IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL

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

PETITIONER PEPSICO, INC. AND AFFILIATES' MEMORANDUM IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT

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

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

Attorneys for Petitioner,
PepsiCo, Inc. and Affiliates

TABLE OF CONTENTS

SUMMARY OF ARGUMENT 1

PROCEDURAL POSTURE 2

SUMMARY JUDGMENT IS APPROPRIATE 2

UNDISPUTED MATERIAL FACTS 3

I. Worldwide Business Operations of PepsiCo, Inc. and Affiliates 3

II. PepsiCo's Bottler Acquisition and Global Restructuring 4

III. Reorganization of FLNA's Domestic and Consolidated Foreign Business Operations 5

A. Reorganizing FLNA's Domestic Business Operations 5

B. Reorganizing International Business Operations of FLNA and Its Subsidiaries 6

IV. The PepsiCo Corporate Group's Expatriate Program and Foreign (Non-U.S.) Secondments 9

A. The PepsiCo Corporate Group's Global Mobility Function 9

1. The Global Mobility Transformation Plan 9

2. Post-Transformation: The Global Mobility HR Function Team 10

B. PGM LLC Entity Formation 11

C. PGM LLC's Business Function to the PepsiCo Corporate Group 11

D. Secondment of PGM LLC Employees to Foreign (non-U.S.) Host Companies 12

E. Compensation Paid to PGM LLC Expatriates and Compliance 12

ISSUE IN DISPUTE 14

ARGUMENT 14

I. FLNA Is An 80/20 Company 15

A. The Illinois Unitary Combined Group Excludes “80/20 Companies”.......16

1. The Plain and Ordinary Language of Illinois’s Statues and Regulations Control..16

2. The Illinois Legislature Intended the Definition of “Unitary Business Group” to Provide “Certainty and Stability” to Illinois Taxpayers..17

3. The 80/20 Rule Is A Mechanical Test.......................................18

4. The Property Factor 19

5. The Payroll Factor 19

a. “Compensation” 19

b. “Employer” 20

c. “Employee” 20

d. The Common Law “Employer-Employee” Relationship...21

6. The Right to Direct and Control the Seconded Employees Is the Key to the Common Law Employer Test...........................22

7. Reimbursement Is “Irrelevant” Under the Common Law Employer-Employee Test..24

8. The Temporary Nature of the Assignment Is Instructive and Material in Determining the Common Law Employer...........25

9. The Common Law Factors Summarized.................................26

B. PGM LLC Is The Employer of Its Expatriate Employees In Fact and Law 27

1. PGM LLC Is Disregarded From FLNA But Is An Employer for Federal and Illinois Tax Purposes.......................................28

2. PGM LLC Is the Employer of Its Seconded Expatriate Employees In Fact..28

3. PGM LLC’s Employment of Its Expatriates Constitutes a Common-Law Employer-Employee Relationship……...……29

a. PGM LLC Has the Right to Control and Direct Its Expatriate Employees 30

i. Right to Control Over the Services Performed 30

ii. Right to Control the Term of the Assignment 33

iii. Right to Control Compensation 33

b. PGM LLC Has the Right to Discharge Its Expatriate Employees' Overall Employment....35

c. Permanency of the Relationship 35

d. Nature of the Relationship Created 36

II. PGM LLC Is Critical to the PepsiCo Corporate Group's Global Success.....37

A. Global Employment Companies Are Best Practice 37

1. Key Business Reasons for Utilizing a Global Employment Company 37

2. Structuring An Effective Global Employment Company 38

B. Formation of PGM LLC Was Necessary To Consolidate and Unify Various Expatriate Entities, Programs, and Policies 39

C. PGM LLC Operates As A Global Employment Company In Accordance with Best Practice 41

D. PGM LLC Provides Critical Benefits to the PepsiCo Corporate Group ...43

1. Limit U.S. Entity Legal Liability In Foreign Jurisdictions 43

2. U.S. Benefits Plan Eligibility 44

3. Limit Permanent Establishment Foreign Tax Exposure.........46

4. Business and Government Compliance Efficiency....46

5. Recruit and Retain Talent....47

6. Develop Talent....48

7. Deploy Technical Expertise 48

III. Reorganization of Foreign Operations Underneath FLNA Cannot Be Equitably Recast 48

A. There Is No Illinois Statutory Authority to Adjust or Attribute Property or Payroll for Purposes of the 80/20 Company Rule 49

B. The Department's Equitable Reallocation and Reapportionment Authority Is Prospective Only 50

C. *Zebra* and *IBM* Do Not Authorize Equitable Reallocation........................50

D. The FLNA 80/20 Company Status Cannot Be Undone By the Economic Substance Doctrine 53

1. The PepsiCo Corporate Group's Global Restructuring Had Valid Business Purpose...53

2. FLNA's Business Function Is Integral to the PepsiCo Corporate Group 54

3. Reorganizing Foreign Business Operations Underneath FLNA As Part of the Overall Global Restructuring 54

4. The Economic Substance Doctrine Cannot Circumvent Clear Illinois Law...56

5. FLNA's Status As An Illinois 80/20 Company Cannot Be Reversed By the Economic Substance Doctrine.......................59

a. Controlling Illinois Law Supersedes the Department's Authority to Equitably Overrule FLNA's 80/20 Company Status...59

b. Judicial Activism Is Not Proper: Separation of Powers Underscores Illinois Governance 61

CONCLUSION 63

IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL

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

SUMMARY OF ARGUMENT

Illinois law is clear: an "80/20 Company" is expressly *excluded* from an Illinois "unitary business group." *See* 35 ILCS 5/1501(a)(27)(A). The statutory framework for determining whether an entity is an 80/20 Company under Illinois law is also clear: "[t]he [unitary business] group will not include those members whose *business activity* outside the United States is 80% or more of any such member's total business activity …" *Id.* (emphasis added) (the "80/20 Rule"). And an entity's "business activity" is expressly, exclusively -- and intentionally -- measured by the average of its property and payroll factors and not by any other metrics. *See id*. and Ill. Admin. Code tit. 86, §§ 100.3350 ("Property Factor"), 100.3360 ("Payroll Factor"), and 100.9700(c) ("Unitary Business Group Defined", "The 80-20 U.S. business activity test").

Frito-Lay North America, Inc. ("FLNA") is an 80/20 Company under Illinois law. The principal argument is whether amounts paid by PepsiCo Global Mobility, LLC ("PGM LLC"), a single-member LLC owned by FLNA, to its foreign expatriate employees constitute "compensation" for Illinois 80/20 Rule purposes. As the record demonstrates, the payroll amounts reported by PGM LLC are required to be "compensation" for numerous reasons including, but certainly not limited to, the Illinois 80/20 Rule. *See* 35 ILCS 5/1501(a)(27)(A) and Ill. Admin.

Code tit. 86, § 100.3360. Furthermore, FLNA's corporate structure has economic substance and must be respected. For these reasons, summary judgment in favor of PepsiCo, Inc. and Affiliates is warranted.

PROCEDURAL POSTURE

"PepsiCo, along with its unitary subsidiaries, timely filed an Illinois Income and Replacement Tax Return on a combined basis ('Illinois Combined Tax Return'), and paid the tax shown due thereon, for tax years 2010 - 2013." Joint Stip. ¶ 133. Consistent with Illinois law and the computations set forth below, FLNA was properly excluded from PepsiCo's Illinois combined group as an 80/20 Company for the 2011-2013 tax years (the "Tax Years at Issue").

FLNA	Payroll Foreign	Avg. Property Foreign	Payroll Everywhere	Avg. Property Everywhere	Foreign Payroll %	Foreign Property %	Avg. Foreign Property & Payroll %
2011	$118,967,981	$36,500,568	$140,069,077	$46,495,392	84.94%	78.50%	81.72%
2012	$141,848,877	$60,876,062	$162,190,795	$71,096,798	87.46%	85.62%	86.54%
2013	$162,953,439	$65,773,951	$185,718,229	$75,927,943	87.74%	86.63%	87.18%

See Joint Stip. ¶¶ 137-139, Exhibits 35-37.

Regardless, the Department assessed PepsiCo for the Tax Years at Issue by including "FLNA in PepsiCo's Illinois Combined Tax Returns for the 2011-2013 tax years." Joint Stip. ¶ 136. PepsiCo timely filed two petitions with the Tax Tribunal in protest of the Department's improper assessment for the Tax Years at Issue -- Petition No. 16 TT 82 for PepsiCo's 2010 - 2011 tax years (the "First Petition") and Petition No. 17 TT 16 for the 2012 - 2013 tax years (the "Second Petition"). After extensive factual development, including written discovery and multiple depositions, the parties jointly executed 158 stipulations of agreed fact on January 17, 2020 (the "Joint Stipulation" or "Joint Stip.").

SUMMARY JUDGMENT IS APPROPRIATE

Summary judgment is proper when "the pleadings, depositions, and admissions on file,

together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." 735 ILCS 5/2-1005(c). To this end, "summary judgment is appropriate when there is no dispute as to any material fact but only as to the legal effect of the facts." *Dockery v. Ortiz*, 185 Ill. App. 3d 296, 304 (2nd Dist. 1989). With regard to Count I of the First Petition and Count I of the Second Petition, there are no issues of material fact. The Joint Stipulation sets forth all material facts in connection with the FLNA 80/20 Company dispute. The only remaining question is the legal effect of those facts. Accordingly, as the parties have agreed, summary judgment is appropriate.

UNDISPUTED MATERIAL FACTS

PepsiCo incorporates the entire Joint Stipulation, including exhibits, into its Motion for Summary Judgment. The material facts are summarized as follows:

I. Worldwide Business Operations of PepsiCo, Inc. and Affiliates

"PepsiCo, Inc. and its world-wide affiliates (hereinafter, the 'PepsiCo Corporate Group') manufactures, markets, and sells a variety of salty convenient, sweet and grain-based snacks, carbonated and non-carbonated beverages and foods in approximately 200 countries, with its largest operations in North America (United States and Canada), Mexico, and the United Kingdom." Joint Stip. ¶ 4. "The PepsiCo Corporate Group's operations are divided into three principal business lines -- the beverage business (*e.g.*, Pepsi, Gatorade, Bubly, etc. beverages), the snack-foods business (*e.g.*, Frito-Lay potato chips), and the grain-based foods business (*e.g.*, Quaker Oats cereals)." Joint Stip. ¶ 5. "The PepsiCo Corporate Group's domestic (U.S.) employees and domestic (U.S.) employer entities generally serve only one of these three business lines; however, outside the U.S., the PepsiCo Corporate Group's three principal business lines are combined, and foreign (non-U.S.) employees and … entities serve all, or some combination of,

the beverage business, the snack-foods business, and/or the grain-based business." Joint Stip. ¶ 6.

"As a 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 (the 'Expatriate Program'). Such postings allow the PepsiCo Corporate Group to, among other things, share information across the globe, identify and capitalize on best practices, familiarize executives with the different market dynamics in which the PepsiCo Corporate Group operates, and grow their executives to be the next generation of high-performing leaders which will run the business. These benefits accrue to the PepsiCo Corporate Group generally, including each business in the PepsiCo Corporate Group that sends executives on an assignment through the Expatriate Program and each business within the PepsiCo Corporate Group which receives executives who have been on such an assignment." Joint Stip. ¶ 7.

II. **PepsiCo's Bottler Acquisition and Global Restructuring**

"On February 26, 2010, the PepsiCo Corporate Group acquired The Pepsi Bottling Group ('PBG') and affiliated entities …" Joint Stip. ¶ 40. The PepsiCo Corporate Group also "acquired PepsiAmericas, Inc. ("PAS") and affiliated entities." Joint Stip. ¶ 41. "PBG and PAS were the two largest publicly traded independent bottlers of Pepsi products prior to their acquisition by the PepsiCo Corporate Group." Joint Stip. ¶ 42. Acquisition of these entities "reduced third-party costs by eliminating transactions between concentrate manufacturers within the PepsiCo Corporate Group and third-party bottlers outside the PepsiCo Corporate Group." Joint Stip. ¶ 43. "At the time of their acquisition, PBG and PAS were publicly traded and together employed more than 84,000 people." Joint Stip. ¶ 44. "PBG and PAS owned more than $18 billion in assets to carry on their bottling and distribution operations." Joint Stip. ¶ 45.

During PepsiCo's 2010 tax year, and in connection with the bottler acquisition, "the

PepsiCo Corporate Group undertook a global restructuring of its business." Joint Stip. ¶ 48. In this regard, the acquisitions of PBG and PAS required integrating 67 domestic and 119 international entities into the PepsiCo Corporate Group's overall corporate structure. *See* Joint Stip. ¶ 46. At the time the bottling businesses were acquired, "the PepsiCo Corporate Group, PBG, and PAS each utilized respectively the following separate entities for their foreign expatriate programs: Beverages Foods & Services Inc. (PepsiCo Corporate Group), C&I Leasing, Inc. (PBG), and Pepsi-Cola General Bottlers, Inc. (PAS)." Joint Stip. ¶ 47.

III. Reorganization of FLNA's Domestic and Consolidated Foreign Business Operations

One focus of the PepsiCo Corporate Group's 2010 global restructuring was to reorganize FLNA's domestic and foreign business operations to create a more effective business structure. *See* Joint Stip. ¶¶ 48-53.

A. Reorganizing FLNA's Domestic Business Operations

"FLNA generates its income by development and operation of the domestic snack food business which includes, among other things: the development, manufacture, marketing, distribution, and sale of snack food products. In operating the domestic snack food business, FLNA contracts with FLI [Frito-Lay, Inc.], an internal PepsiCo entity, for the manufacture of some of the snack foods and contracts with RFLS [Rolling Frito-Lay Sales, L.P.], an internal PepsiCo entity, for the sale and distribution of snack foods." Joint Stip. ¶ 17.

At the time of the 2010 PepsiCo Corporate Group global restructuring, the snack foods business engaged in a significant restructuring of legal entities and associated assets. More specifically, due to an inefficient circular ownership structure, a "corporation formerly known as 'Frito-Lay, Inc.' ('Old Frito-Lay')" merged into FLNA. Joint Stip., Exhibit 43 (DPT0315). Pursuant to the merger between FLNA and Old Frito-Lay, the current Frito-Lay, Inc. entity (FLI)

"became a direct and wholly owned subsidiary of FLNA." *Id*. In connection with this merger, on January 2, 2010, certain "manufacturing plants were contributed to FLI" and "FLNA employees were realigned with their organizational function". *See* Joint Stip. ¶¶ 50-52 and Exhibit 43 (DPT0315). As a result, "[p]ost-restructuring, FLNA continued to employ senior domestic snack food business marketing employees" and "general management" of FLNA. Joint Stip. ¶ 53.

"The management team for the domestic snack food business is employed by and operates out of FLNA, in its Texas offices. That management team runs the strategic arm of that business which includes setting objectives for sales growth, investments, and new product development." Joint Stip. ¶ 11. Essential to developing an effective management team, the "domestic snack foods business sends executives on assignment through the Expatriate Program and also receives executives who have been on such an assignment." Joint Stip. ¶ 13.

B. Reorganizing International Business Operations of FLNA and Its Subsidiaries

In connection with the 2010 global restructuring, the PepsiCo Corporate Group also reorganized international operations of FLNA and its subsidiaries. *See* Joint Stip. ¶ 49 and Exhibit 43 (DPT0189). "The goals of the reorganization were to (i) centralize … foreign branch operations including those of acquired businesses; (ii) establish a platform for the acquisition and funding of future foreign branch operations; (iii) isolate the parent company, PepsiCo, Inc. from the business risk of branch operations; and (iv) align the foreign based expatriates on … U.S. payroll into a single entity." Joint Stip., Exhibit 43 (DPT0189).

"To achieve these objectives, restructuring steps were taken which resulted in the elimination of approximately 30 of the acquired domestic entities as well as several existing PepsiCo holding companies." Joint Stip., Exhibit 43 (DPT0189). "FLNA was identified as the appropriate location for the foreign branch activity as it already had foreign activity through its

Global Market Development group and ownership of a branch in Malaysia, QFL OHQ Sdn. Bhd., through a subsidiary." Joint Stip., Exhibit 43 (DPT0189); *see also* Joint Stip. ¶¶ 14, 60. "Accordingly, PepsiCo Hong Kong LLC was formed under FLNA to hold the Hong Kong operations formally contained in a branch under PepsiCo, Inc. Long Bay, Inc., which also contained foreign branch operations, was merged into FLNA. These transactions were also in line with PepsiCo's long term goal to position the legal entity PepsiCo, Inc. as a pure holding company, isolating it from any operations business risk or liability." Joint Stip., Exhibit 43 (DPT0189); *see also* Joint Stip. ¶ 65.

