and filed all federal and state payroll tax returns. However, customers determined the rate of pay and all increases. Staff Inc. received 3-4% of the workers' compensation as a service charge. Id. at 392. The customers retained and exercised the right to control the employees, as to the work that they would accomplish and to terminate them. While Staff Inc. asserted it had the right to terminate the employees, it could not produce any

evidence that it in fact had ever exercised this right. The Tax Court ruled that customers, not Staff, were the common-law employers based on control they exercised over employees, including recruitment, hiring, work performed and compensation. Id. at 400.

The Tax Court in Professional & Executive Leasing, Inc. v. Commissioner of Internal Revenue, (hereinafter "PEL") 89 T.C. 225 (1987) *aff'd.* 852 F2d. 751 (1988) again focused on economic realities in ruling that a company, Professional & Executive Leasing, Inc. (hereinafter "PEL"), which hired and contracted out the services of professional personnel ("Workers") to businesses ("Recipients") was not the Workers' common-law employer. Workers included doctors, lawyers, veterinarians, and business operators. At issue was whether the Workers were common-law employees of PEL or the Recipients to which they provided services. PEL entered a contract of employment ("COE") with the professionals as well as a separate Personnel Lease Contract ("PLC") with the businesses. The professionals typically owned a portion of the practices to which they were leased. Under the PLC, the Recipient agreed to reimburse PEL for the Worker's compensation as well as pay PEL a setup fee of $1500, and a $110 monthly service fee, for each position staffed. The COE stated that the Worker did not have the right to make any representations on behalf of, or bind PLC to any contract, or transaction but no such restriction applied to the Worker vis-à-vis the Recipients. Instead, the COE stated that PEL would not infringe on the Worker's performance of services, and the Worker and Recipient controlled the details of the Worker's performance of services.

The Tax Court applied the four factors enunciated in Silk to rule that the Workers were the Recipients' common-law employees. The court stated 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." Id. at 233. Regarding the

first factor, control, the court found that while the COE gave PEL exclusive control over the Workers, in reality PEL exercised minimal control over the Workers. While the contract gave PEL the right to reassign the Workers, as a practical matter PEL would be unlikely to make such reassignment since the Workers typically had equity stakes in the practices to which they provided services. The court also held that:

> [m]ost of the Workers were professionals and [PEL] was unqualified to supervise or evaluate the performance of professional services. While we are cognizant that the alleged employer need not 'stand over the employee and direct every move that he makes' . . . that an employer's control over the manner in which professional employees conduct the duties of their positions 'must necessarily be more tenuous and general than the control over nonprofessional employees . . . we remain unpersuaded that even a 'tenuous and general' control exists in the case before us . . . Rather, it is apparent that the Recipient and the Worker control the terms of the arrangement.

Id. at 234. Regarding the second factor, the court held that PEL had no investment in facilities used by the Worker and instead Recipients provided the Worker's workspace. Regarding the third factor, the opportunity to profit and loss from the Worker's services, the court held that PEL had no opportunity for profit and loss from such services, except for the limited amounts received from the Recipient that included the $1500 setup fee and $110 monthly service fee per worker. Finally, regarding the fourth factor, the permanency of the relationship, the court held that PEL's purported right to discharge and reassign workers was as a practical matter illusory, given the factual circumstances.

The court held that while the COE and PLC created a so-called employment relationship between PEL and the Workers, the "economic reality" was that PEL merely performed a bookkeeping and payroll service function. The court held that:

> [t] he existence of a contract specifying that an employer-employee relationship exists is only one factor to be considered. Bartels v. Birmingham, *supra* at 129. In accordance with long established precedent, we find that the transactions embodied in the COE and PLC lack objective economic substance and are not controlling for tax purposes.

The court therefore ruled that the Workers were not PEL's common-law employees. [3]

c. Economic Realities Dictate that the Expatriates Are Not PGM LLC's Common-Law Employees

The controlling case law summarized above clearly dictates that common-law employees only include "workers who [are] such as a matter of economic reality." United States v. Silk, 331 U.S. at 713 (emphasis added). It emphasizes that while "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 v. Birmingham, 332 U.S. at 130 (emphasis added). Viewed in the light of economic realities, it is clear that the expatriates cannot be PGM LLC's common-law employees because PGM LLC has *no* economic substance.

This controlling case law involved a determination of which of two independent contracting businesses was the employer of the workers at issue. In Bartels it was a choice between the bandleader and ballroom operators, in Burnetta a choice between professional service corporations and companies that provided staff employees to them, and in PEL a choice between service businesses and executive leasing companies which "leased" professionals to them. There was no question in these cases that the competing businesses conducted ongoing substantive business operations, the only issue for decision was which of the two businesses, as a matter of

[3] In addition to the four factors addressed in the text, the court also cited Silk as authority for three additional factors in determining whether an employer-employee relationship exists: i) whether the type of work is part of the principal's regular business; ii) right to discharge; and iii) the relationship the parties thought they were creating. Id. at 232. The court's decision did not address the first of these factors. The decision dismissed the second factor in assessing the permanency of the relationship and determining that PEL's right to discharge was illusory as a practical matter. Id. at 234. As addressed in the text, the court dismissed the last factor – the relationship the parties thought they were creating in the contract between PEL and the Worker – as contrary to economic realities. Id. at 235.

economic reality, were the workers dependent upon and therefore with which of the businesses did they share an employer-employee relationship.

By contrast, PGM LLC is a single member disregarded LLC wholly owned by a PepsiCo subsidiary, FLNA. PGM LLC's alleged principal business purpose is that it ". . . facilitates the secondment of high-performing expatriate executives, directors, managers, and analysts . . ." PepsiCo Brief at p. 11 quoting Joint Stip. ¶ ¶ 62 and 92. PGM LLC has no employees, other than the alleged expatriate "employees" who work for Foreign Host Companies. PGM LLC has no real or tangible assets. Joint Stip. ¶ 147. During the period at issue PGM LLC had a *$0 or negative capitalization* as follows**:** 2011 -Total Assets - $0, Shareholders' Equity - ($45,335); 2012 - Total Assets - $2,586, Shareholders' Equity $0 ; and 2013 – Total Assets - $236,260, Shareholders' Equity (R.E.) – ($109,451). Joint Stip. Exhibit 11 (PGM LLC Pro Forma U.S. Corporation Income Tax Return, Schedule L – Balance Sheet, PEP00002536,PEP 00002548 and PEP00002559). In short, PGM LLC lacks any economic substance, let alone the substance necessary to accomplish its business purpose of facilitating the secondment of approximately 200 high-performing executives to Foreign Host Companies:

- <u>PGM LLC Has No Employees to Facilitate Expatriate Foreign Host Company Assignments</u>. PGM LLC has no employees to accomplish its alleged primary business purpose, which is to facilitate the assignment of expatriates to Foreign Host Companies. Joint Stip. ¶ 62. Instead, PepsiCo Core Senior Management Resource personnel employed by various PepsiCo entities, *but not by PGM LLC*, facilitate assignment of expatriates by matching their talent and experience with the needs of Foreign Host Companies Joint Stip. ¶ 74. Approximately 20 other employees comprising a so-called Global Mobility HR Function provide human resource support to expatriates on issues unique to expatriate assignments such as education, immigration, and work permit issues. Joint Stip. ¶¶ 100, 104. The majority of the time spent by these individuals is on non-PGM LLC matters, with the remaining approximately 26% of their time spent on PGM LLC matters. Joint Stip. ¶ 103. There is no written agreement between PGM LLC and the PepsiCo affiliates for the provision of, nor compensation to be paid for matching services, which are at the very heart of PGM LLC's asserted business purpose. Joint Stip. ¶ 90. Neither does PGM LLC otherwise pay these

PepsiCo affiliates, nor the management and human resource employees directly, for their work in facilitating expatriates assignments. Joint Stip. ¶ 91.

- PGM LLC Has No Employees To Direct, Review and Evaluate Expatriate Work. Neither does PGM LLC have any employees to direct, review and evaluate expatriates' work for Foreign Host Companies. Expatriates perform services under the direction and for the benefit of the Foreign Host Companies. Joint Stip. ¶ 94. Foreign Host Company managers assess the expatriates day-to-day performance to determine an annual performance rating and submit this rating to the PepsiCo Corporate Group's Executive Compensation Team. Joint Stip. ¶ 87. Based on this assessment the PepsiCo Corporate Group Executive Team makes compensation determinations for expatriates. Joint Stip. ¶ 88.

- PGM LLC Has Neither Assets Nor Other Means By Which to Insulate the PepsiCo Corporate Group from Legal Liability Associated With Expatriates' Actions. PepsiCo asserts that "one of the purposes of forming PGM LLC was to attempt to protect other U.S. entities within the PepsiCo Corporate Group, such as PepsiCo, Inc., FLI, or FLNA from having direct legal liability for actions of or disputes regarding the seconded expatriates' actions in all of the countries in which each of these executives are assigned." Joint Stip. ¶ 65. However, the foreign host companies are responsible for maintaining insurance coverage with respect to this liability. Joint Stip. ¶ 66. The cost of this coverage is not charged to PGM LLC. See PGM LLC trial balances and general ledger -- Exhibits 32, 33 and 34. Furthermore, without such insurance coverage provided by third parties, PGM LLC's minimal assets and negative capitalization would not be sufficient to serve its purported purpose of limiting affiliate liability for the expatriates. See e.g. Westmeyer v. Flynn, 382 Ill. App. 3d 952, (1st Dist. 2008) (court pierced legal "veil" of limited liability company ("LLC") and ruled that members of the LLC, which was undercapitalized and operated as the alter ego of such members, could be held personally liable for default judgment against LLC in collection action brought by former employee for unpaid wages); and Martin v. Freeman, 272 P.3d 1182 (Colo. Ct. App. 2012) (court pierced legal "veil" of single member limited liability company ("SMLLC") to hold member liable for SMLLC's debts where SMLLC operated as a mere asset-less legal shell whose expenses were paid by its member).

- PGM LLC Has No Employees Nor Assets With Which to Provide Other Alleged Benefits To the PepsiCo Corporate Group. PepsiCo asserts that PGM LLC provides other benefits to the PepsiCo Corporate Group, such as preserving employee participation in U.S. benefits plans, centralizing Permanent Establishment foreign tax exposure related to expatriates, and centralizing government compliance requirements. Joint Stip. ¶ 67. However, PGM LLC has no employees, no assets nor other economic means by which to accomplish any of these objectives. See PGM LLC trial balances and general ledger -- Exhibits 32, 33 and 34.

In summary, PGM LLC is a "paper" corporation wholly lacking in economic substance. It is not a substantive ongoing business operation operating on an arm's length basis to serve an important business function for the PepsiCo Corporate Group. Instead, PGM LLC may more accurately be described as a legal shell and an associated set of general ledger accounts, which track amounts charged by the PepsiCo Corporate group to Foreign Host Companies for work expatriates perform benefitting the Foreign Host Companies and the companies' reimbursement of these charges. As a matter of economic reality, the expatriates are not controlled by, nor does PGM LLC otherwise act as the expatriates' common-law employer, because PGM LLC has no economic substance.

d. Application of Controlling Legal Precedent Requires A Ruling That the Expatriates Are Not PGM LLC's Common-Law Employees

The conclusion that economic realities dictate that PGM LLC is not the expatriates' common-law employer is supported by applying the common-law employer criteria identified in Silk to PGM LLC's facts.

- PGM LLC Has No Employees Exercising Control. PepsiCo Core Senior Management Resource personnel employed by various PepsiCo entities, *but not by PGM LLC*, facilitate assignment of expatriates by matching their talent and experience with the needs of Foreign Host Companies Joint Stip. ¶ 74. The expatriates take their direction from and meet goals that are set by Foreign Host Company management. Foreign Host Company management reviews and evaluates their performance and ultimately determines their compensation. In Burnetta, 68 TC at 391 the court ruled that an administrative staffing service was not a common-law employer where it had insufficient personnel to screen and select employees, and this function instead was handled by employees of its clients. In PEL, the court ruled that PEL did not possess the right to control the Workers, despite contractual provisions purporting to give PEL such control, because even though PEL had employees, none of PEL's employees possessed the technical expertise necessary "to supervise or evaluate the performance of professional services" by the Workers for the Recipients. PEL 89 TC at 234. PGM LLC has *no* employees at all to oversee expatriates' work, let alone employees qualified "to supervise or evaluate the performance of professional services" by expatriates for the Foreign Host Companies. The expatriates work under the direction of Foreign Host Company management who evaluate the expatriates' job performance. Joint Stip. ¶ ¶ 87 and 94.

- PGM LLC Has No Investment in Facilities. The Foreign Host Companies provide facilities and pay all expenses necessary for the expatriates in performing work for them. In PEL the Tax Court ruled that PEL was not the professionals' common-law employer where PEL provided neither office facilities nor tools and equipment to facilitate the professionals' work. PEL 89 TC at 234. PGM LLC has no investment in the facilities used by the expatriates, nor does it otherwise incur any expenses in furtherance of the performance of their work. See PGM LLC trial balances and general ledger -- Exhibits 32, 33 and 34.

