ILLINOIS INDEPENDENT

TAX TRIBUNAL

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

ORDER ON PETITIONER'S MOTION FOR SUMMARY JUDGMENT

The Petitioner, PepsiCo Inc. and Affiliates ("PepsiCo"), filed Illinois Income and Replacement Tax Returns on a combined basis for tax years ending December 31, 2011, December 31, 2012, and December 31, 2013. The Illinois Department of Revenue audited PepsiCo and ultimately issued Notices of Deficiency to PepsiCo covering those three tax years. Those Notices contained audit adjustments by the Department disallowing PepsiCo to treat a member of its business group, Frito-Lay North America, Inc. ("FLNA"), as an excluded 80/20 company and by the Department adding FLNA's income, approximately $2.5 billion each year, to PepsiCo's unitary group's income.

PepsiCo filed two petitions with the Tax Tribunal, 16 TT 82 and 17 TT 16, which have been consolidated for purposes of proceedings before the Tax Tribunal and for which the only unresolved matter is the FLNA 80/20 issue for tax years 2011 through 2013.

In its Petitions and Summary Judgment Motion, PepsiCo argues that 1) FLNA should be treated as an 80/20 company, 2) that the payroll factor used to determine FLNA's eligibility as an 80/20 company should be calculated by including payroll costs reported by PepsiCo Global Mobility, LLC ("PGM LLC"), a single-member LLC owned by FLNA and created in 2011 following a 2010 PepsiCo global reorganization, as compensation paid to expatriate employees, 3) that the expatriate employees who were transferred to related foreign host companies of PepsiCo through secondments should be considered employees of FLNA through PGM LLC, and 4) the reorganization of foreign operations under FLNA and the creation of PGM LLC have economic substance and, in any event, cannot be equitably recast or reversed by the economic substance doctrine as a matter of law.

In its Brief in Response to PepsiCo's Summary Judgment Motion, the Department argues 1) PGM LLC should not be considered the common-law employer of the expatriates and compensation paid to expatriates should not be included in FLNA's 80/20 payroll factor, 2) that the exclusion of FLNA's domestic profits from PepsiCo's combined income is contrary to the purpose of Illinois' water's edge combined apportionment rule and grossly distorts income attributable to PepsiCo's Illinois business activities, 3) FLNA has not met its burden in proving that it conducts 80% or more of its business activities outside the United States, and 4) the substance over form doctrine is applicable and requires that FLNA be included in PepsiCo's unitary group by excluding expatriate compensation from FLNA's payroll factor.

As explained below, PepsiCo's Motion for Summary Judgment is denied.

1. BACKGROUND

A. The 80/20 Test

Under Illinois law, business income from a unitary business group which is properly attributable to Illinois is subject to income taxation. 35 ILCS 5/304(e). A unitary business group is defined as "a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other." 35 ILCS 5/1501(a)(27)(A).

Illinois adopts the water's edge combined apportionment method and allows an exemption to the general inclusionary rule of unitary business group income for members of unitary business groups that can demonstrate that 80% of its business activities fall outside the United States. *Id*. In order for a unitary business group member to qualify for the exemption, it must make certain calculations of its U.S. property and payroll and compare those to calculations of its overall worldwide property and payroll. 86 Ill. Adm. Code 100.9700(c)(2)(A). If those calculations reflect that less than 20% of the unitary business group member's activity is conducted within the United States, or said another way, that over 80% of its business activity is outside the United States, the 80/20 exemption is available for that member and that member's income will be excluded from the overall income of the unitary business group for Illinois income tax reporting purposes.

B. PepsiCo

PepsiCo manufactures, markets, and sells a variety of salty convenient, sweet and grain-based snacks, carbonated and non-carbonated beverages, and foods in approximately 200 countries around the world. Joint Stipulations of Fact ("Joint Stip.") ¶ 4. Its largest operations are in North America and the United Kingdom. *Id*. PepsiCo's operations are divided into three principal business lines—the beverage business (*e.g*., Pepsi and Gatorade), the snack-food business (*e.g*., Frito-Lay potato chips) and the grain-based foods business (*e.g*., Quaker Oats cereal). Joint Stip. ¶ 5.

PepsiCo's domestic (U.S.-based) employees and the domestic employer entities generally serve only one of the three core business lines, however, outside the United States, the three business lines are combined, and foreign (non-U.S.) employees and entities serve all, or a combination of, the beverage business, the snack-food business, and/or the grain-based business. Joint Stip. ¶ 6.

1. PepsiCo's 2010 Acquisitions, Restructuring and Reorganization

In 2010, PepsiCo acquired The Pepsi Bottling Group and related entities ("PBG"). Joint Stip. ¶ 40. It also acquired PepsiAmericas Inc. and related entities("PAS"). Joint Stip. ¶ 41. PBG and PAS were the two largest publicly traded independent bottlers of Pepsi products prior to their acquisition having between them more than $18 billion in assets. Joint Stip. ¶¶ 42 and 45. At the time of the acquisition, the two bottlers together had over 84,000 employees. *Id*.

Following, and in connection with, the acquisition of the bottlers, PepsiCo undertook a global restructuring of its operations that included integrating 67 domestic and 119 international entities into PepsiCo's corporate structure. Joint Stip. ¶ 46.

2. FLNA Reorganization and Restructuring

FLNA operates PepsiCo's domestic snack food business. FLNA contracts with Frito-Lay, Inc. ("FLI"), an internal PepsiCo entity, for the manufacture of some of the snack foods and contracts with Rolling Frito-Lay Sales, L.P. ("RFLS'), an internal PepsiCo entity, for the sale and distribution of snack foods. Joint Stip. ¶ 17. At the time of the 2010 global restructuring, a company formerly known as Frito-Lay, Inc. ("Old Frito-Lay") merged into FLNA. Joint Stip. ¶ 43. Pursuant to that merger, the current Frito-Lay entity, FLI, became a direct and wholly owned subsidiary of FLNA. *Id.* As a result, FLNA continued to employ senior domestic snack food business marketing employees and "general management" of FLNA. Joint Stip. ¶ 53.

FLNA owns the domestic rights to PepsiCo's snack food business, which includes Lays, Doritos, Tostitos, Cheetos, Rold Gold Pretzels, Funyuns, Grandma's Cookies, Sun Chips, Fritos, Ruffles, and Crackerjack. Joint Stip. ¶¶ 11 and 12. All of FLNA's gross sales during the period 2011-2013, which were approximately $8.6 billion per year, were United States sales of snack food products with the exception of approximately $230 million per year in foreign sales from the United States shipped abroad. Joint Stip. ¶¶ 18 and 20. The Frito-Lay North America division of PepsiCo, which includes FLNA, generated more operating profits than the remaining five business segments of PepsiCo during the 2010-2013 period.[1]

As part of its global restructuring in 2010, PepsiCo reorganized the international operations of FLNA and its subsidiaries. Joint Stip. ¶ 7 and Exhibit ('Ex.) 43.[2] "The claimed goals of the reorganization were to (i) centralize…foreign branch operations including those of acquired businesses; (ii) establish a platform for the acquisition and funding of future branch operations, (iii) isolate the parent company, PepsiCo, Inc. from the business risk of branch operations; and (iv) align the foreign expatriates on…U.S. payroll into a single entity." *Id.*

Pursuant to the restructuring, 30 acquired domestic entities and several existing PepsiCo holding companies were eliminated. Additionally, PepsiCo Hong Kong

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[1] The other business segments are Quaker Foods North America; Latin America Foods; PepsiCo Americas Beverages; Europe; and Asia, Middle East and Africa. Joint Stip. ¶¶ 22, 23.

[2] Prior to the filing of PepsiCo's Summary Judgment Motion, the parties submitted proposed exhibits for purposes of proceeding by way of a final hearing. Certain of those exhibits are referenced by the parties and in this decision. The parties agreed that the exhibits can be offered without further authentication, and subject to the rules of evidence, can be used by either party to argue the truth of the matter asserted, but they do not constitute stipulations of fact.

LLC was formed under FLNA to hold Hong Kong operations previously held in a branch under PepsiCo, and Long Bay, Inc. which contained foreign operations was merged into FLNA. Furthermore, two companies, known as CEME and CELE, were bought by FLNA in 2011 from one of the 2010 acquired bottlers, the Bottling Group LLC, although the two companies had small market shares and faced statutory bankruptcy. As of 2016, FLNA had provided funding to those companies in excess of $250 million. Other entities were also reorganized into or under FLNA as disregarded entities for federal and state income tax purposes, including PGM LLC. Pet'r Mem. in Supp. of Mot. for Summ. J. at 5-9.