"In addition, FLNA, with its strong financial position, had significant cash available to provide significant cash flow needed to fund the operations of foreign branches." Joint Stip., Exhibit 43 (DPT0190); *see also* Joint Stip. ¶ 61. "Accordingly, Bottling Group LLC (one of the newly acquired bottlers in 2010) sold its interest in Centro-Mediterreana de Bebidas Carbonica PepsiCo, S.L. and Centro-Levantina de Bebidas Carbonica PepsiCo, S.L. known as CEME and CELE respectively (both of which were facing statutory bankruptcy in prior years) to FLNA in 2011. These two entities consistently generate losses due to its small market share and lack of critical mass. However, PepsiCo's business plan remains that it is important to maintain this market share and funding for CEME and CELE is critical." Joint Stip., Exhibit 43 (DPT0190); *see also* Joint Stip. ¶ 61. As of September 26, 2016, "FLNA ha[d] funded in excess of $250 million of cash requirements." Joint Stip., Exhibit 43.[1]

"Further, in 2011, it was deemed more efficient to put all of the foreign based U.S. expatriates in one legal entity for purposes of payroll, benefits, and general administration

[1] This citation appears on PDF Page 2525 of Joint Stip., Exhibit 43. The document does not appear to have a proper bates stamp.

purposes. These employees were centralized in and are employees of the entity PepsiCo Global Mobility, LLC, formed under FLNA." Joint Stip., Exhibit 43 (DPT0190); *see also* Joint Stip. ¶¶ 54, 57-58, 60, 67, 81-82. "In addition, because the legal employer of expatriates may very well have potential liability in many foreign jurisdictions, [PepsiCo] Global Mobility LLC serves to limit such liability to [PepsiCo] Global Mobility LLC." Joint Stip., Exhibit 43 (DPT0190); *see also* Joint Stip. ¶ 65. "Prior to 2011, expatriates were scattered among various PepsiCo, Inc. affiliates." Joint Stip., Exhibit 43 (DPT0190); *see also* Joint Stip. ¶ 54. The PGM LLC "employees … perform[] services for the various businesses of PepsiCo, Inc." Joint Stip., Exhibit 43 (DPT0190); *see also* Joint Stip. ¶¶ 62, 70, 73, 76-77.

In sum, the following foreign entities / operations were reorganized into or under FLNA as disregarded entities for federal and Illinois income tax purposes:

- PepsiCo Hong Kong, LLC ("FLNA Hong Kong") ("FLNA Hong Kong provides intercompany services to support the Asia Pacific region, including stewardship activities, such as: business strategy, accounting, marketing, and financial services." Joint Stip. ¶ 25. "FLNA Hong Kong operated at a net operating loss position, during the Tax Years at Issue." Joint Stip. ¶ 26);
- Centro-Mediterreanea de Bebidas Carbonicas PepsiCo S.L. ("CEME") ("CEME manufactures, produces, bottles, and sells soft drink products in Spain." Joint Stip. ¶ 34. "CEME operated at a net operating loss position, during the Tax Years at Issue." Joint Stip. ¶ 35);
- QFL OHQ SDN. BHD ("QFL") ("QFL is a supply chain distribution support company for the Asia-Pacific region." Joint Stip. ¶ 37);
- Beverage Services, LLC ("Bev Svcs") ("Bev Svcs provides support services for

franchise-owned bottling operations in Saudi Arabia." Joint Stip. ¶ 39); and

- PepsiCo Global Mobility, LLC ("PGM LLC").

IV. The PepsiCo Corporate Group's Expatriate Program and Foreign (Non-U.S.) Secondments

The PepsiCo Corporate Group's overall "global mobility" structure consists of two discrete, yet complementary components: i) the "Global Mobility Function", whereby PepsiCo Corporate Group human resource personnel manage, service, and oversee the overall global mobility *business* function; and ii) the PGM LLC entity, whereby the global mobility business function for foreign (non-U.S.) secondments is carried on through a *legal* entity.

A. The PepsiCo Corporate Group's Global Mobility Function

"At the time of and in connection with the PepsiCo Corporate Group's 2010 global restructuring, PricewaterhouseCoopers ('PwC') assessed the PepsiCo Corporate Group's overall global mobility practices." Joint Stip. ¶ 55. Prior to 2011, PwC advised PepsiCo that its global mobility practices did not align with "best practice" and "identified [specific] areas of improvement for the PepsiCo Corporate Group's global mobility practices". *See* Joint Stip. ¶ 56. PwC did *not* advise PepsiCo to restructure its global mobility practices for state tax savings; rather, PwC was engaged by PepsiCo solely to advise on best practices in global mobility -- that is, the Global Mobility *function*. *Cf.*, Joint Stip., Exhibit 6 (internal document describing state tax considerations as subsidiary to the business needs for forming PGM LLC) with Joint Stip., Exhibits 17-24 (summarizing PwC's best global mobility practice recommendations and PepsiCo's subsequent implementation of those best practice recommendations).

1. The Global Mobility Transformation Plan

In January 2011, the PepsiCo Corporate Group's human resources function kicked off a formal "global mobility transformation plan" to implement PwC's recommendations and better

align with global mobility best practices. *See* Joint Stip., Exhibits 17-24. In this regard, the PepsiCo Corporate Group restructured its global mobility business operations into three complementary teams: i) the "Center of Excellence Team"; ii) the "Services Team"; and the iii) the "Relationship Team". *See* Joint Stip. ¶ 105, Exhibit 18 (PEP00001343-1347). Through these teams, PepsiCo Corporate Group's Global Mobility HR Function provides day-to-day "management and support functions to PGM LLC and the expatriates" "such as education, immigration, and work permit issues." Joint Stip. ¶ 104.

2. Post-Transformation: The Global Mobility HR Function Team

Post-transformation, and during the Tax Years at Issue, the "Expatriate Program is overseen in its entirety by a group of individuals within the PepsiCo Corporate Group's human resources function (the 'PepsiCo Corporate Group HR Function')." Joint Stip. ¶ 99. "More specifically, within the PepsiCo Corporate Group HR Function, there are approximately twenty individuals located throughout the world who execute employee transfers, relocations, and secondments throughout the PepsiCo Corporate Group in locations across the world ('Global Mobility HR Function')." Joint Stip. ¶ 100. In this regard, during the Tax Years at Issue, the following number of individuals comprised the Global Mobility HR Function: 32 (2011); 19 (2012); and 23 (2013). Joint Stip., Exhibit 8 (PEP00002531). "The majority of the time and resources spent by individuals within the Global Mobility HR Function are dedicated to activities and functions that are unrelated to the management and support functions for PGM LLC and its expatriates." Joint Stip. ¶ 101. "Roughly 26% of the Global Mobility HR Function's time and resources are devoted to management and support functions for PGM LLC and its expatriates." Joint Stip. ¶ 103, Exhibit 8 (PEP00002531). "In providing management and support functions to PGM LLC and the expatriates, the Global Mobility HR Function addresses HR issues unique to

expatriate assignments such as education, immigration, and work permit issues" as described above. Joint Stip. ¶ 104.

B. PGM LLC Entity Formation

PGM LLC "was formed on June 23, 2010 under Delaware law as a single member LLC disregarded for federal and state income tax purposes." Joint Stip. ¶ 27. At the very outset, PGM LLC was formed "to resolve [a] compliance issue related to the [PepsiCo Corporate Group's] employment structure" by "employ[ing] all US paid expatriates." Joint Stip., Exhibit 6 (PEP00002882).

C. PGM LLC's Business Function to the PepsiCo Corporate Group

"PGM LLC facilitates the secondment of high-performing expatriate executives, directors, managers, and analysts from PepsiCo Corporate Group affiliates/operating companies who fulfill temporary key roles with the objective of developing and retaining talent and expanding foreign business operations in established and emerging international (non-U.S.) markets." Joint Stip. ¶ 62. To this end, PGM LLC, through personnel operating the Global Mobility HR Function, provides "the human resource functions associated with supporting high-performing executives sent outside the U.S. to perform temporary key roles for foreign subsidiaries." Joint Stip. ¶¶ 92, 104 ("In providing management and support functions to PGM LLC and the expatriates, the Global Mobility HR Function addresses HR issues unique to expatriate assignments such as education, immigration, and work permit issues."). As a result, PGM LLC -- the PepsiCo Corporate Group's sole global employment company for non-U.S. secondments -- provides countless benefits including (but not limited to): i) limiting U.S. entity legal liability; ii) preserving expatriates' ability to participate in U.S. benefits plans (*e.g.*, pre-tax retirement contribution plans authorized under 26 U.S.C. § 401(k)); iii) limiting permanent establishment exposure for U.S. entities; iv)

easing tax, business, and other government compliance requirements; v) recruiting and retaining high-quality talent; vi) developing talent; and vii) deploying technical expertise at the ground level. *See* Joint Stip. ¶¶ 7, 65, 67, and 73.

D. Secondment of PGM LLC Employees to Foreign (non-U.S.) Host Companies

"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. With regard to the latter, "PGM LLC facilitates the secondment of high-performing expatriate executives, directors, managers, and analysts from PepsiCo Corporate Group affiliates / operating companies who fulfill temporary key roles with the objective of developing and retaining talent and expanding foreign business operations in established and emerging international (non-U.S.) markets." Joint Stip. ¶ 62. "The majority of expatriates seconded through the Expatriate Program either work for the snack-foods business all of the time or work partially for the snack-foods business." Joint Stip. ¶ 68, Exhibit 7 (PEP00004906-4908) (stating over 60% of expatriates worked for snack-foods business during the sample period). "The expatriates are assigned to 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.

E. Compensation Paid to PGM LLC Expatriates and Compliance

"Actual cash payments made to seconded expatriates originate in PGM LLC's books and records as payroll expense." Joint Stip. ¶ 112. The Pepsi International Support Center ("PISC")

and Pepsi-Cola International Limited ("PCIL") "intercompany cross charge[] entities within the PepsiCo Corporate Group for expenses and reimbursements." Joint Stip. ¶¶ 120, 127. To this end, "PISC and PCIL cross-charge PGM LLC's general ledger for accrued employee payroll expense" and for reimbursement of such amounts from the foreign host companies. Joint Stip. ¶ 127; *see also* Joint Stip. ¶¶ 113, 125-126, and 128. Foreign expatriate payroll expenses are initiated in and charged through PGM LLC's accounts of original entry. *See* Joint Stip. ¶ 125. In turn, "PISC contracts with Hewitt Payroll Services [a third party] to issue payroll checks to all PepsiCo Corporate Group affiliate employees on the U.S. benefits plan, including to all expatriates seconded outside the United States and files all necessary payroll tax returns reporting their compensation." Joint Stip. ¶ 123.

Consistent with this accounting, "[i]come taxes are withheld and U.S. payroll and employment taxes are remitted in PGM LLC's name on payments to expatriates who are seconded outside the U.S." Joint Stip. ¶ 114. "For each of the Tax Years at Issue, Forms W-2, Wage and Tax statements were submitted in PGM LLC's name when required under U.S. law to the expatriates seconded to foreign host companies." Joint Stip. ¶ 115. "For each of the Tax Years at Issue, Federal Insurance Contributions Act ('FICA') tax was withheld from payments to expatriates. That tax was remitted in PGM LLC's name to the IRS on Form 941, Employer's Quarterly Federal Tax Return." Joint Stip. ¶ 116. "Payments to and benefits received by expatriates (wages, salaries, bonuses, stock options, etc.) were made on behalf of PGM LLC to expatriates while seconded to the foreign host companies in the following amounts for each of the Tax Years at Issue: $93,463,835 (2011); $100,439,232 (2012); and $116,263,196 (2013)." Joint Stip. ¶ 117.

ISSUE IN DISPUTE

"PepsiCo excluded FLNA from the 2011, 2012 and 2013 Illinois Combined Tax Returns as an 80/20 Company pursuant to 35 ILCS 5/1501(a)(27)." Joint Stip. ¶ 130. During the Tax Years at Issue, FLNA's average foreign property and foreign payroll factors pursuant to 35 ILCS 5/1501(a)(27) equaled: 81.72% (2011); 86.54% (2012); and 87.18% (2013). Joint Stip. ¶¶ 137-139. For purposes of this case, the Department agrees it "will not dispute the payroll and property amounts reported for PepsiCo's 2011-2013 tax years, as set forth in Exhibit 35 through Exhibit 37, with respect to the following entities: FLNA (stand-alone entity); GMD Branch (branch of FLNA); FLNA Hong Kong; CEME; QFL; and Bev Svcs for purposes of the 80/20 company computation under 35 ILCS 5/1501(a)(27)." Joint Stip. ¶ 146. Instead, it is the *classification* of PGM LLC's payroll that is disputed: "[T]he Department agrees as to the completeness and accuracy of the[] dollar amounts reported for PGM LLC; however, the Department does not agree these amounts constitute PGM LLC's 'compensation' or 'wages' for purposes of the 80/20 company computations under 35 ILCS 5/1501(a)(27)." Joint Stip. ¶ 147.

Accordingly, the Tax Tribunal only need resolve one issue on summary judgment: Are PGM LLC's foreign expatriate employees' agreed compensation amounts properly included in FLNA's 80/20 Company calculation as "payroll" under Illinois law?

ARGUMENT

The Department's attempt to include FLNA in PepsiCo's combined group for the Tax Years at Issue is in direct conflict with Illinois law. The Department's results-oriented adjustment is improper for at least three reasons:

First, PGM LLC *is* the employer of the seconded expatriate employees as a matter of fact and law. PGM LLC (and FLNA) pay the seconded expatriate employees' wages. The

classification of the seconded expatriates as employees of PGM LLC is required for PGM LLC to function as a global *employment* company. This classification is required for valid and important business reasons completely separate and apart from the Illinois 80/20 Rule.

Second, PGM LLC is a global employment company formed in accordance with best practice and serves a critical role in the PepsiCo Corporate Group's overall global business operations. Accordingly, PGM LLC (and FLNA) must be respected.

Third, the PepsiCo Corporate Group's 2010 global restructuring impacted "every aspect of [the] business" -- including each of the six operating divisions: Frito-Lay North America; Quaker Foods North America; Latin American Foods; PepsiCo Americas Beverages; Europe; and Asia, Middle East, and Africa. *See* PepsiCo, Inc., Annual Report (Form 10-K), at P.48 (Feb. 27, 2012) and Joint Stip. ¶¶ 22-23.[2] Reorganizing foreign business operations underneath FLNA was an integral component of the global restructuring. *See id*. Accordingly, the economic substance and substance-over-form doctrines cannot be utilized to: (i) reverse PGM LLC's creation or placement under FLNA in the latter's reorganization; (ii) change FLNA's status as an Illinois 80/20 Company; or (iii) move PGM / FLNA to a different, yet to be identified, location within the PepsiCo Corporate Group of the Department's choosing.

I. FLNA Is An 80/20 Company

PGM LLC, a disregarded entity wholly owned by FLNA, is the employer of the seconded expatriate employees. The inclusion of PGM LLC's foreign compensation in the payroll factor, results in FLNA being an 80/20 Company under Illinois law.

---

[2] Excerpts of PepsiCo's 2011 Annual Report (Form 10-K) are attached to this memorandum as **Exhibit A**. The entire report may be accessed here: https://www.sec.gov/Archives/edgar/data/77476/000119312512081822/d269581d10k.htm.

A. The Illinois Unitary Combined Group Excludes "80/20 Companies"

The Illinois Income Tax Act ("IITA"), 35 ILCS 5/101, *et seq*., requires corporate taxpayers "that are members of the same unitary business group [to] be treated as one taxpayer for purposes of any original return …" 35 ILCS 5/502(e). The IITA defines "unitary business group" as "a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other." 35 ILCS 5/1501(a)(27)(A).

Notwithstanding the criteria above, for purposes of filing an Illinois combined return, "[t]he [unitary business] group *will not include* those members whose business activity outside the United States is 80% or more of any such member's total business activity …" 35 ILCS 5/1501(a)(27)(A) (emphasis added) (*i.e.*, the 80/20 Rule). In this regard, "business activity" is "measured by means of the factors ordinarily applicable under … Section 304 except that … such members shall not use the sales factor in the computation and the results of the property and payroll factor computations of subsection (a) of Section 304 shall be divided by 2 …" *Id*. Therefore, the exclusive measurements of foreign business activity for purposes of the 80/20 Rule are the property and payroll factors under Illinois law. *See* Ill. Admin. Code tit. 86, § 100.9700(c).

1. The Plain and Ordinary Language of Illinois's Statues and Regulations Control

"When interpreting a statute, the primary objective is to give effect to the legislatures intent, which is best indicated by the plain and ordinary language of the statute itself." *Hartney Fuel Oil Co. v. Hamer*, 376 Ill. Dec. 294, 302 (2013). "Administrative regulations have the force and effect of law and are interpreted with the same cannons as statutes." *Id*. at 305. With regard to the 80/20 Rule, "[s]uch exemptions are to be "strictly construed". *Zebra Tech. Corp. v. Topinka*, 334 Ill. App. 3d. 474, 484 (1st Dist. 2003). "Strict interpretation" means "[a]n

interpretation according the narrowest, most literal meaning of the words without regard for context and other permissible meanings." *Black's Law Dictionary* 980 (11th ed. 2019).

