IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL

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

ILLINOIS DEPARTMENT OF REVENUE'S BRIEF IN SUPPORT OF THE DEPARTMENT'S CROSS MOTION FOR SUMMARY JUDGMENT – 80/20 ISSUE PENALTIES

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SUMMARY OF ARGUMENT

PepsiCo, Inc. & Affiliates ("PepsiCo") contend that the late payment penalties assessed by the Illinois Department of Revenue (the "Department") should be abated. However, the facts demonstrate that PepsiCo did not make a reasonable attempt to pay its fair share of taxes. PepsiCo's sole objective was to avoid paying taxes in Illinois on the billions of dollars in domestic revenue generated by Frito-Lay North America, Inc. ("FLNA").

Illinois income tax law requires that for PepsiCo to secure an abatement of penalties here, PepsiCo must have made a reasonable attempt to determine its proper Illinois tax liability and pay these taxes. Did it? The answer to this question is a resounding no. As the Tribunal ruled in its May 4, 2021 decision on the underlying substantive tax law at issue here, PepsiCo's purpose here was tax avoidance without a valid legal basis.

Specifically, PepsiCo excluded FLNA, and its billions of dollars in annual domestic income, from PepsiCo's 2011, 2012 and 2013 combined returns under Illinois' 80/20 Test. This test was adopted by the Illinois General Assembly to exclude foreign income **not** domestic income from Illinois combined returns. In 2010, PepsiCo organized a single member, wholly owned shell company, PepsiCo Global Mobility, LLC ("PGM LLC"). PGM LLC is a disregarded entity for federal and state income tax purposes. PepsiCo characterized PGM LLC as the employer of approximately 200 individuals working for PepsiCo foreign subsidiaries. PGM LLC was a paper company that had no management employees, office, property or any economic substance. PepsiCo treated the over $90 million of annual expatriate compensation charged to PGM LLC as FLNA foreign payroll, which had the effect of excluding FLNA from the PepsiCo combined return under the 80/20 test. Beginning in 2011, this exclusion zeroed out PepsiCo's annual Illinois

tax liability and generated tens of millions of dollars of annual Illinois net operating losses. In preparing and filing its returns, PepsiCo ignored longstanding controlling substantive tax law, which precluded it from treating the expatriates as PGM LLC employees based on PGM LLC's lack of economic substance and control over the expatriates. PepsiCo failed to make a good faith effort to determine its 2011, 2012, and 2013 Illinois income tax liabilities. Late payment penalties imposed by the Department against PepsiCo are therefore not abatable for reasonable cause and must be upheld.

UNDISPUTED MATERIAL FACTS

The Department incorporates the entire Joint Stipulation, including exhibits, into the Department's Cross Motion for Summary Judgment – 80/20 Issue Penalties. The facts pertinent to imposition of late payment penalties against PepsiCo are summarized below.

I. PepsiCo's Profitable Business Operations

PepsiCo is one of the pre-eminent soft drink and snack manufacturers in both the US and globally, with profitable business operations both domestically and internationally. Joint Stip. ¶ ¶4 and 23. FLNA is a U.S. "C corporation" for both federal and Illinois corporate income tax purposes and is wholly owned by PepsiCo. Joint Stip. ¶ 10. The management team for the PepsiCo domestic snack food business is employed by and operates out of FLNA's Texas offices. Joint Stip. ¶ 11. FLNA's gross sales during the 2010-2013 were almost exclusively sales of snack food products to, and for distribution domestically by an affiliate. Joint Stip. ¶ 19. The Frito-Lay North America division, which includes FLNA generated more operating profits than any of the other five PepsiCo business segments in 2010, 2011, 2012 and 2013, reporting profits which steadily increased from $3.4 billion in 2010 to $3.9 billion in 2014. Joint Stips. ¶¶ 22 and 23.

II. Foreign Expatriate Compensation Was Charged to PGM LLC, A Shell Company, Wholly Owned by FLNA

PGM LLC was formed on June 23, 2010 as a single member LLC disregarded for federal and state income tax purposes, wholly owned by FLNA. Joint Stip. ¶ 27. PGM LLC's books and records from 2011 forward recorded compensation of approximately 200 PepsiCo domestic employees seconded to foreign host company subsidiaries as PGM LLC foreign payroll. Joint Stip. ¶ ¶ 54 and 113. This expense was offset by foreign host company reimbursements. Joint Stips. ¶ 129. PGM LLC made no profit as "the reimbursement cross-charged to the foreign host companies, and credited to PGM LLC's general ledger as reimbursement, are on a cost basis, *i.e.*, there is no mark-up fee." Joint Stip. ¶ 129. PGM LLC owned no tangible or real property, nor did it maintain an office during any of the tax years at issue. Joint Stip. ¶ ¶ 147 and 151.