3. PepsiCo's Expatriate Program

Like many international companies, PepsiCo attempts to recruit and retain high quality candidates by offering global postings through its Expatriate Program. That program allows each business in the PepsiCo corporate group in the United States to send employees throughout the world on assignment to PepsiCo's related foreign business entities, known as foreign host companies, and to take back executives who have been on such an assignment. Joint Stip. ¶ 7. Employees are sent to foreign host companies as permanent transfers or sent on temporary assignments. Joint Stip. ¶ 72. During the tax years at issue, the expatriates transferred on a temporary basis signed Letters of Understanding and Secondment Agreements that set out the framework of their foreign assignments. Joint Stip. ¶ 94.

At the time the two bottling businesses, PBG and PAS, were acquired in 2010, PepsiCo, PBG, and PAS each utilized respectively the following separate entities for their foreign expatriate programs: Beverages Foods and Services, Inc. for the PepsiCo Corporate Group, C&I Leasing, Inc. for PBG, and Pepsi-Cola General Bottlers, Inc. for PAS. Joint Stip. ¶ 47.

Following a payroll transition to Hewitt, a payroll service provider, the BFSI payroll was eliminated, the PepsiCo corporate group no longer had a separate entity to employ expatriates, and all expatriates who were paid by BFSI were transferred to PepsiCo, Inc. Pet'r Mem. in Supp. of Mot. for Summ. J. at 39-40. "PepsiCo Inc. essentially became their employer, although BFSI [was improperly] referenced [in] their Letter of Understanding and secondment agreement." *Id.*

After the restructuring and acquisitions in 2010 and during the tax years at issue, the PepsiCo expatriate program was overseen in its entirety by approximately 20 individuals employed in the PepsiCo Corporate Group human resource function ('Global Mobility HR Function") and located around the world, who executed employee transfers, relocations and secondments throughout the PepsiCo corporate group. Joint Stip. ¶¶ 99 and 100.

Most expatriates seconded through the Expatriate Program either worked for the snack-foods business all of the time or worked partially for the snack-foods business. Joint Stip. 68. The expatriates were assigned to various locations around the world, including, but not limited to, China, Ireland, Japan, Mexico, Poland, Russia, Spain, Switzerland, Thailand, the U.A.E., and the U.K. Joint Stip. 69. There were 151, 165 and 184 expatriate employees, respectively, during the three tax years at issue. Joint Stip. ¶30.

4. Formation of PepsiCo Global Mobility LLC

PepsiCo created PGM LLC in June 2010 as a Delaware single member limited liability company, formed under FLNA, which PepsiCo elected to treat as a disregarded entity for federal and state income tax purposes. Joint Stip. ¶ 27. The idea of creating PGM LLC and listing all expatriates as employees of PGM LLC was formed in PepsiCo's tax department. Tr. 31.[3] PepsiCo estimated that by creating PGM LLC as a division of FLNA and treating all U.S. paid expatriates on temporary assignments as employees of PGM LLC by using PGM LLC as the single entity connected with foreign-based secondments, PepsiCo would recognize $14 million per year in state income tax savings in 13 states. Joint Stip. ¶¶ 58,59 and Ex. 6.

Those expected tax savings were generated by treating PepsiCo expatriate employees as oversees/foreign employees of PGM LLC and their compensation as foreign payroll in the 80/20 calculation for FLNA, Ex. 6, which resulted in the exclusion of FLNA's approximately $2.5 billion in annual profits from domestic sales of snack foods from PepsiCo's unitary combined return.

5. Function of PepsiCo Global Mobility LLC

The only payroll compensation claimed and reported by PGM LLC was compensation paid to expatriate employees who were assigned to work for and under the direction and control of Foreign Host Companies. Joint Stip. ¶¶21 and 122. PGM LLC had no other listed employees. Its books and records were debited to record expatriate compensation expenses and credited to record as "other income" dollar for dollar reimbursement of that expense by Foreign Host Companies. Joint Stip. ¶113. No mark-up was charged on these reimbursements and PGM LLC

[3] "TR." refers to the transcript of the summary judgment oral argument testimony on March 26, 2021.

earned no profits. *Id*. PGM LLC claimed no other employees, it owned no tangible or real property, and it did not maintain an office during any tax year at issue. Joint Stip. ¶¶ 32,122,147 and 151. PGM LLC did not identify or approve individuals for assignment to Foreign Host Companies, but, instead, PepsiCo Corporate Group management performed that function based on its review and determination of the skill set and interest of each individual and the business needs of the Foreign Host Companies. Joint Stip. ¶ 76.

The Pepsi International Support Center ("PISC") and Pepsi-Cola International Limited ("PCIL") intercompany cross-charged entities within PepsiCo Corporate Group for expenses and reimbursements. Joint Stip. ¶¶120 and 127. PISC and PCIL cross-charged PGM LLC's general ledger for the accrued employee expenses and for the reimbursement of such amounts from the Foreign Host Companies. Joint Stip. ¶ 127.

PISC contracted with Hewitt Payroll Services to issue payroll checks to all PepsiCo Corporate Group affiliate employees on the U.S. benefits plan, including to all expatriates seconded outside the United States and to file all necessary payroll tax returns. Joint Stip. ¶123. As a result, where applicable, income taxes were withheld and U.S. payroll and employment taxes were remitted in PGM LLC's name for the expatriates seconded outside the U.S. Joint Stip. ¶114. Payments to and benefits received by the expatriate employees while seconded to Foreign Host Companies were approximately $93 million, $100 million, and $116 million, respectively, for each of the three tax years at issue. Joint Stip. ¶ 59.

Eligible expatriates were entitled to participate in the PepsiCo's Corporate Group's U.S. benefits plans as were PepsiCo's Corporate Group domestic U.S. employees. Eligible expatriates were entitled to continue to participate in those plans after the formation of PGM LLC. Joint Stip. ¶ 82,88; Ex. 26.

Roughly 26% of PepsiCo's Global Mobility HR Function's time and resources was devoted to management and support functions for PGM LLC and its expatriates. Joint Stip. 103. Ex. 8. The Global Mobility HR Function addressed human resource issues unique to expatriate assignments such as education, immigration, and work permit issues. Joint Stip. ¶104.

6. Secondments

The expatriates signed Letters of Understanding and Secondment Agreements that set out the framework for their foreign assignments, under which they exclusively perform services for Foreign Host Companies. Joint Stip. ¶ 94 and Ex. 25 and 26. Included and stated in those documents are:

- PGM LLC and each seconded expatriate agree to a Contract of Employment/ Letter of Understanding.
- PGM LLC temporarily assigns each seconded expatriate to a foreign host company and causes that expatriate to provide specific technical services to the applicable foreign host company.
- The seconded expatriates are required to do all things established by PGM LLC to complete the assignment and to adhere to all PGM LLC policies and to the laws and regulations of any country in which the seconded employee is assigned.
- The temporary assignment is conditioned on the continued employment relationship between PGM LLC and the seconded expatriate.
- PGM LLC cedes to the foreign host company the right to direct control, and supervise the day-to-day services performed by the seconded expatriate.
- During the assignment, the seconded expatriates are subject to the full direction, control, and supervision of the assigned foreign host company while the expatriate provides the agreed upon service.
- PGM LLC does not exercise any direction, control, or supervision over the seconded employees of any day-to-day duties for the foreign host company performed under the Secondment Agreement.

Joint Stip. ¶ 84.

PGM LLC ceded control over the expatriates to the Foreign Host Companies and did not exercise any direction, control, or supervision in their day-to-day duties. The seconded employees were under full direction, control and supervision of the Foreign Host Companies pursuant to the secondment agreement. *Id.* Work performance was monitored by the Foreign Host Companies as opposed to PGM LLC. Similarly, a Foreign Host Company manager generally assessed a seconded expatriate's performance and submitted that evaluation to the PepsiCo Corporate Group's Executive Compensation Team. Joint Stip. ¶ 87.

Because the Global Mobility Program was overseen in its entirety through the PepsiCo Corporate Group HR Function, and PGM LLC had no employees except for the expatriates listed on its books and records, the approximately 20 employees employed in the PepsiCo Corporate Group HR Function overseeing the Global Mobility Program executed and signed the Letters of Understanding and Secondment Agreements on behalf of PGM LLC. Joint Stip. ¶100.