- PGM LLC Has No Opportunity for Profit and Loss. The Foreign Host Companies derive all profit from the expatriates' work. In PEL, the Tax Court ruled that PEL had "no opportunity of profit and loss" from work of the professionals at issue because its remuneration for its services was limited to reimbursement of compensation paid the professionals plus a $1500 set-up and a $110 monthly maintenance fee per professional. Id. Similarly, the Tax Court ruled in Burnetta that there was insufficient profit and loss potential to qualify the staffing service as the administrative staff's common-law employer where the staffing service received reimbursement of compensation paid plus a fee limited to 3% to 4% of the compensation paid the staff employees. Burnetta 68 TC at 392. PGM LLC derives absolutely no profit from the business activities of its alleged expatriate employees. Instead, PGM LLC is simply credited with a dollar-for-dollar reimbursement from foreign subsidiaries for the compensation charged to PGM LLC for services expatriates perform benefitting exclusively Foreign Host Companies. Joint Stip. ¶¶ 95, 96; and see PGM LLC trial balances and general ledger - Exhibits 32, 33 and 34.

- PGM LLC Has No Employees Determining Permanency of Relationship. The Foreign Host Companies have a contractual right to terminate the assignment of the expatriates upon proper written notice to PGM LLC. Joint Stip. ¶ 97. PGM LLC also has the contractual right to terminate the assignment or overall expatriate employment upon written notice. Joint Stip. ¶ 98. However, as the Tax Court in PEL observed a contractual right to terminate is not evidence of an employer-employee relationship where it is merely "illusory." PEL 89 TC at 234. PGM LLC's contractual right to terminate as a matter of economic reality is illusory. Whoever may or may not exercise the right of termination on behalf of PGM LLC, that person is not a PGM LLC employee. Such person is employed by another PepsiCo affiliate and is removed from day-to-day supervision of the expatriate's work. By contrast, the Foreign Host Companies as a practical matter have the right to terminate expatriates' employment by PGM LLC. PGM LLC does not maintain an ongoing pool of employees available for assignment. PGM LLC only contracts with expatriates who have been assigned to work for a specific foreign subsidiary. Joint Stip. ¶ ¶ 74-78. Termination of an assignment by Foreign Host Company management effectively ends their employment by PGM LLC. Id.

The Tax Court ruled in PEL that while the parties had labeled the agreements between PEL, the professionals, and businesses to which they were leased as an employment relationship between

PEL and the professionals the "objective economic reality of the relationship" did not support the conclusion that the professionals were PEL's employees. Similarly, while the contracts here label this arrangement as an employer-employee relationship, the objective economic reality is that there is simply no economic substance supporting such a relationship. Controlling legal precedent applied to the facts at issue here requires a ruling that PGM LLC is not the expatriates' common-law employer, and that amounts charged to PGM LLC for compensation paid and benefits received by the expatriates is not included in the PGM LLC/FLNA 80/20 Test payroll factor. IITA §§ 102 and 1501(a)(3).

e. Payroll Tax Reports and Returns Filed in PGM LLC's Name Do Not Constitute Evidence Supporting Conclusion That PGM LLC Is The Expatriates' Common-Law Employer

PepsiCo places significant weight in concluding that PGM LLC is the expatriates' employer on the fact that Form W-2, Wage and Tax Statements, and payroll tax reports were filed in PGM LLC's name with the Internal Revenue Service. PepsiCo Br. p. 28. PepsiCo presented no evidence that the Internal Revenue Service had ever audited these tax returns and independently concluded that PGM LLC was the expatriates' common-law employer. In the Bartels, Burnetta, and PEL decisions discussed above, which party filed payroll tax returns and other reports did not sway the court in making its determination of which party was the common-law employer. In all these decisions the court determined that the common-law employer was not the party that filed the payroll tax returns. Presumably, this is explained by the fact that under IRC Section 3401(d)(1), if a common-law employer does not control payment of wages to the employee, the entity that controls payment of such wages shares legal liability and is required to file payroll returns reporting payroll taxes on such wages. *See e.g.* Otte v. United States, 419 US 43 (1974) (bankruptcy trustee obligated to pay pre-bankruptcy wage claims against bankrupt common-law

employer was also legally obligated to withhold and remit federal and state payroll taxes on those wages); and United States vs. Total Employment Company, 305 B.R. 333 (U.S. Dist. Ct. Fla. M.D. 2004) (court ruled that employee leasing company which issued checks to leased employees and filed payroll tax returns shared legal liability for payroll taxes with common-law employer to whom employees were leased and on whose behalf and under the direction and control of such common-law employer the employees performed their work). In summary, contrary to PepsiCo's assertion, whether payroll tax returns were filed for expatriates in PGM LLC's name does not determine whether PGM LLC was the expatriates' common-law employer.

3. Case Law Cited by PepsiCo is Distinguishable and Does Not Support a Ruling That PGM LLC is the Expatriates' Common-Law Employer

The case law on which PepsiCo relies to conclude that the expatriates are PGM LLC employees addresses dramatically different factual circumstances from the economic realities here and is of limited, if any, relevance in determining whether PGM LLC is the expatriates' common-law employer.

a. Legal Presumptions and Factual Circumstances Differ from those Pertinent to the Determination of Whether the Expatriates Are PGM LLC Employees

In concluding that PGM LLC is the expatriates' common-law employer, PepsiCo's Brief relies primarily on the following three cases: Samuel Striker v. Commissioner, TC Memo 2015-248 (12/28/2015); Gillis v. Commissioner, T.C.M. (RIA) 1986-576 (1986); and Adair v. Commissioner, T.C. M. (RIA) 1995-493 (1995). PepsiCo's Br. pp. 22-36. All three cases involve individuals who were employed by the Army (Striker and Adair) or the Air Force (Gillis) and who were posted to an overseas NATO assignment. In each case the principal legal issue was whether the compensation these individuals received for the NATO assignment qualified for the individual income tax foreign earned income exclusion from adjusted gross income contained in

IRC Section 911. If these individuals were NATO employees, they would qualify for this exemption, but if they if they remained Army/Air Force employees they would not. These decisions are of limited, if any, precedential value in determining whether the expatriates are PGM LLC common-law employees given the different legal authority and factual circumstances addressed by this case law.

- Burden of Proof. First, as the Tax Court observed in Striker TC Memo 2015-248 at *4, IRC Section 911 is an exclusion from gross income. Exclusions are construed narrowly, and a taxpayer must clearly establish his or her entitlement to such exclusions. Id. Accordingly, there was a legal presumption that the employees in these cases remained employees of the Army/Air Force (which PepsiCo argues are the equivalent of PGM LLC here). By contrast, under the 80/20 Test, which is a tax exemption, the burden of proof is on PepsiCo to prove that the expatriates are PGM LLC employees and that PGM LLC/FLNA is excludible from the PepsiCo combined return. Zebra Technologies Corp. v. Topinka, 344 Ill. App. 3d 474, 484 (2003).

- Arm's Length Versus Non-Arm's Length Contracts. Second, the contracts in these cases were arm's length contracts between unrelated entities. The expatriate employment contracts are between affiliated entities, PGM LLC and the Foreign Host Companies. They are not comparable to arm's length contracts between unaffiliated entities, for example, as evidenced by the fact that they only provide for a pass-through of compensation costs without even minimal markup. The Foreign Host Companies provide 100% reimbursement and there is no profit at all recognized by PGM LLC. The provisions of these contracts are not entitled to evidentiary weight because they are not the product of fair negotiation and their terms do not comport with economic realities. Bartels 332 U.S. at 129.

- Economic Realities. Finally, there is no question in these cases that the Army/Air Force was the original employer who screened and reviewed the workers job applications and managed their work. By contrast, PGM LLC has no management employees who hired the expatriates or oversaw their work. While there is economic reality attendant to Army/Air Force employment of the workers in these cases, there is none attendant to PGM LLC employment of the expatriates, who are "transferred" from their original employer, a PepsiCo affiliate, to PGM LLC and immediately assigned to Foreign Host Companies. The Foreign Host Companies have economic reality attendant to their relationship with and control over expatriates, and their payment for expatriate services, but PGM LLC does not.

In sum, the differing legal burden of proof and economic realities means the legal precedent on which PepsiCo relies is of limited, if any, value here.

b. Case Law Cited By PepsiCo Supports the Conclusion That the Expatriates are Not PGM LLC Employees

Turning more specifically, to distinguish the cases relied on by PepsiCo, in Striker at issue was whether an individual ("Striker") employed by the Army and then posted to a position with NATO in Afghanistan remained an Army employee or became a NATO employee. The court concluded that Mr. Striker remained an Army employee and that his wages were not excludible for individual income tax purposes from his adjusted gross income under IRC Section 911. PepsiCo cites Striker as support for its position that expatriates remained PGM LLC employees based on the court's determination that Mr. Striker remained an Army employee.

In reaching the conclusion that Mr. Striker remained an Army employee, the court relied primarily on the fact that the Army had the right to control and direct Mr. Striker's work.[4] Army personnel evaluated Mr. Striker's work under standardized Army criteria (DCIPS) and these evaluations were then used to set his pay. Striker at [*16]. By contrast to Striker, the expatriates, once assigned to the Foreign Host Companies, are controlled and directed entirely by these companies. Foreign Host Company management sets seconded employee work objectives and conducts annual reviews to evaluate whether the employee has met those objectives. These

[4] PepsiCo's Brief at pages 21-22 also cites to the Illinois Unemployment Insurance Act ("IUTA") interpreted in Ross vs. Cummins, 7 Ill. 2d. 595, 600 (1956) as legal support for its position that the it was PGM LLC's contractual right of control over the expatriates' employment, rather than the actual exercise of this right, which determines that the expatriates are PGM LLC's employees. As explained *supra* contractual rights are not controlling in common- law employer/employee determinations where they are contrary to economic realities. See e.g. Bartels v. Birmingham, 332 U.S at 132. Furthermore, an examination of the facts at issue in Ross demonstrates economic realities supported the court's determination in that case. The court ruled that F.M. Ross d/b/a Weather-Seal of Peoria was a common-law employer of its salesman based on its determination that F.M. Ross provided the salesmen with training, controlled the prices at which they sold, form of contract used, literature distributed, contract acceptance, contract terms, and other means by which the salesmen sold F.M. Ross' products. Ross 7 Ill. 2d at 598-600. By contrast, PGM LLC exercised no such control over the manner in which expatriates performed their work.

evaluations establish standardized company ratings used to determine the employees' future compensation. The Foreign Host Company management may terminate the seconded employees' assignment based on failure to perform. Such termination will also as a practical matter terminate the expatriates' employment by PGM LLC because PGM LLC only has a contractual relationship with expatriates working for Foreign Host Companies. Authority to terminate expatriates' PGM LLC employment does not rest with PGM LLC employees. None of the human resource personnel authorized to sign the Secondment Agreements and presumably terminate their employment are employed by PGM LLC. They are all employees of other PepsiCo affiliates. There is no written agreement between PGM LLC and the PepsiCo affiliates either granting the human resource personnel authority to act on PGM LLC's behalf, nor requiring PGM LLC to compensate the PepsiCo affiliates for services their employees provide with respect to the expatriates.

PepsiCo similarly cites Gillis v. Commissioner, T.C.M. (RIA) 1986-576 (1986) in support of its position that the expatriates were PGM LLC employees. However, once again a close examination of this decision demonstrates that the relevant facts at issue in Gillis are nothing like those at issue here. In this decision, Mr. William Gillis was a United States lieutenant colonel who in 1979 was assigned by the Air Force to assume a position with NATO. He had no separate contract with NATO. Mr. Gillis worked for NATO under the supervision of a German general. PepsiCo relied in its brief on the Tax Court's ruling that because lieutenant colonel Gillis continued to be controlled by the Army, he remained an Army employee and was not entitled to the IRC Section 911 foreign earned income exclusion. However, applying the Gillis ruling to assert that the expatriates remained PGM LLC employees simply ignores the realities of each situation. Lieutenant Gillis throughout his assignment to NATO remained a lieutenant colonel in the Air

Force, subject to Air Force rules and direction, and remained answerable to superior officers in the Air Force. By contrast, there are no employees at PGM LLC who controlled or otherwise directed the expatriates' activities. Furthermore, unlike Gillis where the taxpayer did not have a separate contract with NATO, the expatriates here have a contract that obligates them to provide services to the Foreign Host Companies.