2. The Illinois Legislature Intended the Definition of "Unitary Business Group" to Provide "Certainty and Stability" to Illinois Taxpayers

From the very outset, the Illinois legislature intended the definition of "unitary business group" in 35 ILCS 5/1501(a)(27)(A) to provide "certainty and stability" necessary to attract business with the promise of understandable tax laws. In 1982, Governor James R. Thompson submitted to the Illinois legislature his recommendations for implementing domestic unitary combined reporting. *See* Letter from Governor James R. Thompson to the Illinois House of Representatives regarding House Bill 2588 (1982), attached to this memorandum as **Exhibit B**. Governor Thompson stated:

> Twenty-seven of the forty-six states which tax corporate income apply some form of combined reporting to unitary businesses. Of these, thirteen apply it on a world-wide basis. In most of these states combined reporting is applied by audit, by regulations or by an administrative ruling process. Illinois will not be unique in applying a form of combined reporting. With my changes, it will be unique in spelling out in *clear statutory language* how combined reporting is to be applied to unitary businesses.
>
> First, I am recommending that Illinois statutes clearly define a unitary business group as one in which the members are in the same line of business, are on the same apportionment formula, and are functionally integrated. In many of the other States which apply combined reporting, these definitions are not spelled out and taxation decisions may be arbitrary and may be based on factors other than *business activity*. With these definitions placed in the Statutes, Illinois will provide the *certainty and stability* so important to businesses, particularly those considering expanding within or into Illinois.
>
> Second, with my changes, I am rejecting world-wide unitary reporting. … [D]omestic combination *with clearly defined provisions* can prove to be a benefit to many businesses.
>
> … I believe that with these changes Illinois will assume a leadership role in the area of corporate taxation. Illinois is a state with a diverse economy and must treat all of its taxpayers fairly. With these changes Illinois will be attractive to businesses

> and will send the signal that we listen, we care, and we can make corrections in the tax system which benefit them and benefit the State as well.

Id. (emphasis added). Immediately thereafter, Governor Thompson specifically recommended the Illinois legislature enact the definition of "unitary business group" on the exact same material terms existing today -- more specifically, the exclusion of "those members whose *business activity* without the United States is 80 percent or more of any such member's total *business activity*", measured by the "property and payroll factor computations". *Id*. (emphasis added).

3. The 80/20 Rule Is A Mechanical Test

Consistent with the legislature's intent, the 80/20 Rule is construed in accordance with its clear statutory language:

> [T]he Department is attempting to use the term "business activity" in a generic sense rather than as specifically defined in the Income Tax Act and departmental regulation. Business activity as prescribed by the law, is to be measured by the property and payroll factors. … I expressly agree with the taxpayer's contention that the Department cannot go beyond the *statutory mechanical test* …

The Department of Revenue v. Taxpayer, IT 96-37 (Jan. 1996) (emphasis added).

Accordingly, the Illinois 80/20 Rule is -- and has always has been -- a straight-forward, mechanical test. The Illinois legislature could have chosen a different test, *e.g.*, the federal "80 percent of the gross income" test under IRC Section 861(c)(1)(A) (repealed after Dec. 31, 2010), but it chose the current regime over the last 40 years for the legitimate reasons outlined by Governor Thompson's letter.[3] As a result, the Illinois 80/20 Rule must be evaluated by applying

[3] For comparison of other options available to the Illinois legislature *see, e.g.,* Tex. Tax Code Ann. § 171.1014(a) ("The combined group may not include a taxable entity that conducts business outside the United States and has no property or payroll if 80 percent or more of the taxable entity's gross receipts … are assigned to locations outside the United States."); and Wis. Stat. § 71.255(2)(c) ("[I]f 80 percent or more of a corporation's worldwide income is active foreign business income, as defined in section 861(c)(1)(B) of the Internal Revenue Code, the income and apportionment factor or factors of the corporation shall not be included in the combined report, but the corporation shall compute and allocate or apportion its income from the

the clear property and payroll computations set forth in Illinois's statutes and restated in the Department's own regulations.

4. The Property Factor

The Illinois "property factor" "is a fraction, the numerator of which is the average value of the person's real and tangible property owned or rented and used in the trade or business in this State during the taxable year and the denominator of which is the average value of all the person's real and tangible personal property owned or rented and used in the trade or business during the taxable year." 35 ILCS 5/304(a)(1)(A); *see also* Ill. Admin. Code tit. 86, § 100.3350(d).

5. The Payroll Factor

The Illinois "payroll factor" "is a fraction the numerator of which is the total amount paid in this State during the taxable year by the person for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year." 35 ILCS 5/304(a)(2)(A). In this regard, a Department regulation clarifies the amount of "compensation" included in each employer's payroll factor is determined as follows: "The payroll factor of the apportionment formula for each trade or business of an employer shall include the total amount paid by the employer in the regular course of its trade or business for compensation during the tax period." Ill. Admin. Code tit. 86, § 100.3360(a)(1). For purposes of this rule, the regulation defines "compensation" by reference to Ill. Admin. Code tit. 86, § 100.3100. *See* Ill. Admin. Code tit. 86, § 100.3360(a)(3) and (a)(4).

a. "Compensation"

The term "compensation" "is defined in IITA Section 150[1](a)(3) to mean wages, salaries,

---

unitary business separately."). Under either of these other statutory regimes, FLNA would not be an 80/20 Company.

commissions and any other form of remuneration paid to employees for personal services. The term is thus the same as the term 'wages' as used in 26 U.S.C. § 3401(a), except that the exceptions set forth in the Code section are inapplicable for purposes of Article 3 of the Act [Allocation and Apportionment of Income]." Ill. Admin. Code tit. 86, § 100.3100(a). To this end, the IRC further defines "wages" as "all remuneration … for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash …" 26 U.S.C. § 3401(a).

b. "Employer"

The classification of an employer-employee relationship under federal tax law and common law controls for Illinois income tax purposes. Although the IITA and the Illinois payroll factor regulations do not expressly define the term "employer," where a term is undefined, "any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code." 35 ILCS 5/102. The IRC defines "employer" as: "[T]he person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that- (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' (except for purposes of subsection (a)) means the person having control of the payment of such wages …" 26 U.S.C. § 3401(d).

c. "Employee"

For Illinois payroll factor purposes, the term "employee" is defined through reference to federal law:

> Employee. Compensation is defined as remuneration for personal services performed by an "employee." If the employer-employee relationship does not exist, remuneration for services performed does not constitute "compensation." The term "employee" includes every individual performing services if the

> relationship between him and the person for whom he performs such services is the legal relationship of employer and employee. *The term has the same meaning under the Illinois Income Tax Act as under 26 U.S.C. Section 3401(c) and 26 CFR 31.3401(c)-1*.

Ill. Admin. Code tit. 86, § 100.3100(b) (emphasis added).

d. The Common Law "Employer-Employee" Relationship

In general, "the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services." Treas. Reg. § 31.3401(c)-1(b). "In this connection, it is not necessary that the employer actually direct or control the manner in which services are performed; it is sufficient if he has the *right* to do so." *Id*. (emphasis added). This "common law" analysis is the same analysis used to determine whether an employer-employee relationship exists under federal law. *See Cave v. Comm'r*, (RIA) T.C.M. 2011-48 (2011) ("The existence of an employer-employee relationship for income tax withholding purposes is determined generally by reference to the usual common law rules applicable in determining such relationships. See sec. 31.3401(c)-1, Employment Tax Regs.").

The IITA, and corresponding Department regulations, do not directly address global employment company ("GEC") expatriate secondments at issue in this matter. However, consistent with federal common law, under the Illinois Unemployment Insurance Act ("IUIA"), "direction or control" "means that an employing unit has the right to control and direct the worker, not only as to the work to be done but also as to how it should be done*, whether or not that control is exercised*." Ill. Admin. Code tit. 56, § 2732.200(g) (emphasis added); *see also Ross v. Cummins*, 7 Ill. 2d 595, 600 (1956) (where the Illinois Supreme Court held "[t]he control contemplated by [the IUIA] is general control, and the right to control may be sufficient even though it is not exercised."). With regard to "employing leasing" arrangements, the IUIA further states:

> Services performed by an individual under a contract between an employee leasing company and client … are services in "employment" of the employee leasing company and are not services in "employment" of the client if all the following conditions are met:
>
> 1. The employee leasing company pays the individual for the services directly from its own accounts;[4] and
>
> 2. The employee leasing company, exclusively or in conjunction with the client, *retains the right to direct and control* the individual in the performance of the services;[5] and
>
> 3. The employee leasing company, exclusively or in conjunction with the client, retains the right to hire and terminate the individual;[6] …

820 ILCS 405/206.1(B) (emphasis added). An "employee leasing company" is an "entity which contracts with a client to supply or assume responsibility for personnel management of one or more workers to perform services for the client on an ongoing basis …" 820 ILCS 405/206.1(A)(2).

6. The Right to Direct and Control the Seconded Employees Is the Key to the Common Law Employer Test

The criteria set forth by the Illinois legislature in 820 ILCS 405/206.1 is linked with the federal criteria established to determine the common law employer-employee relationship. *See* Ill. Admin. Code tit. 86, § 100.3100(b) (citing 26 U.S.C. § 3401(c) and Treas. Reg. § 31.3401(c)-1). Critically, the U.S. Tax Court has applied a common law analysis to arrangements where a U.S. employer temporarily assigns/seconds its employees to perform services for a foreign host entity. In *Striker v. Commissioner*, T.C.M. (RIA) 2015-248 (2015), Mr. Striker was precluded from claiming a foreign income exclusion for wages earned while deployed to NATO missions in

---

[4] *See* Joint Stip. ¶¶ 112, 120, 125-129 (actual cash payments to foreign expatriates originate in PGM LLC's books and records; payroll expenses are charged through PGM LLC's accounts of original entry).

[5] Joint Stip. ¶ 84 ("The seconded expatriates are required to do all things established by PGM LLC to complete the assignment and to adhere to all PGM LLC policies …").

[6] Joint Stip. ¶ 98 ("PGM LLC may end an assignment for any reason, including by termination of overall employment, upon written notice to the foreign host company.").

Afghanistan. The claimed foreign income exclusion at issue in *Striker* is codified in 26 U.S.C. § 911(a)(1) and allows individual taxpayers to "exclude payments from gross income if the taxpayer lived in a foreign country and received amounts 'from sources without the United States (except amounts paid by the United States).'" *See Gillis v. Commissioner*, T.C.M. (RIA) 1986-576 (1986).

The Tax Court employed a common law employer-employee analysis citing Treas. Reg. § 31.3401(c)-1 to determine whether Striker was eligible to exclude payments from gross income due to his assignment from the U.S. Army to a NATO mission organized in Afghanistan. The court determined Striker was an employee of the U.S. Army, not NATO, even though Striker was supervised by NATO personnel on a day-to-day basis. The following facts were central to the court's decision:

- "The Army paid [Striker] on the basis of standard U.S. Government pay scales. … The Army provided him with standard DoD fringe benefits, including health and retirement benefits." *Striker*, T.C.M. 2015-248.

- "The Army furnished him with a bi-weekly 'Civilian Leave and Earnings Statement' showing his gross pay and deductions." *Id.*

- "The Army reported petitioner's wages to the IRS on Forms W-2, Wage and Tax Statement, and withheld from his paychecks the required Federal income and employment taxes." *Id.*

- Furthermore, no contract existed between Striker and NATO, Striker did not receive any benefits from NATO, or otherwise show he was a NATO employee. *See id.*

Based on these facts, the Tax Court held the Army was Striker's employer because it had exclusive authority to hire, discipline, and fire him; it paid Striker's salary and provided all benefits; the Army directed where Striker would be deployed and periods of service; it subjected Striker to the same periodic performance evaluation which all Department of Defense intelligence personnel were subject; and it otherwise had the right to control Striker's work. *Id.*

7. Reimbursement Is "Irrelevant" Under the Common Law Employer-Employee Test

The facts in *Striker* "closely resemble those in *Gillis v. Commissioner* ..." *Striker*, T.C.M. 2015-248. The taxpayer in *Gillis* was an officer in the U.S. Air Force who was assigned to NATO in Germany and worked under the supervision of a German general. *See Gillis*, T.C.M. 1986-576. Like the taxpayer in *Striker*, Mr. Gillis claimed the foreign income exclusion for wages earned while assigned to NATO. The central issue analyzed was "whether the payments received by [Gillis] were amounts paid by the United States." *Id*.

Mr. Gillis asserted "he was employed by NATO and the source of his payments was NATO." *Gillis*, T.C.M. 1986-576. However, the Tax Court held that reimbursement by NATO did not mean Gillis was a NATO employee:

> "The fact that a third party was the ultimate source of the funds was *irrelevant* when that third party had no separate contract with the employees, and no authority to hire, fire or supervise them." … The same legal reasoning applies here. [Gillis] did not show he had a separate contract with NATO. He was assigned to NATO by the Air Force. NATO did not have the authority to hire petitioner or to fire him from the Air Force. Furthermore, [Gillis's] paycheck, was made out by the Air Force rather than NATO. Therefore, even if [Gillis] could prove that NATO was the original source of the funds used to pay his salary, he was controlled and paid directly by the Air Force.

Id. (citing *Smith v. Commissioner*, 701 F.2d 807, 809 (9th Cir. 1978) ("[A] United States customs inspector stationed in the Bahamas, could not exclude overtime pay because his salary was paid by the United States government even though the airlines had to reimburse the Customs Service for the added costs.")) (emphasis added). Therefore, the right to control the employee was the most determinative factor to the Tax Court in *Gillis*, even if NATO ultimately reimbursed the Air Force for the compensation paid.

8. The Temporary Nature of the Assignment Is Instructive and Material in Determining the Common Law Employer

The court in *Striker* contrasted *Adair v. Commissioner*, T.C.M. (RIA) 1995-493 (1995). In *Adair*, the taxpayer was a program analyst with the U.S. Army and was transferred from the Army to NATO after having applied to NATO for a three-year post on NATO's international staff. The court held Mr. Adair was a common law employee of NATO, not the Army, because he had a three-year renewable contract with NATO, he was required to swear an oath of loyalty to NATO and to refuse to accept instructions from the U.S. government, NATO established rules regarding his work hours, holidays and leave rights, and he was subject to performance evaluations and direction from NATO supervisors, the sequence of his tasks, and the means by which the desired results were to be obtained. *See id.* Further, NATO could terminate Adair for reasons including unsatisfactory performance or incapacitation, while the Army did not have the right to require Adair's return to the Army before the expiration of the agreed-upon term. *Id.* In reviewing the relevant factors under the common law employer-employee test, the *Adair* court stated "the control factor overlaps many other factors and is often cited as the fundamental or 'master' test of an employment relationship." *Id.*

The *Adair* court also distinguished individuals who are "detailed"-- that is, "loaned" or "assigned" (*e.g.*, Striker and Gillis) -- from those who are "transferred" (*e.g.*, Adair) for purposes of determining the nature of the relationship / the intent of the parties in a foreign work arrangement. *See Adair*, T.C.M. 1995-493. Under the Federal Employees International Organization Service Act, an "assigned" or "loaned" worker "is deemed an employee of the agency from which detailed for the purposes of preserving his allowances, privileges, rights, seniority, and other benefits, and he is entitled to pay, allowances, and benefits from funds available to that agency." 5 U.S.C. § 3343 ("Details; to international organizations"). In contrast, the term

"transfer" means "a change of position by an employee from an agency to an international organization." 5 U.S.C. § 3581 ("Definitions").

As part of its common law employer-employee analysis, the Tax Court concluded "[u]nlike a detail, a transfer was considered a change in position." *Adair*, T.C.M. 1995-493. Indeed, a "transferred" employee changes his / her position entirely from one agency to an international organization / entity, and thus, loses his / her status of employment, including entitlement to "pay, allowances, and benefits from funds available" from the original employer. *Id*.

9. The Common Law Factors Summarized

In sum, the *Striker*, *Gillis*, and *Adair* decisions apply a common law employer-employee analysis under 26 U.S.C. § 3401(c) and Treas. Reg. § 31.3401(c)-1 to temporary foreign work assignments/secondments. Specifically, in cases where a U.S. employer temporarily assigns an individual to provide day-to-day services to a foreign host entity, "[t]he common law factors most relevant to the latter determination are the right to control, the right to discharge, the permanency of the relationship, and the nature of the relationship the parties believed they were creating." *Striker*, T.C.M. 2015-248.