II.
Analysis

The Illinois Department of Revenue audited PepsiCo for tax years 2011 through 2013. The Department determined that PepsiCo incorrectly excluded FLNA's income for each of the years under audit by claiming FLNA was an 80/20 company. Its findings were included in notices of deficiencies issued to PepsiCo for those tax years. The 80/20 findings contained in those notices are deemed to be *prima facie* correct and are *prima facie* evidence that the amount of tax and penalties calculated on the 80/20 findings due are correct. 35 ILCS 5/904(a). At this juncture in the proceedings, it is PepsiCo's burden to come forward with clear and convincing evidence as to why FLNA should be treated as an 80/20 company with its income excluded from PepsiCo's unitary combined reporting for State of Illinois income tax purposes for the tax years at issue. *See Copilevitz v. Dep't of Revenue*, 41 Ill. 2d. 154, 156-157 (1968).

Summary judgment is proper when "the pleadings, depositions and admissions on file, together with affidavits, if any, show there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." *Performance Marketing Association, Inc. v Hamer*, 2013 IL 11496, ¶12 (2013) (quoting 735 ILCS 5/2-1005(c)(2010)). In the present case, PepsiCo has filed its Motion for Summary Judgment, a Memorandum in Support of its Motion for Summary Judgment, and a Reply Memorandum. The Department has filed a Brief in Response to PepsiCo's Motion for Summary Judgment and a Surreply in Response to PepsiCo's Reply Memorandum.

The Department claims PepsiCo mistakenly asserts in its motion that the parties have agreed that the 80/20 issue is "purely a question of law" as the Department claims the issue is a mixed question of law and fact that requires evaluation of the stipulated facts. Dep't Br. at 4-6. Nevertheless, the Department has agreed to a stipulation of facts so the issue can proceed to summary judgment. 35 ILCS 5/2-1005(c).

In its Reply, PepsiCo argues that the Department distorted several stipulations in characterizing PGM LLC in the Dept's Brief. Pet'r Reply Memorandum at 1-7. The Department has consistently argued in this case and in its brief that PGM LLC has no economic substance and did not serve a business purpose while PepsiCo has consistently argued the exact opposite in this case and in its summary judgment motion and memorandum. PepsiCo argues that 11 out of the 157 stipulations in this case lend themselves to be interpreted that PGM LLC was more active than described by the Department.[4] This court allowed the Department to file a Surreply to address the issue raised by PepsiCo. After conferring with the parties about one stipulation, Joint Stip. 62, the parties agreed to amend the language of that stipulation. Docket No. 43. This court has reviewed each individual stipulation, including amended stipulation 62, and finds that all 11 of the stipulations are neutral on their face, allowing both sides to argue their respective positions without running afoul of the stipulated facts in this case to which both parties are bound.

A. The 80/20 Statute

The 80/20 provision in the Illinois Income Tax Act statute ("IITA") provides, in part:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. The group will not include those members whose business activity outside the United States is 80% or more of any such member's total business activity; for purposes of this paragraph … business activity within the United States shall be measured by means of the factors ordinarily applicable under subsections (a), (b), (c), (d), or (h) of Section 304 except that, in the case of members ordinarily required to apportion business income by means of the 3 factor formula of property, payroll and sales specified in subsection (a) of Section 304, including the formula as weighted in subsection (h) of Section 304, such members shall not use the sales factor in the computation and the results of the property and payroll factor computations of subsection (a) of Section 304 shall be divided by 2…

35 ILCS 1501(a)(27).

Similarly, the Department's regulation on 80/20 companies provides, in part:

> c) The 80/20 U.S. Business Activity Test for Prospective Members of a Unitary Business Group
>
> The factors to be used in determining whether 80% or more of a person's business activity is conducted outside the United States shall be gross figures without eliminations premised on the person's

[4] PepsiCo also referenced 3 exhibits to advance its argument, but the exhibits do not contain factual stipulations agreed by and between the parties.

> membership in any unitary business group. However, the factors should relate to the common taxable year, as defined in Section 100.5265, of the unitary business group of which the person being tested could become a member were the person's business activity found to be less than 80% outside the United States. The factors to be used are as follows:
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> 1) persons who apportion business income under IITA Section 304(a) shall use property and payroll; …

86 Ill. Adm. Code 100.9700(c).

Both PepsiCo and the Department accept that the statutory language of 35 ILCS 1501(a)(27) is clear and concise.[5] Pet'r Mem. in Supp. of Mot. for Summ. J. at 16-19; Dep't Br. at 11-15. Nevertheless, they both provide some legislative historical context for that statute which was enacted in 1982.

The Department points out the statute was enacted to exclude foreign income from combined income as the purpose of water's edge apportionment is to fairly determine income apportionable to Illinois while excluding income from predominately foreign business activities. Dep't Br. at 11-16.

While PepsiCo does not quarrel with the general conclusion drawn by the Department, above, it latches upon the statute's formulary used to calculate payroll and property factors that are used to measure business activity, both foreign and domestic, in determining whether a company is predominately a foreign company

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[5] "The fundamental rule of statutory interpretation is to determine and give effect to the intent of the legislature, and the statutory language is the best indicator of the legislature's intent." *Quality Saw & Seal, Inc. v. Illinois Commerce Commission*, 374 Ill. App. 3d 776, 781 (2nd Dist. 2007). "The best indication of legislative intent is the statutory language, given its plain and ordinary meaning." *Andrews v. Kowa Printing Corp.*, 217 Ill. 2d 101,106 (2005). "Where the language is clear and unambiguous, we must apply the statute without resort to further aids of statutory construction." *Id.* Moreover, in giving a statute or regulation reasonable construction, one should avoid "interpretations that render any part of the statute meaningless or void, and presuming that the legislature did not intend absurdity, inconvenience, or injustice." *Central Illinois Light Co. v. Illinois Department of Revenue*, 335 Ill. App. 3d 412, 415 (3rd Dist. 2002).

whose income is excluded from Illinois income taxation or one that is predominately a domestic corporation, whose income is subject to Illinois income taxation. PepsiCo argues that the 80/20 statute provides a "straight-forward mechanical" test. Pet'r Mem. in Supp. of Mot. for Summ. J. at 18.

The Department argues that strictly accepting PepsiCo's calculations of the 80/20 property and payroll factors, without any additional scrutiny of the payroll factor of FLNA vis-à-vis PGM LLC, results in the exclusion of FLNA's domestic snack foods business income, roughly $2.4 billion to $2.7 billion for the years at issue, from PepsiCo's combined income which is a gross distortion of income attributable to PepsiCo's Illinois business activities. Dep't Br. at 16.

PepsiCo is correct that the 80/20 statute mandates straightforward mathematical calculations. But any suggestion by PepsiCo that the Department must accept 80/20 calculations as provided by a taxpayer, as opposed to analyzing the underlying facts that go into such calculations, goes against the fundamental notion that claimed tax exemptions and tax deductions can be reviewed by the Department as it tasked with the administration and enforcement of the Illinois Income Tax Act. 35 ILCS 5/1401.

PepsiCo's argument that the 80/20 test is a mechanical test that cannot be scrutinized is without merit. Many taxing and tax-savings statutes use formulas, calculations, per centages, cut-offs, safe harbor levels and other mathematical expressions or measurements to include and exclude economic activity under a particular statute. It is hardly a stretch to accept that the Department can look behind such determinations to review the appropriateness of any such claim. The opposite would produce an absurd result.

In another 80/20 case before this court, *International Business Machines v. Illinois Department of Revenue*, 14 TT 229 (Docket No. 5 2015), IBM filed a summary judgment motion requesting that this court find that the Department had to accept IBM's payroll and property calculations without additional scrutiny as a matter of law. As this court wrote in rejecting that argument:

> IBM's position that this Tribunal must accept its salary and payroll calculations to be correct as a matter of law is untenable. Following IBM's argument, if a business claiming to be an exempt 80/20 company accidentally had its entire U.S. staff listed and paid from a related U.S. corporation's payroll, the Department would have to accept those payroll figures as reported and would be precluded as a matter of law from questioning those figures and reallocating those figures during an audit in an effort to determine the U.S. and

> worldwide activity of that business. Accepting taxpayer's evidence as dispositive in the first instance would preclude the Department from ever being able to question a claimed 80/20 exemption. That would turn the law on its head as a taxpayer has the burden of proving clearly it is entitled to an exemption. *United Airlines, Inc. v. Johnson*, 84 Ill. 2d 446, 455-456 (1981).
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> *Id*. (Docket No.10 2015).