The expatriates signed Secondment Agreements and Letters of Understanding that characterized them as PGM LLC employees. Joint Exhibit 25 (Secondment Agreements). These agreements set out the framework of their foreign assignments, including, that "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; during the assignment, the seconded expatriates are subject to the full direction, control, and supervision of the assigned foreign host company while the expatriate provides the agreed upon services; and that PGM LLC does not exercise any direction, control, or supervision over the seconded expatriates of any day-to-day duties for the foreign host company performed under the Secondment Agreement." Joint Stip. ¶ 84. The host company "generally assesses the seconded expatriate's day-to-day performance and determines an annual performance rating reflective of these day-to-day services and submits this rating to the PepsiCo Corporate Group's Executive Compensation Team." Joint Stip. ¶ 87. PGM LLC employed no management personnel to oversee the expatriates Joint Stip. ¶¶ 32 and 122. The Expatriate Program is overseen in its entirety by a group of approximately twenty individuals within the PepsiCo Corporate Group's human resources function (the "PepsiCo Corporate Group HR Function"). Joint Stips. ¶¶ 99 and 100.

III. PepsiCo Characterized Expatriate Compensation Charged to PGM LLC as Foreign Payroll That Excluded FLNA and Its Domestic Snack Foods Income from PepsiCo's Illinois Unitary Group As Foreign Income Under Illinois' 80/20 Test

PepsiCo reported the expatriate compensation as PGM LLC foreign payroll as follows: 2011 -- $93,463,835 foreign (non-U.S.) payroll; 2011 tax year -- $100,439,232 foreign (non-U.S.) payroll; and 2012 -- $116,263,196 foreign (non-U.S.) payroll. Joint Stip. ¶ ¶ 137, 138, 139 and 147. PepsiCo asserted that this foreign payroll required that FLNA and its domestic snack food profits be excluded from PepsiCo's Illinois unitary group. Id. PepsiCo's application of the 80/20 Test to exclude FLNA and its domestic snack food profits from its 2011, 2012 and 2013 Illinois Combined Tax Returns zeroed out PepsiCo's Illinois tax liability for these years as follows:

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

Federal Consolidated Income – Per PepsiCo's Original Return.	1	$1,438,691,738	($1,348,087,235)	(1,424,458,644)	(800,028,430)
*********		*********	************	*********	*********
Total Net Income and Replacement Taxes - Per Audit	52	$ 6,251,010	$ 4,696,736	$ 3,355,864	$ 2,623,354
Total Net Income and Replacement Taxes – Per PepsiCo's Original Return	52	$ 5,350,035	$0	$0	$0

Joint Stip. ¶131. By excluding FLNA and its domestic income from the PepsiCo Illinois unitary business group, PepsiCo not only zeroed out its Illinois tax liability, but also generated substantial annual Illinois net operating loss deductions, which it could carryforward and use to offset Illinois taxable income in the event it ever again reported taxable Illinois base income. These Illinois net operating losses, compared to Illinois base income, computed by the Department as due for the Years at Issue by properly including FLNA in PepsiCo's Illinois unitary group, are summarized as follows:

	IL 1120 Line	2011	2012	2013
Department: Base Income allocable to Illinois – per Audit	39	$67,976,062	$46,400,960	47,805,944
PepsiCo; Base Loss Allocable to Illinois – Per PepsiCo's Original Return	39	(19,950,286)	($48,542,548)	($35,471,676)

Joint Exhibit 43 – EDA-25 at pages 276, 2326 and 2337. In summary, on its federal income tax return PepsiCo continued to report average annual federal consolidated taxable income of over $1.4 billion. On its Illinois return, by treating expatriate compensation charged to PGM LLC as foreign payroll that excluded FLNA snack food profits from its Illinois return, PepsiCo reported average federal consolidated *losses* of over $1 billion. Jt. Stip. ¶ 131. This reduced PepsiCo's Illinois tax liability to $0 for 2011, 2012 and 2013. Id. In addition, this generated net operating

losses allocable to Illinois for carryforward to offset income in future years as follows: 2011 – ($19,950,286); 2012 – ($48,542,548); and 2013 – ($35,471676). Joint Exhibit 43 – EDA-25 at pages 276, 2326 and 2337. PepsiCo introduced no evidence, and has never argued, that its exclusion of FLNA better reflected PepsiCo's Illinois apportionable income and tax liability to Illinois. Instead, the PepsiCo Corporate Group identified approximately $14 million dollars per year in total tax savings in 13 states, including Illinois, by creating PGM LLC as a division of FLNA and using PGM LLC to exclude FLNA from combined returns filed in states adopting the 80/20 Test. Joint Stip. ¶ 59 and Joint Exhibit 6 at PEP00002883.