More relevant here is the Tax Court's decision in Adair v. Commissioner, TC Memo 1995-493 (10/12/1995). Adair involved the assignment of another individual, William Adair, posted by the Department of the Army ("DOA") to a position with NATO. Adair was cited and distinguished by the court in Striker. Mr. Adair was paid on a monthly basis by the DOA, which issued W-2's to Mr. Adair as his employer. Id at [*6]. However, NATO dictated the results that Mr. Adair was to accomplish through his work as well as the means by which he was to attain those results. Id. In Adair, the Tax Court determined that Mr. Adair became a common-law employee of NATO. The Tax Court based its decision on the "common-law" test for employee, specifically whether the Army or NATO held the authority to direct and control the manner in which Mr. Adair performed his work. Id. at [*10]. The court ruled that NATO was Mr. Adair's employer based on "the paramount fact that NATO, rather than the United States, controlled the manner in which his work was performed." Id. at [*12]. The Foreign Host Companies, not PGM LLC controlled the manner in which expatriates performed their work. This control was memorialized in the Secondment Agreements and evidenced by the fact that PGM LLC employed no one who oversaw the expatriates' work.

4. Utah State Administrative Decision is Directly on Point in Concluding That Employee Lessor Is Not An Employer for Payroll Apportionment Factor Purposes and Instead Compensation Paid Leased Employees Is Included in Common-Law Employer-Lessee's Payroll Factor

There is no Illinois case that has specifically addressed whether workers are common-law employers in circumstances comparable to those at issue here. However, the Utah State Tax Commission has addressed this issue in comparable factual circumstances in Taxpayer v. Utah St. Tax Commission, Appeal Nos. 05-0594 and 05-1764 (11/15/2011). https://tax.utah.gov/commission/decision/05-0594.pdf. In doing so, the Commission interpreted the Utah income tax act's payroll factor provision, which like Illinois's payroll factor is based on the model provision contained in Uniform Division of Income for Tax Purposes Act ("UDITPA"). Compare UDITPA Section 13 with Utah Stat. Sec. 59-7-315(1) and 35 ILCS 5/304(a)(2). The Commission concluded that workers were not common-law employees of a company that paid their wages and filed payroll tax returns on their behalf for payroll factor purposes. Instead a Utah taxpayer (the "Taxpayer") for whom the employees worked and that directed and controlled their work was the common-law employer required to include compensation paid the employees for their services in its payroll factor.

In this case, the business that the taxpayer alleged was the employer was a Professional Employer Organization (hereinafter "PEC") from whom the Taxpayer leased the employees at issue. The employees signed employment agreements with the PEC, which paid their wages, and withheld and paid payroll taxes, and filed employment tax forms, for which it was reimbursed by the Taxpayer. Id. at pp. 15 (para. 39) and 84. Under the contract between the PEC and the Taxpayer, the Taxpayer management personnel, like the Foreign Host Companies, directed and controlled the manner in which the employees performed their duties. Also, like the Foreign Host Companies, the Taxpayer's supervisors evaluated employee job performance and conducted

compensation reviews of the employees leased from the PEC. Id. The Taxpayer argued that because the PEC paid the employee wages and withheld and paid payroll taxes the PEC was the employer and compensation paid these individuals was not includible in the Taxpayer's Utah payroll factor. The Tax Commission disagreed with the Taxpayer and ruled, based on the control exercised by the Taxpayer over the employees, that the Taxpayer was their common-law employer under Utah Stat. Sec. 59-7-315(1) and the compensation was includible in its payroll factor, and would not be included in PEC's Utah payroll factor.

Like PEC, PGM LLC is not a common-law employer for payroll factor purposes simply because payroll tax returns are filed in PGM LLC's name as employer reporting compensation paid and payroll taxes withheld from employee wages. Also, like PEC, PGM LLC exercises no direction or control over the employees at issue. It is not the expatriates' common-law employer and cannot include their compensation in its payroll factor under 35 ILCS 5/304(a)(2). See also UPS Worldwide Forwarding, Inc. v. Commonwealth of Pennsylvania, 586 PA. 47 (Pa. Sup. Ct. 2005) (Pennsylvania Supreme Court upheld Commonwealth Courts decision that taxpayer must include in its payroll apportionment factor compensation paid individuals by affiliated corporation of the taxpayer, where the individuals worked under the taxpayer's direction and control and where the taxpayer reimbursed its affiliate dollar-for-dollar for payroll costs incurred by the affiliate).

5. Conclusion - PGM LLC Is Not the Expatriates' Common-Law Employer, and Accordingly FLNA and its Domestic Snack Food Business Is Not Excluded from the PepsiCo Combined Return Under the 80/20 Test

In summary, as addressed above PGM LLC is not the expatriates' common-law employer. PGM LLC has no employees that oversee the work of the expatriates, nor can it earn any profit from their work. PGM LLC has no capital investment in these employees. In short, there is a lack of any economic reality that supports characterizing PGM LLC as the expatriates' common-

law employer. Payroll compensation charged to PGM LLC is not foreign payroll that excludes FLNA and its domestic snack food profits from the PepsiCo Combined Return under the 80/20 Test.

II. FLNA is Included in the PepsiCo Unitary Group Because PepsiCo Has Not Met Its Burden of Proving That FLNA Conducts 80% or More Of Its Business Activities Outside the United States

PepsiCo has adopted the untenable position that it has followed the rules, set out in IITA Section 1501(a)(27) and Department regulations, and is therefore entitled to exclude FLNA from its Illinois unitary group as an 80/20 Company, even though this position is contrary to economic reality. Exclusion of FLNA is an exemption for which PepsiCo bears the burden of proof. To satisfy this burden, PepsiCo must provide clear and convincing evidence to support the conclusion that FLNA conducts 80% or more of its business activities outside the United States. PepsiCo has failed to meet this burden of proof because the extensive factual record here documents that FLNA continued to conduct business during the years at issue primarily within the United States. FLNA's principal business endeavor is developing and conducting PepsiCo's domestic snack foods business. It must be taxed accordingly. In order to conform FLNA's Illinois tax treatment with economic reality, FLNA's 80/20 Test payroll factor must be adjusted to remove expatriate compensation charged to PGM LLC because PepsiCo has not met its burden of proving this compensation reflects FLNA foreign business activity.

A. Both Before and After PGM LLC's Formation FLNA Remained A Corporation Conducting Business Primarily Within the United States

As discussed at length in the previous section of this brief, Illinois' purpose in adopting water's edge combined apportionment was a fair determination of Illinois income by combined apportionment, while at the same time excluding from combined returns corporations conducting 80% or more of their business outside the United States. In 2010, Pepsi underwent a corporate

reorganization, affecting many areas of its business. Contemporaneously with this reorganization, PGM LLC was formed as a single member disregarded Delaware limited liability company owned by FLNA. In addition, ownership of a number of pre-existing foreign based businesses was transferred by other PepsiCo affiliates to FLNA. Foreign entities owned by FLNA included GMD branch, PepsiCo Hong Kong, LLC, CEME and QFL (the "Foreign Entities.") Joint Stip. ¶ 156.

After the reorganization, FLNA continued to own the domestic rights to the PepsiCo domestic snack foods business that includes Lay's, Doritos, Tostitos, Cheetos, Rold Gold Pretzels, Fritos, Ruffles, Crackerjack and other iconic American snack food products. Joint Stip. ¶ 12. After PGM LLC was formed, FLNA continued to generate approximately $2.5 billion of taxable income from the development and operation of its domestic snack foods business. Joint Stip. ¶ 17. PGM LLC and the Foreign Entities together contributed relatively insignificant net foreign losses to FLNA's annual income. These facts are illustrated by the following chart:

	2011	2012	2013
PepsiCo Federal Consolidated Income Which Includes FLNA Income	$1,395,652,666	$1,397,889,650	$1,574,642,751
Foreign Losses Included In PepsiCo Federal Consolidated Income	($ 39,317,275)	($ 39,515,394)	($ 57,437,839)
PGM LLC Losses Included In Foreign Losses	($ 1)	($ 9,064,100)	($ 7,015,640)
Expatriate Compensation Expense Charged to PGM LLC Included by PepsiCo in FLNA 80/20 Test Payroll Factor	$ 93,463,835	$ 100,439,232	$ 116,263,196

Joint Stip. ¶¶ 131, 147, and 156. PGM LLC only contributed net losses to FLNA's net income, equal to deferred expatriate compensation charged to PGM LLC that the Foreign Host Companies

did not reimburse in 2012 and 2013.[5] Yet, PepsiCo asserts that the over $100 million in average annual expatriate compensation charged to PGM LLC reflects PGM LLC foreign business activity that excluded FLNA from the PepsiCo water's edge group under the 80/20 Test. This exclusion is directly contrary to the fact that after PGM LLC's formation FLNA continued to conduct its domestic snack foods business and generate its income within the United States.

B. Taxpayers Bear the Burden of Proving With Clear and Convincing Evidence That 80% or More of Business Activities Are Conducted Outside the United States for Exclusion Under the 80/20 Test

The Appellate Court in Zebra Technologies Corp. v. Topinka, 344 Ill. App. 3d 474 (2003), addressed for its first, and only time to date, the legal basis and standard of proof for excluding a corporation from a unitary group under the 80/20 Test. The Zebra decision and its legal reasoning was followed by this Tribunal in its decision in IBM v. IDOR 14 TT 229 (2016). Both decisions are directly relevant to PepsiCo's applicable burden of proof here.

In Zebra, the taxpayer, Zebra Technologies Corp., was in the business of manufacturing bar coding equipment. Zebra incorporated two wholly owned passive investment companies in Delaware, Zebra Domestic Intangibles and Zebra International Intangibles (henceforth for convenience of reference collectively referred to as the "PIC"), to which Zebra transferred all of Zebra's barcoding patents and trademarks. The PIC licensed this intellectual property back to Zebra and affiliates who annually paid royalties to the PIC under this license. The PIC then issued a dividend back to Zebra in the amount of the royalties. Zebra Technologies Corp. v. Topinka**,** 344 Ill. App. 3d at 478. Zebra excluded the PIC from its unitary group under the 80/20 Test. The Department on audit included the PIC in the Zebra unitary group for 1993 and 1994. Id. at 479.

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[5] Examination of PGM LLC's General Ledger and Trial Balances in Exhibits 32-34, discloses that PGM LLC losses generated in 2012 and 2013 were attributable to Foreign Host Companies' failure to reimburse certain expatriate deferred compensation expense. These amounts were relatively modest and for purposes of simplicity of reference this memorandum generally disregards the Foreign Host Companies lack of reimbursement for these expenses.

The Appellate Court ruled that Zebra failed to sustain its burden of proving the PIC should be excluded from the Zebra unitary group under the 80/20 Test. The Appellate Court incorporated in its decision the trial court's factual findings and legal reasoning. Id. at 482-483. The PIC had a part-time employee, paid $600 per month, who performed ministerial bookkeeping duties in Bermuda, and whose salary served as the basis of the payroll factor calculated by Zebra to exclude the PIC from Zebra's unitary group. The business activity of maintaining the intellectual property was performed by Zebra employees in the United States. These activities were not reflected in the PIC's payroll factor. There was no arm's length agreement allocating this employee expense to the PIC:

> . . . . The highly important function of protecting the patents was retained by Zebra, the Taxpayer, at no cost to the [PIC]. There was no evidence of a contractual relationship between Zebra and the [PIC] for the purchase of these highly technical services. This situation requires a look at substance over form. These monthly meetings of the quality control committee evince a considerable amount of business activity taking place in the U.S. for [the PIC]. The Department's witness stated there was no statute that allowed the Department to impute a payroll figure for these services. However, Zebra knew the amount of time spent by the committee on quality control issues and was capable of allocating this expense to the [PIC] because it was this committee which was protecting the license for [the PIC].

Id. (emphasis added). The trial court determined that the payroll factor computed by Zebra did not accurately reflect that percentage of the PIC's overall business activities conducted outside the United States because the factor did not account for work performed by Zebra's employees in the United States in preserving the PIC's intellectual property. The trial court ruled that Zebra failed to meet its burden of proof for the PIC in "showing that 80% or more of [the PIC's] business activities took place outside the United States. " The trial court therefore ruled the PIC could not be excluded from the Zebra unitary group under the 80/20 Test. Id.

The Appellate Court upheld the trial court's decision. The court concluded that because the 80/20 Test was a tax exemption the taxpayer bore the burden of proving application of the test "clearly" comes withing the exemption:

> [w] e are mindful that taxation is the rule and tax exemption is the exception . . . Here, taxpayer is claiming an exemption from tax on income that would otherwise be assessed but for the 80/20 rule. Thus, taxpayer has the burden of proving clearly that it comes within the statutory exemption . . . Such exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation . . . We find that the taxpayer failed to sustain its burden of proving that [the PIC] should have been excluded from the unitary group.

Id. at 484 (emphasis added). The Appellate Court held that the Department was not required to accept as dispositive, evidence Zebra produced in support of its payroll factor--- the $600 a month in compensation paid the PIC's part-time employee. In determining whether Zebra satisfied its burden of proof, the court held that the Department was entitled to evaluate whether the payroll factor was a fair measure of that portion of the PIC's total business activities that were conducted outside the United States over total worldwide business activities. The court determined that the payroll factor did not constitute such a fair measure because it did not account for the quality control activities conducted by Zebra employees on behalf of the PIC within the United States. Id. at 484. The Appellate Court upheld the trial court's decision that the PIC was not excludible from Zebra's unitary group under the 80/20 Test.