In contesting PepsiCo's claim that PMG LLC's payroll and property calculations should be accepted to exclude FLNA's income from being reported as an 80/20 company, the Department makes two separate, but interrelated arguments. The Department argues that PGM LLC should not be considered the expatriate's employee in light of economic realities, Dep't Br. at 18-37. The Department further argues that PGM LLC has no economic substance and should be disregarded. Dep't Br. at 50-77. Both arguments focus solely on the payroll factor of PepsiCo's 80/20 calculation. The property factor calculation is not raised as an issue in this matter. Pet'r Mem. in Supp. of Mot. for Summ. J. at 14;

PepsiCo, in turn, argues that 1) PGM LLC is the expatriates' employer, both in law and fact, and is critical to PepsiCo's Corporate Group's global success. Pet'r Mem. in Supp. of Mot. for Summ. J. at 27-49; and 2) PepsiCo's formation of PGM LLC under FLNA and the placement of the expatriate as employees of PGM LLC cannot be equitably recast and cannot be reversed by the economic substance doctrine. *Id*. at 48-63.

B. Economic Substance/Substance over Form Doctrines and the Application to PGM LLC

A familiar adage in tax law is that every taxpayer has the right to decrease what otherwise would be owed in taxes, including avoiding tax altogether by any lawful means. *See BB&T Corp. v. United States*, 523 F.3d 461, 471 (4th Cir. 2008). However, taxpayers may not reduce taxes by setting up sham transactions lacking any legitimate business purpose or by affixing labels to transactions that do not reflect their true nature. *Id*. at 472. To that end, judicial anti-abuse doctrines have developed to "prevent taxpayers from subverting the legislative purpose of the tax code." *Coltec Indus., Inc. v. United States*, 454 F. 3d 1340,1353 (Fed. Cir. 2006).

The main anti-abuse doctrine for tax cases is the "substance over form" doctrine which has developed over the last 85 years to include two long-standing, intertwined, and functionally equivalent tax principles that substance over form determines the taxability of transactions and that legal transactions or entities which have neither real economic substance and business purpose are disregarded for tax purposes. [6]

The seminal tax case which first enunciated the substance over form doctrine was the United States Supreme Court decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). The taxpayer desired to transfer shares of stock in the Monitor Securities Corporation to herself held in a company 100% owned by her (the United Mortgage Corporation), without incurring income tax that would be generated by receiving such a corporate dividend. To that end, the taxpayer created a new corporation (Averill), transferred the Monitor stock from United Mortgage to Averill, dissolved the Averill Corporation and liquidated all its assets, which was just the Monitor stock, to herself. The time from creation to the dissolution of Averill took less than one week. The taxpayer immediately sold the Monitor stock. Recognizing the Monitor/Averill transactions as a reorganization, the taxpayer reported the gain on the stock as a capital net gain.

The Commissioner of Internal Revenue claimed the reorganization attempt was without substance and should be disregarded, which would result in casting the stock transactions as if the taxpayer received a dividend from the United Corporation.

The Supreme Court found the taxpayer complied with the letter of the law as it acknowledged every element of what constituted a reorganization under the tax statute regarding distributions of stock on reorganizations was accomplished by the taxpayer. Nevertheless, the Supreme Court disregarded the reorganization.

> Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find?
>
> Simply an operation having no business or corporate purpose-a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new

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[6] Such doctrines are branches from the same tree. Sometimes the doctrinal labels are used interchangeably, or inconsistent terminology is used. But they all look to the underlying economic reality of transactions and claimed business purpose to determine the appropriate tax treatment to be afforded those transactions. The somewhat pejorative term “sham transaction” is also used at times to describe transactions which are found not to be recognized for tax purposes for lack of economic reality or business purpose.

> and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.
>
> In these circumstances, the facts speak for themselves and are susceptible of but one interpretation.
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> The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

293 U.S. at 469-470.

The substance over form doctrine pronounced in *Gregory* has been applied, or at least uniformly recognized even where it was found not to be applicable to a specific fact pattern, over the better part of the last century since *Gregory* was decided, including in both federal and state courts' income and sales tax cases. Illinois is no exception. *E.g., JI Aviation, Inc. v. Dep't of Revenue*, 335 Ill. App. 3d 905 (1st Dist. 2002)(substance over form doctrine required a purchase from a non-retailer, which used a retailer conduit to convey title involving a like-kind exchange of aircraft, to be treated as a non-taxable sale); *Zebra Technologies Corp. v. Topinka*, 344 Ill. App. 3d (1st Dist. 2003) (transactions involving intellectual property between U.S. company and Bermuda subsidiary required "a look at substance over form."). *See also, Exelon Corporation v. Commissioner of Internal Revenue*, 906 F.3d 513 (7th Cir. 2018) (Exelon's structuring of SILO tax shelter transactions did not reflect the economic realities of the transactions); *In re Stoecker*, 179 F. 3d 546, 550 (7th Cir. 1999) (substance over form doctrine applied to disregard title transfer from aircraft retailer to its financing affiliate in a bankruptcy matter).

In applying the substance over form doctrine to a transaction or series of transactions, an objective test is used to determine whether or not there is underlying economic substance to validate the transaction(s) at issue. In *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the United States Supreme Court found the tax transactions at issue to have genuine economic substance. However, in doing so, it elaborated on the substance over form doctrine and its well-established principles:

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," *Commissioner of Internal Revenue v. Tower*, 327 U.S. 280, 291, 66 S.Ct. 532, 538, 90 L.Ed. 670 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S., at 255, 60 S.Ct., at 210. See also *Commissioner of Internal Revenue v. P. G. Lake, Inc.*, 356 U.S. 260, 266–267, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 981 (1945). Nor is the parties' desire to achieve a particular tax result necessarily relevant.

435 U.S. 573.

In the *Frank Lyon* case, the Supreme Court concluded by stating "…that we are not condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance. Such, however, has not happened in this case." *Id*. at 584.

In 2010, Congress codified and clarified the above principles that transactions must have economic substance in enacting Section 7701(o) of the Internal Revenue Code. Section 7701(o) states, in part:

> o) Clarification of economic substance doctrine.--
> (1) Application of doctrine.--In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if--
> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
> (2) Special rule where taxpayer relies on profit potential.--
> (A) In general.--The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

…

(5) Definitions and special rules.--For purposes of this subsection--

(A) Economic substance doctrine.--The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) Exception for personal transactions of individuals.--In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) Determination of application of doctrine not affected.--The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(D) Transaction.--The term "transaction" includes a series of transactions.

26 U.S.C. §7701(o).

From *Gregory* to *Frank Lyon*, along with the enactment of Section 7701, the two overriding takeaways are that labels in tax transactions can be disregarded to examine the substance of tax transactions and that tax transactions must have economic substance or reality to them along with business purpose to be valid.[7]

In the present case, PepsiCo argues that FLNA's status as an 80/20 company cannot be viewed under the lens of the economic substance doctrine as the 80/20 test is merely a straightforward mechanical test and application of that doctrine would thwart the clear legislative intent of the Illinois legislature which enacted the 80/20 formula for companies to avoid taxes on certain overseas business activities. Pet'r Mem. in Supp. of Mot. for Summ. J. at 56-63. In support of that proposition,

[7] PepsiCo cites to a footnote in a Tax Court case, *Dover Corp. v. Comm'r*, 122 T.C. 324, n. 19 (2004) for the proposition that PGM LLC cannot be disregarded for lack of business purpose. Pet'r Mem. in Supp. of Mot. for Summ. J. at 56, but that is not what the footnote says or stands for. *Dover* involved an analysis of the federal check-the-box regulations, Section 301.7701-3(a), which allow certain business entities to voluntarily elect its classification for federal tax purposes which includes the election to be disregarded and have its activities treated as a sole proprietorship, branch, or division of the owner. The footnote cited from *Dover* states that "Nor do the check-the-box regulations require that the taxpayer have a business purpose for such an election or, indeed, for any election under those regulations." While the choice in selecting a classification under those regulations need not have a stated business purpose, it does not stand for the proposition that a disregarded entity, itself, does not need a business purpose to have genuine economic substance. *Dover* is irrelevant and has no application to any economic substance doctrinal analysis and to the present case.

PepsiCo cites to a Sixth Circuit decision, *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017).

In *Summa Holdings,* taxpayers hewed to the literal requirements of several Internal Revenue Code provisions and utilized a Congressionally-created vehicle, a domestic international sales corporation ("DISC"), to transfer money from their family owned company to their son's Roth IRAs through a series of transactions, thereby escaping the contribution limits on Roth IRAs and lowering taxes, including potential tax-free distributions from the Roth IRAs upon retirement. The IRS challenged those transactions by invoking the substance over form doctrine. The Six Circuit rejected that argument and held that there was no basis to recharacterize those transactions. *Id.* at 782.