IV. Late Payment Penalties Were Assessed Against PepsiCo For Failure to Pay Income Tax on Millions of Dollars of FLNA Business Income Properly Apportionable to Illinois

The Department assessed late payment penalties against PepsiCo in the following amounts for 2011, 2012 and 2013:

Tax Year	2011	2012	2013	Total Penalties
Total Net Income and Replacement Taxes - Per Audit	$ 4,696,736	$ 3,355,864	$ 2,623,354	
Total Late Payment Penalties – Per Audit	$939,347.20	$671,172.80	$524,670.80	$2,135,190.80

Joint Exhibit 38, pages 10, 15 and 20. The great preponderance of late payment penalties, and those at issue here were the penalties attributable to the millions of dollars of FLNA business income properly apportionable to Illinois. Id.

TRIBUNAL DECISION

The Department and PepsiCo filed Cross Motions for Summary Judgement on the issue of whether PGM LLC was the expatriates' employer and whether the expatriate compensation charged to PGM LLC was foreign payroll that properly excluded FLNA, as an 80/20 company, from the PepsiCo Illinois unitary group for 2011, 2012 and 2013. The Department and PepsiCo agreed that this issue was determined by whether the expatriates were PGM LLC's common law employees under case law interpreting this term for federal income and withholding tax purposes.

86 Ill. Admin Code § 100.3100(b). ("Compensation . . . has the same meaning under the Illinois Income Tax Act as under IRC Section 3401(c)"; and Treas. Reg. 3401(c)-(1)(b) (providing that employer-employee relationship exists under common-law tests focusing on the payor's control of the payee".)) PepsiCo asserted in its briefs that the expatriates were PGM LLC's common law employees based on the secondment agreements signed on behalf of PGM LLC by PepsiCo Corporate group human resource personnel, which identified the expatriates as PGM LLC employees. Joint Exhibit 25 (Secondment Agreements). The Department argued that the expatriates were not PGM LLC common law employees, based on PGM LLC's utter and complete lack of substance as a shell corporation, including lack of any management personnel employed by PGM LLC to oversee or otherwise control the expatriates' work for foreign host companies.

The Tribunal in addressing these arguments and finding for the Department, observed initially that the substance over form doctrine is a doctrine that has been used for over 85 years to combat tax avoidance:

> The main anti-abuse doctrine for tax cases is the "substance over form" doctrine which has developed over the last 85 years to include two long-standing, intertwined, and functionally equivalent tax principles that substance over form determines the taxability of transactions and that legal transactions or entities which have neither real economic substance and business purpose are disregarded for tax purposes. The seminal tax case which first enunciated the substance over form doctrine was the United States Supreme Court decision in Gregory v. Helvering, 293 U.S. 465 (1935).

PepsiCo Inc. and Affiliates v. Illinois Department of Revenue, 16 TT 82 and 17 TT 16, Decision on Summary Judgment Motions (May 4, 2021) ("Tribunal Decision.") at page 14. As memorialized in the Tribunal's decision, the Court in Gregory disregarded a tax-free business reorganization under the substance over form doctrine because "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. at 15 *quoting* Gregory 293 U.S. 470.

The Tax Tribunal agreed with the Department that PGM LLC was a paper company that lacked any substance. It ruled that the expatriates were not PGM LLC's employees, and therefore compensation paid them was not PGM LLC foreign payroll that excluded PGM LLC and FLNA from the PepsiCo Illinois combined group. In reaching this decision, the Tribunal stated that the 80/20 test measured real economic substance for purposes of excluding corporations that conducted 80% or more of their business activity outside the United States:

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

Id. at 19 (emphasis added). The Tribunal found that PGM LLC was a shell corporation with no economic reality:

> The reality of PGM LLC in the tax years at question was as follows: PGM LLC had no assets, no capitalization, no management or supervisory employees, and no offices. It conducted no business operations that generated or potentially generated any profit. **It was simply a shell corporation with no economic reality.**

Id. at p. 22 (emphasis added). As a shell corporation the Tribunal found that PGM LLC must be disregarded for having no economic substance or valid business purpose:

