

ILLINOIS INDEPENDENT TAX TRIBUNAL

INTERNATIONAL BUSINESS)	
MACHINES COPRPORATION,)	
Petitioner,)	
)	
v.)	14 TT 229
)	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 September 24, 2014, the Department issued the Notices to IBM assessing a total balance due of \$15,641,342.00 in tax, \$6,256,536.80 in penalty, and \$6,024,387.88 in interest for the tax years ended December 31, 2007 and December 31, 2008. The Notice of Deficiency for the tax year ended December 31, 2007 asserts a total tax deficiency of \$8,693,961.00. The Notice of Deficiency for the tax year ended December 31, 2008 asserts a total tax deficiency of \$6,947,381.00. A copy of the Notices is attached as Exhibit A.

Answer: Department admits that factual allegations in paragraph 7, except that Exhibit A of Taxpayer's Petition contains incomplete copies of Notices issued by the Department to Petitioner, in addition to other letters. 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: Department lacks sufficient knowledge and information to either admit or deny the factual 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. Historically, WTC licensed from IBM the right to sublicense computer hardware technology and software technology in foreign countries.

Answer: The Department lacks sufficient information to either admit or deny the factual allegations in paragraph 13.

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

Answer: The phrase “established the terms of” is vague and ambiguous. Department lacks sufficient information to either admit or deny the factual allegations in Paragraph 14 because Department’s auditor did not receive a copy of the Hardware Royalty agreement during her audit.

15. 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 lacks sufficient information to either admit or deny the factual allegations in Paragraph 15 because Petitioner did not tender a copy of the Software License agreement to the Department’s auditor during the audit.

16. Pursuant to the license agreements, IBM and WTC entered into a Cost Sharing Agreement ("CSA"), effective January 1, 2007.

Answer: The term “license agreements” is undefined and therefore vague and ambiguous. 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 “Cost Sharing Amendments”) effective during the tax years at issue. Department denies the remaining allegations in Paragraph 16.

17. 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 to the terms “behind” and “beneficial owner,” which are undefined, and therefore, vague and ambiguous. The Department lacks information sufficient to either admit or deny the factual allegations in Paragraph 17.

18. Pursuant to the CSA, WTC shares research and development costs with IBM.

Answer: Department admits that WTC shares research and development costs with IBM. Department denies the remaining allegations in paragraph 18 because Department did not receive a copy of a “Cost Sharing Agreement” during the audit. It is unclear whether Petitioner is referring to the “Cost Sharing Amendments” for each software, services, and hardware, which were provided to the auditor during the audit.

19. 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 from controlled foreign corporations, as defined by the internal revenue code. Department lacks sufficient information to either admit or deny that the royalty income WTC receives is related to the sale of hardware, software, and services.

20. IBM and WTC have periodically amended these agreements to adjust the hardware royalty rates and software royalty rates according to updated transfer pricing studies.

Answer: Department objects to the term “these agreements” because it is vague and ambiguous. Therefore, the Department lacks information sufficient to either admit or deny the factual allegation in Paragraph 19.

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

22. In 2007 and 2008, WTC had twenty New York based employees in the United States.

Answer: Department admits that Taxpayer provided W-2s for 20 WTC New York – based employees for 2007 and 2008. Department denies that WTC had only 20 employees in the United States in 2007 and 2008. Department denies the remaining allegations in paragraph 22.

23. In 2007 and 2008, WTC operated a network of foreign branches that employed hundreds of employees and at least fifty contractors outside the United States.

Answer: Department admits that WTC had employees based in countries other than the United States in 2007 and 2008. Department has insufficient information to either admit or deny the number of employees or contractors of WTC based in countries other than the United States.

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

Answer: Department has insufficient information to either admit or deny the factual allegations in paragraph 24.

25. WTC had six directors and twelve 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 25.

26. In 2007, WTC had everywhere payroll of approximately \$30 million and U.S. payroll of approximately \$2 million.

Answer: Department denies the allegations in paragraph 26.

27. In 2008, WTC had everywhere payroll of approximately \$14 million and U.S. payroll of approximately \$2 million.

Answer: Department denies the allegations in paragraph 27.

28. In 2007, WTC had everywhere property of approximately \$80 million and U.S. property of approximately \$1.2 million.

Answer: Department denies the allegations in paragraph 28.