This Tribunal similarly concluded in International Business Machines Corporation v. Illinois Department of Revenue ("IBM v. IDOR") 14 TT 229 (2016) that the taxpayer, International Business Machines ("IBM"), failed to meet its burden of proof for excluding its subsidiary, IBM World Trade Corporation ("WTC"), from its unitary group under the 80/20 Test. WTC held certain foreign assets and securities. Id. at *2. The Department on audit asserted that activities conducted by IBM employees in the United States on behalf of WTC were not reflected

in WTC's payroll and property factors and it imputed additional United States payroll and property to WTC. This imputation resulted in WTC failing the 80/20 Test, WTC's inclusion in the IBM unitary combined group, and the Department's issuance of a Notice of Deficiency to IBM. IBM filed a motion asserting that it was entitled to summary judgment based on documentation it had presented to the Department supporting the WTC payroll and property on which it had computed its 80/20 Test. The Tribunal concluded that there were facts in dispute and this matter was not ripe for summary judgment. In reaching this conclusion the Tribunal addressed the legal standard of proof IBM needed to meet in order to exclude WTC under the 80/20 Test. The Tribunal noted that the Department's audit findings were prima facie evidence of the amount of tax due, and that it was "IBM's burden to come forward with *clear and convincing evidence* as to why WTC qualifies as an 80/20 business and why its income should be excluded from IBM's overall unitary business income." Id. at *3. The Tribunal, in a section entitled "The Department has the authority to determine the correct payroll and property tax figures for WTC," (emphasis added) rejected IBM's argument that the Department was precluded by law from imputing United States payroll and property to WTC for 80/20 Test purposes. Id. at *4-7.

> IBM argues in its motion that the Department is precluded by law from imputing payroll and property from one company (IBM) to another (WTC). Assuming, *arguendo*, that there were no factual disputes in this case and that this court could proceed on IBM's issue as a matter of law, that argument would fall.

Id. at *5 (emphasis added). To support its conclusion that the Department had the authority to adjust the taxpayer's 80/20 Test payroll and property factors in evaluating the taxpayer's 80/20 Test, the Tribunal relied on the Appellate Court's decision in Zebra. Id. at * 6. The Tribunal cited the Appellate Court's conclusion that the Department must rely on substantive over formalistic evidence of business activities. Id. The Tribunal rejected as formalistic evidence of business

activities a corporation's mere payment of compensation. Id. at * 7. Ultimately whether a company is excluded under the 80/20 Test depends on whether it conducts 80% or more of its business activities outside the United States. IITA §1501(a)(27). A taxpayer's 80/20 Test payroll and property factors must fairly reflect business activities, and where they do not, they must be adjusted to fairly reflect such activities. IBM at *4-5. Where a taxpayer fails to produce clear and convincing evidence that 80% or more of a corporation's business activities are conducted outside the United States, the corporation cannot be excluded from a combined return under the 80/20 Test. Id. at *3.

C. PepsiCo Failed To Meet Its Burden of Proof For Excluding FLNA From Its Unitary Group Under The 80/20 Test

PepsiCo fails to meet its burden of proof for excluding FLNA from its unitary group with respect to two separate legal issues. First, PepsiCo fails to meet its burden of proof in demonstrating that FLNA conducts a single trade or business with PGM LLC therefore permitting inclusion of expatriate compensation charged to PGM LLC in FLNA's payroll factor. Second, even if expatriate compensation is includible in FLNA's payroll factor, PepsiCo fails to meet its burden of proof in demonstrating that the expatriate compensation represents substantive foreign business activities conducted by FLNA, through PGM LLC, outside the United States that excludes FLNA from the PepsiCo unitary group. These legal issues are addressed in turn below.

1. PepsiCo Failed to Prove That FLNA Conducts a Single Trade or Business With PGM LLC For Purposes of Including Expatriate Compensation in FLNA's Payroll Factor

PepsiCo has not met its burden of proving that FLNA conducts a single trade or business with PGM LLC. The stipulated facts support the opposite conclusion. FLNA's domestic snack food business is separate and independent from any business activities attributed to PGM LLC.

Expatriate compensation charged to PGM LLC, even if it were legally characterizable as PGM LLC payroll, cannot therefore be included in FLNA's 80/20 Test payroll computation.

Illinois Income Tax Regulation, 86 Ill. Admin. Code ("IL Inc. Tax Reg.") § 100.3010 states that if a corporation has more than one "business" it must separately determine business income for each business and separately compute apportionment factors for each business. For example, this regulation states that a corporation, which has three operating divisions separately engaged in aerospace manufacturing, tobacco growing and motion picture production, must separately compute apportionment factors and separately apportion income for each division. IL Inc. Tax Reg. 100.3010 (b). PGM LLC as a single member limited liability, disregarded for federal and state income tax purposes, is treated as a division of FLNA. If FLNA conducts a separate trade or business from PGM LLC, FLNA cannot include the expatriate compensation in its 80/20 Test, even if the compensation is legally characterizable as PGM LLC payroll. Id.

The determination of whether a corporation conducts a single or separate businesses "will turn on the facts in each case." IL Inc. Tax Reg. §100.3010 (b)(2). A corporation conducts a single business when its divisions are integrated with, dependent upon or contribute to each other. Id. Functional integration is a strong indicator of a single business where separate divisions: all engage in the same line of business, such as the retail grocery business; or engage in steps of a vertical process such as mining copper ore, refining it, and manufacturing products from the refined ore. Id. Another indicator of a single business is strong *centralized management* coupled with the existence of centralized departments for functions, such as financing, advertising, research or purchasing. Id. These factors are the same identified in IITA Section 1501(a)(27) as evidence of a unitary business activity among separate corporate entities. The determination of whether legal entities conduct a single (generically hereinafter "unitary") business also depends upon

whether *economies of scale* are recognized from their common business activities, such as volume discounts from common purchasing. Hercules, Inc. v. Department, 324 Ill.App.3d 329, 336 (2001); see also Container Corp. of America, 463 U.S. 159, 179 (1983).

At issue here is whether FLNA conducts a unitary business with PGM LLC, whose passive activities, as reflected in its books and records, are limited to recording charges for expatriate compensation as expenses and crediting reimbursement of these charges by Foreign Host Companies as miscellaneous revenue. See Exhibits 32-34. Analyzing the factors identified in IL Inc. Tax Reg. §100.3010 (b) it is clear that FLNA does not conduct a unitary business with PGM LLC. FLNA and PGM LLC are *not in the same line of business*. FLNA owns domestic rights to the iconic snack foods business that includes Lay's, Doritos, Tostito's, Cheetos, Fritos, Ruffles, and Crackerjack snack foods and generates its income by development and operation of this domestic snack foods business. Joint Stip. ¶¶ 10-23. PGM LLC was limited to facilitating secondment of expatriates to foreign subsidiaries, *outside PepsiCo's Illinois unitary water's edge combined group*. Joint Stip. ¶ 62.

FLNA and PGM LLC were *not steps in a vertical process* as evidenced by the fact that there were no intercompany sales between FLNA and PGM LLC. FLNA's sales were limited to sales of snack foods products, with these sales made almost exclusively to FLNA's affiliate Rolling Frito-Lay Sales, L.P. ("RFLS"). Joint Stip. ¶ 19 PGM LLC's receipts were limited to Foreign Host Companies' reimbursement of expatriate compensation. Joint Stip. ¶ 95. All expatriate work was for the benefit of Foreign Host Companies in "expanding foreign business operations" outside the PepsiCo Illinois water's edge combined group. Joint Stip. ¶ 94. None of this work benefitted or was otherwise connected with FLNA's domestic business activities. Id.

FLNA and PGM LLC also were *not centrally managed*. PGM LLC employed no management personnel. "Core" Global Mobility Senior Management Human Resource employees continued to be spread amongst entities across the PepsiCo Co Corporate group, as they had been prior to PGM LLC's formation, with the majority employed by foreign subsidiaries. Joint Stip. ¶74 and Exhibit 8. FLNA continued to manage its domestic snack foods business, as it had prior to PGM LLC's formation, through the FLNA management team operating out of FLNA's Texas headquarters. Joint Stip. ¶ 11. FLNA employees neither controlled nor directed any of the work performed by expatriates, who instead were directed and controlled by Foreign Host Company management. Joint Stip. ¶ 94. FLNA and PGM LLC *did not recognize economies of scale* from benefits such as discounts or other economies arising from common purchasing, financing, advertising, research departments. FLNA shared no facilities. FLNA remained in its Texas headquarters and PGM LLC neither owned or rented office space, nor otherwise maintained an office at which to conduct its activities. See also MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dept. of Revenue, 553 US 16 (2008) (while United States Supreme Court did not reach unitary issue which it remanded the case to the Illinois Appellate Court to address, Court noted that Illinois Circuit Court had ruled Mead Corp., a paper manufacturer, was nonunitary with its Lexis Division, a provider of legal, government, business and high-tech information, founded by Mead in 1973 because they lacked centralized management, economic integration and economies of scale); ASARCO v. Idaho State Tax Commission, 458 U.S. 307 (1982) (Court ruled that foreign subsidiaries were not unitary with their United States parent based on a lack of centralized management, functional integration and economies of scale); and Woolworth Co. v. Taxation Dept., 458 U.S.354 (1982) (Court noting that the "linchpin" of apportionability is the unitary business principle ruled that a chain of retail department stores were not conducting a unitary

business based on the lack of centralized management, functional integration and economies of scale).

In short, FLNA's business activities are unconnected with activities attributed to PGM LLC. FLNA conducts its domestic snack foods business independently of the expatriate activities attributed to PGM LLC. FLNA and PGM LLC are not functionally integrated, not centrally managed, do not share economies of scale, nor do they otherwise contribute to the income of each other. Even if the expatriate compensation charged to PGM LLC were legally characterizable as PGM LLC payroll, this payroll cannot not be included in the computation of FLNA's 80/20 Test because FLNA's business activities are independent of those attributed to PGM LLC. IL Inc. Tax Reg. 100.3010 (b).

2. PepsiCo Has Not Proven That Expatriate Compensation Reflects FLNA Foreign Business Activity Conducted Through PGM LLC

Even if FLNA and PGM LLC conducted a single business, PepsiCo has not met its burden of proving that expatriate compensation charged to PGM LLC fairly represents substantive foreign business activity includible in FLNA's payroll factor. PGM LLC owned no real or tangible assets. PGM had either a zero or negative capitalization during the years in issue. PGM LLC generated no profits. Joint Stip. ¶ 156. PGM LLC employed no one to manage its business. Human resource personnel who identified expatriates that would participate in the Global Mobility program, as well as human resource personnel who addressed issues, such as visas, unique to the expatriate program were employed by other PepsiCo affiliates. None were employed by PGM LLC. Joint Stip. ¶¶ 74 and 100. Nor did PGM LLC have any employees who otherwise worked to administer the expatriate program. Annual compensation ranging from $93 million to $116 million was paid to the expatriates for work performed under the direction, control, and for the

benefit of Foreign Host Companies and debited to PGM LLC. The Foreign Host Companies' subsequent reimbursement of this expense was credited to PGM LLC. These paper transactions were the sum of PGM LLC "business activity." Joint Stip. ¶ 147. Based on the decisions in Zebra and IBM, PGM LLC's payroll must be adjusted to represent economic realities. Zebra 344 Ill. App. 3d at 484; and IBM v. DOR, 14 TT 229 at *7. Expatriate compensation "parked" in PGM LLC as foreign payroll simply does not fairly represent foreign business activity conducted by PGM LLC. This payroll must be removed from FLNA's 80/20 computation in order for that computation to reflect economic reality. With the expatriates payroll removed, FLNA no longer qualifies as an 80/20 Company.

PepsiCo's attempts to dismiss the decisions in Zebra and IBM as irrelevant. PepsiCo Br. pp 50-53. It argues that the taxpayers lost these cases for failing to meet their burden of proof and develop sufficient facts to sustain exclusion of its affiliates as 80/20 Companies. PepsiCo points to the extensive discovery and stipulated facts in its case as evidence that, unlike the taxpayers in Zebra and IBM, it has developed sufficient facts to support its assertion that FLNA must be excluded from PepsiCo's unitary group. Id. However, PepsiCo's assertion ignores what the extensive factual record here clearly illustrates, that after the formation of PGM LLC, FLNA continued to conduct its business activities almost exclusively within the United States, and that expatriate compensation charged to PGM LLC did not represent substantive PGM LLC foreign business activities.