The Court began its analysis by explaining the purpose behind the creation of DISCs as shell corporations, which was to incentivize companies to export their goods by deferring and lowering their overall taxes. Exporters pay its DISC a commission on exports based on a gross receipts/net income calculation on the exports, but a DISC, in general, does not pay tax on that income. DISCs can then transfer money and assets to its shareholders at the qualified dividend rate without the transfer being first subjected to tax at the corporate level.

Congress, in addition to creating DISCs as a tax-savings vehicle, also expressly allowed IRAs to own shares in DISCs. 26 U.S.C. §§246(d), 995(g). That option became much more attractive when Roth IRAs were created by Congress. While some income tax would have to be paid when DISC dividends went into a Roth IRA, that amount could grow tax-free within the Roth IRA without any capital gains being paid on the increase in value of the DISC shares. *Id.* at 783.

The Sixth Circuit found that the very specific Internal Revenue Code statutory provisions involving DISCs and Roth IRAs expressly allowed the taxpayers to structure their transactions as they did. The Sixth Circuit found that Congress specifically enacted the DISC provisions for tax-reduction purposes and similarly found that the Roth IRA provisions were also designed for tax reduction purposes. *Id.* at 786. "By congressional design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs." *Id.* at 786.

In reaching its decision, however, the Sixth Circuit did not repudiate the substance over form doctrine. In fact, it expressly noted its continued vitality: "The substance-over-form doctrine, it seems to us, makes sense only when it holds true to its roots—when the taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process." *Id*.

PepsiCo relies on *Summa Holdings* for the proposition that the Department is precluded from looking behind the tax calculations used by PepsiCo in making its FLNA/PGM LLC 80/20 payroll calculation by arguing the 80/20 test is simply a mechanical test adopted by the Illinois legislature for the congressionally sanctioned purpose of tax avoidance. Pet'r Mem. in Supp. of Mot. for Summ. J. at 56-63; Pet'r Reply Mem. in Supp. of Mot. for Summ. J. at 52. PepsiCo's reading of *Summa Holdings* is misplaced as well its view of Illinois' legislative purpose in enacting the 80/20 test.

Summa Holdings merely held that the particular facts of that case allowed the taxpayers to take advantage of Congressionally- created tax vehicles for tax avoidance, such as DISCs, which are simply shell corporations with no economic substance, and that to disallow the tax advantages created by those specific transactions as lacking economic reality and substance would contravene Congress' intent. Summa Holdings is irrelevant and has no application to the Illinois' 80/20 statute.

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

While it is not necessary to look behind the clear language of 35 ILCS 1501(a)(27) to divine that the legislative intent behind the statute was to determine income that is fairly apportionable to Illinois and to fairly exclude income generated for the most part through foreign business activities, the Department notes the history behind 35 ILCS 1501(a)(27) including Governor Thompson's 1982 amendatory veto of the General Assembly's attempt to re-institute separate apportionment following the decision in *Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102 (1981). Dep't Br. at 11-15. In exercising his veto, Governor Thompson stated

"Domestic combined reporting allows firms to more clearly reflect the income attributable to Illinois. For these reasons, I am recommending combined reporting for domestic members of a unitary group." His veto language also recommended the 80/20 test. *Id*. That recommended formula was subsequently codified in 35 ILCS 1501(a)(27).

PepsiCo further argues that our state's Supreme Court's decision in *Hartney Fuel Oil Co. v. Hamer*, 2013 IL 115130 (2013) lends additional support for barring the application of the substance over form/ economic substance doctrines in the present case. Pet'r Mem. in Supp. of Mot. for Summ. J. at 62. PepsiCo misreads *Hartney* as the Court found that the challenged transactions, which comported with the then-existing tax regulation on sourcing sales that was at issue, to have real economic substance. The Court wrote:

> The Local Governments have additionally argued that Hartney's arrangement should be disregarded as a sham transaction. Analyzing a sham transaction requires assessment of the multiple steps of a transaction, with each being considered relevant, to determine whether economic reality accords with the formal arrangement. *Commissioner v. Court Holding Co.,* 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 981 (1945). Because we conclude the regulation erroneously sited tax based solely on purchase order acceptance in the case at bar, the sham transaction doctrine is unavailing. Hartney structured its affairs in accordance with the regulation, by relocating its order-receiving function to a lower tax jurisdiction. Hartney's arrangement was not without economic substance or economic effect. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering,* 293 U.S. 465, 469, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

2013 IL 115130 at n.6.

Rather than support PepsiCo's argument that literal compliance with a statute, or in the case of *Hartney*, a regulation, precludes any further examination of transactions, *Hartney* stands for the exact opposite as it doesn't reject the substance over form/economic substance doctrines, but finds them inapplicable when there is real economic substance to the contested transactions.

Accordingly, PepsiCo's arguments that its 80/20 payroll calculations must be facially accepted without further scrutiny of the underlying transactions that form the basis of that calculation are rejected.

1. The Substance of PGM LLC

As noted above, the genesis to identify PGM LLC as PepsiCo's global mobility platform came about at roughly the same time when PepsiCo underwent a large reorganization of its domestic and foreign operations including the acquisition of two large bottling companies. The expatriates had been taken off the BFSI payroll system and "PepsiCo Inc. essentially became their employer, although BFSI [was improperly] referenced [in] their Letter of Understanding and secondment agreement." Pet'r Mem. in Supp. of Mot. for Summ. J. at 39-40.

PGM LLC was created to reduce PepsiCo's overall tax liability. Tr. 31; Ex.6. PepsiCo's tax department determined there was an opportunity for tax savings by creating PGM LLC which would be used to employ all PepsiCo employees lent out on temporary assignments as expatriates throughout the world. According to Ex. 6, a slide presentation, PGM LLC would be registered to the same address as PepsiCo's Beverage Foods & Services company ("BFSI"), which previously had been utilized as the expatriates' employing entity since the 1990s. The BFSI signatory list formed the basis of the PGM LLC signatory list. According to Ex. 6, once PGM LLC was denoted as the employer of all the expatriates, "This entity will save PepsiCo approximately $14 million per year in taxes by taking advantage of the tax filing exclusion in 13 states under the "80/20 Company Rule." Ex. 6 at 4.

As discussed previously, there is absolutely nothing untoward when a taxpayer attempts to reduce taxes and tax reduction can be a primary, even a singular, goal in structuring transactions. Every taxpayer should use whatever lawful means available to limit potential tax liabilities. But that does not allow a taxpayer to structure transactions lacking real economic reality that run afoul of the anti-abuse doctrines outlined above.

PepsiCo argues that PGM LLC is critical to the PepsiCo Corporate Group's Global Success. Pet'r Mem. in Supp. of Mot. for Summ. J. at 37 through 48. It provides a laundry list of business reasons of why a company would want to create a Global Employment Company ("GEC") and what constitutes the "best practices" for running a successful GEC. Those aspirational goals and operational guideposts are laudatory, but they are divorced from the reality of PGM LLC. PGM LLC could not accomplish any of those goals as it did not function as an ongoing business concern.

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

Once PGM LLC was created, PepsiCo swapped in PGM LLC's name on the expatriates' secondment documents, but the switch was illusory. The same group of employees housed in the PepsiCo Corporate Group that administered the expatriate program at PepsiCo by overseeing the various aspects of the program such as expatriate placement and signing contracts with the expatriates continued to do so.[8] PGM LLC ostensibly became the employer of the expatriates on paper for purposes payroll and benefits, but again, all that really occurred was a name change to list PGM LLC as the employer on W-2s and the like. Payroll and related human resource benefits for the expatriates were made to appear to be paid by PGM LLC when, in reality, those amounts were paid by the foreign host companies with PepsiCo making internal journal entries to record those reimbursements so the payments could ostensibly be the payroll and benefits amount paid by and attributed to PGM LLC. Some of the actual administration of the payroll/benefits aspect for the expatriates was offloaded to a third-party benefits administrator.[9]

Another telling example of PGM LLC's insignificance is PepsiCo's International Assignment Handbook which was revised in 2014, years after PGM LLC's formation. Ex. 41. It is replete with references to PepsiCo Inc., including PepsiCo Inc. being listed on the bottom of each page of the handbook. However, there is not one reference to PGM LLC in the handbook, despite being touted in this case as the employer of expatriates.