29. In 2008, WTC had everywhere property of approximately \$73 million and U.S.

property of approximately \$1 million.

Answer: Department denies the allegations in paragraph 29.

PROCEDURAL HISTORY

30. The Department audited IBM's income tax returns for tax years ended December 31, 2007 and December 31, 2008 ("Audit Period").

Answer: Department admits the factual allegations in paragraph 30.

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

Answer: Department denies the allegations in paragraph 31.

32. 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 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. Department's Notice of Deficiency speaks for itself.

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

Answer: Department objects to the term "imputed" because it is vague and ambiguous. Department admits that it allocated U.S. property and payroll to WTC in conducting the 80/20 business activity test, in order to accurately reflect WTC's U.S. property and payroll. Department denies the remaining allegations in paragraph 33.

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

Answer: Department admits the Department's auditor provided Taxpayer with her calculation of the 80/20 business activity test. Department denies the remaining allegations in paragraph 34.

35. 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 allegations in paragraph 35. Because Taxpayer failed to provide the requested documentation, Department's auditor used the best information available to conduct the 80/20 business activity test.

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

Answer: Paragraph 36 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 36.

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

Answer: Department denies the allegations in paragraph 37.

38. The Department 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 38 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.

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

Answer: Department objects to the term "imputed" because it is vague and ambiguous. Department admits that, as part of the 80/20 business activity test, the auditor calculated U.S. rent based on 400 WTC U.S. employees - the best information available since Taxpayer refused to provide the information requested by the auditor. Department denies the remaining allegations in paragraph 39.

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

Answer: The Department objects to the term "conceived" because it is vague and ambiguous. The Department admits it used the best information available as Taxpayer did not provide the requested information and documents during the audit. To the extent an answer is required, Department has insufficient information to either admit or deny the remaining allegations in Paragraph 40.

41. During the audit, IBM provided the Department with documentation illustrating that WTC had 20 statutory employees in the U.S.

Answer: The term "statutory employee" is undefined, and may be meant by Petitioner as a legal term that requires a legal determination through the development of various facts, and therefore the allegation in Paragraph 41 is vague and ambiguous. Department admits Petitioner provided the auditor with W-2 Forms for 20 WTC employees. Department

denies that IBM provided all the requested documentation to the auditor, and denies that WTC has only 20 U.S. employees.

42. 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: The term “conceived an assumption” is vague and ambiguous. Department admits that Department’s auditor determined U.S. rent expense 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 affirmatively states that Petitioner failed to provide Department’s auditor with property lease/rent expense as requested. Department’s auditor used the best information available to determine the amount of WTC property in the U.S. Department denies the remaining allegations in paragraph 42.

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

Answer: Department denies the allegations in paragraph 43 and affirmatively states that the Department’s auditor provided Petitioner with a copy of her calculation and sources.

44. 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 vehicles for 50 vehicles.

Answer: Department objects to the term “imputed” because it is vague and ambiguous. Department admits that, as part of the 80/20 business activity test, the auditor calculated 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 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.

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

Answer: Department denies the allegations in paragraph 45.

46. 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.

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

Answer: Department denies the allegations in Paragraph 47.

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

Answer: The phrase “These officer and directors” is vague and ambiguous. Therefore, Department denies the allegations in paragraph 48.

49. The Department ignored the official list of WTC officers and directors, and their IBM W- 2 wages provided to the auditor during the audit.

Answer: Department denies the allegations in paragraph 49.

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

Answer: Department denies the allegations in paragraph 50.

51. 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 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 IBM officers and directors to WTC. Department denies that it does not have the legal authority to re-allocate payroll to a taxpayer for purposes of the 80/20 business activity test. Department denies the remaining allegations in paragraph 51.

52. 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 objects to the term “imputed” because it is vague and ambiguous. Department admits that, as part of the 80/20 business activity test, the auditor included a portion of IBM Chairman’s compensation to WTC. Department denies the remaining allegations in paragraph 52. Department affirmatively states that Petitioner failed to provide Department’s auditor with the documentation requested.

53. The Department also imputed all 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 objects to the term “imputed” because it is vague and ambiguous. Additionally, Paragraph 53 is vague in that it does not identify the individual to which Petitioner refers. Therefore, the Department lacks the requisite knowledge to either admit or deny the factual allegations in paragraph 53.