> **In essence, not only was no one at home at PGM LLC, it didn't even have a home. It was a shell corporation used to list the expatriates as employees**. Other than being told that PGM LLC was the new PepsiCo entity utilized as the employer for the expatriates, nothing changed for the expatriates. They dealt with the same group of employees in the PepsiCo corporate group for their US-based employment documents/contacts and other U.S.-based human resource needs, but they were supervised on their day-to-day foreign operations by their respective foreign host companies who paid for their salary and benefits by reimbursing PepsiCo through PGM LLC by internal accounting methods.
> Because PGM LLC was nothing but a shell corporation, **it must be disregarded for having no economic substance or valid business purpose.**

Id. at p. 23 (emphasis added). In the Tribunal's examination of longstanding federal income tax case law stretching back to seminal United States Supreme Court cases from the 1930's addressing the common law test for employment, the Tribunal found that the test focuses on control based on economic realities. See Tribunal Decision at pp. 27 et seq. *discussing* United States v. Silk, 331 U.S. 704 (1947); Bartels v. Birmingham, 332 U.S. 126 (1947); Darden in E.E.O.C. v. North Knox School Corp., 154 F.3d 744 (1998); and Professional and Executive Leasing, Inc. v. C.I.R., 89 T.C. 225 (1987). The Tribunal held, based on this case law, that PGM LLC could not control the expatriates based on its lack of economic substance and limited tax avoidance purpose:

> . . . . **PGM LLC is a shell company**. It is not a viable business. It has no management or supervisory employees. There is no one employed at PGM LLC who has the ability to control the expatriates or terminate their employment. Actual control for the day-to-day supervision of the expatriates was ceded to the foreign host companies. Even while the PepsiCo human resource group provided human resource functions for the expatriates, there is nothing in the record to suggest that anyone in that group was authorized or given the right to control the expatriates in a management/ supervisory capacity. No control was exerted over the expatriates by PGM LLC nor was anyone designated and authorized to exert any control on behalf of PGM LLC. **It exists only on paper in order for PepsiCo to avoid certain states' income taxes.**

Id. at 31 (emphasis added). In response to PepsiCo's argument that the expatriates were PGM LLC employees because their employment contracts characterized them as such, the Tribunal held "an employment contract doesn't control when there is a non-existent employer-employee relationship and, by extension, when the contract itself, is illusory." Id. at 33. The Tribunal ruled that PGM LLC must be disregarded based on its lack of economic substance and therefore did not make FLNA an 80/20 company:

> PepsiCo has failed in its burden to prove it is entitled to claim PGM LLC as an 80/20 company. **PGM LLC must be disregarded as it has no economic substance**. Similarly, it cannot be considered the employer of the expatriates. As a consequence, FLNA cannot be considered an 80/20 company and FLNA must be considered a company conducting business within the United States. FLNA must be included in the PepsiCo Illinois unitary group.

Id. at 35 (emphasis added). The Tribunal ruled that the Department's Notices of Deficiency, as they pertain to the 80/20 issue must therefore be upheld. Id.

ISSUE IN DISPUTE

At issue is whether late payment penalties imposed against PepsiCo for improperly zeroing out its Illinois taxable income by excluding FLNA from its Illinois unitary group under the 80/20 Test should upheld or abated for reasonable cause.

ARGUMENT

I. Statutorily Mandated Late Payment Penalties Imposed Against PepsiCo For Improperly Excluding FLNA from its Illinois Unitary Group as an 80/20 Company Are Prima Facie Correct

The Uniform Penalty and Interest Act, 35 ILCS 735/3-1 et. seq. ("UPIA") at section 3-3(b-20) imposes a late payment penalty against corporate taxpayers that fail to timely pay corporate income and personal property replacement taxes (generically hereinafter referred to collectively as "income taxes") required to be shown due on their corporate income tax returns. The penalty equals 20% of tax that is paid after the date the Department has initiated an audit or investigation of the taxpayer. As required by statute, the Department in its audit assessed a penalty equal to 20% of unpaid taxes as determined by its audit to be due from the PepsiCo based on the determination that FLNA was not excludible from the PepsiCo combined group as an 80/20 Company. These late payment penalties are at issue here.

The findings of the Department concerning the correct amount of tax due are *prima facie* correct. 35 ILCS 5/904; see also Balla v. Department of Revenue, 96 Ill.App.3d 293, 295 (1st Dist. 1981). The statutory presumption extends to all elements necessary for a determination that the tax and penalties assessed are due as determined by the Department. Branson v. Department of Revenue, 68 Ill. 2d 247, 258, 659 N.E.2d 961, 966-67 (1995).

The Department's findings related to tax liability and penalties were included in the notices of deficiency issued to PepsiCo for those tax years. The findings contained in those notices are deemed to be *prima facie* correct and are *prima facie* evidence that the amount of tax and penalties calculated are correct pursuant to 35 ILCS 5/904(a).