In this regard, each of these factors are demonstrated as follows: i) *The Right to Control* - the home employer retains the right to control the employee and the manner in which the work is performed by the employee, *i.e.*, the right to control the services performed, the right to control the term of the assignment, and the right to control compensation; ii) *The Right to Discharge* - the home employer retains the exclusive right to terminate the employee's overall employment; iii) *The Permanency of the Relationship* - the assignment to the host employer is temporary nature; and iv) *The Nature of the Relationship Created* - all documentation regarding the assignment

reflects the intent that the seconded employee remain an employee of the home employer. *See Striker*, T.C.M. 2015-248 and Internal Revenue Service National Field Service Advice, FSA 199917010 (May 1999) ("The contractual designation of the worker is 'very significant in close cases.'").

According to the common law criteria analyzed in *Striker*, *Gillis*, and *Adair*, the following factors are of less importance in the context of employment in foreign work arrangements: the individual's level of integration into the host company's business; the level of day-to-day supervision provided by the host company; training provided by the host company; and performance reports provided by the host company. *See Striker*, T.C.M. 2015-248 ("Petitioner urges that several of these factors point to his status as an employee: … [including] he did not provide his own tools or workspace. But these factors are chiefly relevant in determining whether a person is an independent contractor as opposed to an employee."); (a contractor was determined to be "an employee of the United States where [the] agency had the right to control the taxpayer's work even though his work 'was not supervised or controlled on a day-to-day basis.'"); ("Petitioner regularly participated in NATO-sponsored training and workshops, some of which were mandatory."); and ("The [NATO] team leader conducted petitioner's performance evaluations but had no authority to discipline him or discharge him from his post."); *Weber v. Comm'r*, 103 TC 378, 388 (1988) (an employer "need not stand over the employee and direct [his] every move" in order to exercise the requisite control.).

B. <u>PGM LLC Is The Employer of Its Expatriate Employees In Fact and Law</u>

The Department's singular argument with regard to the 80/20 Rule is whether PGM LLC payroll amounts constitute "compensation" of that entity as the employer of its foreign expatriate

employees. *See* Joint Stip. ¶ 147. The Department's position does not withstand scrutiny based on the facts and applicable law and authorities.

1. PGM LLC Is Disregarded From FLNA But Is An Employer for Federal and Illinois Tax Purposes

Illinois law conforms to federal entity classification rules. 35 ILCS 5/403(a); 35 ILCS 5/1501(a)(4). FLNA directly owns PGM LLC, a single member LLC under federal law. Joint Stip. ¶ 27. Therefore, FLNA is required to treat PGM LLC -- a disregarded entity -- as a branch for both federal and Illinois corporate income tax purposes. *See* 35 ILCS 5/403(a); 35 ILCS 5/1501(a)(4). All property and payroll reported by PGM LLC is reported directly by FLNA under the IITA. *Id.*[7]

2. PGM LLC Is the Employer of Its Seconded Expatriate Employees In Fact

PGM LLC is the employer of expatriates seconded / assigned to the foreign host companies and paid compensation in the exact amounts reported in FLNA's 80/20 Company computations for the Tax Years at Issue. Supporting evidence includes (but is not limited to):

- **Form W-2, Wage and Tax Statements for PGM LLC Employees**. These documents verify PGM LLC directly pays its employees' wages, and thus, is their employer for federal and Illinois tax purposes. Joint Stip. ¶ 115 and Exhibit 27.
- **Form 941, Employer's Quarterly Federal Tax Return (FICA)**. PGM LLC files each of these forms on behalf of its employees as required by federal law. Joint Stip. ¶ 116 and Exhibit 28.
- **Letters of Understanding / Secondment Agreements**. These agreements outline the terms of employment between PGM LLC and its expatriate employees and state the obligations between the parties, including PGM LLC compensating the seconded employees and reimbursement from the host companies for the costs of employment, *i.e.*, base salary, bonus payments, contributions under 26 U.S.C. § 401(k), etc. Joint Stip. ¶¶ 63-64 and Exhibits 25-26.

---

[7] For U.S. income and social security tax withholding purposes, PGM is considered the direct "employer" regardless of its status as a disregard entity. *See* Treas. Reg. § 301.7701-2(c)(2)(iv)(B).

- **PepsiCo Global Mobility Progress Toward Transformation Slide Decks**. These documents overview the critical services provided by the Global Mobility HR Function, including "providing management and support functions to PGM LLC and the expatriates". Joint Stip. ¶¶ 99-110, Exhibits 8-9 and 17-24.

- **PGM LLC Benefits Plans.** PGM LLC expatriates are eligible to participate in the PepsiCo Corporate Group's U.S. savings plan, pension plan, healthcare plan, etc. Joint Stip. ¶¶ 63, 79-82, 95-96, 117, 119 and Exhibit 29.

- **PGM LLC Books and Records**. These documents show all compensation expenses originate with PGM LLC and are then invoiced to the foreign host companies and reimbursed by the foreign host companies as the "secondment fees" agreed to in the secondment agreements. Joint Stip. ¶¶ 111-129 and Exhibits 30-34.

- **PGM LLC Payroll Reports** -- Original and contemporaneous business records listing the total number of PGM LLC expatriates and their compensation amounts included in FLNA's 80/20 Company computation for the 2011 - 2013 tax years. Joint Stip. ¶¶ 30-32, 63-64, 117 and Exhibit 4.

In sum, these documents prove PGM LLC is the employer of its expatriates who work outside the United States and pays these employees' compensation / wages, issues W-2s, withholds taxes, etc. All PGM LLC compensation amounts tie to FLNA's 80/20 Company computations and are sourced to the expatriates' base of operations in the foreign host company jurisdictions in accordance with Ill. Admin. Code tit. 86, § 100.3120(a)(1) -- that is, "the place or fixed center from which [each PGM LLC expatriate] works." Ill. Admin. Code tit. 86, § 100.7010(d). As a result, FLNA's property and payroll factors, with the inclusion of compensation paid by PGM LLC, exceeds "80% or more of [FLNA's] total business activity" "outside the United States" pursuant to IITA Section 1501(a)(27) for the Tax Years at Issue -- 81.72% average foreign property and payroll in 2011; 86.54% average foreign property and payroll in 2012; and 87.18% average foreign property and payroll in 2013. *See* Joint Stip. ¶¶ 137, 138, and 139.

3. PGM LLC's Employment of Its Expatriates Constitutes a Common-Law Employer-Employee Relationship

PGM LLC is the common law employer of its expatriate employees pursuant to Ill. Admin. Code tit. 86, § 100.3100(b) (citing 26 U.S.C. § 3401(c) and Treas. Reg. § 31.3401(c)-1) because:

i) it has the right to control the employees; ii) it has the right to discharge its employees; iii) each seconded expatriate is employed by PGM LLC and temporarily assigned / seconded to the applicable foreign host company; and iv) all documentation clearly proves PGM LLC, its expatriate employees, and the foreign host companies intended PGM LLC to remain the common law employer throughout the duration of the assignment/secondment. *See Striker*, T.C.M. 2015-248.

a. *PGM LLC Has the Right to Control and Direct Its Expatriate Employees*

PGM LLC has "the right to control and direct the individual who performs the services" pursuant to Ill. Admin. Code tit. 86, § 100.3100(b) (citing 26 U.S.C. § 3401(c) and Treas. Reg. § 31.3401(c)-1). This is evidenced by PGM LLC's actual right to control the services performed by its expatriates, PGM LLC sets the term of each assignment, and it controls its employees' compensation.

i. Right to Control Over the Services Performed

The *right* to control does not mean actual control need be exerted on a day-to-day basis. Indeed, federal regulations state: "[T]he relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services." Treas. Reg. § 31.3401(c)-1(b) (as cited in Ill. Admin. Code tit. 86, § 100.3100). "In this connection, it is not necessary that the employer actually direct or control the manner in which services are performed; *it is sufficient if he has the right to do so*." *Id*. (emphasis added). Here, PGM LLC "causes" the seconded individuals to provide "services" to the host companies. *See* Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 1) (PEP00001643). In accordance with the agreement, PGM gives the seconded individuals instructions on where to

be, when to be there, and when to come back. Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 3) (PEP00001643).

More specifically, the letters of understanding and the secondment agreements uniformly state:

- "The seconded expatriates are required to do all things established by PGM LLC to complete the assignment and to adhere to all PGM LLC policies and to the laws and regulations of any country in which the seconded expatriate is assigned." Joint Stip. ¶ 84.

- PGM LLC is the "Employer" of the "individuals who are […] seconded to [the] Host Company pursuant to this Agreement." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 1) (PEP00001642).

- As the Employer, "PepsiCo Global Mobility LLC *shall cause* the Employees to perform the Role [or "Services"] in accordance with the terms of this Agreement." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 1 (emphasis added)) (PEP00001643).

- The "Roles" (or "Services") which PGM LLC "causes" its "Employees to perform" include: HR Senior Vice President, Communications Director, Financial Planning and Analysis, Chief Financial Officer, Communication Manager, etc. Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Schedule 1) (PEP00001651).

- "During the term, the Employees are and shall remain employed by Employer [PGM LLC]." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 5) (PEP00001644).

While PGM LLC retains the right to control throughout its expatriate's employment, "PGM LLC *cedes* to the foreign host company the right to direct, control, and supervise the *day-to-day* services performed by the seconded expatriate." Joint Stip. ¶ 84 (emphasis added). Simply put, you can't give what you don't have.[8] Consistent with this fundamental precept, PGM LLC retains the overall "right to control and direct the individual who performs the services" for the entire

[8] From the common law maxim, *nemo dat quod non habet* ("No one gives what he does not have; no one transfers (a right) that he does not possess."). *Black's Law Dictionary* 1983 (11th ed. 2019).

assignment in accordance with Treas. Reg. § 31.3401(c)-1, Joint Stip. ¶ 85, and the controlling legal documents. Federal case law succinctly summarizes this point:

> In short, even though the taxpayer in *Gillis* was subject to the *day-to-day* supervision of a German NATO commander, we concluded that he was "controlled by the Air Force" because the Air Force hired him, paid his salary, assigned him to the NATO post, and had exclusive authority to discharge him from military service.

Gillis, T.C.M. 1986-576 (emphasis added).

Not only does PGM LLC have the right to control its expatriate employees, but it actually exerts control as a functional GEC. To this end, "[t]he degree of control necessary to find an employer-employee relationship varies depending on the nature of the services provided by the worker. … The level of control necessary to find employee status generally is lower when applied to professionals than when applied to non-professionals." *Cave*, T.C.M. 2011-48. In every case, PGM LLC expatriate employees are "high-performing executives, directors, managers, [or] analysts ..." Joint Stip. ¶ 62. "Line level employees (staff, factory workers, clerks, etc.) are not eligible for assignments as part of the Expatriate Program." Joint Stip. ¶ 77. PGM LLC employees are assigned to the foreign host companies to lead and develop the business in foreign markets by "provid[ing] highly skilled industry knowledge and technical expertise not otherwise available to the foreign host company through the local talent pool." Joint Stip. ¶ 73.

Naturally, then, the level of control PGM LLC must exercise over its employees is lower than if it employed lower-level line employees. *See Weber*, 103 TC 378, 388 ("The threshold level of control necessary to find employee status is generally lower when applied to professional services than when applied to nonprofessional services."). Within the PepsiCo Corporate Group's human resources global mobility function, "there are approximately twenty individuals located throughout the world who execute employee transfers, relocations, and secondments through the PepsiCo Corporate Group in locations across the world." Joint Stip. ¶ 100 and Exhibit 8 (to be

exact: 32 individuals (2011); 19 individuals (2012); and 23 individuals (2013)) (PEP00002531). A significant portion of these individuals' time is "devoted to management and support functions for PGM LLC and its expatriates." Joint Stip. ¶ 103. "In providing management and support functions to PGM LLC and the expatriates, the Global Mobility HR Function addresses HR issues unique to expatriate assignments such as education, immigration, and work permit issues." Joint Stip. ¶ 104. Accordingly, while not exerting day-to-day control over the highly skilled PGM LLC expatriates, these individuals are exerting "management and support functions" in a very real and practical way required for any effective GEC.

ii. Right to Control the Term of the Assignment

In addition to "causing" its expatriate employees to perform services for the foreign host companies, PGM LLC sets the length / term of each assignment:

> Employer [PGM LLC] will second the Employees identified on Schedule 1 to Host Company for the period specified in Schedule 1 subject to earlier termination …

Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 2.1) (PEP00001643).

The letters of understanding further state: "The duration of your assignment is an estimate and, at any time after the effective date of this Letter, you may be reassigned to another location in which the Company [PGM LLC] or any of its affiliates does business." Joint Stip. ¶ 64, Exhibit 26 (R. Provillon Letter of Assignment, Page 5 (PEP00000125)).

iii. Right to Control Compensation

PGM LLC controls its employees' compensation during their assignments, as supported in detail by the record:

- "Actual cash payments made to seconded expatriates originate in PGM LLC's books and records as payroll expense." Joint Stip. ¶ 112.
- "[E]ach Employee shall remain on Employer's [PGM LLC's] payroll during the Term and shall continue to be eligible to participate in Employer's employee benefit plans

…." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 4.1) (PEP00001644).

- "Income taxes are withheld and U.S. payroll and employment taxes are remitted in PGM LLC's name on payments to expatriates who are seconded outside the U.S." Joint Stip. ¶ 114.
- "Forms W-2, Wage and Tax statements were submitted in PGM LLC's name when required under U.S. law to the expatriates seconded to foreign host companies." Joint Stip. ¶ 115
- "Federal Insurance Contributions Act ("FICA") tax was withheld from payments to expatriates. That tax was remitted in PGM LLC's name to the IRS on Form 941, Employer's Quarterly Federal Tax Return." Joint Stip. ¶ 116.
- "Employer [PGM LLC] will, with respect to each Employee, withhold and remit in a timely manner all payroll and employment taxes required by statute, law, rule or regulation to be so withheld and paid by an employer on behalf of such employee […]." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 4.1) (PEP00001644).
- "In consideration of Employer making available the Employees and the provision of the Services by the Employees for Host Company, Host Company will pay to Employer a secondment fee based on the cost to Employer of each Employee's compensation, benefits and reimbursed business expenses as agreed to from time to time between Employer and Host Company." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 3.1) (PEP00001643).

While PGM LLC is ultimately reimbursed by the foreign host companies, this fact does not alter the determination that it controls its employees' compensation. In *Gillis*, the U.S. Tax Court held: "The fact that a third party was the ultimate source of the funds was *irrelevant* when that third party had no separate contract with the employees, and no authority to hire, fire or supervise them." *Gillis*, T.C.M. 1986-576 (emphasis added).

Here, actual cash payments made to seconded expatriates originate in PGM LLC's books and records as payroll expense, which, like all other PepsiCo Corporate Group U.S. entities, are properly charged through a single general ledger payroll account unique to the employer-entity, *i.e.*, PGM LLC. Joint Stip. ¶¶ 113, 125-128. In contrast, the foreign host companies reimburse the payroll expense PGM LLC bears as the employer. *See* Joint Stip. ¶¶ 113, 118, 119, 126, and 128; *see also* Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 3.1) (noting the

reimbursed amounts comprise the "secondment fee" agreed to in the secondment agreements.) (PEP00001643). Accordingly, PGM LLC controls every aspect of its employees' compensation, *i.e.*, payment of wages, withholding of taxes, furnishing wage statements, filing FICA returns, etc. *See* Joint Stip. ¶¶ 111-129.

b. *PGM LLC Has the Right to Discharge Its Expatriate Employees' Overall Employment*

In each secondment agreement, PGM LLC retains the right to terminate each individual's secondment and overall employment:

- "A foreign host company may end an assignment for any reason upon written notice to PGM LLC; however, the Secondment Agreement does not provide the foreign host company the right to terminate a seconded expatriate's overall employment." Joint Stip. ¶ 97.
- "PGM LLC may end an assignment for any reason, including by termination of overall employment, upon written notice to the foreign host company." Joint Stip. ¶ 98.