54. 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: Department admits that during the audit, IBM's agent discussed using gross receipts as an alternative to the auditor's method. Department denies the remaining allegations in Paragraph 54.

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

Answer: Department admits that IBM's calculation of payroll resulted in 80/20 status for WTC. However, Department denies that this method is accurate, and denies that WTC meets the test for an 80/20 company.

56. On August 23, 2012, the Department issued a Notice of Proposed Deficiency assessing an additional liability in the amount of \$15,371,719.00 in tax, \$4,611,516.00 in penalties, and \$4,075,764.00 in interest for the Audit Period.

Answer: Department admits the factual allegations in paragraph 56.

57. On October 18, 2012, 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 IBM submitted a request for an Informal Conference Board review. Department lacks information sufficient to admit or deny the remaining factual allegations in Paragraph 57 because Informal Conference Board requests are confidential. 86 Ill. Admin. Code § 215.120(d).

58. On June 25, 2014, the Informal Conference Board issued an Action Decision.

Answer: Department admits the factual allegations in paragraph 58.

59. Although the Informal Conference Board sustained the Department's proposed assessment, it expressly held that the Department could not impute research and development payroll to WTC from the cost share payment to IBM for purposes of the 80/20 test.

Answer: Department admits that the Informal Conference Board sustained the Department's proposed assessment and denied Taxpayer's request for audit adjustment. Department admits the ICB held that "WTC's payroll factor should not include research & development wages reimbursed to International Business Machines Corporation ("IBM") by WTC under the terms of the Shared Services Cost Sharing Amendment, because the recipients of those wages were not concurrently employed by IBM and WTC." Department denies the remaining allegations in Paragraph 59.

60. On September 24, 2014, the Department issued the Notices to IBM assessing a total balance due of \$15,641,342.00 in tax, \$6,256,536.80 in penalty, and \$6,024,387.88 in interest for the tax years ended December 31, 2007 and December 31, 2008.

Answer: Department admits the factual allegations in paragraph 60.

FIRST COUNT

61. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 60 as if set forth fully herein.

Answer: Department restates and incorporates its Answers to paragraphs 1 through 60 as if fully set forth herein.

62. 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 62 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.

63. 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 63 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.

64. 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: The term "Illinois tax law" is vague and ambiguous. Paragraph 64 also 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.

65. 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 65 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 the case law referred to in Paragraph 65 and states that such law speaks for itself.

66. Illinois Tax Law requires the comparison of United States business activity to worldwide business activity ("Business Activity Test"). 35 Ill. Comp. Stat. 5/1501(a)(27)(A); Ill. Admin. Code tit. 86, § 100.9700(c).

Answer: Paragraph 66 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.

67. 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 67 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.

68. 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 68 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 I.A.C. 100.2000 et seq.) and states that such regulation speaks for itself.

69. 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 69 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 I.A.C. 100.2000 et seq.) and states that such regulation speaks for itself.

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

Answer: Paragraph 70 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 I.A.C. 100.2000 et seq.) and states that such regulation speaks for itself.

71. 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 71 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.

72. 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 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 the Illinois Income Tax Act (35 ILCS 5/101 et seq.) and states that such statute speaks for itself.

73. 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 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 Regulations (86 I.A.C. 100.2000 et seq.) and states that such regulation speaks for itself.

74. 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 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 Regulations (86 I.A.C. 100.2000 et seq.) and states that such regulation speaks for itself.

75. 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 allegations in paragraph 75.

76. 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 76 alleges a statement made in an Administrative Hearings decision. Department admits the existence, force and effect of its administrative decisions and states that such decision speaks for itself.

77. 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.

78. 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 78.

79. 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 denies that the 80/20 exemption applies to WTC.

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

- a. Finding that WTC is not an 80/20 company;
- b. Holding that the Department's Notices of Deficiency are correct, as issued; and
- c. Such other and further relief as the Tribunal may deem just and appropriate.

SECOND COUNT

80. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 79 as if set forth fully herein.

Answer: Department restates and incorporates its Answers to paragraphs 1 through 79 as if fully set forth herein.

81. 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 81.

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

Answer: Department objects to the term “imputing” on the basis that it is vague and ambiguous. Department admits it adjusted WTC's business activity fractions by allocating additional United States property and payroll to WTC. Department denies the remaining factual allegations in paragraph 82.

83. 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 83.

