**IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL**

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

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

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## <u>SUMMARY OF ARGUMENT</u>

The question here is whether PepsiCo, Inc.("PepsiCo") made a reasonable effort to determine its proper Illinois tax liability for 2011, 2012, and 2013, thereby avoiding penalties assessed by the Department. This is not a close question. PepsiCo sought to avoid paying *any* Illinois income taxes, and instead generated massive losses for these years even though it does not dispute that its business operations generated billions of dollars of profits for these tax years. PepsiCo did not make a reasonable attempt to determine its proper Illinois tax liability. Penalties imposed against PepsiCo must be upheld.

PepsiCo is a publicly traded company that owns the rights to many of the United States most iconic domestic snack food products. It is an extremely profitable company, which reported billions of dollars of income for 2010, 2011, 2012, and 2013, both on its audited financial statements, as well as on its federal income tax returns. For example, on its 2010 Illinois income tax return PepsiCo reported $1.4 billion of federal consolidated taxable income, on which, after adjustment and attribution to Illinois, it paid $5.4 million dollars of Illinois income taxes. However, in 2011, while PepsiCo reported $1.4 billion in federal consolidated taxable income, PepsiCo transformed this into a ($1.35) billion federal consolidated loss on its 2011 Illinois income tax return, on which it paid no taxes. PepsiCo similarly reported losses and paid no Illinois income taxes in 2012 and 2013.

What led to this divergence on PepsiCo's Illinois returns from the billions of dollars of income PepsiCo reported in its audited financial statements and on its federal income tax returns for 2011, 2012 and 2013? PepsiCo's subsidiary, Frito-Lay of North America, Inc. ("FLNA") in which PepsiCo lodged all its snack food profits, formed PepsiCo Global Mobility LLC ("PGM LLC") as a disregarded single member limited liability company. PepsiCo charged compensation of expatriate employees working for its foreign subsidiaries to PGM LLC. PepsiCo asserts this made FLNA an 80/20 Company, whose billions of dollars of domestic snack food profits were transformed into foreign income excluded from PepsiCo's Illinois returns under Illinois' 80/20 Rule. The Tribunal rejected this argument, characterizing PGM LLC as a "shell company" that "exists only on paper in order for PepsiCo to avoid certain states' income taxes."

Since 2011 PepsiCo has not tried to determine its proper Illinois tax liability. Instead, it has used PGM LLC for just the opposite purpose, its misguided intention of avoiding payment of any Illinois income taxes. PepsiCo's arguments that penalties do not apply here are easily defeated.

First, PepsiCo asserts that it made a good faith effort to determine its Illinois tax liability from 2011 forward in accordance with existing law. In fact, PepsiCo's attempt to avoid paying Illinois income taxes was contrary to decades old case law dictating that substance, not form, controls tax determinations.

Second, PepsiCo asserts its application of the 80/20 Test to generate massive net losses on its Illinois returns has no bearing on whether it made a reasonable attempt to determine its proper Illinois tax liability. These massive losses should have served as a red flag to PepsiCo of its misapplication of law. However, PepsiCo failed to critically review its returns in attempting to ascertain its proper Illinois tax liability for 2011, 2012, and 2013. If it had conducted such a review, its massive Illinois losses compared to the billions of dollars of income reported for financial and federal income tax purposes would have alerted PepsiCo that its filing position was contrary to controlling law. While PepsiCo asserts it critically reviewed its returns, it has provided not *one shred* of documentation that such a critical review ever took place. Instead, the documentary evidence proves that PepsiCo's goal was simply to avoid paying Illinois income taxes.

Third, PepsiCo asserts that PGM LLC was not a "company formed solely for tax avoidance purposes," but, instead it had "non-tax business purpose and objectives." Regardless of what PepsiCo's original *intention* was in forming PGM LLC, the record clearly discloses, and the Tribunal has held, that PGM LLC's non-tax business purposes and objectives were illusory, and that PepsiCo simply used PGM LLC to avoid paying state income taxes.

Fourth, PepsiCo asserts that Illinois and federal penalty case law supports PepsiCo's penalty abatement request. In reality, this case law dictates the opposite conclusion. PepsiCo's use of PGM LLC, a shell company, for pure tax avoidance purposes is the classic factual circumstance in which imposition of penalties is appropriate.

