

**ILLINOIS INDEPENDENT TAX TRIBUNAL
CHICAGO, ILLINOIS**

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| INTERNATIONAL BUSINESS |) | |
| MACHINES CORPORATION, |) | |
| Petitioner, |) | |
| v. |) | 16-TT-115 |
| |) | |
| ILLINOIS DEPARTMENT OF REVENUE, |) | |
| Respondent. |) | |

NOTICE OF FILING

TO: Marc.simonetti@sutherland.com
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Andrew Appleby
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The undersigned representative for the Illinois Department of Revenue (the "Department") certifies that, on July 15, 2016, she filed the Department's Answer with the Illinois Independent Tax Tribunal.



Susan Budzileni
Special Assistant Attorney General

CERTIFICATE OF SERVICE

The undersigned representative for the Illinois Department of Revenue certifies that, on July 15, 2016, she served the Department's Answer on the individual identified above, at the email address shown above.



Susan Budzileni
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ILLINOIS INDEPENDENT TAX TRIBUNAL

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| INTERNATIONAL BUSINESS |) | |
| MACHINES CORPORATION, |) | |
| Petitioner, |) | |
| |) | |
| v. |) | 16 TT 115 |
| |) | Chief Judge James M. Conway |
| ILLINOIS DEPARTMENT OF REVENUE, |) | |
| Respondent. |) | |

ANSWER

NOW COMES the Department of Revenue of the State of Illinois (“Department”), through its attorney, Lisa Madigan, Attorney General of and for the State of Illinois, and for its Answer to Taxpayer’s Petition respectfully pleads as follows:

PARTIES

1. Petitioner, International Business Machines Corporation ("IBM"), is a publicly traded corporation duly organized and existing under the laws of New York.

Answer: The allegations in Paragraph 1 are required by Illinois Independent Tax Tribunal Regulation (“Rule”) 310(a)(1)(A) (86 Ill. Adm. Code §5000.310), are not material allegations of fact, and therefore do not require an answer pursuant to Rule 310(b) (2). To the extent an answer is required, Department admits the factual allegations in Paragraph 1.

2. Petitioner maintains its principal place of business at 1 New Orchard Road, Armonk, New York 10504-1722.

Answer: The allegations in Paragraph 2 are required by Illinois Independent Tax Tribunal Regulation (“Rule”) 310(a) (1) (A) (86 Ill. Adm. Code §5000.310), are not material allegations of fact, and therefore do not require an answer pursuant to Rule 310(b) (2). To the extent an answer is required, Department denies the allegations in Paragraph 2.

3. Petitioner's telephone number is (914) 499-1900.

Answer: The allegation in Paragraph 3 is required by Illinois Independent Tax Tribunal Regulation (“Rule”) 310(a) (1) (A) (86 Ill. Adm. Code §5000.310), is not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b) (2). To the extent an answer is required, Department denies the allegations in Paragraph 3.

4. Petitioner's tax identification number is 13-0871985.

Answer: Department admits the factual allegations in Paragraph 4.

5. Petitioner is represented by Sutherland Asbill & Brennan LLP attorney Marc A. Simonetti, who is located at The Grace Building, 40th Floor, 1114 Avenue of the Americas, New York, NY 10036-7703 and can be reached at (212) 389-5015 or marc.simonetti@sutherland.com.

Answer: The allegations in Paragraph 5 are required by Rule 310(a)(1)(A), are not material allegations of fact, and therefore do not require an answer pursuant to Rule 310(b)(2). To the extent an answer is required, Department admits the factual allegations in Paragraph 5.

6. Respondent, Illinois Department of Revenue ("Department"), is an agency of the state of Illinois responsible for administering and enforcing the revenue laws of the state of Illinois.

Answer: Department admits that the Department is an agency of the State of Illinois and that the Department is responsible for enforcing the Illinois Income Tax Act (35 ILCS 5/101 et seq.), which is relevant to the legal claims raised in Taxpayer's Petition. The term "revenue laws" is vague and therefore the Department denies all other allegations in Paragraph 6.

JURISDICTION

7. On March 31, 2016, the Department issued the Notices to IBM assessing a total balance due of \$19,159,241.00 in tax; \$3,831,848.20 in penalty; and \$2,791,586.68 in interest for the tax years ended December 31, 2009 and December 31, 2010. The Notice of Deficiency for the tax year ended December 31, 2009 asserts a total tax deficiency of \$9,737,283. The Notice of Deficiency for the tax year ended December 31, 2010 asserts a total tax deficiency of \$9,421,958. A copy of the Notices is attached as **Exhibit A**.

Answer: Department admits that factual allegations in paragraph 7. The Notices of Deficiency speak for themselves.

8. This Tribunal has original jurisdiction over all Department determinations reflected in Notices of Deficiency where the amount at issue exceeds \$15,000.00, exclusive of penalties and interest. 35 Ill. Comp. Stat. 1010/1-45.

Answer: Department admits the existence, force and effect of the Independent Tax Tribunal Act (35 ILCS 1010/1-10 et seq.), and alleges that the statute speaks for itself.

BACKGROUND

9. IBM World Trade Corporation ("WTC") is a Delaware corporation with its headquarters in New York.

Answer: Department admits the factual allegations in paragraph 9.

10. WTC is a wholly-owned subsidiary of IBM.

Answer: Department admits the factual allegations in paragraph 10.

11. In 1949, IBM contributed its foreign assets and foreign securities to WTC.

Answer: Upon information and belief, Department admits the allegations in paragraph 11.

12. During the audit period, WTC conducted its business operations primarily outside the United States.

Answer: The term “primarily” is undefined, and therefore, the allegation in paragraph 12 is vague and ambiguous. Therefore, Department denies the allegations in paragraph 12.

13. WTC did not make any sales in the U.S.

Answer: The Department lacks the knowledge or information sufficient to form a belief as to the truth or falsity of the allegations contained in Paragraph 13.

14. Historically, WTC licensed from IBM the right to sublicense computer hardware technology and software technology in foreign countries.

Answer: The allegation in Paragraph 14 is not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2). Department objects to the term “historically” and the lack of a definite time period for the facts alleged. Because no time period is specified, the Department lacks the information sufficient to form a belief as to the truth or falsity of the allegations contained in Paragraph 14.

15. IBM and WTC established the terms of the Hardware Royalty agreement in 1963.

Answer: Department objects to the phrase “established the terms of” because it is vague and ambiguous. Department admits IBM and WTC entered into a “License Agreement” dated January 1, 1963. That agreement speaks for itself. Department denies the remaining factual allegations in Paragraph 15.