Summary judgment is proper when "the pleadings, depositions and admissions on file, together with affidavits, if any, show there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Performance Marketing Association, Inc. v Hamer, 2013 IL 11496, ¶12 (2013) (quoting 735 ILCS 5/2-1005(c)(2010)). There are no genuine issues here of material fact here. Accordingly, the issue of whether late payment penalties imposed against PepsiCo should be upheld is ripe for summary judgment. Id.

II. PepsiCo's 80/20 Penalties Do Not Qualify For Abatement Under the Reasonable Cause Exception Because PepsiCo Did Not Make a Good Faith Effort to Determine Its Proper Illinois Tax Liability

A. Under a Plain Reading of the Department's Regulations PepsiCo's 80/20 Penalties Do Not Qualify For Abatement for Reasonable Cause

PepsiCo contends that the penalties assessed by the Department should be abated for reasonable cause. In its Petitions, (Count X of 16-T-82 and Count XV of 17-TT-16) PepsiCo alleges that it made a good faith effort to determine its tax liability. The Department strenuously disagrees with the allegations in the relevant sections of PepsiCo's Petitions related to requested penalty abatement. PepsiCo did not make a reasonable determination of its proper tax liability, and the penalties are not abatable.

UPIA Section 3-8 provides that reasonable cause for abatement is determined in accordance with the Department's rules and regulations:

> The penalties imposed under the provisions of Sections 3-3, 3-4, 3-5, and 3-7.5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. 35 ILCS 735/3-8.

The Department's regulations state that the most important factor in determining reasonable cause for abatement is whether the taxpayer has made a good faith effort to determine its proper Illinois tax liability:

> The determination of whether a taxpayer acted with reasonable cause is made on a case by case basis taking into account all pertinent facts and circumstances. **The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine the proper tax liability and to file returns and pay the proper liability in a timely fashion**.

86 Ill. Admin. Code § 700.400(b) (2001). (emphasis added). PepsiCo clearly did not make a good faith effort to determine its proper tax liability. PepsiCo relied on its establishment of a shell company, PGM LLC, without any economic substance to exclude FLNA and its domestic profits from its Illinois combined return. PepsiCo thereby avoided millions of dollars in annual Illinois income taxes, as well as millions of dollars in income taxes in other states adopting the 80/20 Test, in sum totaling $14 million in annual estimated tax savings. Joint Stip. ¶ 59 and Joint Exhibit 6 at PEP00002883. PepsiCo's attempt to exclude FLNA in this manner, not only generated a $0 Net Income Tax Liability for 2011, 2011 and 2012, but it also created a potential additional tax benefit to PepsiCo -- tens of millions of dollars of net operating losses for each of these years for carryforward to future years in the event the PepsiCo combined group ever again reported Illinois net income. There was no change in PepsiCo's business operations or general profitability as PepsiCo continued to report average federal consolidated income of over $1.4 billion annually. Furthermore, the FLNA income excluded by PepsiCo from its combined return under the 80/20 Test was income from its domestic snack foods business, not foreign income.

What PepsiCo has done here is the polar opposite of attempting to properly determine its Illinois tax liability. It used the 80/20 Test, the legislative purpose of which was to exclude foreign income from Illinois combined returns, to exclude FLNA and its domestic income from PepsiCo's Illinois combined return, zero out PepsiCo's annual Illinois income tax liability and generate net operating losses available for carryforward to future years. PepsiCo clearly was keenly aware of the millions of dollars of tax savings it thought it could derive from using PGM LLC, a "shell company" that exists "only on paper," in this fashion to exclude FLNA from the PepsiCo combined return. Joint Stip. ¶ 59 and Joint Exhibit 6 at PEP00002883. PepsiCo has never argued, nor has it introduced any evidence, that application of the 80/20 Test to exclude FLNA and its domestic profits from its combined return better reflected its "proper tax liability." PepsiCo clearly did not make a good faith effort to determine its property Illinois tax liability. Under the plain language of Regulation §700.400(b) it has not demonstrated reasonable cause for abatement of the statutorily mandated late payment penalties imposed against it.