Accordingly, while the foreign host company may end the foreign assignment "for any reason", only PGM LLC, not the host company, can terminate the employee from his/her overall employment. *See* Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 7.1(b)) (PEP00001645). In *Striker*, the Tax Court stated that the NATO commander could exclude Striker from the base effectively ending his assignment. *See Striker*, T.C.M. 2015-248. Nevertheless, the court held the U.S. Army "had exclusive authority to discharge him from military service"; not just the NATO assignment. *Id.* Thus, a foreign host company's ability to end an assignment does not mean it has the right to discharge an individual from overall employment. In this case, such ultimate power lies solely with PGM LLC. *See id.*

c. *Permanency of the Relationship*

The U.S. Tax Court draws a distinction between assignments where an individual is temporarily "detailed", "loaned", or "assigned" (*e.g.*, *Striker* and *Gillis*) -- from those assignments

where the individual is permanently "transferred" (*e.g.*, *Adair*) for purposes of determining the nature of the relationship / the intent of the parties in a foreign work arrangement. *See Adair*, T.C.M. 1995-493. Here, all PGM LLC expatriate employees are *assigned* -- not transferred -- to the foreign host companies on a temporary basis. *See* Joint. Stip. ¶ 78. ("The term/duration of the temporary assignment is set in advance of the secondment and typically lasts no longer than three to five years."). The temporary nature of these assignments are in fact core to the purpose of the PepsiCo Corporate Group's Expatriate Program. *See* Joint. Stip. ¶ 62 (the secondments are intended to fulfill "*temporary* key roles with the objective of developing and retaining talent and expanding foreign business operations.") (emphasis added). Therefore, the pool of expatriates employed by PGM LLC changes every year. *See id.*

d. *Nature of the Relationship Created*

Finally, all documentation verifies the nature of the relationship the parties (PGM LLC, its employees, and the foreign host companies) believed they were creating -- that is, a relationship where PGM LLC remains the common law employer of the employees throughout the duration of the secondment:

- "PGM LLC and each seconded expatriate agree to a Contract of Employment / Letter of Understanding." Joint Stip. ¶ 84.
- "In the Secondment Agreements and accompanying Letters of Understanding, the Parties state their intent that the expatriates remain employed by PGM LLC during the term of the assignment." Joint Stip. ¶ 85.

There is thus no factual dispute that PGM LLC was *intended to be* the common law employer of the seconded expatriates from the outset. And the reason for this extends far beyond state taxation. For example, and as described in detail below, continued participation in the PepsiCo Corporate Group's U.S. benefits plans are contingent upon a common-law U.S. employer-employee relationship. *See, e.g.*, Joint Stip. ¶¶ 67, 82, Exhibit 29, and Treas. Reg. §§ 1.401(k)-6

and 1.410(b).

II. PGM LLC Is Critical to the PepsiCo Corporate Group's Global Success

PGM LLC is a "global employment company" and serves the PepsiCo Corporate Group's global business operations in accordance with best practices -- that is, PGM LLC seconds the right people to the right places, at the right time, with proper support in a lawful manner, to develop foreign non-U.S. entity business operations at the ground level with high-performing expatriate managers, directors, and executives. *See* Joint Stip. ¶¶ 62, 73, 75, 77, 92 and Exhibits 17-24. In turn, seconded expatriates develop critical experience and leadership capabilities during their assignment for continued use upon repatriation. *Id*.

A. Global Employment Companies Are Best Practice

In today's global economy, multinational companies have recognized "their futures are heavily dependent on the development of a cadre of ambitious and talented mobile employees with a genuine international outlook." Matthew Howse and Lee Harding, "Dealing with International Assignments", *Labour & Employment in 39 Jurisdictions Worldwide* (2014).[9] "In the war for talent, a sophisticated international employee mobility [program] is vital in attracting and retaining tomorrow's future business leaders." *Id*.

1. Key Business Reasons for Utilizing a Global Employment Company

In its most basic sense, a GEC is a separate corporate entity that exists to provide "employment-related services globally to the organizations international operations or projects." Michael Dickmann & Yehuda Baruch, *Global Careers* 270 (2011). The GEC is generally

[9] A court may take judicial notice of articles where not offered for the truth of the opinions expressed in them, but rather to show the existence of public knowledge. *See Ner Tamid Congregation v. Krivoruchko*, 638 F. Supp. 2d 913, 925 n.8 (N.D. Ill. 2009) (exercising judicial notice of law journal and newspaper articles to show that a public debate existed about the risk of recession).

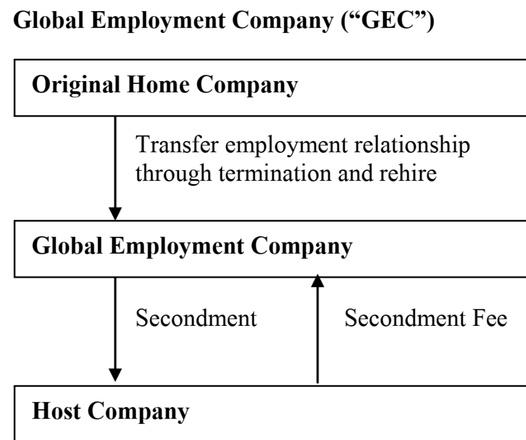
"responsible for the employment, compensation and benefits, immigration and income and social tax matters" for expatriate employees. Andrew Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?", *The National Law Review* (2014). In this regard, throughout the duration of an assignment, the GEC enables "continuous employment with one entity" and "handles all required administrative support" for the expatriate working outside his/her home country. *See id*.

The GEC provides "uniform global compensation and benefits for [internationally mobile employees] moving through numerous locations." Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?". For instance, U.S. citizens who are internationally mobile "usually prefer to remain on US retirement and other benefits for ease of administration and tax planning. These individuals may also wish to remain on the US Social Security system to avoid reduced benefit resulting from ineligible employment." *Id.* In turn, GECs "protect the parent company from myriad local employment laws and suits, and can achieve employment taxes in the GEC home country that are more predictable … than those in many other locations." *Id*. With regards to foreign tax exposure, "[a] GEC can serve to protect members of a controlled group being subject to tax in a foreign jurisdiction if an [employee's] activities were to create a corporate taxable presence or permanent establishment in the host country." *Id*.

2. Structuring An Effective Global Employment Company

Establishing a GEC "requires careful planning to ensure the employment arrangement will be respected by local authorities." Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?". From a legal entity standpoint, the GEC "is typically a separate legal entity that provides employee services to other entities in exchange for a management or service fee." "Global Mobility Companies - Time to Rethink their Strategic Value?" PricewaterhouseCoopers

(2018). "The GEC typically becomes the contractual employer for a specified population of globally mobile employees who may travel to and/or be seconded to other global entities within the organization." *Id*. Accordingly, GECs are commonly formed in accordance with the following basic structure:



Pursuant to this structure, the GEC owns the overall employment relationship with the employee, is responsible for core employment functions, retains the right to hire and fire, and controls compensation. *See id*. As the legal employer, the GEC generally is not responsible for the day-to-day supervision / instruction of the expatriate employee. *Id*.

B. <u>Formation of PGM LLC Was Necessary to Consolidate and Unify Various Expatriate Entities, Programs, and Policies</u>

"Prior to PGM LLC's formation, the PepsiCo Corporate Group utilized three separate Expatriate Program entities for foreign-based (non-U.S.) secondments -- Beverages Foods & Services, Inc. (PepsiCo Corporate Group), C&I Leasing, Inc. (PBG), and Pepsi-Cola General Bottlers, Inc. (PAS)." Joint Stip. ¶ 57. In this regard, the PepsiCo Corporate Group utilized BFSI "as the employing entity for expatriates since the [19]90's." Joint Stip., Exhibit 6 (PEP00002882). "[E]mploying expatriates through BFSI mitigated the risk of exposing profits of other PepsiCo entities to taxation in foreign countries because of presence and/or activities of expatriates." *Id*.

However, in connection with a transition to an alternate payroll service provider, "Hewitt Services", "BFSI payroll was eliminated"; and as a result, the PepsiCo Corporate Group no longer had a separate entity to employ expatriates. *Id*. "All expatriates & inpatriates who were paid by BFSI were [thus] transferred to PepsiCo, Inc." *Id*. "PepsiCo, Inc. essentially became their employer, although BFSI [was improperly] referenced [in] their Letter of Understanding and secondment agreement." *Id*.

This employment structure resulted in "approximately 200 U.S. / foreign national expatriates within the PepsiCo Corporate Group -- consisting of high performing executives, managers, and analysts -- [being] scattered across various PepsiCo affiliates (including former PBG and PAS affiliates [C&I Leasing, Inc. (PBG) and Pepsi-Cola General Bottlers, Inc. (PAS)]) and seconded outside the U.S. to serve the various businesses of the PepsiCo Corporate Group as part of the then-existing Expatriate Programs." *See* Joint Stip. ¶¶ 54, 57. Consequently, U.S. entities -- including PepsiCo, Inc. -- were unnecessarily exposed to direct legal and taxing authority of foreign jurisdictions due to "the presence and/or activities of expatriates." *See* Joint Stip., Exhibit 6 (PEP00002882).

The PepsiCo Corporate Group "launched a project with Corporate Tax & Legal to resolve the compliance issue related to the employment structure" caused by the elimination of BFSI's payroll and the acquisition, consolidation, and harmonization of PBG's and PAS's expatriate employer entities and related policies. *See* Joint Stip., Exhibit 6 (PEP00002882); *see also* Joint Stip. ¶¶ 54, 57. At this same time, PwC was engaged to evaluate PepsiCo Corporate Group's existing global mobility practices. PwC ultimately recommended that existing practices be improved by, among other things, eliminating "[s]ignificant duplication of effort across the function [and] opportunities to streamline, automate, [and] remove non-value added work". Joint

Stip. ¶¶ 54-55.[10] The PepsiCo Corporate Group created PGM LLC under Delaware law as a single member LLC disregarded for federal and state income tax purposes. *See* Joint Stip. ¶ 27 and Exhibit 6 (PEP00002883). "After PGM LLC's formation, the PepsiCo Corporate Group utilized PGM LLC as the single Expatriate Program entity for foreign-based (non-U.S.) secondments." Joint Stip. ¶ 58.

C. PGM LLC Operates As A Global Employment Company In Accordance with Best Practice

PGM LLC is a GEC formed in accordance with global mobility workforce best practices. Each individual within the PepsiCo Corporate Group who is selected for assignment as a PGM LLC expatriate severs ties with the individual's original employer and his / her overall employment is formally transferred to PGM LLC. *See, e.g.,* Joint Stip. ¶ 64 and Exhibit 26 ("Letter of Understanding") (PEP00000121-129). As a result, "PGM LLC and each seconded expatriate agree to a Contract of Employment / Letter of Understanding." Joint Stip. ¶ 84. Each PGM LLC employee executes a Letter of Understanding countersigned by an authorized PGM LLC representative. *Id*. The Letter of Understanding confirms the individual's employment with PGM LLC and "outlines the principle terms which will apply during [the] assignment". Joint Stip., Exhibit 26 (PEP00000121-129). In this regard, each seconded expatriate is "required to do all things established by PGM LLC to complete the assignment and to adhere to all PGM LLC policies and to the laws and regulations of any country in which the seconded expatriate is assigned." Joint Stip. ¶ 84. Furthermore, the Letter of Understanding states, among other things: i) the physical location where the individual is assigned while employed by PGM LLC; ii) the foreign host company to whom the PGM LLC expatriate has been assigned to provide day-to-day services; iii)

[10] PwC did not provide PepsiCo with advice on where to place PGM LLC within the corporate structure.

job title; iv) salary amount; v) employee benefits; and vi) the anticipated duration of the assignment. *See* Joint Stip. ¶ 64, Exhibit 26 (PEP00000121-129).

In conjunction with each PGM LLC expatriate executing a Letter of Understanding, "PGM LLC and the applicable foreign host company execute[] a Secondment Agreement." Joint Stip. ¶ 63 and Exhibit 25. In accordance with each Secondment Agreement: "PGM LLC temporarily assigns each seconded expatriate to a foreign host company and causes that expatriate to provide specific technical services to the applicable foreign host company." Joint Stip. ¶ 84. "The jobs the seconded expatriates perform while on assignment are mid-level to senior-level jobs within the PepsiCo Corporate Group. Examples of services/roles performed by the seconded expatriates include (but are not limited to): executive management, human resources, business strategy and development, communications, marketing, and financial planning. Line level employees (staff, factory workers, clerks, etc.) are not eligible for assignments as part of the Expatriate Program." Joint Stip. ¶ 77.

"PGM LLC cedes to the foreign host company the right to direct, control, and supervise the day-to-day services performed by the seconded expatriate." Joint Stip. ¶ 84. However, "[t]he temporary assignment is conditioned upon the continuation of an employment relationship between PGM LLC and the seconded expatriate." *Id*. Furthermore, in accordance with the Secondment Agreements, "PGM LLC may end an assignment for any reason, including by termination of overall employment, upon written notice to the foreign host company." Joint Stip. ¶ 98. In consideration of PGM LLC making available its employees and the provision of services by its employees for the foreign host companies, each foreign host company pays to PGM LLC "a secondment fee based on the cost to Employer [PGM LLC] of each Employee's compensation benefits and reimbursed business expenses as agreed to … between Employer and Host

Company." Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 3.1) (PEP00001643).

Finally, the personnel within the PepsiCo Corporate Group's Global Mobility HR Function provide day-to-day "management and support functions to PGM LLC and the expatriates" "such as education, immigration, and work permit issues." Joint Stip. ¶ 104. More specifically, "[t]he Global Mobility HR Function was divided into three main teams to oversee each expatriate seconded by PGM LLC: 1) the '**Center of Excellence Team**' [to drive strategy, best practices, policies, reporting, guidance, etc.]; 2) the '**Services Team**' [initiating relocations, preparing packages for seconded employees, executing core processes, and resolving issues]; and 3) the '**Relationship Team**' [managing the seconded employees overall experience, providing training, education support, and teaching support, etc.]." Joint Stip. ¶¶ 105-110.

D. PGM LLC Provides Critical Benefits to the PepsiCo Corporate Group

PGM LLC is essential to the success of the PepsiCo Corporate Group's global operations, providing -- at minimum -- seven critical benefits. Each of these benefits exemplify how legitimate and genuine intercompany legal relationships impact the economic welfare of the parties involved. *See Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 124 (2nd Cir. 1956) ("all legitimate and genuine corporation-stockholder arrangements have legal -- *and hence economic* -- significance, and must be respected in so far as the rights of third parties, *including the tax collector*, are concerned.") (emphasis added).

1. Limit U.S. Entity Legal Liability in Foreign Jurisdictions

"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 those executives are assigned." Joint Stip. ¶ 65. *See also* Liazos,

"Global Employment Company: Is It the Right Fit for Your Organisation?" ("GECs can also better protect the parent company from myriad local employment laws and suits"); and Dickmann, *Global Careers* 281 ("failing to comply with local regulations, or getting that compliance wrong, can seriously expose the business to a legal challenge from employees, partners or the authorities.").

2. U.S. Benefits Plan Eligibility

"Having a single entity, like PGM LLC, [second] all outbound expatriate employees: (i) preserves seconded employees' continued participation in U.S. benefits plans (*e.g.*, pre-tax retirement contribution plans authorized under 26 U.S.C. § 401(k));" Joint Stip. ¶ 67. To this end, "[d]ue to their Secondment Agreement with PGM LLC, a U.S. entity, seconded expatriates are eligible to participate in the PepsiCo Corporate Group's U.S. benefits plans, including: the PepsiCo Savings Plan; the PepsiCo Salaried Employees Retirement Plan; the PepsiCo Pension Equalization Plan for the Pre-Section 409A Program; the PepsiCo Pension Equalization Plan for the Section 409A Program; the PepsiCo Automatic Retirement Contribution Equalization Plan; and the PepsiCo Employee Health Care Program." Joint Stip. ¶ 82. *See also* Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?" (Expatriates "often retire in the United States and usually prefer to remain on US retirement and other benefits for ease of administration and tax planning.").

PGM LLC's expatriates *must* be common law employees of PGM LLC (and remain so throughout the duration of their secondment) for reasons completely separate and apart from state tax considerations. For example, the PepsiCo (U.S.) Savings Plan requires:

- <u>Article II – Section 2.1, Eligibility to Participate (Page 33)</u>. "An Employee is eligible to participate in the Plan if he or she is classified by an Employer as being a *common law employee* of an Employer, is paid some or all of his or her cash remuneration from a U.S. payroll …" Joint Stip. ¶ 82, Exhibit 29 (PEP00003658) (emphasis added).

- Appendix L – List of Employers (Page 224). "As of January 1, 2011, each of the following members of the PepsiCo Organization is an "Employer" as defined in Article I: […] *PepsiCo Global Mobility LLC* […]." Joint Stip. ¶ 82, Exhibit 29 (PEP00003849) (emphasis added).

- "Eligibility You are eligible to participate in the plan if you are on a *U.S. payroll* …" Joint Stip. ¶ 82, Exhibit 29 (PEP00004278) (emphasis added).

- "Ineligible Employees You are NOT eligible to participate in the plan if you are: […] Not on a U.S. payroll (for this purpose, U.S. payroll means the 50 states and the District of Columbia) …" Joint Stip. ¶ 82, Exhibit 29 (PEP00004278-4279).[11]

Critically, the foreign host companies are *not* eligible employers for the PepsiCo (U.S.) Savings Plan because they do not compensate their employees from U.S. payroll. *See id.* If the PGM LLC expatriates were improperly deemed common law employees of the foreign host companies, eligibility to participate in the PepsiCo (U.S.) Savings Plan (and other benefit plans) would terminate for the duration of the assignment. *See* Joint Stip. ¶ 82 ("Due to their Secondment Agreement with PGM LLC, a U.S. entity, seconded expatriates are eligible to participate in the PepsiCo Corporate Group's U.S. benefits plans, including: the PepsiCo Savings Plan", etc.). *See also* Joint Stip. ¶¶ 67, 81.