16. IBM and WTC established the terms of the Software License agreement in 1988.

Answer: Department objects to the phrase “established the terms of” because it is vague and ambiguous. Department admits IBM and WTC entered into an “Agreement” dated January 1, 1988. That agreement speaks for itself. Department denies the remaining factual allegations in Paragraph 15.

17. IBM and WTC entered into three Cost Sharing Agreements, one each for hardware, software, and services (collectively, the "CSA"), effective January 1, 2007.

Answer: The Department admits that IBM and WTC entered into agreements entitled “IBM World Trade Corporation Software Intangibles and Shared Services Cost Sharing Amendment,” “IBM World Trade Corporation Services Intangibles and Shared Services Cost Sharing Amendment,” and “IBM

World Trade Corporation Hardware Intangibles and Shared Service Cost Sharing Amendment” (hereinafter the “CSA”) each effective December 31, 2006. Department denies the remaining allegations in Paragraph 17.

18. IBM is the legal owner of the intellectual property behind its hardware and software technology, while WTC is the beneficial owner for the geographic territories assigned to it under the CSA.

Answer: Department objects the allegation in Paragraph 18 as vague and ambiguous. The terms “behind,” “beneficial owner,” “hardware and software technology” are not defined. Nor is the term “geography territories” defined in the CSA. The Department admits the existence of the CSA. Department denies the remaining allegations in Paragraph 18.

19. Pursuant to the CSA, WTC shares research and development costs ("R&D") and selling, general, and administrative expenses ("SG&A") with IBM.

Answer: The Department admits the existence of the CSA and alleges that those agreements speak for themselves. Department denies the remaining factual allegations in Paragraph 19.

20. WTC receives royalties from the controlled foreign corporations ("CFCs") related to the sale of hardware, software, and services

Answer: Department admits that WTC receives royalty income. Department lacks sufficient information to either admit or deny that the royalty income WTC receives is from CFCs related to the sale of hardware, software, and services.

21. WTC also sells directly to third party customers outside the U.S.

Answer: Department has insufficient information to either admit or deny the factual allegations in paragraph 21.

22. License agreements have been periodically amended to adjust the hardware royalty rates and software royalty rates according to updated transfer pricing studies.

Answer: Department objects to the term “License agreements” because it is undefined and therefore, vague and ambiguous. Therefore, the Department lacks information sufficient to either admit or deny the factual allegation in Paragraph 22.

23. The most recent software royalty transfer pricing study indicated that the royalty is within the interquartile range for comparable uncontrolled software license transactions.

Answer: Department denies the allegations in paragraph 23 and demands strict proof thereof.

24. In 2009, WTC had seventeen employees in the United States, all based in New York.

Answer: Department admits that Taxpayer provided W-2s for 17 WTC employees for 2009 all of whom were based in New York. Department denies that WTC had only 17 employees in the

United States in 2009. Department denies the remaining allegations in Paragraph 24.

25. In 2010, WTC had four employees in the United States, all based in New York.

Answer: Department admits that Taxpayer provided W-2s for 4 WTC employees for 2010 all of whom were based in New York. Department denies that WTC had only 4 employees in the United States in 2010. Department denies the remaining allegations in Paragraph 25.

26. In 2009 and 2010, WTC operated a network of foreign branches that employed hundreds of employees and many contractors outside the United States.

Answer: Department objects to the allegation in Paragraph 26 as vague and ambiguous. The phrase “network of foreign branches” is not defined. Additionally, the alleged employees and contractors “outside the united states” are not defined with sufficient specificity to allow the Department to determine the veracity of the allegation. Therefore, Department has insufficient information to either admit or deny the allegations in Paragraph 26.

27. WTC's branch employees performed sales distribution functions, including sales, finance, human resources, marketing, sales operations, delivery, and customer service.

Answer: As no job descriptions have ever been provided to the Department for “WTC’s branch employees,” Department has insufficient information to either admit or deny the factual allegations in paragraph 27.

28. In 2009 and 2010, WTC had approximately six directors, and between nine and eleven officers, some of whom were also directors or officers of IBM.

Answer: Department admits that WTC had officers and directors and that some of those officers and directors were also officers and directors of IBM. Department has insufficient information to either admit or deny the remaining factual allegations in paragraph 28.

29. Most of WTC's directors and officers were directors or officers of many other IBM subsidiaries.

Answer: Department has insufficient information to either admit or deny the remaining factual allegations in paragraph 28.

30. In 2009, WTC had everywhere payroll of approximately \$17 million and U.S. payroll of approximately \$1.2 million.

Answer: Department denies the allegations in paragraph 30.

31. In 2010, WTC had everywhere payroll of approximately \$17.7 million and U.S. payroll of approximately \$336,000.

Answer: Department denies the allegations in paragraph 31.

32. In 2009, WTC had everywhere property of approximately \$66.7 million and U.S. property of approximately \$177,000.

Answer: Department denies the allegations in paragraph 32.

33. In 2010, WTC had everywhere property of approximately \$66 million and U.S. property of approximately \$9,000.

Answer: Department denies the allegations in paragraph 33.

PROCEDURAL HISTORY

34. The Department audited IBM's income tax returns for tax years ended December 31, 2009 and December 31, 2010 ("Audit Period").

Answer: Department admits the factual allegations in paragraph 34.

35. IBM responded to all audit information requests in a timely and sufficient manner.

Answer: Department denies the allegations in paragraph 35.

36. As a result of the audit, the Department issued an assessment of additional tax because the Department disregarded WTC's statutory characterization as an excluded "80/20 Company." A copy of the 80/20 calculation workpapers is attached as Exhibit B.

Answer: Department admits it issued a Notice of Deficiency with a proposed assessment of additional tax, penalties and interest because WTC did not meet the 80/20 business activity test in 2009 or 2010. Department's Notice of Deficiency speaks for itself. Department admits that Petitioner's Exhibit B contains some audit workpapers.

37. The Department imputed additional property and payroll to WTC for purposes of the 80/20 test.

Answer: Department denies the allegation in Paragraph 37. The Department did not impute property or payroll to WTC. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the factors were not shown on WTC's books and were not readily discernable from Taxpayer's books and records. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27).

38. The Department provided workpapers that detailed its assumptions and calculations for the 80/20 test.

Answer: Department admits that during the audit its auditor provided workpapers to the Taxpayer showing the auditor's analysis of the business activity test based upon the best information available.

39. The Department imputed property and payroll to WTC based on unverified information from websites, such as corporationwiki.com, manta.com, and hoover.com.

Answer: Department denies the allegation in Paragraph 39. The Department did not impute property or payroll to WTC. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the factors were not shown on WTC's books and were not readily discernable from Taxpayer's books and records. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27).