B. PepsiCo's 80/20 Penalties Cannot Be Abated Because It Ignored Longstanding Controlling Substantive Tax Law When It Treated The Expatriates as PGM LLC Common Law Employees In Order to Exclude FLNA From the PepsiCo Illinois Unitary Group

Reasonable cause generally has been interpreted by Illinois courts to mean the exercise of ordinary business care. Du Mont Ventilation Co. v. Dep't of Revenue , 99 Ill. App. 3d 263, 266

(1981). There is reasonable cause for abatement penalties where a taxpayer is unable to ascertain a clear legal standard through no fault of its own. See Du Mont Ventilation Co. v. Dep't of Revenue, 99 Ill. App. 3d 263, 266 (3d Dist. 1981). On the other hand, reasonable cause is inapplicable when a taxpayer does not exercise ordinary business care by neglecting clear statutory or judicial authority against its tax reporting position. See PPG Indus. Inc. v. Dep't of Revenue, 328 Ill. App. 3d 16, 26 (1st Dist. 2002); Kroger Co. v. Dep't. of Revenue, 284 Ill. App. 3d 473, 484 (1st Dist. 1996). This memorandum will first discuss this Illinois penalty abatement caselaw and then address why penalties imposed against PepsiCo are not abatable for reasonable cause based on the clarity of controlling substantive tax law here, which relies on substance rather than form in determining employer-employee relationships.

In Kroger Co. v. Department of Revenue 284 Ill. App. 3d 473 (1st. Dist. 1996) at issue was whether Kroger Co's gain from the sale of over 600 food and drugstores was business income or nonbusiness income. At the time, Illinois statutorily defined business income as:

> . . . [1] income arising from transactions and activity in the regular course of the taxpayer's trade or business . . . , and [2] 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.

35 ILCS 5/1501(a)(1) (prior to amendment effective July 1, 2004 by Public Act 93-0840). At issue in this case was whether this statutory definition, based on the definition contained in the Uniform Division of Income for Tax Purposes Act, contained two separate tests for business income. The Department argued that this definition contained two separate tests: i) based on the first clause above, the transaction test under which gain is treated as business income if it arose from transactions in the regular course of the taxpayer's business; and ii) under the second clause, the functional test, under which the gain is treated as business income where the acquisition, management and disposition of the assets constituted a regular part of the taxpayer's trade or business. Kroger argued that the second clause was merely a subset of the first and that the gain was only business income if it was a transaction in the regular course of the Kroger's business operations. Kroger's sale of 600 stores did not meet the transactional test – the sale of over 600 stores was not a sale in the regular course of the taxpayer's business. However the sale did meet the functional test because the stores were acquired, managed and disposed of as part of Kroger's business.

The court ruled in favor of the Department that the gain was business income. The Appellate Court found that the Illinois Appellate Court in its earlier decision in National Realty v. Dep't. of Revenue, 144 Ill. App. 3d 541 (2nd Dist.1986) had made it clear that the Illinois statutory definition contained both a transactional and functional test. Accordingly, the gain was taxable under the functional test. Kroger argued that even if the gain was taxable as business income, it should not be subject to late payment penalties because it had paid taxes in excess of the taxes assessed by the Department and it had simply not paid estimated taxes on the gain on time. Kroger also argued that courts in other states had interpreted the same UDITPA based statutory definition to include just a transactional test, under which its gain would not have been taxable. The Kroger court rejected the taxpayer's arguments against penalties, finding that Illinois imposed a separate

statutory penalty for payment of late estimated taxes, and that Kroger's failure to appreciate that Illinois law applied a functional test that treated the gain at issue as business income was not excusable as reasonable cause for abatement of penalties. Similarly in PPG Industries v. Dep't. of Revenue 328 Ill. App 3d 16, 28 (1st Dist. 2002) the Appellate Court once again ruled that taxpayer's gain from asset sale constituted business income under the functional test, and that the taxpayer's ignorance of Illinois law did not constitute reasonable cause for abatement of penalties.

In Tyson v. Illinois Dep't of Revenue, 312 Ill. App. 3d 64 (1st Dist. 1996) the Illinois Appellate similarly refused to abate failure to file and late payment penalties where the controlling substantive tax law was clear. In this decision the court rejected Tyson's argument that is was protected from taxation by P.L. 86-272, under which taxpayers cannot be subjected to state income taxes where they limit their activities within the state to solicitation of purchase orders for acceptance outside the state. The court ruled based on longstanding case law that the Tyson's maintenance of an office within Illinois clearly fell outside the protection of PL 86- 72 and upheld the income tax assessments against Tyson. The court similarly ruled in light of this longstanding controlling case law that the penalties imposed against Tyson were not abatable for reasonable cause. Id. at 76.