Without question, then, it is unlikely anyone would volunteer for a foreign assignment where critical U.S. retirement benefits are completely forfeited for three to five years. *See* Joint Stip. ¶ 78. The PepsiCo Corporate Group, in turn, would lose its ability to recruit talent for the Expatriate Program. Without this talent, development of business operations in these emerging

---

[11] *See also* **PepsiCo Salaried Employees Retirement Plan** (Article II -- Definitions (Page 18). "Employee: Any person who is receiving remuneration for personal services as a common law employee rendered in the employment of an Employer …"); and **PepsiCo Pension Equalization Plan** ("Article II -- Definitions and Construction (Page II-5, II-14). "Employee: An individual who qualifies as an 'Employee' as that term is defined in the Salaried Plan." "Employer: An entity that qualifies as an 'Employer' as that term is defined in the Salaried Plan.") Joint Stip., Exhibit 27.

foreign markets would likely be significantly impaired. *See* Joint Stip. ¶¶ 7, 73. Furthermore, the foreign host companies would also incur serious economic harm should they suddenly be deemed common law employers of PGM LLC's expatriates -- for instance, these entities would become responsible for benefit plans consistent with the PepsiCo U.S. benefit plans guaranteed to each expatriate in their employment agreements. *See, e.g.,* Joint Stip. 64, Exhibit 26 (PEP00000122-123) ("You will continue to be eligible to participate in the PepsiCo Savings Plan while on assignment to Hungary in accordance with and subject to the terms of the PepsiCo Savings Plan and the legal framework provided that you remain a US citizen and remain employed by a US legal entity."). Additional foreign jurisdiction local employment legal obligations may also be triggered should PGM LLC's expatriates be deemed common law employees of the foreign host companies.

3. Limit Permanent Establishment Foreign Tax Exposure

"Having a single entity, like PGM LLC, [second] all outbound expatriate employees: … (ii) centralizes Permanent Establishment foreign tax exposure related to expatriates working abroad to a single legal entity;" Joint Stip. ¶ 67. Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?" ("A GEC can serve to protect members of a controlled group from being subject to tax in a foreign jurisdiction if an [internationally mobile employees'] activities were to create a corporate taxable presence or permanent establishment in the host country.") and Dickmann, *Global Careers* 272 ("organizations implement GE[C]s to mitigate potential permanent establishment risks.").

4. Business and Government Compliance Efficiency

"Having a single entity, like PGM LLC, [second] all outbound expatriate employees: … (iii) centralizes tax, business, and other government compliance requirements (including but not

limited to: certificates of coverage, foreign country work permits, and simplifies the process of foreign assignments)." Joint Stip. ¶ 67. *See also* Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?" ("GECs also facilitate coordination of payroll tax withholding and reporting from a single location, as opposed to relying on several groups in each host country to manage those activities.").

For example, a "certificate of coverage" agreement between the United States Social Security Administration and a foreign government ensures each expatriate remains on U.S. social security, rather than be subject to the foreign country's social security system. *See* Joint Stip. ¶ 67, Exhibit 39 (Certificate of Coverage for Michael [redacted] (PEP00000140-141)). *See also* Liazos, "Global Employment Company: Is It the Right Fit for Your Organisation?" (U.S. expatriates generally prefer "to remain on the US Social Security system to avoid a reduced benefit resulting from ineligible employment."). Again, 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.

Finally, PGM LLC is also required to "cooperate with [the] Host Company and use its reasonable endeavours to assist with the procurement of valid work permits or the appropriate entry clearance for the Employees to perform the [agreed upon] [s]ervices." *See* Joint Stip. ¶ 63, Exhibit 25 (Secondment Agreement, Section 4.2 (PEP00001644)) and Joint Stip. ¶¶ 67 and 104, Exhibit 40 (Alejandra [redacted] Work Permit issued by Mexico's National Institute of Migration (PEP00000179)).

5. Recruit and Retain Talent

"As a 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." Joint Stip. ¶ 7. Howse, "Dealing with International Assignments" ("In the war for talent, a sophisticated international employee mobility programme is vital in attracting and retaining tomorrow's future business leaders.").

6. Develop Talent

"Seconded expatriates are assigned to foreign host companies for a variety of reasons, including: 1) to advance their career development within the PepsiCo Corporate Group;" Joint Stip. ¶ 73. Howse, "Dealing with International Assignments" ("In today's closely connected and ever-changing world, many global multinational companies have recognized that their futures are heavily dependent on the development of a cadre of ambitious and talented mobile employees with a genuine international outlook.")

7. Deploy Technical Expertise

"Seconded 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." Joint Stip. ¶ 73. Gordon Zovko, "Global Employment Companies: Just a Current Trend or the Long Term Solution?", International HR Adviser (2015) ("GECs have grown into a key corporate HR strategic partner ensuring fast and efficient employment and deployment of companies' best resources.").

III. Reorganization of Foreign Operations Underneath FLNA Cannot Be Equitably Recast

It is "well settled that a taxpayer is free to adopt such legal organization for the conduct of his affairs as he may choose…" *Twin Oaks Co. v. Comm'r*, 183 F.2d 385, 387 (9th Cir. 1950). This means Illinois taxpayers cannot be denied their "legal right to conduct their business affairs through a medium of their own choice." *Id*. While FLNA's reorganization was driven by non-tax business reasons, "[i]n the complexity of today's business and tax jungle, a corporate president

who does not obtain tax advice before an acquisition, or merger or substantial dollar transaction ought to be fired." *Brumley-Donaldson Co. v. Comm'r*, 443 F.2d 501, 510 (9th Cir. 1971) (Trask, J., dissenting).

The economic substance doctrine is not applicable when controlling provisions of the law are clear; this is the case even if tax savings result. *See Gitlitz v. Comm'r*, 531 U.S. 206, 220 (2001) ("Because the Code's plain text permits the taxpayers to receive these benefits, we need not address … policy concern[s]."). In turn, the judicial branch may not overturn clear tax laws to unilaterally fill perceived loop holes. *Id.* Rather, it is incumbent upon the Illinois legislature, or the Department through formal prospective regulation, to create tax rules.

A. <u>There Is No Illinois Statutory Authority to Adjust or Attribute Property or Payroll for Purposes of the 80/20 Company Rule</u>

The Department has no authority to adjust or attribute FLNA's property or payroll for purposes of the 80/20 Rule by statute, regulation, or other case law. *See Zebra Technologies Corp. v. Topinka,* 344 Ill. App. 3d 474, 483 (1st Dist. 2003) ("The Department's witness stated there was no statute that allowed the Department to impute a payroll figure for these services.").[12] As a necessary corollary, the Department has no authority to extract expatriate employees from PGM LLC's payroll; doing so would impermissibly render *void ab initio* the clear language utilized by the Illinois legislature to determine "business activity" for purposes of the 80/20 Rule in violation of Illinois Supreme Court precedent. *See Hartney Fuel Oil,* 376 Ill. Dec. at 302 ("When

[12] Even if payroll for the Global Mobility HR Function were attributed to PGM LLC, FLNA's status as an 80/20 Company would not change. "The total cost of the individuals dedicated to the Global Mobility HR Function" equals between $1.5 million and $2.3 million in payroll and $630 thousand and $3.1 million in property for the Tax Years at Issue (2011-2013). *See* Joint Stip. ¶ 102, Exhibit 9 (PEP00004921). Attributing 100% of the these amounts, let alone the actual amount (26%), does not change FLNA's 80/20 Company status. *See* Joint Stip. ¶ 103, Exhibit 8 (PEP00002531) and Exhibit 9 (PEP00004921).

interpreting a statute, the primary objective is to give effect to the legislature's intent, which is best indicated by the plain and ordinary language of the statute itself.").

B. The Department's Equitable Reallocation and Reapportionment Authority Is Prospective Only

When a business qualifies as an 80/20 Company under Illinois law, "absent the circumstances set forth in either §§ 304(f) or 404 of the IITA, there is nothing in the IITA's 80/20 test that grants the authority to reallocate to one person payroll or property that is properly allocable to another person. 35 ILCS 5/304(f), 5/404, 5/1501(a)(27)." *The Department of Revenue of the State of Illinois v. Shanghai, Inc*., IT 02-1 (Feb. 2002).

With regards to any potential alternative allocation or apportionment under IITA Section 304(f), the Department can only require a taxpayer to adopt an alternative method of allocation / apportionment *prospectively*. *See* Ill. Admin. Code tit. 86, § 100.3380(a)(2). More specifically, Department regulations require "[f]or tax years beginning prior to the effective date of the rulemaking adopting a method of apportioning business income, the Department will not require a taxpayer to adopt that method …" *Id*. Furthermore, Illinois has a separate reallocation statute for the Department to adjust base income "improperly or inaccurately reflected". *See* 35 ILCS 5/404. However, any such adjustment must be "made pursuant to regulation adopted by the Department and such regulations provide methods and standards by which the Department will utilize its authority under Section 404 of this Act." 35 ILCS 5/203(b)(2)(E-12) and (E-13). Accordingly, to the extent the Department wants to reallocate a taxpayer's base income, it must first adopt a regulation providing "methods and standards" for such reallocation. *See id*. To date, no such regulation exists with respect to the 80/20 Rule under either IITA Sections 304(f) or 404.

C. *Zebra* and *IBM* Do Not Authorize Equitable Reallocation

Without basis in fact or law, the Department's primary equitable argument has been to

stretch two Illinois cases -- *Zebra Tech.* and *IBM* -- beyond their clear import to void the Illinois legislature's 80/20 Rule. Simply put, neither case stands for this purpose. Instead, both cases narrowly hold the taxpayers in these matters did not meet their burden of proof.

The taxpayer in *Zebra Tech* argued two of its affiliates -- Zebra Domestic Intangibles, Inc. ("ZDI") and Zebra International Intangibles, Inc. ("ZII") -- had no U.S. property or payroll. *Zebra Tech,* 344 Ill. App. 3d 474 (1st Dist. 2003). Both entities rented office space in Bermuda and each employed the same employee "to manage business affairs for the companies" "at their offices in Bermuda." *Id*. at 478; Cir. Ct. Rul., Case No. 1998-L-50479. The Illinois Appellate Court rejected the Department's "substance-over-form" argument, finding "genuine economic substance to forming [ZDI] and [ZII] even though the formation of these companies in Bermuda was also for the purpose of avoiding taxes." *Id.* at 483. Indeed, "economic substance" was not the issue in dispute. *See id*. Rather, "[t]he issue properly before the court [was] whether taxpayer ha[d] satisfied its burden to show that it was entitled to exclude ZDI and ZII from its unitary business group." *Id*. The Illinois Appellate Court found the taxpayer "chose to stand on the evidence it produced" "and nothing more." *Id.* at 484. Solely on these grounds, the Court ruled the "taxpayer failed to sustain its burden on the threshold issue of qualifying to exclude ZDI and ZII from its unitary business group under section 1501(a)(27) of the Act." *Id*.

The *IBM* decision is no different. There, the taxpayer moved for summary judgment less than four months after filing its complaint on the basis of excluding one of its subsidiaries, World Trade Corporation ("WTC"), from its Illinois combined group pursuant to the 80/20 Rule. *See International Business Machines Corp. v. Dept. of Revenue*, 14 TT 229 (Jun. 2015). The Tax Tribunal denied the taxpayer's motion for summary judgment, holding: "It is abundantly clear there are material factual issues in this case …" *Id*. "[I]t is IBM's burden to come forward with

clear and convincing evidence as to why WTC qualifies as an 80/20 business …" *Id*. The *IBM* decision clarifies the Department is entitled to fully developed factual record -- for example, "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 is entitled to question the taxpayer's figures." *Id*. (emphasis added). In this regard, the taxpayer in *IBM* provided "little support for IBM … as it has not been tested by deposition or trial testimony or agreed to by stipulation by the Department." *Id*.

PepsiCo is in the exact opposite position from the taxpayers in *Zebra Tech* and *IBM*. Contrary to those disputes, in this matter, PepsiCo and the Department engaged in collaborative discovery efforts on the FLNA 80/20 Company issue spanning nearly six years -- two years during audit and four years after PepsiCo's petition was first filed with the Tax Tribunal:

- **2014 04 02 -- The Department Issues a Notice of Audit Initiation for Tax Years 2010 and 2011.**

- **2016 04 29 -- PepsiCo Files the First Petition**. The parties confer through informal discovery.

- **2017 02 08 -- PepsiCo Files the Second Petition**. The parties confer through informal discovery.

- **2017 08 17** -- **The Parties Exchange Formal Discovery Requests (Interrogatories and Requests for Production of Documents).**

- **2017 11 22 -- PepsiCo Submits Formal Written Responses to the Department's Discovery Requests**. The parties continue to confer through informal discovery conferences and discuss the possibility of agreeing to a stipulated record.

- **2019 03 04 -- PepsiCo Submits Supplemental Responses to the Department's Request for Production of Documents.**

- **2019 03 15 -- The Department Conducts Detailed Depositions of Six PepsiCo Witnesses in Purchase, NY (Spanning Three Days)**. Post-depositions, the parties continue to work informally to resolve remaining discovery issues.

- **2020 01 17 -- The Parties Execute and File the Joint Stipulations of Fact**. The Joint Stipulation is filed with the Tax Tribunal, containing 158 stipulations, 47 exhibits, and thousands of pages of business records / evidence.

In sum, PepsiCo provided the Department access to *every* requested witness, contract, tax return, business record, trial balance, general ledger, journal entry, etc. Accordingly, unlike *Zebra* and *IBM*, the Tax Tribunal here has access to a fully stipulated record -- made possible by the parties' extensive efforts, no factual dispute remains.

D. The FLNA 80/20 Company Status Cannot Be Undone By the Economic Substance Doctrine

The Department's last stand may be to argue FLNA's status as an 80/20 Company, or the mere reorganization of foreign entities / operations underneath FLNA pursuant to the PepsiCo Corporate Group's 2010 global restructuring, somehow lacks "economic substance" or fails to have "substance" consistent with its form. If made, this argument will also fail. There was "genuine economic substance to forming [PGM LLC]" even though formation of this entity also resulted in secondary state tax benefits. *See Zebra Tech,* 344 Ill. App. 3d 474.

1. The PepsiCo Corporate Group's Global Restructuring Had Valid Business Purpose

As an initial matter, and for all the reasons set forth above, PepsiCo's 2010 global restructuring -- including reorganizing foreign business entities / operations underneath FLNA -- had economic substance in its own right separate and apart from any tax effects. More specifically, the global restructuring impacted "every aspect of the [the PepsiCo Corporate Group's] business [to] strengthen … complementary food, snack and beverage businesses by leveraging new technologies and processes across PepsiCo's operations, go-to-market and information systems; heightening the focus on best practice sharing across the globe; consolidating manufacturing, warehouse and sales facilities; and *implementing simplified organization structures, with wider*

spans of control and fewer layers of management." PepsiCo, Inc., Annual Report (Form 10-K), at P.48 (Feb. 27, 2012) (emphasis added), attached to this memorandum as **Exhibit A**. To this end, the global restructuring was "expected to enhance PepsiCo's cost-competitiveness, provide a source of funding for future brand-building and innovation initiatives, and serve as a financial cushion for potential macroeconomic uncertainty …" *Id.*

2. FLNA's Business Function is Integral to the PepsiCo Corporate Group

FLNA is integral to the PepsiCo Corporate Group's domestic and international business operations. FLNA generates the majority of its "income by development and operation of the domestic snack food business which includes, among other things: the development, manufacture, marketing, distribution, and sale of snack food products. In operating the domestic snack food business, FLNA contracts with FLI, an internal PepsiCo entity, for the manufacture of some of the snack foods and contracts with RFLS, an internal PepsiCo entity, for the sale and distribution of snack foods." Joint Stip. ¶ 17. Historically, FLNA engaged in international operations through ownership of the GMD Branch charged with exporting PepsiCo Corporate Group snack products to the Asia-Pacific and Caribbean regions. Joint Stip. ¶ 14. In addition, as part of the snack-foods business, FLNA "sends executives on assignment through the Expatriate Program and also receives executives who have been on such an assignment." Joint Stip. ¶ 13.

Accordingly, FLNA itself cannot be a sham or disregarded. FLNA generated over $8 billion in sales for each of the Tax Years at Issue (2011 - 2013). *See* Joint Stip. ¶ 18. Of these amounts, $230 million were foreign sourced sales for each of the Tax Years at Issue. *See* Joint Stip. ¶ 20.