In essence, not only was no one at home at PGM LLC, it didn't even have a home. It was a shell corporation used to list the expatriates as employees. Other than being told that PGM LLC was the new PepsiCo entity utilized as the employer for the expatriates, nothing changed for the expatriates. They dealt with the same group of employees in the PepsiCo corporate group for their US-based employment

[8] The Expatriate Program was overseen in its entirety by a group of individuals within the PepsiCo Corporate Group's human resources function. Joint Stip. ¶ 99.

[9] The use of a third-party processor for employee payroll and benefits is quite common for a business of any size, but in this situation, it just emphasizes the lack of any relationship of PGM LLC to the expatriates as PGM LLC was not a functioning entity and incapable of administering even the most basic payroll functions.

documents/contacts and other U.S.-based human resource needs, but they were supervised on their day-to-day foreign operations by their respective foreign host companies who paid for their salary and benefits by reimbursing PepsiCo through PGM LLC by internal accounting methods.

Because PGM LLC was nothing but a shell corporation, it must be disregarded for having no economic substance or valid business purpose.

C. Expatriates as PGM LLC Employees

Separate from arguing that PGM LLC must be disregarded for lacking economic substance, the Department argues that PGM LLC should not be considered the employer of the expatriates, Dep't Br. at 17-36, while PepsiCo argues that PGM LLC must be considered the employer of the expatriates. Pet'r Mem. in Supp. of Mot. for Summ. J. at 27-36, Pet'r Reply at 42.

Illinois' payroll factor is calculated at 35 ILCS 5/304(a)(2)(A) by determining "compensation paid." Compensation is defined to mean "wages, salaries, commissions and any other form of remuneration paid to employees for personal services." 35 ILCS 1501(a)(3).

PepsiCo and the Department agree that the term "employer" is not specifically defined in the Illinois Income Tax Act or the Department's regulations, but both agree that the definition of "employer" found in the Internal Revenue Code ("IRC") is to be used in making determinations of who is an employer.[10] "Employer" is defined under the IRC as "[T]he person for whom an individual performs or performed any service, of whatever nature, as the employee of such person,…" 26 U.S.C. § 3401(d).

Federal tax regulations adopt a common law analysis in determining employer/employee relationships and states, in part:

> (b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is,

[10] When a term is undefined in the Illinois Income Tax Act, "any term used in this Act, shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code." 35 ILCS 5/102.

> an employer is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

Treas. Reg. §31.3401(c)-1(b).

Illinois employee/ employer tax regulations for the Illinois Income Tax Act incorporate both the related Internal Revenue Code and the federal tax regulation provisions, therefore a common-law test is to be applied in making employer determinations for purposes of the Illinois Income Tax Act. Additionally, the Department's own regulations state, in part:

> Section 100.3100- Compensation (IITA Section 302)
>
> b) Employee
>
> Compensation is defined as remuneration for personal services performed by an "employee". If the employer-employee relationship does not exist, remuneration for services performed does not constitute "compensation." The term "employee" includes every individual performing services if the relationship between him or her and the person for whom he or she performs the services is the legal relationship of employer and employee. The term has the same meaning under the Illinois Income Tax Act as under IRC Section 3401(c) and 26 CFR 31.3401(c) -l.

86 Ill. Adm. Code 100.3100(b).

While the Illinois Income Tax Act and the Department's regulations do not directly address global expatriate secondments and what factors should be used to determine if employees loaned out on temporary assignments should be recognized as employees of the domestic company, PepsiCo cites to three U.S. Tax Court cases to highlight certain common-law factors that were considered determinative in making similar decisions about oversees employees.

In *Striker v. Commissioner*, T.C.M. 2015-248 (2015)[11], a U.S. Army employee, on assignment in Afghanistan to a NATO operation, was denied a claimed foreign income exclusion for gross income from sources outside the United States by the Tax Court as it found Striker to be an employee of the Army, despite the fact that NATO supervised Striker on a day-to-day basis. The Court focused on the facts that the Army provided Striker 1) fringe benefits including health and retirement benefits, 2) bi-weekly pay stubs, and 3) the Army reported Striker's wages to the IRS and withheld the requisite income and employment taxes from his paycheck. Additionally, Striker did not receive any benefits from NATO and there were no indicia that he was an employee of NATO.

The Tax Court stated: "The 'right-to-control' test is crucial to determine the working relationship…. But 'the degree of control' necessary to find employee status varies according to the nature of the services provided." *Id*. "The Army had the right to control, and actually did control petitioner's work. The Army had exclusive authority to hire, discipline, and fire petitioner; it paid his salary and provided all benefits; it directed where he would be deployed and the periods of his service; and it subjected petitioner to periodic performance evaluations." *Id*.

In *Gillis v. Commissioner*, T.C.M. 1986-576 (1986), Gillis was a U.S. Air Force employee assigned to NATO in Germany under the supervision of a German general. Like Striker, Gillis was trying to claim a gross income exclusion by claiming he was employed by NATO. The Tax Court found Gillis to be an employee of the Air Force as Gillis was paid by the Air Force, he did not have a separate contract with NATO, and NATO had no authority to hire or fire him." *Id*. Gillis also failed to show any of his salary was paid for by NATO, but the Tax Court concluded that even if he could show that NATO reimbursed the Air Force for his salary, that it would still hold that Gillis was an employee of the Air Force as "he was controlled and paid directly by the Air Force." *Id*.

In *Adair v. Commissioner*, T.C.M. 1995-493 (1995), the Tax Court came to the opposite conclusion of those in *Striker* and *Gillis*.

Adair, a U.S. Army employee, was transferred to NATO in Belgium pursuant to the Federal Employees International Organization Service Act, a statute

[11] United States Tax Court memorandum opinions (cited as T.C.M.) are nonprecedential, unpublished decisions of the Tax Court.

addressing details and transfers of Federal employees to international organizations, a statute clearly not applicable in the present case. Gillis had a three-year renewable contract with NATO. Gillis chose to be hired on a "reimbursable" basis as opposed to a direct hire basis which allowed him to retain his Civil Service retirement and other benefits when he was transferred to NATO. Gillis was directly paid by the United States while overseas, but the United States received reimbursement from NATO for his salary and emoluments. *Id.* When Gillis commenced working at NATO, he had to sign an oath of allegiance to NATO and performed services solely for NATO while deployed overseas with NATO. NATO, in turn, "dictated the results that petitioner was to accomplish through his work, as well as the means by which he was to attain those results. *Id.* NATO also regularly evaluated Adair's performance.

While acknowledging that a transferred employee, under the federal program that was at issue, could be considered a U.S. employee for the limited purpose of retaining retirement, health and life insurance benefits as well as workman's compensation coverage, the Tax Court concluded that Adair was an employee of NATO. "The determination of whether petitioner was an employee of the United States depends on all facts and circumstances, including the paramount fact that NATO, rather than the United States, controlled the manner in which his work was performed." *Id.*

In summarizing the three Tax Court cases, PepsiCo highlights the factors found to be relevant in those cases in applying a common-law analysis to individuals assigned to work overseas, those being: 1) the right to control the individual, 2) the right to discharge the individual, 3) the permanency of the relationship, and 4) the nature of the relationship created. Pet'r Mem. in Supp. of Mot. for Summ. J. at 26.

The Department, in turn, cites to and discusses in its Brief two Supreme Court cases, *United States v. Silk*, 331 U.S. 704 (1947) and *Bartels v. Birmingham*, 332 U.S. 126 (1947).

In *Silk*, the issue before the Court was whether workers who unloaded coal and truckers who delivered coal for the Albert Silk Coal Co. were employees of Silk for purposes of the Social Security Act. The Court found the unloaders to be employees, but the truckers to be independent contractors. It noted that no one factor is controlling in determining employer/employee relationships, and the Court chose to place less emphasis on purported legal terms of employment documents and instead, placed greater emphasis on defining employees as "workers who were such as a matter of economic reality." *United States v. Silk*, 331 U.S. 704, 713-715. The Court stated:

> The problem of differentiating between employee and an independent contractor or between an agent and an independent contractor has given difficulty through the years before social legislation multiplied its importance. When the matter arose in the administration of the National Labor Relations Act, 29 U.S.C.A. s 151 et seq., we pointed out that the legal standards to fix responsibility for acts of servants, employees or agents had not been reduced to such certainty that it could be said there was 'some simple, uniform and easily applicable test.' The word 'employee,' we said, was not there used as a word of art, and its content in its context was a federal problem to be construed "in the light of the mischief to be corrected and the end to be attained." We concluded that, since that end was the elimination of labor disputes and industrial strife, 'employees' included workers who were such as a matter of economic reality. The aim of the Act was to remedy the inequality of bargaining power in controversies over wages, hours and working conditions. We rejected the test of the "technical concepts pertinent to an employer's legal responsibility to third persons for the acts of his servants." This is often referred to as power of control, whether exercised or not, over the manner of performing service to the industry.
>
> *Id*. at 713.