In Horsehead Corporation v. Dep't of Revenue, 441 Ill. Dec. 532, 157 N.E.3d 453 (Ill. Sup. Ct. 2019) the Illinois Supreme Court upheld a use tax imposed against Horsehead Corporation, but, nonetheless, ruled that late payment penalties imposed should be abated based on reasonable cause. At issue in this case was whether Horsehead's purchase of coke was exempt from tax under the Illinois Use Tax Act's "chemical exemption," which exempts from tax:

> . . . chemicals or chemicals acting as catalysts but only if the chemicals or chemicals acting as catalysts effect a direct and immediate change upon a product being manufactured . . .

35 ILCS 105/3-5(18). Horsehead was in the business of recovering zinc from electric arc furnace (EAF) dust generated by steel mills as zinc oxide. Horsehead acquired coke and combined it with the EAF dust as part of a manufacturing process to produce the zinc oxide. The court determined that the coke did not qualify for the exemption because based on testimony of expert witnesses the coke did not interact directly with the EAF Dust to affect a direct and immediate change on it to produce zinc oxide. Accordingly, the court upheld the Department's use tax assessment against Horsehead. However, the court ruled that "due to the absence of any controlling case law or a specific statutory definition providing what it means to 'effect a direct and immediate change' upon the manufactured project" it was not unreasonable for Horsehead to conclude that the coke qualified for the exemption. Accordingly, the court ruled that the late payment penalties should be abated for reasonable cause. See also, Security Life of Denver Insurance Company v. Illinois Dep't of Revenue, 14 TT 89 (Amended Order on Summary Judgment dated June 27, 2016) (Tribunal ruled that income tax penalties should be abated for reasonable cause where 35 ILC 5/1501(a)(27) did not provide any direction on how a holding company income/losses should be apportioned between separate unitary business groups).

The controlling substantive tax law here is clear. The parties agreed that whether the expatriate compensation was foreign payroll included in FLNA's 80/20 Test depended on whether

the expatriates were PGM LLC's common law employees as interpreted for federal income tax purposes. PepsiCo & Affiliates' Memorandum in Support of Its Motion for Summary Judgment at p. 20 ("The classification of an employer-employee relationship under federal tax law and common law controls for Illinois income tax purposes."); Illinois Department of Revenue's Brief In Response to PepsiCo & Affiliates' Motion for Summary Judgment at p. 2 ("FLNA cannot be an 80/20 Company because the expatriates are not PGM LLC's common-law employees."). The Tribunal confirmed in its ruling that whether the expatriates were PGM LLC's common law employees was controlling and determinative here. Tax Tribunal Decision on Motion for Summary Judgment Motions, PepsiCo & Affiliates v. Illinois Department of Revenue Dckts. 16 TT 82 and 17 TT 16 (Decision on Summary Judgment Motions dated May 4, 2021) at p. 14 ("Illinois employee/ employer tax regulations for the Illinois Income Tax Act incorporate both the related Internal Revenue Code and the federal tax regulation provisions, therefore a common-law test is to be applied in making employer determinations for purposes of the Illinois Income Tax Act.").

The parties disagreed over the common law definition of employee. PepsiCo argued that the form – characterization of the expatriates as PGM LLC employees in their employment contracts -- dictated that the expatriates were PGM LLC employees and accordingly that the 80/20 applied to exclude FLNA and its domestic income from PepsiCo's combined return. This argument was contrary to the legislative purpose of the 80/20 Test, which was to exclude foreign, not domestic income, from Illinois combined returns. This also was contrary to PepsiCo's financial statements and federal income tax returns which reported billions of dollars of domestic profits for the years at issue. By contrast, the Department argued that economic substance determined whether expatriates were PGM LLC common law employees, and that because PGM LLC was a shell corporation without management employees, assets or any other substance to it, it could not be the expatriates' common law employer and that FLNA was not excludable from the PepsiCo Illinois unitary group under the 80/20 Test. This result was consistent with the legislative purpose of the 80/20 Test and also consistent with the billions of dollars of domestic profits that PepsiCo reported on its financial statements and federal consolidated returns for the years at issue.

The Tribunal ruled in favor of the Department that economic substance determines whether the expatriates were PGM LLC's common law employees. As the Tribunal observed in its decision the seminal tax case which first enunciated the substance over form doctrine was the United States Supreme Court decision over 85 years ago in Gregory v. Helvering, 293 U.S. 465 (1935). The Tribunal's decision quoted the Court in Gregory, which ruled that substance not form must govern tax determinations because "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Tribunal Decision at 15 *quoting* Gregory 293 U.S. 470. This is precisely what has PepsiCo attempted to do here, exalt artifice over reality in depriving the 80/20 Test of all serious purpose here. In fact, PepsiCo has ignored controlling law to turn the 80/20 Test on its head by using it to exclude FLNA's domestic rather than foreign income from PepsiCo's Illinois combined returns. Unlike the novel legal determination in Horsehead Corporation – which addressed never previously interpreted statutory language -- the Tribunal's ruling that the expatriates were not PGM LLC common law employees was based on many decades of well-established case law. See Tribunal Decision at pp. 27 et seq. *discussing* United States v. Silk, 331 U.S. 704 (1947); Bartels v. Birmingham, 332 U.S. 126

(1947); Darden in E.E.O.C. v. North Knox School Corp., 154 F.3d 744 (1998); and Professional and Executive Leasing, Inc. v. C.I.R., 89 T.C. 225 (1987).