40. Open source websites such as corporationwiki.com allow anyone to enter or change information on the site.

Answer: Paragraph 40 does not contain an allegation of material fact, and therefore, no answer is required pursuant to Rule 302(b)(2). To the extent an answer is required, Department has insufficient information to either admit or deny the factual allegations in paragraph 40.

41. The Department imputed property and payroll to WTC based on several faulty and baseless assumptions.

Answer: Department denies the allegations in paragraph 41.

42. During the audit, IBM provided the Department with documentation illustrating that in 2009, WTC had seventeen employees in the United States, all based in New York; and that in 2010, WTC had four employees in the United States, all based in New York.

Answer: Department admits Petitioner provided the Department with seventeen W-2s for 2009 and four W-2s for 2010 that were issued by WTC to employees based in New York. Department denies the remaining allegations in paragraph 42.

43. The Department ignored the information IBM provided and instead re-computed WTC's U.S. property fraction by calculating a rent amount determined by multiplying a fabricated number of WTC employees by a fabricated per employee rental rate.

Answer: Department denies the allegations in paragraph 43 and affirmatively states that because

Petitioner failed to provide the information and documentation requested by the auditor, the auditor used the best information available to determine WTC's U.S. property.

44. The Department calculated the imputed U.S. rent based on 400 WTC U.S. employees.

Answer: Department denies the allegation in Paragraph 44. The Department did not impute property or payroll to WTC. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the business activity test factors were not shown on WTC's books and were not readily discernable from Taxpayer's books and records. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27).

45. The Department conceived the number of employees based on Internet postings on an unverified open-source website.

Answer: Department objects to the phrase "conceived" because it is vague and ambiguous. The Department admits Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. Department denies the remaining allegations in Paragraph 44.

46. The Department conceived an assumption of 250 square feet per employee (400 square feet per officer); more than 7,000 square feet of common space; and rent at \$15 per square foot, for a total imputed U.S. rent of \$13.5 million per year.

Answer: Department objects to the phrase "conceived an assumption" because it is vague and ambiguous. Department admits that it included \$13.5 million in the property factor numerator and denominator, based on an estimate of 250 square feet per employee (400 square feet per officer); more than 7,000 square feet of common space; and rent at \$15 per square foot, for real property used by WTC in 2009 and 2010. Department denies the remaining allegations in paragraph 46.

47. The Department provided no support for its rental assumptions.

Answer: Department denies the allegations in Paragraph 47 and affirmatively states that Petitioner improperly failed to include property used by WTC's U.S. employees and officers in its 80/20 business activity test property factor pursuant to 86 Ill. Adm. Code 100.3380(b).

48. The Department also imputed \$1.68 million per year for U.S. capital leases (vehicles) for executives and salesmen. The Department used an assumption of \$350/month per vehicle for 50 vehicles.

Answer: Department admits that, in analyzing WTC's property factor of the 80/20 business

activity test, the auditor included U.S. capital leases of \$1.68 million using \$350/month lease rates per vehicle multiplied by 50 vehicles. Department denies the remaining allegations in paragraph 44. Department affirmatively states that Petitioner improperly failed to include property used by WTC's U.S. employees and officers in its 80/20 business activity test property factor pursuant to 86 Ill. Adm. Code 100.3380(b) and failed to provide the Department's auditor with vehicle capital lease expenses as requested. Department's auditor used the best information available to determine the amount of WTC property in the U.S. properly includable in the property factor.

49. The Department provided no support for its capital lease assumptions.

Answer: Department denies the allegations in paragraph 49.

50. During the audit, IBM informed the Department that WTC did not provide any vehicles to any employees, officers, or directors.

Answer: Department lacks sufficient information to either admit or deny the allegations in paragraph 46.

51. The Department devised U.S. compensation for WTC officers and directors by imputing 100% of their IBM compensation to WTC.

Answer: The Department objects to the term "devised" as vague and ambiguous. The Department did not impute compensation to WTC. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Department's auditor found that WTC's proffered payroll factor did not include compensation paid to WTC officers and directors. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the business activity test factors were not shown on WTC's books and were not readily discernable from Taxpayer's books and records provided to him. Taxpayer failed to provide auditor with the compensation amounts paid to WTC's officers and directors. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27). The Department denies the remaining allegations in Paragraph 51.

52. These officers and directors did not work exclusively for WTC.

Answer: The phrase "These officer and directors" is vague and ambiguous as the officers are not named nor otherwise defined. Therefore, Department denies the allegations in paragraph 52.

53. The Department ignored the official list of WTC officers and directors, and their IBM W-2 wages provided by IBM.

Answer: Department denies the allegations in paragraph 53.

54. Instead, the Department grossly overestimated the officers' and directors' IBM compensation based on information from unreliable sources.

Answer: Department denies the allegations in paragraph 54. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity.

55. During the audit, IBM explained that even if the Department had the authority to impute payroll-which it does not-that the Department could not impute 100% of the officers' and directors' IBM wages to WTC.

Answer: Paragraph 55 does not contain material allegations of fact, rather an argument in law, and therefore does not require an answer pursuant to Rule 310(b)(2). Department admits that an agent of IBM made statements to the Department's auditor in which the IBM agent claimed that the Department did not have the authority to impute payroll of WTC officers and directors to WTC. The Department denies the remaining allegations in paragraph 55.

56. The Department also imputed a portion of the IBM Chairman's compensation to WTC, even though he was not an officer, director, or' employee of WTC.

Answer: Department denies the allegations in paragraph 56.

57. The Department also imputed 100% of another individual's compensation to WTC, even though he was not an officer, director, or employee of WTC, based entirely on information from corporationwiki.com.

Answer: Department denies the factual allegations in paragraph 57.

58. The Department expressly recognized that it could not impute any of IBM's payroll under the CSA to WTC.

Answer: Department denies the factual allegations in paragraph 58.

59. The Department's workpapers stated that "IBM Corporation's Salaries claimed for R&D Tax credit are excluded from WTC 80/20 calculation."

Answer: Department admits the factual allegations in paragraph 59.

60. During the audit, to illustrate the Department's flawed analysis, IBM provided a calculation that used the ratio of IBM's gross receipts to WTC's gross receipts as a proxy to divide the officers' and directors' wages between the two entities.

Answer: The Department objects to Taxpayer's characterization of Department's analysis as "flawed." Such a characterization is argumentative and improper. Department lacks sufficient information to either admit or deny the allegations in paragraph 60.