PepsiCo also argues that the Department has no statutory authority to adjust FLNA's payroll factor. PepsiCo Br. p. 49.[6] PepsiCo relies on the Zebra decision to support this assertion,

[6] PepsiCo argues that while in Zebra the court ruled that Department may adjust the payroll factor of a company asserting 80/20 exclusion, to add payroll of United States affiliate employees working on behalf of the company, the Department has no authority to "extract" PGM LLC's payroll from FLNA's payroll factor. PepsiCo Br. p. 49. There is no logical distinction supporting this argument. As addressed in the text of this brief in either instance the

despite the Tribunal's determination in Zebra that payroll and property factors must reflect economic realities. PepsiCo's arguments ignore the rulings in Zebra and IBM that the Department is not bound by formalistic evidence propounded by a taxpayer in support of its 80/20 Test payroll and property factors. Instead, they ruled that to qualify for an 80/20 Test exclusion a taxpayer must present clear and convincing substantive evidence that a corporation conducts 80% of its business activities outside the United States. Most pertinent here, the Tribunal in IBM stated that payment of compensation by a corporation does not preclude the Department from challenging whether that corporation can claim the payroll for 80/20 Test purposes.

> IBM's position that this Tribunal must accept its salary and payroll calculations to be correct as a matter of law is untenable. Following IBM's argument, if a business claiming to be an exempt 80/20 company accidentally had its entire U.S. staff listed and paid from a related U.S. corporation's payroll, the Department would have to accept those payroll figures as reported and would be precluded as a matter of law from questioning those figures and reallocating those figures during an audit in an effort to determine the U.S. and worldwide activity of that business. Accepting taxpayer's evidence as dispositive in the first instance would preclude the Department from ever being able to question a claimed 80/20 exemption. That would turn the law on its head as a taxpayer has the burden of proving clearly it is entitled to an exemption.

Id. at *7 (emphasis added). The Tribunal's example clearly indicates that taxpayers bear the burden of proving entitlement to the 80/20 exemption based on payroll and property factors computed consistently with economic realities. This example underscores that the Department is not bound to accept the taxpayer's payroll and property factor figures as dispositive and may question them at audit and adjust those figures where they do not reflect economic realities. The Department at audit here did just that. The Department excluded expatriate compensation charged

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Department has the legal authority to adjust the payroll and property factors of the company asserting 80/20 exclusion in order to conform the factors to economic realities. Zebra 344 Ill. App. 3d at 484; and IBM v. DOR, 14 TT 229 at *7.

to PGM LLC from FLNA's 80/20 Test payroll factor because economic realities clearly disclose that this foreign payroll does not reflect PGM LLC substantive foreign business activities. PepsiCo has not met its burden of proving that the expatriate compensation should be included in FLNA's payroll as a reflection of substantive PGM LLC foreign business activities.

3. Conclusion: PepsiCo Failed to Meet Its Burden of Proof That PGM LLC Excludes FLNA from the PepsiCo Illinois Unitary Combined Group

In summary, PepsiCo failed to meet its burden of proof in demonstrating that FLNA was unitary with PGM LLC and that any compensation attributable to PGM LLC could be included in FLNA's 80/20 Test. PepsiCo also failed to meet its burden of proof in demonstrating, even if FLNA and PGM LLC are unitary, that the compensation fairly reflected substantive foreign business activity conducted by FLNA through PGM LLC. Because PepsiCo has not met its burden of proving FLNA conducted 80% or more of its business outside the United States, FLNA cannot be excluded from the PepsiCo unitary combined group as an 80/20 Company under Illinois Income Tax Act Section 1501(a)(27).

III. The Substance Over Form Doctrine Requires This Tribunal to Rule That Economic Substance Dictates That FLNA Must Be Included in the PepsiCo Illinois Unitary Group

The substance over form doctrine is another legal basis on which FLNA must be included in the PepsiCo unitary group. In form, PGM LLC, is listed as employer of the expatriates on the contracts entered with expatriates and payroll tax forms PepsiCo files reporting expatriate compensation to the Internal Revenue Service. However, PGM LLC is totally lacking in any real economic substance. Consequently, under the substance over form doctrine, expatriate

compensation charged to PGM LLC does not represent PGM LLC foreign payroll that excludes FLNA from the PepsiCo unitary group.

A. Substance Over Form Doctrine Is Universally Accepted

The principle that substance rather than form governs taxation is one of the cornerstones of taxation. Weinert's Estate v. Commissioner 294 F.2d 750, 755 (5th Cir. 1961). It was a doctrine first adopted by the United States Supreme Court in its decision in Gregory v. Helvering, 293 US 465 (1935). In the eighty-five years that have elapsed since the Court issued its Gregory decision, the substance over form doctrine has been universally accepted and applied by a variety of courts in order to insure imposition of income taxes based on economic substance. For instance, in Estate of Weinert, the United States Court of Appeals for the Fifth Circuit held that the "substance over form" doctrine carried "out perhaps the most basic principle in taxation: economic realities determine tax consequences." Estate of Weinert, 294 F.2d at 752. This court further found that "[t]ax law deals in economic realities, not legal abstractions." Id. at 755. The doctrine has been applied by federal and state courts alike, including those in Illinois, and has been addressed in Illinois income as well as sales/use tax contexts. See Young v. Hulman, 39 Ill.2d 219, 225, 234 N.E.2d 797 (1968) (court in ruling that business was retailer required to pay sales tax on its mobile home sales held ". . . we must look to the substance rather than the form of a transaction, and the categorization given to a relationship by the interested parties is not conclusive of the nature of the relationship."); In re Stoecker, 179 F.3d 546 (7th Cir.1999) (court looked to "substance over form" in disregarding parties' characterization of transaction as sale through intermediary parties and upholding imposition of sales/use tax based on direct transfer from seller to ultimate purchaser); Zebra Technologies Corp. v. Topinka, 344 Ill. App. 3d 474 (2003) (court took note of Illinois

Department of Revenue's argument of substance over form doctrine in 80/20 Test case, but declined to address doctrine because it decided case in Department's favor on other legal grounds); International Business Machines v. Illinois Department of Revenue, 14 TT 229 (2015) (Illinois Tax Tribunal referencing Zebra found that "substance over form" doctrine can be applied in state income tax context even where transaction has some business purpose and substance, while rejecting taxpayer's summary judgment motion on other grounds as premature); and JI Aviation v. Department of Revenue, 335 Ill. App. 3d 905 (2002) (court held in favor of taxpayer under substance over form doctrine that seller's transfer of airplane title through conduit had no economic substance and must be ignored for Illinois use tax purposes).

B. PepsiCo's Assertion That Substance Over Form Doctrine is Inapplicable Here Is Contrary to Facts and Law

PepsiCo devotes approximately the last half of its initial brief – from page 37 through 64 -- to arguing why the substance over form doctrine is inapplicable here. PepsiCo's arguments are supported by neither facts nor law.

1. Facts Demonstrate That PGM LLC is All Form and No Substance

PepsiCo devotes page 37 through 48 of its brief to an explanation of: i) the general benefits derived by multinational corporations from forming and operating a global employment company ("GEC"); ii) the strategic importance of the expatriate Global Mobility program to PepsiCo and its affiliates; and iii) how PGM LLC, acting as a GEC, achieves these benefits for PepsiCo and affiliates. In this regard, PepsiCo cites to several authoritative articles addressing the pros and cons, as well as nuts and bolts of establishing GECs. Based on this authority, PepsiCo asserts that "PGM LLC is a GEC formed in accordance with global mobility workforce best practices." PepsiCo Br. p. 41. PepsiCo does follow the formalistic "best practices" for establishing a GEC

outlined in the articles it cites. PGM LLC is organized as a separate legal entity. PGM LLC is listed as employer on Letters of Understanding and Secondment Agreements executed in connection with expatriate assignment to Foreign Host Companies. Joint Stip. ¶ 63 and 64. PGM LLC is identified as the expatriates' employer for tax and retirement benefit reporting purposes Joint Stip. ¶ 64. However, PepsiCo in operating its global mobility function, after establishing PGM LLC, despite its assertion otherwise, has failed to achieve essential substantive benefits identified in the articles it cites in establishing PGM LLC and to implement substantive best practices in operating it.

Benefits of establishing and operating a GEC include that it "simplifies global mobility administration" by managing the secondment function under "one entity" and thereby creating a "mobility P&L to facilitate proactive cost management." "Global Workforce Management, Best Practice Approach to Global Employment Companies" Deloitte (2018) at p. 2 (emphasis added). Important factors, identified as potential challenges, to consider in establishing the GEC include geographical location of the GEC, its governance structure, number of individuals the GEC will employ to facilitate expatriate secondment to foreign subsidiaries, and insuring the GEC is operated as a "business." Id. at 11. Best practices that must be implemented to insure a GEC will be respected as such by local authorities, rather than disrespected as a mere corporate shell, are described as follows:

> Establishing a GEC requires careful planning to ensure the employment arrangement will be respected by local authorities . . . Whether or not the local government will respect the GEC as the employer will depend upon whether the arrangements are determined to be bona fide, i.e., the GEC can show that it is more than a shell existing only on paper. Critical factors that will determine whether or not the GEC will be respected as the employer of [expatriates] include, but are not limited to
>
> - Establishing a reasonable service fee for the [expatriates'] services
> - Having an individual(s) employed to operate the GEC

- Drafting appropriate legal documentation of the employment and assignment of the [expatriates]
- Operating the GEC in a manner consistent with the GEC's legal documentation
- Having the GEC be responsible for core employment functions

Andrew Liazos. "Global Employment Company: Is it the Right Fit for Your Organization," The National Law Review (2014) (emphasis added).

PGM LLC achieves none of these objectives nor best practices. There is no simplification of global mobility administration. PGM LLC employs not even a single individual to oversee the administration of PepsiCo's expatriate program. Numerous individuals who match expatriates with job openings, as well as others who address human resource issues like visas unique to overseas assignments, continue to be employed and work for the same PepsiCo subsidiaries they did before PGM LLC was formed. PGM LLC has no office, no employees, and no assets with which to administer the global mobility expatriate program. PGM LLC is not operated consistently with letters of understanding and secondment agreements that post expatriates to overseas assignments with Foreign Host Companies because the individuals who sign these contracts on behalf of PGM LLC are not even employed by PGM LLC. There is no "reasonable service fee" charged by PGM LLC to Foreign Host Companies for the expatriates services. There is simply a pass-through of their compensation cost. There is no fee charged by PGM LLC to Foreign Host Companies for placing expatriates with them. Nor does PGM LLC pay PepsiCo affiliates an arm's length charge for the services of human resource personnel employed by those affiliates for their work administering the global mobility expatriate program. Needless to say, PGM LLC does not generate a "mobility P&L to facilitate proactive cost management' of the global mobility function.

PepsiCo's brief pages 43-48 points to a number of critical benefits that PGM LLC provides to the PepsiCo Corporate Group's global operations. These alleged benefits, addressed in turn below, are also not supported by any substantive PGM LLC business operations:

- PGM LLC Does Not Limit US Entity Legal Liability in Foreign Jurisdictions. PepsiCo asserts that PGM LLC protects other entities, such as FLNA, from "having direct legal liability for actions of or disputes regarding the seconded expatriate's actions" PepsiCo Br. p. 43. However, PGM LLC is a legal shell with no capitalization. As such it does not afford FLNA such legal protection. See e.g. Westmeyer v. Flynn, 382 Ill. App. 3d 952, (1st Dist. 2008); and Martin v. Freeman, 272 P.3d 1182 (Colo. Ct. App. 2012).

- U.S. Benefits Plan Eligibility. PepsiCo asserts that PGM LLC permits expatriates to continue to participate in U.S. retirement plans which requires that they be PGM LLC common-law employees. PepsiCo Br. pp. 44-46. As addressed in the preceding section of this memorandum, the conclusion that the expatriates are PGM LLC's common-law employees is contrary to economic realities and applicable law. While PepsiCo may treat the expatriates as common-law employees for this purpose, PepsiCo presented no evidence that the Internal Revenue Service has ever issued a determination letter agreeing with this conclusion or has otherwise examined this issue.

- PGM LLC Does Not Limit Permanent Establishment Foreign Tax Exposure. PepsiCo makes a conclusory assertion that PGM LLC protects the PepsiCo Corporate Group from foreign tax exposure if PepsiCo affiliates were determined by a foreign government to have a permanent establishment in a foreign country as a result of the activities of the expatriates activities. PepsiCo Br. p. 46. Rather than explain how PGM LLC in fact, and under what legal authority, provides such protection, the brief simply cites to and quotes the Liazos Global Employment article addressed at length above in this regard. It should be noted that the author of this article also emphasized that it was essential in order to achieve such protection that the foreign country respect that the GEC was the employer of the expatriates and for this purpose it was essential that the GEC be operated as a substantive business operation, with employees responsible for administering the GEC's expatriate program for which the GEC charged a reasonable service fee. PGM LLC has no such economic substance nor assets, and presumably provides no such protection. Id.