PepsiCo's penalties do not qualify for abatement and must be upheld.

## ARGUMENT

### I. PepsiCo's Penalties Cannot Be Abated for Reasonable Cause Because No Good Faith Legal Dispute Was at Issue Here

In support of its requested abatement of penalties for reasonable cause, PepsiCo points to Illinois Income Tax Regulation 700.400(b), 86 Ill. Admin. Code Sec. 100.400(b), which states that the most important factor in determining reasonable cause is whether a taxpayer has made a good faith effort to determine its proper tax liability. PepsiCo, Inc. and Affiliates' Response to the Illinois Department of Revenue's Cross-Motion for Summary Judgment to Uphold Late Payment Penalties ("PepsiCo's Response") p. 2. PepsiCo argues that it made a good faith effort to determine its tax liability because the question of whether FLNA was excludible from the PepsiCo unitary group as an 80/20 Company[1] was a narrow and purely legal question decided as a matter of first impression by the Tribunal. It further argues that there was no case law guidance or clear legal standard to guide PepsiCo in filing its Illinois tax returns, and its conclusion that FLNA was excludible as an 80/20 Company was wholly "consistent with Illinois case law existing at the time the returns were filed." PepsiCo's Response p.3. PepsiCo

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[1] In making this argument, PepsiCo misstates the facts, asserting that the "Department has agreed that PepsiCo accurately computed FLNA's property and payroll factors for 80/20 purposes." citing Joint Stip. ¶¶ 146-147. PepsiCo's Response p. 3. The Department did no such thing. The Department simply agreed in Joint Stip. ¶ 146 that " [f]or purposes of this case, the Department will not dispute the payroll and property amounts reported for PepsiCo's 2011-2013 tax years." (emphasis added). The immediately following stipulation makes clear that the Department disputes that amounts charged to PGM LLC were wages or compensation that could be included in computing FLNA's payroll factor. Joint Stip. 147 (" the Department does not agree these amounts constitute PGM LLC's 'compensation' or 'wages' for purposes of the 80/20 company computations under 35 ILCS 5/1501(a)(27)").

concludes that "this good faith legal dispute" alone constitutes reasonable cause for abatement of all penalties. Id. PepsiCo's arguments are *directly contrary* to relevant facts and controlling law.

### A. The Tribunal's Ruling That FLNA Was Not an 80/20 Company Was Primarily a Factual Determination

Contrary to PepsiCo's assertion that the Tribunal addressed a narrow legal issue, the Tribunal's determination here was primarily that of a factual issue. As PepsiCo concedes, whether FLNA was excluded as an 80/20 Company turned on whether the expatriates were PGM LLC employees under federal common law, which "requires an analysis of the unique facts and circumstances of each case." Id. Common-law employer-employee determinations are fact-intensive, and focus on the amount of control exercised over a worker by an entity for whom the services are provided. Professional and Executive Leasing, Inc. 89 T.C. 225 (1987) (Tax Court ruled that employment relationship did not exist between a leasing company and workers because an examination of the facts disclosed that the leasing company exercised minimal, if any control over the workers); and The Importance of Properly Identifying the Employer, The Tax Adviser, AICPA (July 1, 2017), https://www.thetaxadviser.com/issues/2017/jul/importance-identifying-employer.html ("the determination of which entity is the employer is fact intensive . . ").

Furthermore, the Tribunal's ruling was based on its application of substance over form principles in determining that PGM LLC was not the expatriates' employer. Substance over form determinations by their very nature are fact intensive inquires requiring "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974); and Bowen v. Commissioner, 78 T.C. 55, 79 (1982) (same). For example, the Illinois Appellate court in JI Aviation v. Illinois Department of Revenue, 335 Ill. App. 3d 905 (2003) carefully scrutinized the stipulated factual record in making its factual findings that a third-party intermediary, through which an aircraft's title passed from seller to purchaser, had no substantive role in the purchase and must be ignored for Illinois use tax purposes. Id. at 914. Similarly, the Tribunal here carefully examined the stipulated factual record in making its factual findings that PGM LLC as a shell company, based on its lack of control over the expatriates, could not be their employer and must be ignored for Illinois income tax purposes. The Tribunal's determination that PGM LLC could not be the expatriates employer based on its lack of substance, like the court's decision in JI Aviation, was principally a factual determination.