61. Even imputing wages using the gross receipts ratio, WTC still qualified as an 80/20 Company.

Answer: Department denies the allegations in paragraph 61.

62. On November 21, 2014, the Department issued a Notice of Proposed Deficiency assessing an additional liability in the amount of \$19,157,894.00 in tax; and \$2,873,684.00 in penalties, for the Audit Period (the Notice of Proposed Deficiency did not calculate interest).

Answer: Department admits the factual allegations in paragraph 62.

63. On January 16, 2015, IBM submitted a request for an Informal Conference Board review of the Notice of Proposed Deficiency pursuant to Ill. Admin. Code tit. 86, § 215.115.

Answer: Department admits that on January 29, 2015, the auditor was notified by the ICB administrator that ICB was taking jurisdiction over the audit of Petitioner for the years at issue. Department lacks sufficient information to either admit or deny the factual allegations in paragraph 63. Pursuant to Department Regulation 215.120(e), Recommendations, notes, memoranda and other records of the ICB with respect to issues raised in ICB matters are not subject to disclosure and do not become part of the audit file. 86 Ill. Adm. Code 215.120(e).

64. The Informal Conference Board hearing was adjourned shortly after it began because two board members were called away from the hearing.

Answer: Paragraph 64 does not contain a material allegation of fact, and therefore, does not require an answer pursuant to Rule 310(b)(2). To the extent an answer is required, upon information and belief, Department admits that two of the three members of the Informal Conference Board were unexpectedly called away from the in-person conference. Department denies the remaining factual allegations in paragraph 64. The Informal Conference Board does not hold hearings. It holds conferences. See 86 Ill. Adm. Code 215.100 et seq. Additionally, the informal conference board only holds in-person conferences if requested by the taxpayer. 86 Ill. Adm. Code 215.120(f).

65. IBM requested a full hearing.

Answer: Paragraph 65 does not contain a material allegation of fact, and therefore, does not require an answer pursuant to Rule 310(b)(2). To the extent an answer is required, Department lacks sufficient information to either admit or deny the allegations in paragraph 65. Pursuant to Department Regulation 215.120(e), Recommendations, notes, memoranda and other records of the ICB with respect to issues raised in ICB matters are not subject to disclosure and do not become part of the audit file. 86 Ill. Adm. Code 215.120(e).

66. The Informal Conference Board denied IBM a full hearing.

Answer: Paragraph 66 does not contain a material allegation of fact, and therefore, does not require an answer pursuant to Rule 310(b)(2). To the extent an answer is required, Department

denies the factual allegations in paragraph 66. The Informal Conference Board does not hold hearings. It holds conferences to review proposed adjustments by auditors of the Department of Revenue's Audit Bureau prior to the issuance of a protestable notice. See 86 Ill. Adm. Code 215.100 et seq. The purpose of the informal review process is to afford taxpayers an opportunity to resolve disagreements with the Department after a liability, deficiency, or claim denial has been proposed, but before commencement of the formal protest and administrative hearing process. 86 Ill. Adm. Code 215.100. According to Exhibit C of the Petition, ICB conferee, Craig Callahan, indicated in his email dated January 19, 2016, that he "discussed the 'audit file 80/20 test information' with the audit team, reviewed the documents [IBM] presented at the informal conference, and concluded there was no additional information needed by the Informal Conference Board for its deliberation of IBM's objections to the Notice of Proposed Deficiency. Further, Mr. Callahan stated as follows in a prior email dated June 10, 2015:

I spoke to the auditor. He will send me a list of the "80/20 test" documentation provided by the taxpayer. I will discuss the same with the audit team, and identify any additional information we need before the Board can determine if WTC "proved clearly" that it is entitled to the 80/20 exemption- the threshold of proof referred to by the *Zebra* appellate court.

See Petition, Exhibit C.

67. IBM requested that the Informal Conference Board reconsider its denial and grant a full hearing so that IBM could provide any additional information (beyond the voluminous information IBM provided during the audit) that the Department might want for the 80/20 Company determination.

Answer: Paragraph 67 does not contain a material allegation of fact, and therefore, does not require an answer pursuant to Rule 310(b)(2). To the extent an answer is required, Department admits the Taxpayer requested an ICB in-person conference by tendering an ICB-1. Upon information and belief, Department admits that ICB Conferee, Craig Callahan, understood that IBM, through its counsel, Andrew Appleby, requested another opportunity to address the Informal Conference Board. See email dated January 19, 2016. The Informal Conference Board does not hold hearings. See 86 Ill. Adm. Code 215.100 et seq. It holds conferences to review proposed adjustments by auditors of the Department of Revenue's Audit Bureau prior to the issuance of a protestable notice. "Recommendations, notes, memoranda and other records of the ICB with respect to issues raised in ICB matters are not subject to disclosure and do not become part of the audit file. 86 Ill. Adm. Code 215.120(e). Department lacks sufficient information to either admit or deny the remaining factual allegations in Paragraph 67.

68. The Informal Conference Board expressly "concluded there was no additional information needed by the Informal Conference Board for its deliberation of IBM's objections to the Notice of Proposed Deficiency." See email from Informal Conference Board Conferee attached as Exhibit C.

Answer: Paragraph 68 does not contain a material allegation of fact and therefore does not require an answer pursuant to Rule 310(b)(2). To the extent an answer is required the Department admits the existence of the email dated January 19, 2016 from Craig Callahan, ICB Conferee, to Andrew Appleby. The email speaks for itself.

69. On January 11, 2016, the Informal Conference Board issued an Action Decision sustaining the Department's Notices of Proposed Deficiency.

Answer: Department admits the factual allegations in paragraph 69.

70. On March 31, 2016, the Department issued the Notices to IBM assessing a total balance due of \$19,159,241.00 in tax; \$3,831,848.20 in penalty; and \$2,791,586.68 in interest for the tax years ended December 31, 2009 and December 31, 2010.

Answer: Department admits the factual allegations in paragraph 70.

COUNT I

The law requires that a taxpayer include all proscribed factors in the 80/20 business activity test in order to determine if a unitary group member may be excluded from the group.

71. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 70 as if set forth fully herein.

Answer: Department restates and incorporates its Answers to paragraphs 1 through 70 as if fully set forth herein.

72. Illinois tax law limits the composition of a unitary combined return to a water's-edge combined filing methodology. 35 Ill. Comp. Stat. 5/1501 (a)(27)(A).

Answer: Paragraph 72 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b) (2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

73. A taxpayer must compute each unitary entity's business activity to determine whether it is included in the Illinois water's-edge unitary combined group return.