- Business and Government Compliance Efficiency. PepsiCo references the joint factual stipulation which states that as a matter of form having "a single entity, like PGM LLC, be the counterparty to all of the Secondment Agreements for all outbound expatriate employees . . . centralizes tax, business and other government compliance requirements . . . " PepsiCo Br. pp. 46-47. While this assertion is true as a matter of payroll tax reporting and other governmental forms PepsiCo has filed, it provided no proof that Internal Revenue Service, or other government agency with which such forms were filed examined and definitively determined the expatriates were as a matter of law common-law employees of PGM LLC. Indeed,

as a result of PGM LLC's lack of economic substance it is clear that they are not. Also, while PepsiCo asserts that "to the extent the foreign host companies are abruptly deemed the common-law employers of PGM LLC's expatriates, they will incur extraordinary U.S. and local government compliance obligations," there is no legal authority cited that supports PepsiCo bootstrapping these potential liabilities as a basis for arguing they somehow give PGM LLC substance it so clearly lacks.

- PGM LLC Does Not Affect Talent Recruitment and Retention. PepsiCo quotes the joint factual stipulation that as 'as global business, a critical element of the PepsiCo Corporate Group's ability to recruit and retain high quality candidates is the ability to offer such candidates global postings through an expatriate program. PepsiCo Br. pp. 47-48. However, while as a matter of form PGM LLC's name may be on secondment agreements and letters of understanding, there is nothing that substantively ties recruitment and retention of talent to PGM LLC. The human resource personnel who manage the expatriate program are all employed by other PepsiCo entities and PGM LLC is not charged for their expatriate program services.

- PGM LLC Does Not Affect Talent Development. PepsiCo quotes the joint factual stipulation that "[s]econded expatriates are assigned to foreign host companies for a variety of reasons, including: 1) to advance their career development within the PepsiCo Corporate Group." PepsiCo Br. p. 48. Again, there is nothing that substantively ties to PGM LLC this talent development function. The human resource personnel who manage the expatriate program are all employed by other PepsiCo entities and PGM LLC is not even charged for their expatriate program services.

- PGM LLC Does Not Affect Technical Expertise Deployment. Finally, PepsiCo quotes the joint factual stipulation that the "[s]econded expatriates are assigned to foreign host companies for a variety of reasons, including . . . 2) to provide highly skilled industry knowledge and technical expertise not otherwise available to the foreign host company through the local talent pool." Id. While in form PGM LLC's name is on the secondment agreements and letters of understanding, there is nothing that substantively ties the services provided by the highly skilled expatriates to PGM LLC. The cost of their compensation is offset in its entirety by foreign host company reimbursement of these charges. PGM LLC does not charge the Foreign Host Companies a service or other arm's length fee.

While PepsiCo claims the global mobility function is an important to it, the facts clearly demonstrate that it is not substantively conducted through PGM LLC.

2. Case Law On Which PepsiCo Relies Does Not Support Its Assertion That the Department Is Precluded From Arguing Substance over Doctrine

PGM LLC has no economic substance. It has no office, no assets, no employees, and no profits. Instead, it is a legal shell to which PepsiCo charges expatriate compensation expense and credits host company reimbursement. In light of PGM LLC's complete lack of economic substance, it is not surprising that PepsiCo argues the Department is legally precluded from even raising a substance over form argument. The legal authority PepsiCo's relies on does not support this argument.

a. Case Law Addressing Statutory Interpretation Irrelevant

PepsiCo argues that the "economic substance doctrine is not applicable when controlling provisions of the law are clear; this is the case even if tax savings result." PepsiCo Br. p. 49. In support of this argument PepsiCo cites Gitlitz v. Comm'r. 531 U.S. 206, 220 (2001) and the Supreme Court's statement that "because the Code's plain test permits the taxpayers to receive these benefits, we need not address . . . policy concern[s]." Based on Gitlitz, PepsiCo asserts that the judicial branch may not overturn clear tax laws to unilaterally fill perceive loopholes, and instead it is incumbent on the Illinois legislature or Department to create a new tax rule to address such loopholes.

While PepsiCo quotes Gitlitz, it does not closely examine or otherwise explain why this decision is pertinent here. A close examination of this decision reveals that it addresses completely unrelated facts and law and is of no precedential value. The case involved an S Corporation whose income and losses were passed through and reported by its two shareholders. To avoid double taxation, the shareholders were permitted by the Code to increase their basis in S Corporation stock by items of income they reported on their individual income tax returns. The S

Corporation, which was insolvent, recognized approximately $2.0 million forgiveness of indebtedness income. Because the corporation was insolvent, this income was excluded from its gross income under IRC Section 108(a)(1). Nonetheless, the taxpayers argued that the forgiveness of indebtedness income was an "item of income" that permitted them to increase their basis in the S Corporation stock and thereby deduct certain losses incurred in previous years and suspended as a result of insufficient taxpayer basis in the corporation's stock.. The Court agreed, with the taxpayers' reading of the IRC as permitting them to increase their stock basis by the amount of the forgiveness of indebtedness income. In response to the Commissioner's argument that this interpretation of the statute gave the taxpayers a "double windfall" -- exclusion of the income while permitting taxpayers to use it to increase their stock basis for purposes of deducting previously suspended losses – the court said that because this is what the plain text of the IRC provided it "need not address this policy concern."

The Gitlitz decision does not even address the substance over form doctrine.[7] There was no question of economic substance diverging from form here. It was undisputed that the S Corporation recognized approximately $ 2 million in forgiveness of indebtedness income, the legal issue the court addressed was a question of statutory interpretation as to whether the IRC permitted the taxpayers to both exclude the income from their individual tax returns while at the same time using it to increase the basis in their S Corporation stock. The Commissioner did not raise a substance over form argument. The Court merely stated that the wisdom of the taxpayers' double windfall resulting from the court's interpretation of the IRC was a tax policy decision that was not

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[7] PepsiCo's brief at on page 56 at footnote 13 similarly cites a case, Dover Corp. v. Comm'r, 122 TC 324, n. 19 (1997) which does not address the substance over form doctrine. PepsiCo's footnote cites this case for the assertion that PGM LLC cannot be disregarded for lack of business purpose under the federal check the box regulations by which it elected to be treated as single member limited liability company effectively taxable as a division of FLNA. The Department is not attempting to disregard PGM LLC as a separate legal entity, only treatment of expatriate compensation charged to PGM LLC as payroll includible in the 80/20 Test.

its concern. In contrast, here substance and form do diverge. PepsiCo alleges that PGM LLC is the expatriates' employer, whereas economic realities all indicate it is not their employer.

b. Case Law Addressing Doctrine in Context of Invalid Department Regulation Is Irrelevant

PepsiCo next misreads the Illinois Supreme Court's decision in Hartney Fuel Oil Co. v. Hamer, 376 Ill. Dec 294 (2013) to conclude that the substance over form doctrine, addressed in passing in a footnote of that decision, precludes application of that doctrine here. PepsiCo's truncated misreading of this decision distorts the true import of the court's ruling. The Hartney decision does not support legally precluding the Department from applying the substance over form doctrine here. A full review of Hartney's facts, law and ruling is necessary to understand how PepsiCo has misapplied this decision to reach its erroneous conclusion.

Hartney Oil is an Illinois retailer of fuel oil, which is headquartered in Forest View, in the suburbs of Chicago, Illinois. The retail fuel oil sales business is a high volume, low margin, price competitive business. To survive and prosper, it was essential that Hartney sell its product at the lowest possible price. To keep its prices as competitive as possible, Hartney engaged in tax planning designed to insure that it sold its product subject to the lowest possible Illinois state and local sales tax rate.

The State of Illinois has long imposed an Illinois Retailers' Occupation Tax ("State ROT"), generically referred to as a "sales tax" at a statewide sales tax rate of 6.25% of retail sales price on the "business of selling" tangible personal property at retail. In addition, local counties, municipalities, mass transit and other taxing jurisdictions have the legal authority to impose local Retailers Occupation Taxes ("Local ROT") that can bring the combined state and local sales tax rate to over 10%. Where a sale is sourced for Illinois sales tax purposes can have a dramatic

effect on the price and also on the retailer's profitability in a market as sensitive to competitive pricing as the fuel oil sales business. The Department adopted state and local sales tax regulations, likely for purposes of administrative convenience, which sourced sales based on where the seller accepted the purchase order. These regulations opened the door to Hartney and other retailers in tax planning to minimize their Illinois state and local sales tax burdens.[8]

Hartney located a sales purchase order acceptance office in the Village of Mark, Putnam County in Central Illinois. The advantage of this location was that the county, municipality, and other taxing authorities imposed no local sales taxes. Sourcing sales to Mark would lower Hartney's sales tax rate from 10.0%, in effect at its headquarters in Forestview, to 6.25% in effect in Mark. Hartney was meticulous in its tax planning to source its sales to Mark, Illinois. Hartney contracted with a local business for a clerk to take fuel orders in Mark, Illinois. Id. at 299. The local business provided the services of one of its own employees to receive Hartney's orders via phone. Hartney paid the local business a flat rate for the employees' services to Hartney. Hartney paid the local business $1000 per month for a lease of 200 square feet and the services of the clerk. Hartney had two types of fuel contracts with customers, daily orders, and long-term contracts. For daily orders customers called the Mark office and if the clerk determined that the customer was on

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[8] Admittedly, the Village of Mark did not fit the profile of a typical tax haven, but had what it took in Hartney's eyes – no local sales taxes and the ability to offer tax rebates:

> Mention "tax haven," and glamorous locales such as the Cayman Islands or Bermuda come to mind. But what about Mark, Ill.? The tiny village, population about 500, in downstate Putnam County has no white-sand beaches or posh corporate headquarters — it doesn't even have a stop light. And neither does it have any local sales taxes. It does, however, now have an office of the Hartney Fuel Oil Co., a major Midwest petroleum marketer that claims sales of more than $200 million annually . . . Not only does Hartney pay no local sales tax, local officials gave the company a sweetener. Under a 2005 agreement with the county, Mark rebates half of the county's share of state sales tax revenue to the company.

Business Accused of Creating Unlikely Tax Haven: Village of Mark, pop. 500 , The Joplin Globe, April 29, 2011, https://www.joplinglobe.com/news/business-accused-of-creating-unlikely-tax-haven-village-of-mark/article_a1414041-c9ec-5e62-ad68-157d58dd18d0.html

a list approved for credit, the clerk approved the order. Long-term contracts were negotiated by Hartney's president and sent to Mark where he traveled to execute the contracts and where the originals were stored. These contracts were negotiated on a keep full basis under which the common carrier retained by Hartney to transport fuel to customers monitored the customers' needs and transported additional fuel as need to the customer, without further intervention from the Mark office. Id. The Department audited Hartney and issued an assessment based on the assertion that Hartney was in the business of selling from its Forestview headquarters, where the bulk of its selling activities took place there. The Department assessed taxes on Hartney's sales based on the 10% tax rate imposed in Forestview.

The Illinois Supreme Court issued rulings on two separate legal issues in resolving this litigation: i) whether the Department's regulations interpreting the business of selling as sourcing sales based on where purchase orders were accepted was an invalid interpretation of the law; and ii) if the regulation was invalid, whether Hartney was entitled to abatement of tax under the Illinois Taxpayer's Bill of Rights. The court's answer to both questions was yes. The Illinois Supreme Court rejected Hartney's scheme by ruling that the Department regulations were an invalid interpretation of the Illinois State and Local ROT that unduly narrowed the scope of Illinois State and Local ROT.[9] The court held that determination of where the business of selling took place was a fact intensive inquiry that required an examination of where all the retailers' selling activity took place. Id. at 312. The Court ruled that Hartney's sales should be sourced to Forestview where the bulk of its selling activities took place including marketing, inventory maintenance, price setting, and cultivating sales relationships. The Court upheld the Department's assessment.

[9] Court Shuts Down Tax Havens, Chicago Tribune, November 28, 2013. https://www.chicagotribune.com/opinion/ct-xpm-2013-11-28-ct-sales-tax-haven-edit-1128-20131128-story.html

Before, addressing the abatement issue, the court noted that the Taxpayer's Federation of Illinois and Illinois Retailers Merchant Association filed amicus briefs which argued that certainty is a high priority for taxpayers and numerous states adopted a bright-line test for sourcing sales. Id. at 312-313. They argued that the court by interpreting the statutory term "business of selling" to require a fact-intensive inquiry as to all selling activities was completely contrary to the idea of giving taxpayers certainty regarding taxation of their sales. The court rejected tax policy considerations:

> It is not incumbent upon this court to decide the tax policy, the court is to decide the tax policy the legislature has chosen and communicated through the statute.

Id. at 313. The court refused to consider the desirability, as a matter of tax policy, of having a rule that was fact specific and provided certainty in sourcing sales over a fact-intensive rule with significant uncertainty in its application.