### B. Case Law Governing the Tribunal's Decision Was Well Established and Consistently Applied Over a Period of Approximately 90 Years

PepsiCo also wrongly asserts that the 80/20 issue decided by the Tribunal was a "legal issue of first impression." PepsiCo's Response p. 4. PepsiCo cites the decisions in Horsehead Corp. v. Ill. Dept. of Revenue, 2019 IL 124155, ¶ 51 and Security Life of Denver Insurance Company v. Illinois Dept. of Revenue, 14 TT 89 (April 11, 2016) in support of its position that tax liabilities attributable to legal issues decided as a matter of first impression constitute a good faith legal dispute that justifies abatement of penalties for reasonable cause. Id. at p. 3.

The Department has already addressed and distinguished the Horsehead and Security Life decisions at page 12 of the Department's Brief in Support of the Department's Cross Motion for Summary Judgment – 80/20/ Issue Penalties and ("Department's 80/20 MSJ Brief"), and at pages 10-11 of its Response Brief in Support of Its Cross Motion for Summary Judgment – 80/20 Issue Penalties and Motion to Strike the Certification of Charles Mueller ("DOR Response Brief and Motion to Strike"). The issue in Horsehead was whether chemicals were exempt from Illinois use tax under an exemption for catalytic chemicals "if the chemicals acting as catalysts effect a direct and immediate changes upon a product being manufactured." There was no previous case law interpretation of this statutory language. The court ruled in Horsehead that there was a good faith legal dispute as to what this language meant and consequently the taxpayer qualified for abatement of penalties. Similarly in Security Life, the Tribunal abated penalties for reasonable cause stemming from failure of 35 ILCS 5/1501(a)(27) to provide direction on how holding company income/losses should be apportioned between two separate unitary business groups.

Unlike these decisions, the Tribunal addressed no legal issue of first impression here. The parties agreed that determination of whether FLNA is an 80/20 Company depends on whether PGM LLC was an "employer" of the expatriates under the federal income tax common law definition of employer adopted by Illinois Income Tax Regulation 100.3100(b). 86 Ill. Admin. Code §100.3100(b). The Tribunal applied a wealth of case law addressing the common law definition of employer, dating back some 90 years, in ruling under substance over form principles that PGM LLC was not the expatriates' common law employer due to PGM LLC's total lack of substance. Tribunal Decision on Summary Judgment Motions, dated May 4, 2021 ("Tribunal 80/20 Decision") pp. 33-34. Unlike the legal issues of first impression in Horsehead and Security Life, the substance over form principles applied by the Tribunal have "been universally accepted" and carry:

> . . . 'out perhaps the most basic principle in taxation: economic realities determine tax consequences.' Tax law deals in economic realities, not legal abstractions.

JI Aviation vs. Dept. of Revenue, 335 Ill. App. 3d 905,918 quoting Estate of Weinert, 294 F.2d 750, 752 ( 5th Cir. 1961).

### C. PepsiCo's Exclusion of FLNA from PepsiCo's Unitary Group Was Based on Tax Avoidance Motives and Accordingly Resulting Penalties Do Not Qualify for Abatement

There was no good faith narrow and purely legal dispute at issue here. The Tribunal's ruling that FLNA was excludible was primarily a factual determination based on application of one of the most basic principles in taxation – economic realities, not legal abstractions, determine tax consequences. PepsiCo was not making a good faith effort to determine its proper tax liability. PepsiCo excluded FLNA from its unitary group, contrary to facts and longstanding law, for tax avoidance purposes, and the penalties imposed against PepsiCo therefore cannot be abated for reasonable cause.

## II. If PepsiCo Had Applied Proper Tax Return Preparation and Review Protocols, The Massive Losses Generated by Excluding FLNA From Its Unitary Group as an 80/20 Company Would Have Alerted PepsiCo to Its Misapplication of Law

Despite PepsiCo's unsupported assertions that it followed appropriate tax return preparation and review protocols, it is clear PepsiCo did not follow such protocols. If it had followed proper protocols, the massive net losses generated by excluding FLNA from its combined return, would have alerted PepsiCo to its misapplication of law.