Answer: Paragraph 73 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

74. An Illinois unitary combined group does not include a unitary entity if its business activity outside the United States is 80% or more of its total business activity (commonly referred to as an 80/20 Company). *Id.*; see also *Dover Corp. v. Illinois Dep 't of Revenue*, No.98 L 50170 (Ill. Cir. Ct. Cook Jan. 14, 2000).

Answer: Paragraph 74 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states

that such statute speaks for itself.

75. Illinois tax law expressly provides that an 80/20 Company cannot be included in the Illinois unitary combined return. 35 Ill. Comp. Stat. 5/1501(a)(27)(A).

Answer: Department objects to the term “Illinois tax law” as vague and ambiguous. Paragraph 75 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b) (2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

76. Illinois Tax Law requires the comparison of United States business activity to worldwide business activity ("Business Activity Test"). 35 Ill. Comp. Stat. S/1501(a)(27)(A); Ill. Admin. Code tit. 86, § 100.9700(c).

Answer: Department objects to the term “Illinois tax law” as vague and ambiguous. Paragraph 76 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b) (2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

77. The Business Activity Test involves two fractions-property and payroll. The numerators of the fractions represent property and payroll from sources within the United States, and the denominators of the fractions represent respective worldwide property and payroll. *Id.*

Answer: Paragraph 77 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b) (2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

78. Illinois regulations provide that the fractions shall be gross figures without intercompany eliminations based on the entity's membership in any unitary business group. Ill. Admin. Code tit. 86, § 100.9700(c).

Answer: Paragraph 78 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of the Illinois Income Tax Regulations (86 Ill. Adm. Code 100.2000 et seq.) and states that such regulation speaks for itself.

79. The taxpayer must compute each entity's property and payroll fractions using the same methodology for both Business Activity Test and apportionment purposes. *Id.*

Answer: Paragraph 79 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Regulations (86 Ill. Adm. Code 100.2000 et seq.) and states that such regulation speaks for itself.

80. A taxpayer must average the two fractions to arrive at its business activity fraction. *Id.*

Answer: Paragraph 80 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Regulations (86 Ill. Adm. Code 100.2000 et seq.) and states that such regulation speaks for itself.

81. The property fraction is a fraction comprised of a numerator, which is the average value of the United States real and tangible personal property owned or rented and used in the trade or business during the taxable year; and a denominator, which is the average value of all the real and tangible personal property owned or rented and used in the trade or business during the taxable year. 35 Ill. Comp. Stat. 5/304(a)(1)(A). The value of property is averaged using the beginning and end of year balances. 35 Ill. Comp. Stat. 5/304(a)(1)(C).

Answer: Paragraph 81 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

82. The payroll fraction is a fraction comprised of a numerator, which is the total compensation paid within the United States during the taxable year; and a denominator, which is the total compensation paid everywhere during the taxable year. 35 Ill. Comp. Stat. 5/304(a)(2)(A).

Answer: Paragraph 82 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of the Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

83. If the employer-employee relationship does not exist, any payment for services performed does not constitute "compensation." Ill. Admin. Code tit. 86, § 100.3100(b).

Answer: Paragraph 83 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Regulations (86 Ill. Adm. Code 100.2000 et seq.) and states that such regulation speaks for itself.

84. Illinois regulations expressly provide that "employee" includes an individual performing services only if the relationship between the person and the entity for which the person performs such services is the "legal relationship of employer and employee." *Id.*

Answer: Paragraph 84 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of Illinois Income Tax Regulations (86 Ill. Adm. Code 100.2000 et seq.) and states that such regulation speaks for itself.

85. The Department does not have the authority to impute property or payroll for purposes of the 80/20 Business Activity Test.

Answer: Department denies the allegation in paragraph 85.

86. The Office of Administrative Hearings expressly stated that the Department is precluded from imputing payroll from one company to another when the employees in question (including directors and officers) provide only minor services or receive no compensation from the entity, when the companies have economic substance. *Ill. Dep 't of Revenue v. Shanghai, Inc.*, IT 02-1 (Office of Admin. Hearings Feb. 7, 2002).

Answer: Paragraph 86 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of its administrative decision and states that such decision speaks for itself.

87. IBM employees, directors, and officers provide only minor services to WTC and receive no compensation from WTC.

Answer: Department denies the allegations in paragraph 77.

88. WTC has hundreds of employees worldwide who conduct WTC's business operations.

Answer: Because Petitioner failed to fully respond to Department's auditor's information requests, Department has insufficient information to either admit or deny the allegations in paragraph 88.

89. Because Illinois statutorily excludes 80/20 Companies from the unitary group return, the 80/20 Company's income is necessarily excluded from the unitary group's Illinois taxable income.

Answer: Paragraph 79 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence, force and effect of the Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself. Department further states that a unitary company is only excluded from the Illinois unitary business group if the taxpayer can show by clear and convincing evidence that the claimed 80/20 member meets the 80/20 business activity test, as defined by the IITA and the corresponding regulations.

WHEREFORE, Department respectfully requests this Tribunal enter judgment in favor of the Department and enter an Order:

- a. Finding that Petitioner has failed to show by clear and cogent evidence that WTC meets the statutory and regulatory requirements for an 80/20 company;
- b. Finding that WTC did not meet the 80/20 business activity test for the tax years ending December 31, 2009 or December 31, 2010;
- c. Holding that the Department's Notices of Deficiency are correct, as issued; and
- d. Such other and further relief as the Tribunal may deem just and appropriate.

COUNT II

The Department's auditor identified information and amounts properly includable in the property and payroll factors that Petitioner excluded from its calculation of WTC's 80/20 business activity test and therefore, Petitioner did not meet its burden to prove by clear and convincing evidence that WTC met the 80/20 business activity test.

90. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 89 as if set forth fully herein.

Answer: Department restates and incorporates its Answers to paragraphs 1 through 89 as if fully set forth herein.

91. Even if the Department had the authority to impute property or payroll from one entity to another for purposes of the 80/20 test-which it does not-WTC still qualifies as an 80/20 Company when accurate data is used to calculate the adjustments.

Answer: Department denies the allegations in paragraph 91.

92. Specifically, the Department has adjusted WTC's business activity fractions by imputing additional United States property and payroll to WTC.

Answer: Department denies the allegations in paragraph 92. The adjustment made by the Department was the denial of the claimed 80/20 business activity test exemption for WTC and the inclusion of WTC in Petitioner's Illinois Unitary Business Group.

93. Even using the Department's faulty methodology to impute additional United States presence to WTC, based on WTC's actual facts WTC continues to have more than 80% of its business activity outside the United States.

Answer: Department denies the allegations in paragraph 93.