PepsiCo's reliance on PGM LLC to exclude FLNA and its domestic profits from the PepsiCo Illinois combined return, despite longstanding judicial precedent requiring that PGM LLC be disregarded as a shell company did not constitute the exercise of ordinary business care required to qualify the penalties at issue here from abatement under the reasonable cause exception. Kroger Co. v. Department of Revenue 284 Ill. App. 3d 473 (1996). Illinois courts have repeatedly ruled that ignorance of the law does not constitute reasonable cause for abatement of penalties. In Kroger and Tyson, the courts ruled that the taxpayers' ignorance of the statutory test for Illinois business income did not constitute reasonable cause for abatement of penalties imposed for failure to treat gain from asset sales as taxable Illinois business income. In Tyson, the court ruled that the taxpayer's failure to report taxable Illinois business income based on ignorance of the limitations of protection from taxation afforded by federal PL 86-272 did not constitute reasonable cause for abatement of penalties. Similarly, PepsiCo's ignorance of longstanding case law, which dictated that FLNA's income was not excludible from PepsiCo's returns under the 80/20 Test because PGM LLC, a shell company, was not the expatriates' common law employer, does not constitute reasonable cause for abatement of penalties This conclusion is particularly true here where instead of attempting to determine its proper Illinois tax liability, PepsiCo's apparent tax avoidance motives were so clearly contrary to the legislative purpose of the 80/20 Test to exclude foreign, not domestic income, from Illinois combined returns. 86 Ill. Admin. Code § 700.400(b). Illinois law interpreting the reasonable cause exception clearly dictates that PepsiCo has not demonstrated reasonable cause for abatement of late payment penalties.

C. Reasonable Cause Exception Is Inapplicable To Tax Avoidance Transactions Lacking Economic Substance

As addressed above, Illinois courts have issued numerous decisions interpreting the UPIA's reasonable cause exception. However, there is no reported Illinois decision, in which a taxpayer, such as PepsiCo here, has attempted to avoid Illinois income taxes by using a shell company lacking any substance, in which a court has addressed a taxpayer argument that late payment penalties should be abated for reasonable cause. Federal decisions addressing reasonable cause for abatement of federal income tax penalties, however, have addressed and repeatedly rejected taxpayer arguments for abatement of penalties for reasonable cause for tax avoidance transactions lacking economic substance. This federal case law supports the conclusion that the reasonable cause exception is inapplicable here based on PGM LLC's lack of economic substance.

For example, in Stobie Creek Invs. LLC v. United States, 608 F.3d 1366 (2010) the United States Court of Appeals for the Federal Circuit applied the economic substance doctrine to disregard a taxpayer's attempt to step up the basis of capital assets with a series of paper transactions and thereby avoid payment of tax on a sale of the assets. The court observed that the economic substance doctrine seeks to distinguish between structuring a real transaction in a particular way to obtain a tax benefit, which is legitimate, and creating a transaction to generate a tax benefit, which is illegitimate. The court stated that "[u]nder that doctrine, a court disregards

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

CONCLUSION

PepsiCo failed to exercise ordinary business care in excluding FLNA from its combined return by treating PGM LLC, a shell company, as the expatriates' employer with annual foreign payroll of over $90 million that excluded FLNA from the PepsiCo combined return under the 80/20 Test. PepsiCo ignored longstanding case law which dictated that the expatriates could not be PGM LLC's common law employees based on PGM LLC's lack of economic substance. The Department's motion for summary judgment that the late payment penalties with respect taxes attributable to the exclusion of FLNA from the PepsiCo combined return should be granted.

Respectfully submitted,

Illinois Department of Revenue

By:/s/Alan V. Lindquist

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CERTIFICATE OF SERVICE

The undersigned counsel of record certifies that a copy of the **ILLINOIS DEPARTMENT OF REVENUE'S BRIEF IN SUPPORT OF THE DEPARTMENT'S CROSS MOTION FOR SUMMARY JUDGMENT – 80/20 ISSUE PENALTIES** was served on March 17, 2022 on the following persons:

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