### A. The Illinois Income Tax Act Imposes a Tax on Income Apportioned to Illinois

PepsiCo makes an astounding argument in attempting to twist the Illinois Income Tax Act in knots to support what asserts is the reasonableness of its position that from 2011 forward its proper Illinois tax liability equaled $0. PepsiCo argues that computation of its "proper Illinois tax liability," by excluding FLNA as an 80/20 Company from its return, is "neither informed, nor governed, by the amount of PepsiCo's resulting Illinois tax liability." PepsiCo's Response p.5 (emphasis added). In other words, PepsiCo argues that computation of its proper Illinois tax liability has nothing whatsoever to do with the actual amount of this liability. PepsiCo supports this argument by asserting that the "Department's claim that the purpose and intent of the 80/20 statute is to exclude 'foreign income' from the Illinois return is overly simplistic, self-serving, and most importantly in conflict with the clear statutory language." Id. PepsiCo continues that "the intent of the 80/20 Rule was to exclude foreign business activity" not foreign income from Illinois combined returns. Id. PepsiCo concludes that since the General Assembly's goal in enacting the 80/20 test was to exclude foreign business activity, not foreign income, from Illinois combined returns, the fact that PepsiCo's exclusion of FLNA's domestic income generated massive Illinois losses does not undermine PepsiCo's filing position. Id. at p. 6.

The tax act at issue here is entitled the "Illinois Income Tax Act." 35 ILCS 5/101 (emphasis added). It imposes a tax based on PepsiCo's *income,* not business activity, apportioned to Illinois. Illinois Department Administrative Hearing Decision 97-16, p. 19 ("The IITA does not impose a tax measured by activities conducted within Illinois; it imposes a tax measured by net income.") Furthermore, the Taxpayer's reading of 1501(a)(27) is directly contrary to the purpose of Illinois' 80/20 Rule, as addressed at pages 14 and 15 of the Illinois Department of Revenue's Brief in Support of Its Motion for Summary Judgment on the 80/20 Issue. ("DOR MSJ 80/20 Brief"). Governor Thompson in rejecting the General Assembly's attempt to re-institute separate apportionment, stated in his amendatory veto adopting the 80/20 Rule that domestic combination could prove to be of significant benefit to corporations conducting business in Illinois because it would more clearly reflect *income* attributable to Illinois:

> Companies operating an economic enterprise throughout the various states may, for a variety of reasons, choose to organize themselves as separate corporations rather than as branches or divisions of a single corporation. The business structure should not be the determining factor in taxation. Domestic combined reporting allows firms to <u>more clearly reflect the income attributable to Illinois.</u> For these reasons, I am recommending combined reporting for domestic members of a unitary group.

Governor Thompson Amendatory Veto, Illinois Senate Journal at p. 3757 (November 19, 1982). Id. at p. 3757. ( emphasis added). The amendatory veto further advised that domestic combination have a provision, the 80/20 Test, clearly identifying those corporations excluded from the unitary group. <u>Id</u>. at pp. 3756-3757. The 80/20 Test recommended by Governor Thompson, now contained in IITA Section 1501(a)(27), excluded from combined returns those corporations that primarily conduct business outside the United States:

> The group will not include those members whose business activity without the United States is 80 percent or more of any such member's total business activity; for purposes of this paragraph . . . business activity within the United States shall be measured . . . [by] the results of the property and payroll factor computations divided by two . . .

<u>Id</u>. at p. 3760 (emphasis added). In other words, the basis for excluding a corporation and its income from the water's edge combined returns was that it conducted 80% or more of its business activities outside the United States. The 80/20 Test, using payroll and property factors, was adopted as a clear and concise test for measuring foreign business activity. This

measurement was not, as PepsiCo argues, adopted simply to exclude foreign business activity from Illinois returns. Instead, the 80/20 Test was used to exclude the income of corporations primarily conducting business activities outside the United States in order to "more clearly reflect . . . income attributable to Illinois." Id.

At issue is whether PepsiCo made a good faith attempt to compute its proper tax liability by properly apportioning income to clearly reflect its income attributable to Illinois. PepsiCo argues that the 80/20 Test excludes foreign business activity, rather than foreign business income from Illinois combined returns. PepsiCo's argument only underscores the fact that PepsiCo is interested in tax avoidance rather than more clearly reflecting its income attributable and proper tax liability payable to Illinois.