Property Fraction

94. The Department imputed additional U.S. property to WTC for purposes of calculating the property fraction.

Answer: Department denies the allegations in Paragraph 94. The Department did not impute property or payroll to WTC. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the factors were not shown on WTC's books and were not discernable from Taxpayer's books and records provided in the audit. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its

everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27).

95. During the audit, IBM provided the Department with documentation illustrating that WTC had between four and seventeen statutory employees in the U.S. during the Audit Period.

Answer: Department objects to the term “statutory employee,” which is undefined and requires a legal determination. Paragraph 95 contains a legal conclusion and therefore, does not require an answer pursuant to Rule 301(b)(2). To the extent an answer is required, Department admits Petitioner provided the auditor with W-2 Forms for 17 WTC employees in 2010 and 4 WTC employees in 2011. Department denies that IBM provided all the requested documentation to the auditor, and denies the remaining allegations in paragraph 95.

96. The Department ignored the information IBM provided and instead calculated a rent amount based on multiplying a fabricated number of WTC employees by a fabricated per employee rental rate.

Answer: Department denies the allegations in paragraph 96.

97. The Department's calculation of the imputed rent is flawed because it is based on a completely inaccurate number of WTC employees.

Answer: Department denies the allegations in paragraph 97.

98. The Department relied on unverifiable and inaccurate sources-such as corporationwiki.com, www.manta.com, and www.hoover.com, among others-to compute WTC's property fraction.

Answer: Department admits its auditor used information from various websites to make an estimate of the property used by WTC because IBM failed to provide all the requested information. Department's auditor used the best information available to determine the amount of property properly includable in WTC's property factor.

99. The Department calculated the imputed U.S. rent based on 400 WTC U.S. employees.

Answer: Department admits the auditor calculated WTC's reasonable market rental rate of U.S. property used based on 400 WTC U.S. employees. Department denies the remaining factual allegations in paragraph 99.

100. The Department conceived the number of employees based on Internet postings on an open-source website.

Answer: Department denies the allegation in paragraph 100.

101. The Department conceived an assumption of 250 square feet per employee (400 square feet per officer); more than 7,000 square feet of common space; and rent at \$15 per square foot,

for a total imputed U.S. rent of \$13.5 million per year.

Answer: Department objects to the term “conceived an assumption” as vague and ambiguous. Department admits that Department’s auditor estimated a U.S. reasonable market rental rate of property used by WTC of approximately \$13.5 million per year by using 250 square feet per employee, 400 square feet per officer, more than 7,000 square feet of common space, all multiplied by rent of \$15 per square foot. Department denies the remaining allegations in paragraph 101. Department affirmatively states that Petitioner failed to provide Department’s auditor with property cost, lease/rent expense, or reasonable market rental rate information as requested. Department’s auditor used the best information available to determine the amount of WTC property in the U.S.

102. The Department provided no support for its rental assumptions.

Answer: Department denies the allegations in paragraph 102.

103. The Department also imputed \$1.68 million per year for U.S. capital leases (vehicles) for executives and salesmen. The Department used an assumption of \$350/month per vehicle for 50 vehicles.

Answer: Department admits that, as part of the 80/20 business activity analysis, the auditor included tangible personal property in the form of U.S. capital leases of \$1.68 million using \$350/month lease rates per vehicle multiplied by 50 vehicles. Department denies the remaining allegations in paragraph 103. Department affirmatively states that Petitioner failed to provide Department’s auditor with vehicle capital lease expenses as requested. Department’s auditor used the best information available to determine the amount of WTC property in the U.S.

104. During the audit, IBM informed the Department that WTC did not provide any vehicles to any employees, officers, or directors.

Answer: Department lacks sufficient information to either admit or deny the allegation in paragraph 104. Additionally, the allegation in paragraph 104 is not a relevant material fact. If an employee, officer or director of WTC used a leased vehicle provided by Petitioner, that amount must be included in the property factor. 86 Ill. Adm. Code 100.3380(b)(2).

105. The Department provided no support for its capital lease assumptions.

Answer: Department denies the allegations in paragraph 105.

106. In its workpapers, the Department miscalculated WTC's as-filed property figures, which produced inflated U.S. property figures.

Answer: Department denies the allegations in paragraph 106.

107. During the Audit Period, WTC had between four and seventeen employees in the United States as defined in Illinois tax law and regulations. See Ill. Admin. Code tit. 86, § 100.3100(b).

Answer: Department denies the allegations in paragraph 107.

108. Even using the Department's faulty rental rate and square footage guesses, using WTC's accurate number of U.S. employees yields a foreign property fraction that exceeds 97% for the Audit Period.

Answer: Department denies the allegations in paragraph 108.

109. Therefore, WTC remains an 80/20 Company, even if the Department were permitted to impute additional property to it, using the Department's methodology but with the accurate number of employees.

Answer: Department denies the allegations in paragraph 109.

Payroll Fraction

110. The Department also imputed additional U.S. payroll to WTC for purposes of calculating the payroll fraction.

Answer: Department denies the allegation in Paragraph 110. The Department did not impute property or payroll to WTC. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the factors were not shown on WTC's books and were not discernable from Taxpayer's books and records provided to the auditor. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27).

111. The Department's calculation of the imputed payroll is flawed because it is based on completely inaccurate compensation figures and alleged number of employees.

Answer: Department denies the allegations in paragraph 111.

112. The Department devised U.S. compensation for WTC officers and directors by imputing all of their IBM compensation to WTC.

Answer: Department denies the allegations in paragraph 112.

113. The Department ignored the official list of WTC officers and directors, and their IBM W-2 wages that IBM provided to the Department.

Answer: Department denies the allegations in paragraph 113.

114. Instead, the Department grossly overestimated the officers' and directors' IBM compensation based on information from unreliable sources.

Answer: Department denies the allegations in paragraph 114.

115. The Department also imputed a portion of the IBM Chairman's compensation to WTC, even though he was not an officer, director, or employee of WTC.

Answer: Department denies the allegations in paragraph 115.

116. The Department also imputed 100% of another individual's compensation to WTC, even though he was not an officer, director, or employee of WTC, based entirely on information from corporationwiki.com.

Answer: Department denies the allegation in paragraph 116.

117. During the audit, IBM explained that even if the Department had the authority to impute payroll-which it does not-that the Department could not impute 100% of the officers' and directors' IBM wages to WTC.

Answer: Department lacks sufficient information to either admit or deny the allegations in paragraph 117. . Department denies that it does not have the legal authority to impute payroll to a taxpayer for purposes of the 80/20 business activity test. Department denies that the Department's auditor included all of IBM's officers' and directors' wages in the WTC payroll factor of the 80/20 business activity test.