3. Reorganizing Foreign Business Operations Underneath FLNA As Part of the Overall Global Restructuring

The acquisition of PBG and PAS necessitated an overhaul of the PepsiCo Corporate

Group's structure to integrate thousands of additional employees, hundreds of domestic and international legal entities, and billions of dollars in assets. *See* Joint Stip. ¶¶ 44-46. One component of the restructuring was to reorganize foreign operations underneath FLNA due to the entity's historic international presence and its ability to fund historically loss-generating foreign entities. Joint Stip. ¶¶ 20, 61. In this regard, the following foreign "entities and their operations were consolidated under FLNA: FLNA Hong Kong; PGM LLC; CEME; QFL; and Bev Svcs." Joint Stip. ¶ 49.

After it was determined that PGM LLC would be formed, the entity was placed underneath FLNA for a variety of reasons, including (but not limited to): i) the importance of the snack-foods business to the PepsiCo Corporate Group's domestic and international business operations; ii) FLNA's continuing presence in international markets, including generating $230 million in sales for each of the Tax Years at Issue; iii) FLNA's consistent role in sending high performing executives, managers, etc. on foreign assignments and receiving such individuals post-assignment; iv) the fact that the "majority of expatriates seconded through the Expatriate Program either work for the snack-foods business all of the time or work partially for the snack-foods business"; v) FLNA's employment of high-performing senior employees and general management charged with running the strategic arm of the domestic snack-foods business (*e.g.*, setting objectives for sales growth, investments, and new product development), some of whom are alumni of the Expatriate Program; and vi) the decision to put other foreign operations / entities underneath FLNA, including loss-generating entities needing immediate access to FLNA's available capital. Joint Stip. ¶¶ 11, 13, 14, 20, 49, 53, 61, and 68, Exhibit 7 (PEP00004906-4908). As part of the PepsiCo Corporate Group's independent due diligence, placement of PGM LLC underneath FLNA was also determined to be the most cost-effective location within the corporate structure from a state tax

standpoint. *See* Joint Stip. ¶ 59. Simply put, PGM LLC had to be put *somewhere*, and FLNA was the prudent location to house PGM LLC for business *and* tax reasons. [13]

4. The Economic Substance Doctrine Cannot Circumvent Clear Illinois Law

Long-standing rules of statutory construction require "[w]hen interpreting a statute, the primary objective is to give effect to the legislature's intent, which is best indicated by the plain and ordinary language of the statute itself." *Hartney Fuel Oil*, 376 Ill. Dec. at 302 (2013). For more than 100 years, the U.S. Supreme Court has applied this same rule. *See Caminetti v. United States*, 242 U.S. 470, 485 (1917) ("[T]he meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain, … the sole function of the courts is to enforce it according to its terms."). Courts must "presume that a legislature says in a statute what it means and means in a statute what is says there." *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253–54 (1992). *See also People v. Savory,* 309 Ill. App. 3d 408, 416 (3rd Dist. 1999) ("when it comes to trying to figure out the intent of the legislature, we must assume that it means what is says and says what it means.") (Holdridge, J., dissenting); and *Burgess v. United States*, 553 U.S. 124, 130 (2008) ("When a statute includes an explicit definition, [courts] must follow that definition …"). At first glance, the economic substance doctrine would appear to conflict with these well-established principles of statutory construction by ignoring technical compliance with the statute, but the two principles of law can be reconciled by putting the economic substance doctrine in its proper context.

[13] PGM LLC itself cannot be disregarded for lack of business purposes just because it is a disregarded entity. *See Dover Corp. v. Comm'r*, 122 TC 324, n.19 (1997) ("Nor do the check-the-box regulations require that the taxpayer have a business purpose for such an election or, indeed, for any election under those regulations. Such elections are specifically authorized 'for federal tax purposes'. Sec. 301.7701-3(a), Proced. & Admin. Regs.").

The Illinois Supreme Court's instruction to focus on statutory text does not mean courts must blindly apply the labels chosen by taxpayers. For example, a court is not bound by the taxpayer's labeling of a transaction as a "reorganization" if it really isn't one. *See Gregory v. Helvering*, 293 U.S. 465, 468–70 (1935). Instead, when the facts show that a transaction does not fit within the concept that the statutory text is intended to cover, then the taxpayer's label will be disregarded and the statute applied consistent with the legislature's intent. *See id.* In such a case, the court is said to look to the "substance" of a transaction, rather than its "form" (*i.e.*, the taxpayer-applied label). As tax law professor Joseph Isenbergh aptly explained, "[w]hen someone calls a dog a cow and then seeks a subsidy provided by statute for cows, the obvious response is that this is not what the statute means." Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859, 865 (1982).

Similarly, if the taxpayer did not actually own the cows but instead simply claimed them as his own, the taxpayer's label will be ignored. Conversely, if the taxpayer's actions are consistent with the statutory terms (*i.e.*, they really did own a cow) then the text of the statute controls, regardless of how beneficial the legislature made it to own that cow versus a dog or anything else. As a result, "[t]he economic substance doctrine, like other common law tax doctrines, can thus perhaps best be thought of as a tool of statutory interpretation." *Mazzei v. Commissioner*, No. 16702-09, 2018 U.S. Tax Ct. LEXIS 7, at *19–20 (T.C. March 5, 2018) (quoting *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 21 (1st Cir. 2016)).

The Illinois Supreme Court's focus on the meaning of the relevant statutory text is reflected in the seminal cases that established the economic substance doctrine.[14] For instance, in *Gregory*,

[14] *See Gregory*, 293 U.S. 465, 468–70 (1935); *Higgins v. Smith*, 308 U.S. 473 (1940); *Knetsch v. United States*, 364 U.S. 361 (1960); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Fla.*

the U.S. Supreme Court analyzed whether the taxpayer effectuated a "reorganization" within the meaning of § 112(g) of the Revenue Act of 1928. 293 U.S. at 467–68. The Court looked to whether the taxpayer's actions fell within what Congress intended when it used the word "reorganization." *Id*. at 469. Based on the use of the business term "reorganization," the U.S. Supreme Court concluded the statute only covered transfers made pursuant to a plan of reorganization of corporate business, and not to other kinds of asset transfers. *Id*. at 468–69.

Given its power and breadth, the economic substance doctrine presents a real danger of being extended beyond its proper scope. Improperly applied, the doctrine provides an excuse to change clear tax rules established by the legislature and yield improper results. If divorced from the statutory text in such a way, the doctrine presents the danger of rendering the words reflected in the statutes and regulations mere niceties. This is fundamentally inconsistent with the general rules of statutory interpretation (not to mention the rule of law) and creates pernicious uncertainty in the tax system.

The Sixth Circuit recently recognized the danger of the excessive creep of judicial doctrines in the tax law. Its opinion begins with an explanation of the danger of applying judicial doctrines to avoid clearly authorized legislative terms:

> Caligula posted the tax laws in such fine print and so high that his subjects could not read them . . . That's not a good idea, we can all agree. How can citizens comply with what they can't see? And how can anyone assess the tax collector's exercise of power in that setting? . . . 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 the 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. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence -- to allow *him* to determine the substance of a law

---

Dep't of Revenue v. Piccadilly Cafeterias, Inc., 554 U.S. 33, 52 (2008); and *Burgess*, 553 U.S. 124, 130 (2008).

> and to make it govern "over" the written form of the law -- and to call it a "doctrine" no less.

Summa Holdings, Inc. v. Commissioner, 848 F.3d 779, 781–82 (6th Cir. 2017) (citation omitted) (emphasis in the original).

So too here. The *substance* of the 80/20 Rule is its *form*. 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's revenue collections. *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956) is illustrative of this point. In that case, the taxpayer entered into tax-savings transactions under "mechanical" provisions of the tax laws. 238 F.2d at 672. The First Circuit rejected the Commissioner's attempt to deny the deduction because "[a]gain and again the courts have pointed out that a 'purpose to minimize or avoid taxation is not an illicit motive'" … and "the Commissioner's own regulations … emphasize the rigid requirements of the section and make no allowance for the type of [end-result theory] advanced in this case." *Id.* at 675 (citations omitted).

5. FLNA's Status As An Illinois 80/20 Company Cannot Be Reversed By the Economic Substance Doctrine

As the Sixth Circuit explained in *Summa*, two natural and clear limitations on the economic substance doctrine exist. 848 F.3d 779. First, that doctrine is not applicable when the controlling provisions of law are clear even where tax-savings results. *See id*. at 786. Second, and relatedly, the economic substance doctrine is not available to either overturn policy judgments reflected in bright-line tax rules or to fill perceived loopholes. *See id*.

a. Controlling Illinois Law Supersedes the Department's Authority to Equitably Overrule FLNA's 80/20 Company Status

First, to the extent a transaction, when viewed as a whole, fits within a statute's intended purpose, the economic substance doctrine is inapplicable. The Illinois legislature's clear and

unambiguous definition of "unitary business group" in 35 ILCS 5/1501(a)(27)(A) excludes 80/20 Companies as determined by "business activity" measured by a taxpayer's property and payroll factors. The statutes and regulations setting forth the mechanical requirements for determining an 80/20 Company are crystal clear as set forth above in painstaking detail. Most simply stated, the Department may not "recharacterize the meaning of statutes--to ignore their form, their words, in favor of his perception of their substance. … [b]efore long, allegations of tax avoidance begin to look like efforts at text avoidance." *Summa Holdings*, 848 F.3d at 785, 787. Therefore, Illinois courts cannot read into the bright line 80/20 Rule an unspoken "unless" clause rendering the entire provision meaningless. Instead, courts must look to whether the economic substance of a transaction falls within the purposes of the actual words used in a statute (*e.g.*, cow, 80/20 Company, reorganization).

There is also no limitation or requirement under Illinois law for corporations to maximize tax obligations pursuant to corporate reorganizations. To the contrary, "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Hartney Fuel Oil*, 376 Ill. Dec at 314. (citing *Gregory*, 293 U.S. at 469) (internal citations omitted). "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury"; "[t]here is no patriotic duty to increase one's taxes." *Summa Holdings*, 848 F.3d at 787 (citing *Helvering v. Gregory,* 69 F.2d 809, 810 (2nd Cir. 1934)) (internal citations omitted).

Consistent with these principles, equitable adjustments are "not intended to alter the tax treatment of certain *basic business transactions* that, under longstanding judicial and administrative practice are respected, merely because the *choice* between meaningful economic alternatives is largely or entirely based on comparative tax advantages." Joint Committee on

Taxation Technical Explanation (Comm. Print 2010) (emphasis added). "Among these basic business transactions are: … the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C …" *Id*.

In this case, the PepsiCo Corporate Group's 2010 global restructuring required a "series of transactions that constitute a corporate organization or reorganization under subchapter C …" *See* JCT Tech. Explanation (2010). One of the many components of the PepsiCo's 2010 global restructuring was the "choice between meaningful economic alternatives" of reorganizing disregarded foreign entities/operations, including PGM LLC, underneath FLNA or some other entity. Setting aside all other business reasons for reorganizing these foreign operations underneath FLNA, and analyzing the simple placement of substantive foreign entities purely in a vacuum as "entirely based on comparative tax advantages", the economic substance doctrine expressly does *not* apply where the transaction constitutes a basic business transaction expressly permitted under Illinois law. *See id. and Kraft Foods Co.*, 232 F.2d at 128 ("Since the acts were real and the taxable entities cannot be characterized as sham entities, the transaction should not be disregarded merely because the transaction was entered into in response to … the governing tax law."). The economic substance doctrine has no application to the formation of PGM LLC or its ownership by FLNA.

b. Judicial Activism Is Not Proper: Separation of Powers Underscores Illinois Governance

The Illinois judiciary is tasked with interpreting and applying statutes and administrative regulations as written; not inventing its own standards to determine how the law -- in its opinion -- should work. *See People ex rel. Sklodowski v. State*, 162 Ill. 2d 117, 130 (1994) ("The judicial branch of the government is not charged with political or legislative decision making and its role in the government's balance of powers has certain defined limits.").

In *Hartney Fuel Oil*, a Department regulation instructed taxpayers to source taxable airplane fuel sales to the location where the purchase is accepted by the seller. *Hartney Fuel Oil*, 376 Ill. Dec. 294. In response to Hartney Fuel Oil Co. structuring its business operations to source sales receipts away from higher taxing jurisdictions, the Illinois Supreme Court held: "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 statute. Those gaps must be filled through the lawmaking process, not judicial fiat. *See Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc*., 554 U.S. 33, 52 (2008) ("[I]t is not for us to substitute our view of . . . policy for the legislation which has been passed by Congress." (quoting *In re Hechinger Inv. Co. of Del*., 335 F.3d 243, 256 (3rd Cir. 2003)). These principles should apply "even when taxpayers discover that two sections interact to provide benefits Congress likely didn't intend, or even foresee." *Mazzei v. Commissioner*, No. 16702-09, 2018 U.S. Tax Ct. LEXIS 7, at *84 (T.C. March 5, 2018) (Holmes, J., dissenting).

With regard to the 80/20 Rule, two separate branches of government -- the legislature and the executive branch -- have full authority to amend the law as *they* see fit. In the first instance, the Illinois legislature designed the 80/20 Rule in 1982 with the goal of creating a "certain and stable" state tax environment for Illinois businesses. Gov. Thompson, Letter - H.B. 2588 (1982). In such circumstances, it is incumbent upon the legislature -- not the courts -- to change the 80/20

Rule as *it* deems appropriate. *See Hartney Fuel Oil*, 376 Ill. Dec. at 313.

Alternatively, the Department can promulgate its own regulation pursuant to rulemaking authority under the Illinois Administrative Procedure Act, 5 ILCS 100/1-1, *et seq*. The procedure for such rulemaking authority requires: (1) "first notice" where "the public can comment and request a public hearing" regarding an administrative agency's proposed rule; (2) "second notice" where the legislature's Joint Committee on Administrative Rules ("JCAR") reviews the proposed rule "and can file a certification of no objection" "or a statement objecting to or prohibiting the filing of the proposed rule"; and (3) the rule's adoption to the extent certification of no objection from JCAR is received. *See Ill. Dept. of Revenue v. Ill. Civil Serv. Commission*, 357 Ill. App. 3d 352, 356 (1st Dist. 2005). As stated above, the Department has rulemaking authority to create a *prospective rule* to reapportion / reallocate under IITA Sections 303(f) and 404. However, as is abundantly clear, the Department has not done so to date.

CONCLUSION

For the foregoing reasons, FLNA is an 80/20 Company pursuant to clear Illinois law and the jointly stipulated facts. Summary judgment in PepsiCo's favor is proper on Count I of the First Petition and Count I of the Second Petition.

Respectfully submitted,

PepsiCo, Inc. and Affiliates

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

Theodore R. Bots (ARDC No. 6224515)
David A. Hemmings (ARDC No. 6307850)
BAKER & MCKENZIE LLP
300 E. Randolph Street, Ste. 5000

Chicago, IL 60601
Telephone: (312) 861-8845
Fax: (312) 698-2004
theodore.bots@bakermckenzie.com
drew.hemmings@bakermckenzie.com

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

Attorneys for Petitioner,
PepsiCo, Inc. and Affiliates

EXHIBIT A

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2011

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission file number 1-1183

PepsiCo, Inc.
(Exact Name of Registrant as Specified in Its Charter)

North Carolina (State or Other Jurisdiction of Incorporation or Organization)	**13-1584302** (I.R.S. Employer Identification No.)
700 Anderson Hill Road, Purchase, New York (Address of Principal Executive Offices)	**10577** (Zip Code)

Registrant's telephone number, including area code: 914-253-2000

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class	Name of each exchange on which registered
Common Stock, par value 1-2/3 cents per share	New York and Chicago Stock Exchanges

Securities registered pursuant to Section 12(g) of the Securities Exchange Act of 1934: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes ☐ No ☒

53rd Week

In 2011, we had an additional week of results (53rd week). Our fiscal year ends on the last Saturday of each December, resulting in an additional week of results every five or six years. The 53rd week increased 2011 net revenue by $623 million and operating profit by $109 million ($64 million after-tax or $0.04 per share).

Mark-to-Market Net Impact

We centrally manage commodity derivatives on behalf of our divisions. These commodity derivatives include metals, energy and agricultural products. Certain of these commodity derivatives do not qualify for hedge accounting treatment and are marked to market with the resulting gains and losses recognized in corporate unallocated expenses. These gains and losses are subsequently reflected in division results when the divisions take delivery of the underlying commodity. Therefore, the divisions realize the economic effects of the derivative without experiencing any resulting mark-to-market volatility, which remains in corporate unallocated expenses.

In 2011, we recognized $102 million ($71 million after-tax or $0.04 per share) of mark-to-market net losses on commodity hedges in corporate unallocated expenses.

In 2010, we recognized $91 million ($58 million after-tax or $0.04 per share) of mark-to-market net gains on commodity hedges in corporate unallocated expenses.

In 2009, we recognized $274 million ($173 million after-tax or $0.11 per share) of mark-to-market net gains on commodity hedges in corporate unallocated expenses.