In *Bartels*, another case involving the Social Security Act and decided one week after *Silk*, the Supreme Court had to decide whether band leaders, hired by public dance halls, were the employers of the band members when the underlying contracts stated the ballroom operators were the employer of both the band leaders and band members. The Supreme Court overruled the 8th Circuit Court of Appeals which concluded that the ballroom operators were the employers as the contracts between the operators and the musicians gave the operators the "right to control" the musicians, including the bandleaders, regardless of whether the control was actually exercised. *Bartels v. Birmingham*, 332 U.S. 126, 129 (1947).

In reviewing the overall relationships between the operators, band leaders, and band members, the Supreme Court found the band leaders to be the employees of the band members by rejecting the notion that the terms that set out control, or the right to control, in the underlying contracts necessarily define the relationship or are the dominant factors in determining an employment relationship. "Obviously control is characteristically associated with employer-employee relationship but in the application of social legislation employees are those who as a matter of economic reality are dependent upon the business to which they render service." *Id*. at 131-132. The Supreme Court noted "In *Silk*, we pointed out that permanency of the relation, the skill required, the investment in the facilities for work and opportunities for profit or loss from the activities were also factors that should enter judicial determination as to the coverage of the Social Security Act. It is the total situation that controls." *Id*. at 131.

In its Reply, PepsiCo counters that the economic realities test enunciated in *Silk* and *Bartels* was overruled some forty years later in two other Supreme Court cases, *Community for Creative Non-Violence v. Reid*, 490 U.S. 730 (1989)("CCNV") and *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992) and, as a result, the Department's analysis in disregarding PGM LLC as the expatriate's employer by ignoring PGM LLC's secondment agreements and employment contracts is flawed. Pet'r Reply at 13-30.

CCNV, a nonprofit association dedicated to eradicating homelessness, entered into an oral agreement with Reid, a sculptor, to create a work of art depicting contemporary homeless people in a modern Nativity scene setting. Disagreements arose between the parties as to final sculpted depiction as the work proceeded and following the completion of the work, CCNV demanded the sculpture be given to them. Reid refused to turn over the sculpture, which prompted the ensuing litigation.

The jurisdiction for the lawsuit lay in the Copyright Act of 1976 and whether the sculpture constituted a "work made for hire" which, if so, would result in the employer, CCNV, being the author and owner of the copyright, and, therefore, the sculpture. 17 U.S.C. §201(b). Section 101(1) of the 1976 Copyright Act provides, in part, that a work is made for hire if it is "(1) a work prepared by an employee within the scope of his or her employment…"

In its analysis of who constitutes an employee under the federal Copyright Act, the Supreme Court noted that the terms "employee" and "scope of employment" were not defined in that particular statute and that when Congress doesn't define those terms for a particular statute, Congress intends to describe the conventional master-servant relationship as understood by common-law agency doctrine." *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 739-740. (1989). The Court determined that the "right to control" and the "actual control" tests proposed by CCNV were inconsistent with the language of Section 101 and held that in determining whether a work was for hire under the copyright statute, a court should look to additional factors under the general common law of agency. *Id*. at 750-751. The Court went on to list some of those factors:

> In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party. See Restatement § 220(2) (setting forth a non-exhaustive list of factors relevant to determining whether a hired party is an employee). No one of these factors is determinative. See *Ward,* 362 U.S., at 400, 80 S.Ct., at 792; *Hilton Int'l Co. v. NLRB,* 690 F.2d 318, 321 (CA2 1982) (footnotes omitted).
>
> *Id*. at 751.

The Court found Reid was an independent contractor in light of the factors above and stated: "But the extent of control the hiring party exercises over the details is not dispositive. Indeed, all the other circumstances weight heavily against finding an employment relationship." *Id*. at 752.

In the other case cited by PepsiCo, *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992), the Supreme Court was asked to determine whether Darden, an insurance agent of Nationwide, was an employee or independent contractor under ERISA in a pension benefits dispute. The Supreme Court found the definition of employee under ERISA to be "completely circular" and proceeded to review the common-law test to determine the relationship to the parties while citing to the factors to consider that were listed in *Reid* and cited above. *Id*. at 323-324.[12]

The Supreme Court disagreed with the 4th Circuit Court of Appeals which held that, while Darden would most likely not be an employee under traditional principles of agency law, Darden was an employee under ERISA as it found the traditional definition inconsistent with the "declared policy and purposes" of ERISA. *Id*. at 321. The 4th Circuit cited to *Silk* for the proposition that the definition of

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[12] The undefined term "employee" in the Illinois Income Tax Act is relevant to this matter, not the definition of "employee" under the Federal ERISA statute.

employee should be more expansive than under a common-law test for purposes of ERISA, the purpose being the protection of an employee's expectation of pension benefits as "ERISA was necessary to "assur[e] the equitable character of such plans and their financial soundness." *Id*. at n.1. Ultimately, the Supreme Court remanded the case so that a ruling premised on a common-law test could be made. *Id*. at 328.

In reversing the 4th Circuit, the Supreme Court overruled *Silk's* broader definition of employee which expanded the common-law test to include a determination of Congress' goals when the term "employee" is either undefined or ambiguous in a particular statute used to advance a social legislative agenda, at least for purposes of determining an employee/employer relationship under ERISA.

In arguing that *CCNV* and *Darden* stand for the proposition that the economic realities of an employment relationship are to be abandoned and ignored in favor of common-law agency factors in determining the employment status of an individual[13], PepsiCo is throwing the baby out with the bath water. The Supreme Court stated a common-law test should be used to determine employment relationships and rejected that the definition of "employee" should be overlaid with Congressional desires hoped for in enacting certain statutes used to advance social goals. That is the only part of *Silk* that the Supreme Court found troublesome. The Supreme Court did not hold that underlying economic realities are not considered in conducting a common-law test. The economic realities of an employment situation are simply factors to be considered, along with other factors, such as the terms of an employment contract, in administering a common-law test. We know that to be true as cases following *CCNV* and *Darden* hold as much.[14]

Our own federal circuit held that economic realities are to be considered post-*Darden* and stated that was what the Supreme Court said in *Darden* in *E.E.O.C. v. North Knox School Corp*., 154 F.3d 744 (1998) when the court, in deciding if two school bus drivers were employees of a school district under the Age Discrimination in Employment Act, stated:

> The ADEA, like Title VII and ERISA, does not further define "employee." *See* 29 U.S.C. § 630(f) (defined as "an individual

[13] Pet'r Reply at 19.

[14] See, e.g., *Santos v. Commissioner*, T.C. Memo. 2020-88 (2020) (no single factor is dispositive, and all facts and circumstances must be considered.) *E.E.O.C. v. Sidley Austin Brown and Wood*, 315 F.3d 696 (7th Cir. 2002) (employee determinations are not mechanical tests); *Mazzei v. Rock N Around Trucking, Inc*., 246 F. 3d 956, (7th Cir. 2001) (citing to *Darden* that in conducting employee common-law test, "all of the incidents of the relationship must be assessed and weighed with no factor being decisive."). *Id*. at 963.

> employed by any employer"); *also Darden*, 503 U.S. at 323, 112 S.Ct. 1344 (virtually identical definition in ERISA "completely circular and explains nothing"). Courts have thus developed their own analyses to distinguish employees from non-employees such as independent contractors. In *Spirides v. Reinhardt*, 613 F.2d 826, 831 (D.C.Cir.1979) (Title VII), the court adopted an "economic realities" test, **which "calls for application of general principles of the law of agency to undisputed or established facts."** This analysis has generally been accepted, including by this court, *Knight,* 950 F.2d at 378–79 (Title VII), and by the Supreme Court, *Darden*, 503 U.S. at 322–24, 112 S.Ct. 1344 (ERISA) (emphasis added).
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> *Id.* at 747.