118. During the audit, to illustrate the Department's flawed analysis, IBM provided a calculation that used the ratio of IBM's gross receipts to WTC's gross receipts as a proxy to divide the officers' and directors' wages between the two entities.

Answer: The Department objects to Taxpayer's characterization of Department's analysis as "flawed." Such a characterization is argumentative and improper. Department lacks sufficient information to either admit or deny the allegations in paragraph 118.

119. Even imputing wages using the gross receipts ratio, WTC had a payroll fraction that is between 78% to 86% for the Audit Period.

Answer: Department denies the allegations in Paragraph 119.

120. Consequently, even if the Department were permitted to impute property and payroll and the Department's methodology were correct-neither of which are true-using accurate figures, WTC had 87.9% of its business activity outside of the United States in 2009 and 92.5% in 2010.

Answer: Department denies the allegations in paragraph 120.

121. Therefore, WTC is an 80/20 Company based on the express Illinois statutory requirements.

Answer: Department denies the allegations in paragraph 121.

122. Because WTC is an 80/20 Company for the entire Audit Period based on the correct calculations, it was improper for WTC to be included in IBM's unitary combined return.

Answer: Department denies the allegations in paragraph 122.

WHEREFORE, Department respectfully requests this Tribunal enter judgment in favor of the Department and enter an Order:

- (a) Finding that WTC did not meet is burden of proving its claimed 80/20 business activity test exemption for the tax years ending December 31, 2009 and December 31, 2010;
- (b) Holding that WTC must be included in Petitioner's Illinois unitary business group for the tax years ending December 31, 2009 and December 31, 2010;
- (c) Holding that the Department's Notices of Deficiency are correct, as issued; and
- (d) Such other and further relief as the Tribunal may deem just and appropriate.

COUNT III

The Taxpayer Bears-and Failed to Carry-the Burden to Prove that WTC Was an 80/20 Company

The legal argument in this Count III has already been addressed by this Tribunal in its Order on Motion for Summary Judgment dated June 30, 2015 in docket number 14-TT-229.

123. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 122 as if set forth fully herein.

Answer: Department restates and realleges its answers in paragraphs 1 through 122 as if fully set forth herein.

124. The Department bears the burden of proof because IBM offered adequate books and records to the Department for review, but the Department disregarded those books and records and instead based its assessment on unverifiable and inaccurate sources.

Answer: Department denies the allegations in paragraph 124.

125. IBM provided sufficient documentation during the audit that proved that WTC was an 80/20 Company.

Answer: Department denies the allegations in paragraph 125.

126. In addition, after IBM requested an Informal Conference Board hearing, IBM expressly stated that it would provide any additional documentation the Department thought necessary to illustrate that WTC was an 80/20 Company.

Answer: Department admits IBM's agent offered to provide additional information to the ICB. Department denies the remaining allegations in paragraph 126.

127. The Department refused to acknowledge the voluminous documentation IBM provided during the audit (e.g., actual W-2 wage data) and expressly refused to accept any additional documentation.

Answer: Department denies the allegations in paragraph 127.

128. Instead, the Department improperly asserted that WTC was not an 80/20 Company based on unverifiable and inaccurate sources of information, including open source websites such as corporationwiki.com.

Answer: Department denies the allegations in paragraph 128.

129. The Department's Notice of Deficiency is not presumed to be correct, and the Department must carry the burden of proof in this proceeding because the Department's Notice of Deficiency is based on an inadequate review of the taxpayer's books and records. See *Taylor v. Helvering*, 293 U.S. 507 (1935); *United States v. Janis*, 428 U.S. 433 (1976); see also *J H Walters & Co. v. Dep 't of Rev.*, 44 Ill.2d 95 (Ill. 1969).

Answer: Paragraph 129 contains a legal conclusion and not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department denies the allegations in paragraph 129.

130. Additionally, the Department must carry the burden of proof because IBM offered adequate books and records to the Department for review, but the Department opted to base its conclusion on unverifiable and inaccurate sources, and thus used an indirect method to calculate tax due. See *Ruth v. United States*, 823 F.2d 1091, 1094 (7th Cir. 1987); *Pittman v. Comm 'r*, 100 F.3d 1308, 1313 (7th Cir. 1996); *Zuhones v. Comm 'r*, 883 F.2d 1317, 1325 (7th Cir. 1989); *Mitchell v. Dep 't of Revenue*, 230 Ill. App.3d 795, 800 (Ill. App. Ct. 1992); see also *Names in the News v. New York State Tax Comm 'n*, 75 A.D.2d 145, 147 (N.Y. Sup. Ct. App. Div. 1980); *Matter of Chartair, Inc. v. State Tax Comm'n*, 65 A.D.2d 44 (N.Y. Sup. Ct. App. Div. 1978).

Answer: Paragraph 130 contains a legal conclusion and not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department denies the allegations in paragraph 130.

131. When a taxpayer provides evidence that "is not so inconsistent or improbable in itself as to be unworthy of belief, the burden then shifts to the Department which is required to prove its case by competent evidence." *Fillichio v. Dep 't of Revenue*, 15 Ill.2d 327, 333 (Ill. 1958); see also, *PPG Industries, Inc. v. Dep't of Revenue*, 328 Ill. App.3d 16 (Ill. Ct. App. 2002); *Goldfarb v. Dep 't of Revenue*, 411 Ill. 573 (Ill. 1952).

Answer: Paragraph 131 contains a legal conclusion and not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is

required, Department denies the allegations in paragraph 131. Department asserts that Petitioner has misconstrued the burden of the petition and that the cases cited by Petitioner concern the applicability of a tax, not the applicability of an exemption from tax, which is relevant here. See *Fillichio v. Dep 't of Revenue*, 15 Ill.2d 327, 333 (Ill. 1958) (whether sales had been understated); *PPG Industries, Inc. v. Dep't of Revenue*, 328 Ill. App.3d 16 (Ill. Ct. App. 2002) (whether gain was non-business income and whether sales factor was correct,); and *Goldfarb v. Dep 't of Revenue*, 411 Ill. 573 (Ill. 1952) (whether sales were underreported).

132. The Department disregarded IBM's sufficient documentation proving that WTC was an 80/20 Company.

Answer: Department denies the allegations in paragraph 132. Department did not accept Taxpayer's proffered 80/20 calculation as correct because it failed to include items of property and payroll required by the Department's regulations. Additionally, Department determined that Taxpayer had structured its affairs in a certain way and that a consequence of that arrangement was that some items of property and payroll properly includable in the factors were not shown on WTC's books and were not discernable from Taxpayer's books and records. Department's auditor used the best information available to him in his analysis of WTC's 80/20 business activity. That analysis showed that WTC had property and payroll in the U.S. in excess of 20% of its everywhere property and payroll. Additionally, Department determined that WTC could not meet its burden to prove, by clear and cogent evidence, that WTC met the 80/20 business activity exemption from tax in IITA Section 1501(a)(27).