The court then turned to the equitable issue of whether Hartney was entitled to abatement of the taxes at issue, totaling $23 million, under the Illinois Taxpayer Bill of Rights. These taxes consisted of Forest View, Cook County and Regional Transportation Authority (the "Local Governments") local sales taxes which Hartney escaped by sourcing its sales to the Village of Mark, rather than Forestview, the location of its corporate headquarters. Id. at 300. The Local Governments had joined in the Department's lawsuit against Hartney. The court found that while Hartney's actions were not consistent with the state statute, they were consistent with the Department's regulations, and that Hartney shut down its Mark sales office and had not sourced sales there for more than six years. The court ruled as a matter of equity that Hartney was entitled to abatement of the taxes at issue under the Illinois Taxpayer Bill of Rights. In footnote six to the

abatement section of its decision the court touched in passing on the Local Government's substance over form argument:

> The Local Governments have additionally argued that Hartney's arrangement should be disregarded as a sham transaction. Analyzing a sham transaction requires assessment of the multiple steps of a transaction, with each being considered relevant, to determine whether economic reality accords with the formal arrangement . . . Because we conclude the regulation erroneously sited tax based solely on purchase order acceptance in the case at bar, the sham transaction doctrine is unavailing. Hartney structured its affairs in accordance with the regulation, by relocating its order-receiving function to a lower tax jurisdiction. Hartney's arrangement was not without economic substance or economic effect.

Id. at 313 F.N. 6. In other words, the court dismissed the Local Government's substance over form argument because Hartney in structuring its business operations had relied on the invalid Department regulations that unduly narrowed the scope of the statute. The court held that the facts Hartney established, which included renting an office in Mark, paying a clerical employee to accept purchase orders at that office, and execution of purchase contracts at the office was sufficient to avoid application of the substance over form doctrine. These facts established that the office was more than a sham because substantive purchase order acceptance activity actually took place at that office.

Nonetheless, PepsiCo seized on this conclusion to argue that:

> Hartney structured its affairs in accordance with the regulation, by relocating its order-receiving function to a lower tax jurisdiction. Hartney's arrangement was not without economic substance or economic effect. Id. at 314. In reaching this conclusion, the Illinois Supreme Court affirmed "[i]t is not incumbent upon this court to decide the best tax policy, the court is to decide the tax policy the legislature has chosen and communicated through the statute." Hartney Fuel Oil, 376 Ill. Dec. at 313 (emphasis added). Therefore, the economic substance and substance-over-form doctrines cannot be used to fill perceived policy gaps that are found in the statue.

PepsiCo Br. at p. 62. PepsiCo, then argues that the Tribunal is powerless here to apply the substance over form doctrine. PepsiCo argues it is up to the Illinois General Assembly to fix the

alleged hole PepsiCo has discovered in the 80/20 Test, which permits it to exclude domestic income from its combined return under this test. Id.

First, the Hartney court's refusal to be swayed by tax policy considerations related to the court's interpretation of the statutory term "business of selling," not to its refusal to apply the substance over form doctrine. Hartney Oil 376 Ill. Dec 313. Second, the basis for the court's out-of-hand dismissal of the Local Government's substance over form argument was that in determining whether the taxpayer was entitled to tax abatement the court found that the taxpayer had followed the very narrow and invalid interpretation of the statutory term "business of selling" in the Department's regulations. Id. at F.N. 6.

By contrast, at issue here is whether as a substantive matter the expatriate payroll truly reflects broader substantive foreign business activity conducted through PGM LLC. For the myriad of reasons addressed above it does not. Further, PGM LLC did not even have the minimum of business activity documented by Hartney in proving that its office met the much narrower (and invalid) standard of purchase order acceptance in the Department's regulations. PGM LLC had no office, and paid no employees or even independent contractors to administer the expatriate program.

c. Case Law Addressing Doctrine in Context of Legislatively Sanctioned Income Tax Avoidance Provisions Irrelevant

PepsiCo's brief then quotes numerous other equally inapplicable cases, without analysis or fuller discussion, in support of its conclusion that the Department is legally precluded from arguing substance over form doctrine. PepsiCo Br. pp. 56-63, This brief will address one of these decisions, which appears to be the focus of this discussion. PepsiCo cites the Sixth Circuit Court of Appeals' decision in Summa Holdings Inc. v. Commissioner, 848 F.3d 779, 781-82 (6th

Cir. 2017) as recognizing the "danger of the excessive creep of judicial doctrines" such as the substance over form doctrine, and the danger of "applying judicial doctrines to avoid clearly authorized legislative terms." PepsiCo Br. p. 58. Specifically, PepsiCo's brief quotes the decision as stating that:

> Each word of the 'substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. Form is substance when it comes to the law.

Based on this quote PepsiCo argues the "substance of the 80/20 Rule is its form" and consequently where "80 percent of the combined payroll and property are foreign, the entity is an 80/20 Company regardless of whether that is good or bad for Illinois' revenue collections." PepsiCo's conclusion based on Summa Holdings that this decision precludes the Department from raising the substance over form doctrine here would lead the reader to believe that this decision constitutes a sweeping rejection of the substance over form doctrine. However, a closer examination of this decision reveals the court's ruling is limited to a very narrow set of facts and legal circumstances, which make this decision totally inapplicable here.

Summa Holdings involved the Commissioner's unsuccessful attempt to apply the substance over form doctrine to reverse the taxpayers', the Benenson family's, tax planning strategy which used a domestic international sales corporation ("DISC") to transfer money in a tax advantaged manner from their family business to their sons' Roth individual retirement accounts ("IRA's"). Congress created DISCs in 1971 as the first vehicle by which to provide a tax incentive for exports. The exporting company pays a sales commission to the DISC, a paper corporation, of up to 4% of gross receipts or 50% of net income from qualified exports. The DISC pays no tax on commission income up to $10 million. DISCs may be owned by corporations and

other entities, including IRAs. When the DISC distributes money to a corporate shareholder, there is corporate level tax, while a tax-exempt shareholder will pay unrelated business income tax on the distribution. However, once the distribution is made to a Roth IRA shareholder and the tax on such distribution is paid, the Roth account holder may invest those proceeds tax-free like any other asset of the Roth, and there is also no tax when the assets are distributed up to the account holder at the requisite retirement age. Additionally, this structure provides a path for utilization of Roth accounts by high income individuals, who are otherwise legally prohibited from making direct contributions to these accounts.

Summa Holdings was the parent corporation of a group of family companies owned by the Benensons. In 2001, the Benenson sons each set up a Roth IRA and made a nominal contribution. The Roth IRAs then purchased stock in a newly formed DISC held through a holding company. Summa Holdings paid commissions to the DISC that distributed the money up the chain to the Roth IRAs. By 2008, each Roth IRA had accumulated more than $3 million.

The IRS asserted that the substance-over-form doctrine should apply to reclassify the payments as dividends from Summa Holdings up to its shareholders, followed by a contribution into the Roth accounts. Re-casted, the transfers would not count as commissions to the DISC, meaning that Summa Holdings would pay income tax on the DISC commissions it had deducted and the holding company would obtain a refund for the corporate income tax it had paid on the dividend from the DISC. The Benenson sons would be ineligible to make Roth contributions since their income was so high and would thus be subject to a 6% excise penalty.

The court stated that the "substance-over-form doctrine, it seems to us makes sense only when it holds true to its roots – when the taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process." Id. at 787

(emphasis added). In contrast to such factual situations when application of this doctrine is appropriate, the court emphasized that Congress designed DISCs to enable exporters to defer corporate income tax. By design they are all form and no substance, since they essentially operate as shell corporations that receive commissions and pay dividends. Similarly, a Roth IRA is designed with the purpose of tax reduction. And Roths are allowed to own DISC shares pursuant to the IRC. Since pursuant to tax law, the intended purpose of these structures is tax avoidance and deferral, it cannot be said that the taxpayer followed a "devious path" to avoid the tax consequences of a "straight path." The court stated that the "Code authorizes DISC commissions and dividends, regardless of whether they have economic substance, in order to reduce the tax burden of exporters." Id. at 789 (emphasis added). The court concluded that it was unwilling to use the substance-over-form doctrine to restructure such transactions where the Code sections at play have the sole purpose of tax avoidance, and instead held that if such results were unintended, it was within Congress' power to correct it.

With this full understanding of the narrow scope of the court's decision in Summa Holdings in mind, it is clear that contrary to PepsiCo's assertion, this decision has no applicability here. The 80/20 Test is not a mechanism adopted, without economic substance, for General Assembly sanctioned tax avoidance. Instead this test, as addressed in Section I. of this memorandum, was intended in furtherance of fair combined apportionment of multinational corporate income to Illinois, while excluding from such apportionment income from foreign business activities, as measured by an average of payroll and property factors. PepsiCo's application of the 80/20 Test is completely contrary to this legislative purpose in that it distorts combined apportionment of income by excluding income from domestic not foreign business activities. In short PepsiCo's formal characterization of expatriate compensation charged to PGM LLC as PGM LLC foreign

payroll denoting foreign business activity that excludes FLNA from the PepsiCo combined group is contrary to economic reality. Id. This is the classic circumstance for application of the substance over form doctrine described in Summa Holdings. Id. at 787.

C. The Substance Over Form Doctrine Is Applicable Here Because Substance and Form Diverge

1. Substance Over Form Doctrine Applies to Impose Tax Based on Economic Realities

As Professor Iserbergh observed in his article "Musings on Form and Substance in Taxation" cited extensively in PepsiCo's memorandum, "tax laws necessarily have a limited number of terms, but must be applied to a nearly unlimited number of transactions." "Musings on Form and Substance in Taxation," Joseph Iserbergh, 49 U. Chi. L. Rev. 859, 864 (1982). Furthermore, he states that "[f]rom the beginning of taxation people have sought advantage in calling one thing another. Id. at 865. He cites as an example, calling compensation a gift. He states the "principle of following 'substance' rather than 'form' has always meant sweeping aside pretenses of this sort." Id. Similarly, PepsiCo here is attempting to call expatriate compensation charged to PGM LLC, PGM LLC compensation representing PGM LLC foreign business activity, rather than what it truly is -- compensation paid by the Foreign Host Companies for work performed for them and under their direction.

2. Case Law Requires Application of Substance Over Form Doctrine In Ignoring Conduit and Imposing Income Tax Based on Economic Substance Rather Than Form

PepsiCo in its brief asserts that the Department is precluded from arguing substance over form to dispute PepsiCo's assertion that expatriate compensation charged to PGM LLC is PGM LLC foreign payroll. As legal support for this assertion PepsiCo cites case law, that does not

address this doctrine in a context where substance and form diverge. However, the Illinois Appellate Court in JI Aviation, Inc. v. Department of Revenue, 335 Ill. App. 3d 905 (2002) applied the substance over form doctrine in just such a context to rule that economic substance, not form, controls Illinois taxation. The court ruled that a conduit, without economic substance, for conveyance of title must be ignored for Illinois use tax purposes This decision supports the Department's application of the substance over form doctrine here to similarly disregard expatriate compensation charged to PGM LLC, a disregarded entity, without economic substance in computing FLNA's 80/20 Test payroll factor.

In JI Aviation, JI Aviation and Richland Development Corp. entered into an Aircraft Acquisition Agreement. In the agreement, Richland characterized itself as a nonretailer not in the business of selling aircraft at retail. The Agreement indicated Richland's sale of the aircraft (the Gulfstream G-II) to JI Aviation was an isolated or occasional sale. Pursuant to the Agreement, JI Aviation was to deposit the sum of the purchase price into an escrow account controlled by Richland and Richland would deliver the aircraft to JI Aviation. The Agreement further stated title to the aircraft would pass "from Richland to JI Aviation free and clear" upon Richland's physical delivery of the airplane to JI Aviation even though a separate provision of the Agreement indicated Richland would, upon receipt of the purchase price from JI Aviation, transfer title to Nationsbanc Leasing Corporation who would then transfer title to JI Aviation.

In fact, Richland and Nationsbanc entered into an agreement where Richland was to "transfer full legal and valid title to the Gulfstream G-II aircraft to Nationsbanc free and clear of any and all liens, pledges, mortgages, security interests or other encumbrances of any type". Id. The agreement was fulfilled, and the bill of sale was executed listing Richland as the seller and

Nationsbanc as the buyer of the Gulfstream G-II. On the same date, Nationsbanc issued a warranty bill of sale to JI Aviation for the Gulfstream G-II. Specifically, the bill of sale warranted:

> (i) Seller has received a Warranty Bill of Sale from Richland Development Corporation and an Aircraft Bill of Sale on Federal Aviation Administration Form 8050–2 from Richland Development Corporation purporting to transfer title in the Aircraft to Seller; (ii) Seller has good and lawful right to sell its right title and interest in and to the Aircraft to Purchaser; (iii) such title transferred hereunder is transferred to Purchaser free from any lien, charge or encumbrance created by or through Seller, and (iv) Seller, at its sole cost, will defend said title transferred hereunder forever against the claims of any and all third parties.

On the same date, title to the Gulfstream G-II was transferred from Richland to Nationsbanc and from Nationsbanc to JI Aviation one minute later. Nationsbanc is a retailer in the business of selling aircrafts and the purpose of Richland transferring title to Nationsbanc was to permit Richland to effectuate a like-kind exchange pursuant to which it could defer gain under IRC Section 1031. Id. Pursuant to the agreement, Richland would transfer title to the Gulfstream G-II to Nationsbanc in exchange for title to a separate aircraft, the Gulfstream G-IV that Richland had identified to Nationsbanc that Richland intended to purchase. Under IRC Section 1031, Richland by exchanging its old aircraft with Nationsbanc was able to defer recognition for federal income tax purposes of any gain on its disposition of the Gulfstream G-II, including deferral of any depreciation recapture. Nationsbanc then conveyed title to the G-II.