1. Common Law Factors Determinations Between PGM LLC and the Expatriates

PepsiCo argues that contractual rights are critical to common-law employer-employee determinations and that PGM LLC contracts of employment and secondment agreements must be enforced as intended and that among the most relevant factors to consider are the "right to control" and the right to discharge." Pet'r Reply at 19-32. PepsiCo is correct that the right to control or actual control are the most fundamental factors in a common-law employer/employee test, and that terms in employment contracts that spell out those right should be presumptively respected, but that doesn't mean that employment contracts are determinative or foreclose additional scrutiny to examine if the contract terms accurately depict the actual relationship at question.

PepsiCo's position that PGM LLC must be considered the employer of the expatriates because those rights are reserved by PGM LLC in its contracts/agreements with the expatriates is a red herring. By focusing one's attention on the terms in the contracts, one is distracted from the true issue, that is, whether PGM LLC has the wherewithal to execute any of those terms or whether PepsiCo's depiction of PGM LLC as the expatriate's employer on those contracts is illusory.

As previously stated, PGM LLC is a shell company.[15] It is not a viable business. It has no management or supervisory employees. There is no one employed at PGM LLC who has the ability to control the expatriates or terminate their employment. Actual control for the day-to-day supervision of the expatriates was ceded to the foreign host companies. Even while the PepsiCo human resource group provided human resource functions for the expatriates, there is nothing in the record to suggest that anyone in that group was authorized or given the right to control the expatriates in a management/ supervisory capacity. No control was exerted over the expatriates by PGM LLC nor was anyone designated and authorized to exert any control on behalf of PGM LLC. It exists only on paper in order for PepsiCo to avoid certain states' income taxes.

In arguing against PepsiCo's argument that contracts invariably control the determination of employment relationships is simply contrary to governing law, the Department cites to a United States Tax Court case, *Professional and Executive Leasing, Inc. v. C.I.R.*, 89 T.C. 225 (1987) ("*PEL*"). In *PEL*, the Tax Court decided that the petitioner, a company that leased management and professionals to commercial businesses, should not be considered the employee of those personnel under the petitioner's pension and profit-sharing plans. The Court noted some factors that courts have looked at to determine the existence of an employment relationship:

> Among the factors to which the courts have looked in determining the existence of an employment relationship are the following: (1) the degree of control exercised over the details of the work; (2) investment in the work facilities; (3) opportunity for profit or loss; (4) whether the type of work is part of the principal's regular business; (5) right to discharge; (6) permanency of the relationship; and (7) the relationship the parties think they are creating. United States v. Silk, 331 U.S. 704, 716 (1947); Simpson v. Commissioner, supra at 985; Ellison v. Commissioner, supra at 153. Although no one factor is controlling, the test usually considered fundamental is 'whether the person for whom the work is performed has the right to control the activities of the individuals whose status is in issue, not only as to results but also as to the means and method to be used for accomplishing the result. ' Packard v. Commissioner, supra at

[15] Many of the factors used to determine that PGM LLC should be disregarded under the substance over form doctrine also doom its employer arguments as those same factors are reviewable to look beyond formulaic documents to the underlying realities at play to assess the claimed employer/employee relationship.

629; see also Alsco Storm Windows, Inc. v. United States, 311 F.2d 341, 343 (9th Cir. 1962).

Id. at 232-233.

The Court further noted that "A contract purporting to create an employer-employee relationship will not control where the common law factors (as applied to the facts and circumstances) establish that the relationship does not exist." *Id.* at 233.

PepsiCo describes *PEL* as "overruled law" as it cited to *Silk* and was decided prior to the *Darden* decision. The chronology of the cases is immaterial as *PEL* is still good law as it simply listed common law factors used to determine an employment relationship and *PEL* stands for the undeniable proposition that an employment contract doesn't control when there is a non-existent employer-employee relationship and, by extension, when the contract, itself, is illusory.[16]

PGM LLC did not have actual control over the expatriates and did not have the right or the ability to control the expatriates. The terms to the contrary in the expatriates' secondment contracts and letters of understanding carry no weight as they are completely contradicted by the actual underlying facts that describe PGM LLC and its lack of employer/employee interaction with the expatriates.[17] PGM LLC had no ability to control the manner and means by which the work output by the expatriates was produced by virtue of it being an empty shell company.

Prior to the creation of PGM LLC, PepsiCo handled its expatriate program through the PepsiCo Corporate Group. Joint Stip. ¶ 47. After the creation of PGM LLC, the PepsiCo expatriate program was overseen in its entirety by approximately 20 individuals employed in the PepsiCo Corporate Group human resource function ('Global Mobility HR Function") and located around the world, who executed employee transfers, relocations and secondments throughout the PepsiCo corporate group. Joint Stip. ¶¶ 99 and 100. In other words, the very same group of people that signed off on expatriate assignments and otherwise oversaw the expatriate program prior to PGM LLC was the very same group of people that signed off on

[16] PepsiCo cites *Blue Lake Rancheria v. United States*, 653 F.3d 1112 (9th Cir. 2011) to claim "controlling law renders the *PEL* case useless." (Pet'r Surreply at 39-40). *Blue Lake Rancheria* is simply another employer definition case that, while decided after *PEL*, makes no reference to *PEL*. In fact, the 9th Circuit cited to *PEL* approvingly in another employer definition case decided after *CCNV* and *Darden* in *Stahl v. U.S.*, 626 F.3d 520 (2010).

[17] Similarly, there is nothing in the record to suggest anyone was designated or had the authority to act on behalf of PGM LLC to terminate any expatriate's employment or adjust the duration of any overseas assignment of any expatriate.

expatriate assignments and oversaw the expatriate program after PGM LLC was formed. Joint Stip. ¶¶ 54 and 74. Those individuals performed human resource functions. None of those H.R. employees have been identified to have any supervisory or management authority over the expatriates on behalf of PGM LLC. Similarly, expatriates participated in PepsiCo's Corporate Group's U.S. benefits plans and had their payroll administered by a third-party processor both before and after the formation of PGM LLC. Joint Stip. ¶¶ 79 and 111. The only negligible change that occurred following the formation of PGM LLC was that PGM LLC was inserted as the employer's name on certain documents relating to the expatriates. *Id.*[18]

In looking at other common-law factors to determine PGM LLC and the expatriates' relationship, PGM LLC fares no better:

PGM LLC did not provide any instrumentalities or work tools to the expatriates and did not have the ability to do so as it has no assets.

PGM LLC had no investment in the overseas work facilities of the expatriates.

PGM LLC had no ability to assign additional projects to the expatriates No one was authorized on behalf of PGM LLC to assign projects. Day-to-day control and supervision over projects rested with the foreign host companies.

PGM LLC did not have the ability to dictate the timing and length of any particular work assignment. No one was assigned that authority on behalf of PGM LLC.

PGM LLC was not a functional business. It conducted no business. Therefore, the expatriates' work could not be considered part of PGM LLC's business.

PGM LLC did not pay the expatriates as the foreign host companies reimbursed PGM LLC through a series of journal entries for both salary and benefits of the expatriates. No backend payroll or benefits functions were handled by PGM LLC, rather they were administered through PepsiCo's corporate group's

[18] No actual or right to control the expatriates resided at PGM LLC nor was that true of the PepsiCo H.R. department employees, It would be rather odd in a large company with a siloed H.R. department with no supervisory or management authority over employees in other parts of the company for an employee to have a discussion with an H.R. representative about claimed exemptions on a W-4 one day, only to be told on the next day by the same H.R representative that he or she was personally firing that employee.

human resource group along with Hewitt, the third-party payroll/benefits administrator. Just putting PGM LLCs name on W2s and other other payroll, benefits, and tax forms was meaningless.

For the reasons stated above, PepsiCo has failed in its burden to show that PGM LLC was the true employer of the expatriates, and, by extension, FLNA was the true employer of the expatriates.

III.

Conclusion

PepsiCo has failed in its burden to prove it is entitled to claim PGM LLC as an 80/20 company. PGM LLC must be disregarded as it has no economic substance. Similarly, it cannot be considered the employer of the expatriates. As a consequence, FLNA cannot be considered an 80/20 company and FLNA must be considered a company conducting business within the United States. FLNA must be included in the PepsiCo Illinois unitary group. The Department's Notices of Deficiency, as they pertain to the 80/20 issue, are upheld.

For the reasons stated above, PepsiCo's Motion for Summary Judgment is DENIED.

This is a final order subject to appeal under section 3-113 of the Administrative Review Law, and service by email is service under section 3-113(a). See 35 ILCS 1010/1-90; 86 Ill. Adm. Code 5000.330. The Tribunal is a necessary party to any appeal.

_/s/ *James Conway*_______
JAMES M. CONWAY
Chief Administrative
Law Judge

Date: April 13, 2021