133. Additionally, IBM offered to provide supplemental documentation further demonstrating that WTC was an 80/20 Company.

Answer: Department admits the allegations in paragraph 133 with respect to the ICB conference only.

134. The Department refused to accept any supplemental documentation.

Answer: Department denies the allegations in paragraph 134.

135. Instead, the Department relied on unverifiable and inaccurate sources to assert that WTC was not an 80/20 Company.

Answer: Department denies the allegations in paragraph 135.

136. Consequently, the Department bears the burden to prove that WTC was not an 80/20 Company.

Answer: Department denies the allegations in paragraph 136. The burden of proof is on the taxpayer to show by clear and convincing evidence it is entitled to the exemption or credit provided by statute. *Zebra Technologies Corp. v. Topinka*, 799 N.E.2d 725, 733 (Ill. App. Ct. 2003). ("We are mindful that taxation is the rule and tax exemption is the exception. *Chicago Bar Ass'n v. Department of Revenue*, 163 Ill.2d 290, 301, 206 Ill.Dec. 113, 644 N.E.2d 1166 (1994). Here, taxpayer is claiming an exemption from tax on income that would otherwise be assessed but for the

80/20 rule. Thus, taxpayer has the burden of proving clearly that it comes within the statutory exemption. *United Air Lines, Inc. v. Johnson*, 84 Ill.2d 446, 455-56, 50 Ill.Dec. 631, 419 N.E.2d 899 (1981). Such exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation. *United Air Lines*, 84 Ill.2d at 455, 50 Ill.Dec. 631, 419 N.E.2d 899."); *Balla v. Dep't of Revenue*, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981); *Bodine Electric Co. v. Allphin*, 81 Ill. 2d 502, 410 N.E.2d 828 (1980).

137. The Department failed to carry its burden to prove that WTC was not an 80/20 Company.

Answer: Department denies the allegations in paragraph 137.

WHEREFORE, Department respectfully requests this Tribunal enter judgment in favor of the Department and enter an Order:

- (a) Holding that the Notices of Deficiency are entitled to *prima facie* correctness;
- (b) Holding that Petitioner has the burden of establishing by clear and convincing evidence that it meets the 80/20 Business Activity Test, an exemption from Illinois taxation;
- (c) Finding that Petitioner failed to show by clear and convincing evidence that it meets the 80/20 Business Activity Test
- (d) Finding that WTC was not an 80/20 company for the tax years ending December 31, 2009 and December 31, 2010;
- (e) Holding that the Department's Notices of Deficiency are correct, as issued; and
- (f) Such other and further relief as this Tribunal may deem just and appropriate.

COUNT IV

No Reasonable Cause Exits to Abate Penalties

138. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 137 as if set forth fully herein.

Answer: Department restates and realleges its answers in paragraphs 1 through 137 as if fully set forth herein.

139. Any penalties must be abated for reasonable cause.

Answer: Department denies the allegations in paragraph 139.

140. The Department assessed penalties for the Audit Period in the amount of \$3,831,848.20.

Answer: Department admits the factual allegations in paragraph 140.

141. Under Illinois law, no penalties shall be imposed on a taxpayer if his failure to pay tax was due to reasonable cause. 35 Ill. Comp. Stat. 735/3-8.

Answer: Paragraph 141 contains a legal conclusion, not a material allegation of fact.

Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence force and effect of the Uniform Penalty and Interest Act (“UPIA”) (35 ILCS 735/3-1 et seq.) and admits that such statute speaks for itself.

142. Under Illinois regulations, "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 his proper tax liability and to file and pay his proper liability in a timely fashion." Ill. Admin. Code tit. 86, § 700.400(b).

Answer: Paragraph 142 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence force and effect of the UPIA Regulations (86 I.A.C. 700.100 et seq.) and admits that such regulation speaks for itself.

143. A taxpayer is considered to have made a good faith effort to determine, file, and pay his tax liability if "he exercised ordinary business care and prudence in doing so." Ill. Admin. Code tit. 86, § 700.400(c).

Answer: Paragraph 143 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence force and effect of the UPIA Regulations (86 I.A.C. 700.100 et seq.) and admits that such regulation speaks for itself.

144. A taxpayer's filing history is also considered when determining whether there is reasonable cause. Ill. Admin. Code tit. 86, § 700.400(d).

Answer: Paragraph 144 contains a legal conclusion, not a material allegation of fact. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department admits the existence force and effect of the UPIA Regulations (86 I.A.C. 700.100 et seq.) and admits that such regulation speaks for itself.

145. IBM followed the statutory requirements set forth in Illinois tax law to determine whether WTC was an 80/20 Company.

Answer: Department denies the allegations in paragraph 145.

146. Pursuant to the statutory requirements, WTC is an 80/20 Company and IBM properly excluded WTC from its Illinois combined return.

Answer: Department denies the allegations in paragraph 146.

147. The Department attempts a discretionary adjustment, which renders penalties inappropriate.

Answer: Department denies the allegations in paragraph 146.

148. IBM made a good faith effort to determine its proper tax liability and to file and pay its

proper tax liability in a timely fashion.

Answer: Department denies the allegations in paragraph 148.

149. IBM exercised ordinary business care and prudence in determining its proper tax liability and filing and paying its proper tax liability in a timely fashion.

Answer: Department denies the allegations in paragraph 149.

150. IBM has a long history of timely filing Illinois corporate income tax returns and paying Illinois corporate income tax in a timely manner.

Answer: Department denies the factual allegations in paragraph 150.

151. The penalties imposed by the Department must be abated for reasonable cause.

Answer: Department denies the allegations in paragraph 151.

WHEREFORE, Department respectfully requests this Tribunal enter judgment in favor of the Department and enter an Order:

- a. Finding that Petitioner failed to plead facts sufficient to show that it exercised ordinary business care and prudence to determine and timely pay its proper tax liability;
- b. Finding that Petitioner failed to exercise ordinary business care and prudence to determine and timely pay its proper tax liability;
- c. Holding that no reasonable cause exists to abate penalties;
- d. Holding that the Department's Notices of Deficiency are correct, as issued; and
- e. Such other and further relief as the Tribunal may deem just and appropriate.

Respectfully Submitted,

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