Property Fraction

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

Answer: Department objects to the term “imputed” on the basis that it is vague and ambiguous. Department admits that, as part of the 80/20 business activity test, the auditor calculated WTC's U.S. property fraction.

85. The Department 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 85.

86. 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 86.

87. 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 determine the number of WTC's employees because IBM failed to provide all the requested documentation. Department's auditor used the best information available to determine the amount of property allocable to WTC.

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

Answer: Department objects to the term "imputed" on the basis that it is vague and ambiguous. Department admits the auditor calculated WTC's U.S. rent based on 400 WTC U.S. employees. Department denies the remaining factual allegations in paragraph 88.

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

Answer: Because IBM failed to provide all the requested information and documentation, Department's auditor used the best information available to determine the amount of property to allocate to WTC.

90. During the audit, IBM provided the Department with documentation illustrating that WTC had twenty statutory employees in the U.S.

Answer: The term "statutory employee" is undefined, and may be meant by Petitioner as a legal term that requires a legal determination through the finding of various facts, and therefore the allegation in Paragraph 41 is vague and ambiguous. Department admits Petitioner provided the auditor with W-2 Forms for 20 WTC employees. Department denies that IBM provided all the requested documentation to the auditor, and denies that WTC has only 20 U.S. employees. Department denies the remaining allegations in paragraph 90.

91. 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: The term "conceived an assumption" is vague and ambiguous. Department admits that Department's auditor determined U.S. rent expense 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 affirmatively states that Petitioner failed to provide Department's auditor with property lease/rent expense information as requested. Department's auditor used the best information available to determine the amount of WTC property in the U.S. Department denies the remaining allegations in paragraph 91 .

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

Answer: Department denies the allegations in paragraph 92 and affirmatively states that Department's auditor provided Petitioner with a copy of Department's calculation and sources.

93. 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 vehicles for 50 vehicles.

Answer: Department objects to the term "imputed" on the basis that it is vague and ambiguous. Department admits that, as part of the 80/20 business activity test, the auditor calculated 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 93. 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..

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

Answer: Department denies the allegations in paragraph 94.

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

Answer: Department denies the allegations in paragraph 95.

96. WTC has twenty 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 96.

97. 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 96% for the Audit Period.

Answer: Department denies the allegations in paragraph 97.

98. 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 98.

Payroll Fraction

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

Answer: Department objects to the term “imputed” on the basis that it is vague and ambiguous. Department admits that the auditor allocated payroll to WTC for purposes of calculating the payroll fraction of the 80/20 business activity test. Department denies the remaining allegations in paragraph 99.

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

Answer: Department denies the allegations in paragraph 100.

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

Answer: Department denies the allegations in paragraph 101.

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

Answer: Department denies the allegations in paragraph 102.

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

Answer: Department denies the allegations in paragraph 103.

104. 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 objects to the term “imputed” on the basis that it is vague and ambiguous. Department lacks sufficient information to either admit or deny whether IBM’s Chairman during the years at issue was an officer, director or employee of WTC. The Department admits the remaining factual allegations in paragraph 104. Department affirmatively states that Petitioner failed to provide Department’s auditor with the documentation requested.

105. The Department also imputed all 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 objects to the term “imputed” on the basis that it is vague and ambiguous. Department admits that, as part of the 80/20 business activity test, the auditor

included a portion of the IBM Chairman's compensation in the WTC payroll fraction. Department denies the remaining allegations in paragraph 105. Department affirmatively states that Petitioner failed to provide Department's auditor with the documentation requested.

106. 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 all the officers' and directors' IBM wages to WTC.

Answer: Department admits that an agent of IBM stated to the Department's auditor that the Department did not have the authority to impute payroll to WTC and that the Department could not impute all the officers' and directors' IBM wages to WTC. 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. Department denies the remaining allegations in paragraph 106.

107. 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: Department admits that during the audit, IBM's agent discussed using gross receipts as an alternative to the auditor's method. Department denies the remaining allegations in Paragraph 54.

108. Even imputing wages using the gross receipts ratio, WTC had a payroll fraction that is between 69% to 86% for the Audit Period.

Answer: Paragraph 108 contains a legal conclusion. WTC's payroll fraction for purposes of the 80/20 business activity test requires a legal analysis. Therefore, pursuant to Rule 310(b)(2), no answer is required. To the extent an answer is required, Department denies the allegations in paragraph 108.