Restructuring and Impairment Charges

In 2011, we incurred restructuring charges of $383 million ($286 million after-tax or $0.18 per share) in conjunction with our multi-year productivity plan (Productivity Plan), including $76 million recorded in the FLNA segment, $18 million recorded in the QFNA segment, $48 million recorded in the LAF segment, $81 million recorded in the PAB segment, $77 million recorded in the Europe segment, $9 million recorded in the AMEA segment and $74 million recorded in corporate unallocated expenses. The Productivity Plan includes actions in every aspect of our business that we believe will strengthen our complementary food, snack and beverage businesses by leveraging new technologies and processes across PepsiCo's operations, go-to-market and information systems; heightening the focus on best practice sharing across the globe; consolidating manufacturing, warehouse and sales facilities; and implementing simplified organization structures, with wider spans of control and fewer layers of management. The Productivity Plan is expected to enhance PepsiCo's cost-competitiveness, provide a source of funding for future brand-building and innovation initiatives, and serve as a financial cushion for potential macroeconomic uncertainty beyond 2012. As a result, we expect to incur pre-tax charges of approximately $910 million, $383 million of which was reflected in our 2011 results, approximately $425 million of which will be reflected in our 2012 results and the balance of which will be reflected in our 2013, 2014 and 2015 results. These charges will be comprised of approximately $500 million of severance and other employee-related costs; approximately $325 million for other costs, including consulting-related costs and the termination of leases and other contracts; and approximately $85 million for asset impairments (all non-cash) resulting from plant closures and related actions. These charges resulted in cash expenditures of $30 million in 2011, and we anticipate approximately $550 million of related cash expenditures during 2012, with the

balance of approximately $175 million of related cash expenditures in 2013 through 2015. The Productivity Plan will be substantially completed by the end of 2012 with incremental productivity initiatives continuing through the end of 2015.

In 2009, we incurred charges of $36 million ($29 million after-tax or $0.02 per share) in conjunction with our Productivity for Growth program that began in 2008. The program included actions in all divisions of the business, including the closure of six plants, to increase cost competitiveness across the supply chain, upgrade and streamline our product portfolio, and simplify the organization for more effective and timely decision-making. This program was completed in the second quarter of 2009.

Gain on Previously Held Equity Interests

In 2010, in connection with our acquisitions of PBG and PAS, we recorded a gain on our previously held equity interests of $958 million ($0.60 per share), comprising $735 million which was non-taxable and recorded in bottling equity income and $223 million related to the reversal of deferred tax liabilities associated with these previously held equity interests.

Merger and Integration Charges

In 2011, we incurred merger and integration charges of $329 million ($271 million after-tax or $0.17 per share) related to our acquisitions of PBG, PAS and WBD, including $112 million recorded in the PAB segment, $123 million recorded in the Europe segment, $78 million recorded in corporate unallocated expenses and $16 million recorded in interest expense. These charges also include closing costs and advisory fees related to our acquisition of WBD.

In 2010, we incurred merger and integration charges of $799 million related to our acquisitions of PBG and PAS, as well as advisory fees in connection with our acquisition of WBD. $467 million of these charges were recorded in the PAB segment, $111 million recorded in the Europe segment, $191 million recorded in corporate unallocated expenses and $30 million recorded in interest expense. The merger and integration charges related to our acquisitions of PBG and PAS were incurred to help create a more fully integrated supply chain and go-to-market business model, to improve the effectiveness and efficiency of the distribution of our brands and to enhance our revenue growth. These charges also include closing costs, one-time financing costs and advisory fees related to our acquisitions of PBG and PAS. In addition, we recorded $9 million of merger-related charges, representing our share of the respective merger costs of PBG and PAS, in bottling equity income. In total, the above charges had an after-tax impact of $648 million or $0.40 per share.

In 2009, we incurred $50 million of merger-related charges, as well as an additional $11 million of merger-related charges, representing our share of the respective merger costs of PBG and PAS, recorded in bottling equity income. In total, these charges had an after-tax impact of $44 million or $0.03 per share.

Inventory Fair Value Adjustments

In 2011, we recorded $46 million ($28 million after-tax or $0.02 per share) of incremental costs in cost of sales related to fair value adjustments to the acquired inventory included in WBD's balance sheet at the acquisition date and hedging contracts included in PBG's and PAS's balance sheets at the acquisition date.

IN WITNESS WHEREOF, each of the undersigned has executed this instrument on the date indicated opposite its, his or her name.

PEPSICO, INC.

By:

Signature	Title	Date
/s/ Indra K. Nooyi Indra K. Nooyi	Chairman of the Board of Directors and Chief Executive Officer	February 27, 2012
/s/ Hugh F. Johnston Hugh F. Johnston	Chief Financial Officer	February 27, 2012
/s/ Marie T. Gallagher Marie T. Gallagher	Senior Vice President and Controller (Principal Accounting Officer)	February 27, 2012
/s/ Shona L. Brown Shona L. Brown	Director	February 27, 2012
/s/ Ian M. Cook Ian M. Cook	Director	February 27, 2012
/s/ Dina Dublon Dina Dublon	Director	February 27, 2012
/s/ Victor J. Dzau Victor J. Dzau	Director	February 27, 2012
/s/ Ray L. Hunt Ray L. Hunt	Director	February 27, 2012
/s/ Alberto Ibargüen Alberto Ibargüen	Director	February 27, 2012
/s/ Arthur C. Martinez Arthur C. Martinez	Director	February 27, 2012

EXHIBIT B

STATE OF ILLINOIS

OFFICE OF THE GOVERNOR

SPRINGFIELD 62706

JAMES R. THOMPSON
GOVERNOR

The Honorable Members of
The House of Representatives
82nd General Assembly

Pursuant to Article IV, Section 9(e) of the Illinois Constitution of 1970, I hereby return House Bill 2588 entitled "AN ACT relating to taxation and amending an Act herein named" with my specific recommendations for change.

House Bill 2588 prohibits combined reporting by corporations. Combined reporting is a method of taxing a group of businesses which operate as a single business entity. It has been a cause for great debate in the business community. Business taxpayers on both sides of the issue have expressed concerns about the impact of this legislation on the business climate of Illinois and on our ability to attract and retain industry and jobs.

Because of both the complexity and importance of this issue, an extensive amount of analysis and consultation has been undertaken during my review. After a very careful deliberation, I am convinced that with my recommendations for change Illinois can serve as a model for the rest of the states in its taxation treatment of multinational and multistate corporations.

Twenty-seven of the forty-six states which tax corporate income apply some form of combined reporting to unitary businesses. Of these, thirteen apply it on a world-wide basis. In most of these states combined reporting is applied by audit, by regulations or by an administrative ruling process. Illinois will not be unique in applying a form of combined reporting. With my changes, it will be unique in spelling out in clear statutory language how combined reporting is to be applied to unitary businesses.

First, I am recommending that Illinois statutes clearly define a unitary group as one in which the members are in the same line of business, are on the same apportionment formula, and are functionally integrated. In many of the other States which apply combined reporting, these definitions are not spelled out and taxation decisions may be arbitrary and may be based on factors other than business activity. With these definitions placed in the Statutes, Illinois will provide the certainty and the stability so important to businesses, particularly those considering expanding within or into Illinois.

Second, with my changes, I am rejecting world-wide unitary reporting. World-wide combined reporting causes 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.

World-wide unitary is clearly an undesirable form of state taxation, yet domestic combination with clearly defined provisions can prove to be a benefit to many businesses. 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.

Third, in order to treat multinational businesses fairly in relation to domestic businesses, two further changes are recommended. Dividends from foreign subsidiaries should be treated in the same manner as are dividends from domestic subsidiaries. Also, sales between domestic and foreign members of a unitary group should be treated the same way we treat intercompany sales between members who are totally domestic. These changes are an important economic development incentive.

By eliminating the differential treatment of foreign and domestic dividends a thorn in the side of Illinois multinational businesses can be removed. This differential is particularly costly to businesses headquartered in Illinois. Treating foreign dividends fairly will make Illinois very attractive to multinational businesses and serves as a clear incentive to locate corporate headquarters here in Illinois.

The concept of combined reporting is being litigated at the U.S. Supreme Court level and legislation is being considered by Congress. Their actions may necessitate other statutory changes. However, my recommended changes are closer to national trends in corporate taxation than either world-wide combined reporting or the total prohibition of all combined reporting. This issue may have to be reexamined when national decisions are reached.

I believe that with these changes Illinois will assume a leadership role in the area of corporate taxation. Illinois is a state with a diverse economy and must treat all of its taxpayers fairly. With these changes Illinois will be attractive to businesses and will send the signal that we listen, we care, and we can make corrections in the tax system which benefit them and benefit the State as well.

I therefore specifically recommend that:

At page 1, line 5, "404" be deleted and "1501" be inserted in lieu thereof.

At page 3, line 34, "and" be deleted and "and" inserted in lieu thereof.

At page 4, line 3, the period be deleted and "; and" inserted in lieu thereof.

At page 4, the following be inserted immediately following line 3:

"(J) An amount equal to: (i) 85 percent of the amount by which dividends included in taxable income and received from a corporation that is not created or organized under the laws of the United States or any state or political subdivision thereof exceeds the amount of the modification provided under subparagraph (F) of paragraph (2) of this subsection (b) which is related to such dividends, plus; (ii) 100 percent of the amount by which dividends included in taxable income and received from any such corporation specified in (i) above that would, but for the provisions of Section 1504(b)(3) of the Internal Revenue Code, be treated as a member of the affiliated group which includes the dividend recipient exceeds the amount of the modification provided under subparagraph (F) of paragraph (2) of this subsection (b) which is related to such dividends."

At page 4, lines 8 through 12 be deleted.

At page 12, line 6, the following be inserted immediately following the period:

"Nor will sales of tangible personal property be in this State if the seller and purchaser would be member of the same unitary business group but for the fact that either the seller or purchaser is a person with 80 percent or more of total business activity without the United States and the property is purchased for resale."

At page 16, the following be inserted immediately following line 25:

"(e) Combined apportionment. Where two or more persons are engaged in a unitary business (see section 1501(a)(27)), a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method."

At page 16, line 26, the designation "(e)" be deleted and "~~(e)~~(f)" be inserted in lieu thereof.

At page 16, line 27, the designation "(d)" be deleted and "~~(d)~~(e)" be inserted in lieu thereof.

At page 17, lines 4 through 19 be deleted and "business income." be inserted in lieu thereof.

At page 17, line 20, the designation "(f)" be deleted and "~~(f)~~(g)" be inserted in lieu thereof.

At page 17, following line 21, "(Ch. 120, par. 4-404)" and lines 22 through 34 be deleted and the following be inserted in lieu thereof:

"(Ch. 120, par. 15-1501)

Section 1501. Definitions.

(A) In general. When used in this Act, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof:

(1) Business income. The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Such term does not include compensation or the deductions allocable thereto.

(2) Commercial domicile. The term "commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(3) Compensation. The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(4) Corporation. The term "corporation" includes associations, joint-stock companies, insurance companies and cooperatives.

(5) Department. The term "Department" means the Department of Revenue of this State.

(6) Director. The term "Director" means the Director of Revenue of this State.

(7) Fiduciary. The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person action in any fiduciary capacity for any person.

(8) Financial organization. The term "financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, or investment company.

(9) Fiscal year. The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December.

(10) Includes and including. The terms "includes" and "including" when used in a definition contained in this Act shall not be deemed to exclude other things otherwise within the meaning of the term defined.

(11) Internal Revenue Code. The term "Internal Revenue Code" means the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes in effect for the taxable year.

(12) Mathematical error. The term "mathematical error" includes the following types of errors, omissions, or defects in a

return filed by a taxpayer which prevents acceptance of the return as filed for processing:

(a) arithmetic errors or incorrect computations on the return or supporting schedules;

(b) entries on the wrong lines;

(c) omission of required supporting forms or schedules or the omission of the information in whole or in part called for thereon; and

(d) an attempt to claim, exclude, deduct, or improperly report, in a manner directly contrary to the provisions of the Act and regulations thereunder any item of income, exemption, deduction or credit.

(13) Nonbusiness income. The term "nonbusiness income" means all income other than business income or compensation.

(14) Non resident. The term "nonresident" means a person who is not a resident.

(15) Paid, incurred and accrued. The terms "paid", "incurred" and "accrued" shall be construed according to the method of accounting upon the basis of which the person's base income is computed under this Act.

(16) Partnership and partner. The term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term "partner" includes a member in such syndicate, group, pool, joint venture or organization.

(17) Part-year resident. The term "part-year resident" means an individual who became a resident during the taxable year or ceased to be a resident during the taxable year. Under Section 1501(a)(20)(A)(i) residence commences with presence in this State for other than a temporary or transitory purpose and ceases with absence from this State for other than a temporary or transitory purpose. Under Section 1502(a)(20)(A)(ii) residence commences with the establishment of domicile in this State and ceases with the establishment of domicile in another State.

(18) Person. The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, firm, company, corporation or fiduciary.

(19) Regulations. The term "regulations" includes rules promulgated and forms prescribed by the Department.

(20) Resident. The term "resident" means:

(a) an individual (i) who is in this State for other than a temporary or transitory purpose during the taxable year; or (ii) who is domiciled in this State but is absent from the State for a temporary or transitory purpose during the taxable year;

(b) the estate of a decedent who at his death was domiciled in this State;

(c) a trust created by a will of a decedent who at his death was domiciled in this State; and

(d) an irrevocable trust, the grantor of which was domiciled in this State at the time such trust became irrevocable. For purpose of this subparagraph, a trust shall be considered irrevocable to the extent that the grantor is not treated as the owner thereof under Sections 671 through 678 of the Internal Revenue Code.

(21) Returns. The term "returns" includes declarations of estimated tax required under this Act.

(22) Sales. The term "sales" means all gross receipts of the taxpayer not allocated under Sections 301, 302, and 303.

(23) State. The term "state" when applied to a jurisdiction other than this State means any state of the United State, the District of Columbia, the Commonwealth of Puerto Rico, any Territory or Possession of the United States, and any foreign country, or any political subdivision of any of the foregoing.

(24) Taxable year. The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the base income is computed under this Act. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of this Act, the period for which such return is made.

(25) Taxpayer. The term "taxpayer" means any person subject to the tax imposed by this Act.

(26) International banking facility. The term international banking facility shall have the same meaning as is set forth in the Illinois Banking Act or as is set forth in the laws of the United States or regulations of the Board of Governors of the Federal Reserve System.

(27) Unitary business group. The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. 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 and Section 304(a)(3)(B)(ii), business activity within the

United States shall be measured by means of the factors ordinarily applicable under subsections (a), (b), (c), and (d) of section 304 except that, in the case of corporations ordinarily required to apportion business income by means of the three factor formula of property, payroll and sales specified in subsection (a) of Section 304, such corporations shall not use the sales factor in the computation and the results of the property and payroll factor computations shall be divided by two (by one if either the property or payroll factor has a denominator of zero). Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (e.g., manufacturing, wholesaling, retailing, insurance, transportation, finance, et al.); or, (2) are steps in a vertically structured enterprise or process (e.g., the steps involved in the production of natural resources, viz., exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member). In no event, however, will a unitary group include both persons who are ordinarily required to apportion income by means of the three factor formula of property, payroll and sales and persons who are ordinarily required to apportion income by means of the single factors specified in subsections (b), (c) and (d) or section 304.

(B) Other definitions.

(1) Words denoting number, gender, and so forth, when used in this Act, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof:

(a) Words importing the singular include and apply to several persons, parties or things;

(b) Words importing the plural include the singular; and

(c) Words importing the masculine gender include the feminine as well.

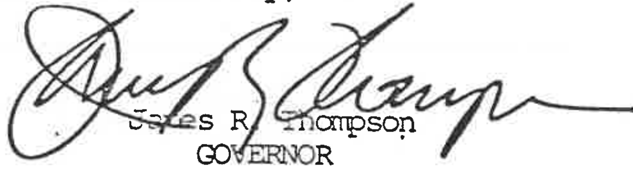
(2) "Company" or "association" as including successors and assigns. The word "company" or "association", when used in reference to a corporation, shall be deemed to embrace the words "successors and assigns of such company or association", and in like manner as if these last-named words, or words of similar import, were expressed.

(3) Other terms. Any term used in any Section of this Act with respect to the application of, or in connection with the provisions of any other Section of this Act shall have the same meaning as in such other Section."

At page 18, lines 1 through 3 be deleted.

With these changes, House Bill 2588 will have my approval.

Sincerely,



James R. Thompson
GOVERNOR

CERTIFICATE OF SERVICE

The undersigned counsel of record certifies that a copy of the **PETITIONER PEPSICO, INC. AND AFFILIATES' MEMORANDUM IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT** was served on April 17, 2020 to the following persons:

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

<u>/s/ Theodore R. Bots</u>
Attorney for Petitioner,
PepsiCo, Inc. and Affiliates