Illinois imposes a use tax on s retailer's transfer of title or ownership of tangible personal property to a purchaser by sale pursuant to Illinois Use Tax Section 2. 35 ILCS 105/2. Excluded from tax is an isolated or occasional sale of tangible personal property by a seller that is not in the business of selling such property at retail. Id. JI Aviation's acquisition of title from Nationsbanc, a retailer, clearly fit within the statutory definition of purchase at retail subject to Illinois use tax. Id. The Department assessed a use tax based on Nationsbanc's transfer of title to the aircraft to JI

Aviation. JI Aviation protested this tax assessment arguing that under the substance over form doctrine Nationsbanc's role as a mere conduit in transferring title to JI Aviation must be disregarded and Richland's substantive sale of the aircraft directly to JI Aviation was a nontaxable occasional sale.

The Appellate Court agreed with JI Aviation and ruled that the substance over form doctrine required that the transfer of title by a conduit, Nationsbanc, to JI Aviation must be ignored for Illinois use tax purposes despite the fact that Richland had reported this for federal income tax purposes as a like kind exchange with Nationsbanc on its federal income tax return, and the fact that title transfer by Richland to Nationsbanc followed by title transfer by Nationsbanc to JI Aviation had been recorded with the FAA. However, the court found that in substance Richland sold the G-II directly to JI Aviation because there was no economic substance in Nationsbanc's role in this transaction as a conduit for the transfer of title. Id. The Appellate Court ruled that economic substance governs Illinois use tax consequences and that the sale was exempt from Illinois use tax as an isolated or occasional sale by Richland, a nonretailer, directly to JI Aviation. Id. 483-484.

Similarly, there is no economic substance in PGM LLC's role here. Federal payroll tax and other compensation reports reflect PGM LLC as the expatriates' employer. However, there is no accompanying economic substance to support PGM LLC's role as employer just as there was no economic substance attendant to Nationsbanc's role as a conduit for conveyance of title:

- Compensation Expense and Reimbursement Offset Flowed Through PGM LLC. Nationsbanc retained no funds or other profit, but instead was contractually obligated to reconvey the purchase price of the Gulfstream II received from JI Aviation and apply it against the purchase price of the Gulfstream IV. Similarly, expatriate compensation was charged to PGM LLC without any markup and this charge was offset by Foreign Host Companies' reimbursement credited to PGM LLC. PGM LLC retained no funds

as profit and simply acted as a conduit through which expenses and offsetting reimbursement flowed.

- PGM LLC Incurred No Expenses. Nationsbanc incurred no closing costs or other expenses connected with its transfer of the Gulfstream II aircraft. Similarly, PGM LLC incurred no expenses in connection with the expatriate compensation, which was offset by Foreign Host Company reimbursements.

- PGM LLC Incurred No Liabilities. Nationsbanc had no liability for title warranties because it was completely indemnified by Richland for the title it received from and immediately conveyed on behalf of Richland. Similarly, PGM LLC incurred no liabilities in connection with the expatriates' work. PepsiCo asserts that a stated purpose for forming PGM LLC was to attempt to protect other U.S. Entities from having direct legal liability for actions or disputes regarding the seconded expatriates' actions in all of the countries in which they were assigned. Joint Stip. ¶ 65. However, PGM LLC was effectively indemnified for such liabilities because the Foreign Host Companies, without payment or reimbursement by PGM LLC, were responsible for maintaining insurance coverage for any liabilities incurred by the seconded expatriates in their work for the Foreign Host Companies. Id. at ¶ 66.

In short, expatriate compensation charged to PGM LLC was offset by the Foreign Host Companies' reimbursement of this charge also credited to PGM LLC, and PGM LLC incurred no tangential expenses or liabilities. Expatriate compensation must be disregarded for Illinois income tax purposes under the substance over form doctrine because PGM LLC merely acted as a conduit through which compensation charges and reimbursement offsets flowed.

3. Substance Over Form Doctrine Applies to 80/20 Determinations Where Substance and Form Diverge

It was estimated by PepsiCo's tax consultants that exclusion of FLNA from its combined group was worth approximate $14 million in state tax savings. Joint Stip. ¶ 69. Indeed, with such significant tax dollars potentially at state, it is not surprising that the 80/20 Test has been the focus of considerable tax planning efforts by Illinois taxpayers over the years, including at least: i) one Illinois Department administrative hearing decision -- Appeal of Shanghai, IT 02-1 (February 7, 2002); ii) one Appellate Court decision – Zebra Technologies Corp. v. Topinka, 344 Ill. App. 3d

474 (2003); and iii) one Tax Tribunal decision – IBM v. DOR, 14 TT 229 (June 30, 2015). The latter two decisions touch on the substance over from doctrine raised by the Department in contesting the taxpayer's 80/20 Test characterization of its subsidiary, but are decided on other grounds. The Department did not raise the substance over form doctrine in the Department administrative hearings decision, and not coincidentally it is the only one of the three decisions in which the taxpayer prevailed in excluding an 80/20 Company from its unitary group.

Appeal of Shanghai involved the Department's challenge of an Illinois based multinational group of affiliated corporations' exclusion of a Foreign Sales Corporation ("FSC") from their unitary business group under the 80/20 Test. FSCs replaced DISCs, addressed in the discussion of the Summa Holdings above, as the mechanism by which the Congress chose to provide a federal income tax subsidy to exporters. *Overview of the Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) Exclusion*, (January 2, 2002). As with DISCs, a chief tax benefit of forming a FSC is that the exporter is entitled to a tax deduction for a sales commission paid to the FSC. FSCs are taxed favorably for federal income tax purposes by paying tax effectively on only approximately 8 per cent of their profits. *Small Foreign Sales Corporations*, CPA Journal Online (January 1990). In contrast to DISCs, and in response to claims by United States trading partners that DISCs constituted an illegal export tax subsidy without any associated economic substance, FSCs were required by IRC § 921 to maintain an office and books of account overseas, and one director who resided overseas. Treas. Reg. §1.921-2 Foreign Sales Corporation - general rules. In addition, FSCs were required to pay at arm's length rates for any services they received in providing their export activities. IRC §§ 924 and 925.

As required by IRC § 921, the FSC in Shanghai maintained an office outside the United States on which it paid annual rental of approximately $2,000 per year. Appeal of Shanghai,

Statement of Facts (No. 7). The FSC entered Agency Agreements in which its unitary affiliates agreed to pay the FSC a sales commission the FSC for the performance of export sales activities. Id. (No. 13). The income tax treatment of the FSC for federal income tax purposes was effectively adopted for Illinois income tax purposes too. Illinois piggybacks federal taxable income and it consequently piggybacked the deduction taken by the unitary affiliates included in the combined return for the sales commission paid the FSC, which was accordingly also excluded from Illinois combined income. The FSC entered Service Agreements with affiliates in which the FSC agreed to pay them arm's length fees for performance of sales activities the FSC was obligated to perform under the Agency Agreements. Id. (Nos.3,19 and 21)). Because it contracted for the services it was required to perform, the FSC owned no tangible personal property other than its books and records, and it owned no real property. Id. (No. 4). It also had no employees. Id.

The Department of Revenue attempted to argue that the FSC had employees within the United States that caused it to fail the 80/20 Test for exclusion from the unitary group. The Department administrative law judge rejected this argument based on the Department's factual stipulation that the FSC had no employees. Importantly here though is that the Department did not argue the substance over form doctrine in attempting to include the FSC in the taxpayer's Illinois unitary group. This is not surprising. This is the exact situation addressed by the court in Summa Holdings as the circumstance in which the substance over form doctrine cannot be argued -- a federal income tax sanctioned tax avoidance scheme (adopted here by Illinois in piggybacking federal taxable income) with a modicum of substance that the taxpayer followed to the letter of the law. This is not the situation here. As discussed above, exclusion of an 80/20 company from a unitary group is not a General Assembly sanctioned tax avoidance scheme. Furthermore, as also addressed above PGM LLC's form and economic substance clearly do diverge. However, PGM

LLC has not even met the modicum of substance maintained by the FSC in Appeal of Shanghai. Unlike the FSC, PGM LLC maintains no foreign office nor does it pay any employees to administer the expatriate Global Mobility program, nor even pay affiliates for the efforts of their employees in managing and administering this program.

By contrast to Appeal of Shanghai, the two decisions in which the taxpayers have *unsuccessfully* argued that corporations should be excluded from an Illinois unitary business group under the 80/20 Test, did not involve a legislatively sanctioned avoidance tax scheme. In Zebra the taxpayer established two intellectual property passive investment companies (the "PIC") in Bermuda to which it transferred intellectual property and to which it paid a royalty for use of the intellectual and with respect to which the taxpayer took a deduction on its Illinois combined return. By excluding the PIC from its combined return under the 80/20 Test the royalty income earned by the PIC was excluded from combined income. In IBM the Illinois taxpayer, International Business Machines Corporation, had formed a subsidiary, WTC, which held certain foreign assets and securities since 1949. At issue was whether WTC and its income would be included in IBM's combined return

As addressed in Section II of this memorandum, the Illinois Appellate Court in Zebra ruled that the taxpayer had failed to satisfy its burden of proof for excluding the PIC from its unitary group because it failed to account in its 80/20 factor computations for the efforts of the taxpayer's employees within the United States in protecting the PIC's intellectual property. Similarly, in the IBM v. DOR case, which was before the Tribunal on a motion for summary judgment filed by the taxpayer, the Tribunal ruled that the case was not ripe for summary judgment because insufficient facts had been developed regarding WTC's U.S. and worldwide busines activities to determine whether or not WTC was excluded from the taxpayer's combined group under the 80/20 Test.

Neither the Appellate Court nor Tribunal reached the Department's substance over form arguments, however, the Tribunal's comments regarding the Department substance over form argument in IBM v. DOR is instructive here.

> In the present case, IBM suggests that the rationale in Zebra Technologies which allowed a reallocation of expenses from one company to another is limited to cases where there is a finding of a complete lack of economic substance for one of the companies, and because WTC has economic substance, its payroll and property figures cannot be challenged. Zebra Technologies did not hold that a company must have a complete lack of economic substance before a specific intercompany transaction can be analyzed for its own lack of economic substance. The doctrine of "substance over form" is applied to transactions and does not necessarily mean that a party to a questioned transaction must have no business purpose or lack economic reality. Whether or not the "substance over form" doctrine is even applicable or relevant in the present case is a question best left for another day as it cannot be answered on the undeveloped record before the Tribunal.

IBM at pp. 6-7. In other words, the Tribunal stated that the substance over form doctrine is not limited to situations in which there is a complete lack of economic substance or business purpose.

4. Substance Over Form Doctrine Applies to Exclude Expatriate Compensation from FLNA's Payroll Factor

The substance over form doctrine applies here to exclude the expatriate compensation from FLNA's 80/20 Test payroll factor. Regardless of how important the expatriate Global Mobility program is to the PepsiCo corporate group, there is simply no economic substance that connects this program and the expatriate compensation with the legal entity, PGM LLC. The benefits of a GEC cited in PepsiCo's brief such as limited liability and ease of administration on closer examination simply do not exist here. PGM LLC pays no employees to administer the expatriate program, nor does PGM LLC have any assets or other means manage and administer the program.

The case law cited by PepsiCo as authority for the position that the substance over form doctrine is inapplicable here is distinguishable. Unlike Summa Holdings, no legislatively

sanctioned tax avoidance scheme is at issue here. The expatriate compensation is completely unrelated to FLNA's domestic income. which PepsiCo is attempting to exclude from its combined return. The JI Aviation decision supports ignoring expatriate compensation charged to PGM LLC for Illinois income tax apportionment purposes, regardless of how this compensation is treated for unrelated federal income tax withholding and other purposes.

CONCLUSION

FLNA must be included in the PepsiCo Illinois unitary group under the 80/20 Test contained in IITA Section 1501(a)(27) under three separate and independent alternative legal bases: i) PGM LLC is not the expatriates' common-law employer and compensation for the expatriates' services charged to PGM LLC cannot be included in the computation of FLNA's 80/20 Test payroll factor; ii) PepsiCo has not met its burden of proof under IITA Section 1501(a)(27) that FLNA conducts 80% or more of its business activities outside the United States; and iii) the substance over form doctrine requires that the expatriate compensation cannot be treated as FLNA foreign payroll that excludes it from the PepsiCo Illinois unitary group as an 80/20 Company. The Department requests that this Tribunal rule in favor of the Department and uphold the Notices of Deficiency issued to PepsiCo as they pertain to the inclusion of FLNA in the PepsiCo unitary group.

Respectfully submitted,

Illinois Department of Revenue

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