109. Consequently, even if the Department were permitted to impute property or payroll and the Department's methodology were correct - neither of which are true - using accurate figures WTC had 91.57% of its business activity outside of the United States in 2007 and 82.98% in 2008.

Answer: Department denies the allegations in paragraph 109.

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

Answer: Department denies the allegations in paragraph 110.

111. 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 111.

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

- a. Finding that WTC was not an 80/20 company for the tax years ending December 31, 2007 and December 31, 2008;
- b. Holding that the Department's Notices of Deficiency are correct, as issued; and
- c. Such other and further relief as the Tribunal may deem just and appropriate.

THIRD COUNT

112. IBM hereby restates and realleges the allegations contained in paragraphs 1 through 111 as if set forth fully herein.

Answer: Department restates and realleges its answers in paragraphs 1 through 111 as if fully set forth herein.

113. Any penalties must be abated for reasonable cause.

Answer: Department denies the allegations in paragraph 113.

114. The Department assessed penalties for the Audit Period in the amount of \$6,256,536.80.

Answer: Department admits the factual allegations in paragraph 114.

115. 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 115 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.

116. 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 116 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.

117. 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 117 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.

118. 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 118 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.

119. 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 119.

120. 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 120.

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

Answer: Department denies the allegations in paragraph 121.

122. 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 122.

123. 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 123.

124. 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 admits the factual allegations in paragraph 124.

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

Answer: Department denies the allegations in paragraph 125.

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

- a. Finding that Petitioner failed to exercise ordinary business care and prudence to determine and timely pay its proper tax liability;
- b. Holding that no reasonable cause exists to abate penalties;
- 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.

Respectfully Submitted,

LISA MADIGAN
Attorney General
State of Illinois

By: _____

Special Assistant Attorney General

Susan Budzileni
Sean Cullinan
Jennifer Kieffer
Special Assistant Attorneys General
Illinois Department of Revenue
Office of Legal Services
100 W. Randolph St., 7-900
Chicago, IL 60601

Telephone: (312) 814-1716
(312) 814- 3078
(312) 814-1533

Facsimile: (312) 814-4344

Email: Susan.Budzileni@Illinois.gov
Sean.Cullinan@illinois.gov

Jennifer.Kieffer@Illinois.gov

DATED: January 7, 2015

ILLINOIS INDEPENDENT TAX TRIBUNAL

INTERNATIONAL BUSINESS)	
MACHINES CORPORATION,)	
Petitioner,)	
)	
v.)	14 TT 229
)	Chief Judge James M. Conway
ILLINOIS DEPARTMENT OF REVENUE,)	
Respondent.)	

**AFFIDAVIT OF ANGELE MORGAN
PURSUANT TO TRIBUNAL RULE 5000.310(b)(3)**

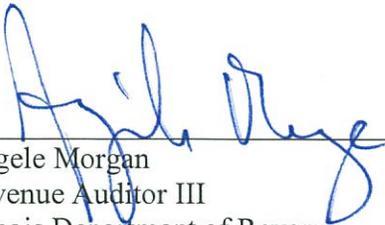
STATE OF NEW JERSEY

COUNTY OF BERGEN

Under penalties as provided by Section 1-109 of the Code of Civil Procedure, 735 ILCS §5/1-109, I, Angele Morgan, being first duly sworn on oath, depose, and state as follows:

1. I am currently employed by the Illinois Department of Revenue.
2. My current title is Revenue Auditor III.
3. I audited IBM's Illinois Corporate Income and Replacement Tax Returns for the tax years ending December 31, 2007 and December 31, 2008.
4. I lack the requisite knowledge to either admit or deny the allegations alleged in Taxpayer's Petition paragraphs 11, 13, 14, 15, 17, 19, 20, 21, 23, 24, 25, 36, 40, 46, 53, 57, 78, and 104.
5. I am an adult resident of the State of New Jersey and can truthfully and competently testify to the matters contained herein based upon my own personal knowledge.

Under penalties as provided by law pursuant to Section 1-109 of the Code of Civil Procedure, the undersigned certifies that the statements set forth in this instrument are true and correct, except as to matters therein stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he verily believes the same to be true.



Angele Morgan
Revenue Auditor III
Illinois Department of Revenue

Date: 1-6-2015