## B. If PepsiCo Had Applied Proper Return Preparation and Review Protocols, It Would Have Avoided a Misapplication of Law That Excluded FLNA From Its Illinois Combined Return

If PepsiCo had followed proper tax return preparation and review protocols, it would have been alerted to a misapplication of law that caused it to exclude FLNA as an 80/20 Company. It clearly did not apply proper protocols.

### 1. PepsiCo Produced No Documentation to Support the Assertion That It Extensively Investigated FLNA's Qualification as an 80/20 Company

#### a. Unaudited Federal Payroll Tax Filings Do Not Constitute Legal Authority for the Position That the Expatriates were PGM LLC's Common-Law Employees

PepsiCo asserts that its "tax department followed the proper protocols by extensively investigating FLNA's qualification as an Illinois 80/20 Company, which necessarily included the classification of PGM LLC as the common law employer of the expatriate employees." PepsiCo's Response p. 8. PepsiCo attempts to bootstrap this assertion by pointing to Form W-2s's and federal payroll tax reports PepsiCo filed reporting the expatriates as PGM LLC employees. Id. PepsiCo has provided no documentation that these W-2's and payroll tax returns were ever audited by the Internal Revenue Service ("IRS"), or that the IRS otherwise determined that the expatriates were PGM LLC employees. All these filings demonstrate is that PepsiCo took the position in its payroll filings that expatriates were PGM LLC employees, they do not prove that this was the correct filing position. Myers v. Commissioner, 1995 Tax Ct. Memo LEXIS 325, *4 ("Petitioners' returns, which are in evidence, simply prove that these were the returns that were filed; they are not self-proving as to the truth of their contents.")

**b. PepsiCo's Self-Serving Assertions That It Extensively Investigated FLNA's Qualifications as an 80/20 Company Are Unsupported by *Any* Documentary Evidence and Accordingly Do Not Carry Its Burden of Proof**

PepsiCo also attempts support its filing position by asserting that Charles Mueller, PepsiCo's Senior Director of State and Local Tax, after reviewing Illinois law concluded that the expatriates were PGM LLC employees and FLNA was an 80/20 Company. The *only* support for this assertion that PepsiCo provides is Mr. Muller's Certification ("Mueller Certification"), which was attached to PepsiCo's Memorandum in Support of Its Motion for Summary. In reaching this conclusion Mr. Mueller states that he relied on Zebra Technologies Corp. v. Topinka, 344 Ill. App. 3d 747 (1st Dist. 2003) in concluding that FLNA was an 80/20 Company. Mueller Certification ¶¶ 59-68.

In Zebra the court ruled in favor of the Department that the taxpayer's foreign passive investment companies ("PICs") were not excludible from its unitary group as 80/20 Companies –

the opposite of what PepsiCo argues here. Even more importantly, the Zebra decision did not address the legal issue that the parties have agreed is determinative here, whether foreign workers were common law employees of the legal entity that the taxpayer sought to treat as an 80/20 Company. Mr. Mueller accordingly failed to identify, analyze or attempt to distinguish the long line of case law, which the Tribunal relied on in ruling that PGM LLC, as a shell company without substance, could not be the expatriates' common law employer.

Mr. Mueller's certification also states that he contacted Bruce Hunton, PepsiCo State Tax Counsel, and other members of the PepsiCo tax department who confirmed Mr. Mueller's conclusions regarding FLNA's exclusion as an 80/20 Company. Mueller Certification ¶¶ 68-69. The certification states that Mr. Mueller also contacted the PWC tax and consulting firm which similarly confirmed his conclusions that FLNA was an excludible 80/20 Company. Mueller Certification ¶ 70 and 71. The certification states that Mr. Mueller consulted with the PepsiCo global mobility transformation project team and that *based on these discussions* this team confirmed that PGM LLC was the expatriates' common law employer (¶72), and Mr. Mueller concluded that PGM LLC had business purpose (¶73), and economic substance (¶74).

PepsiCo did not produce a single written memorandum. summary, email, conversation note, or other evidentiary proof of Mr. Mueller's legal analysis, "discussions" with Mr. Hunton, other tax department personnel, PWC, or the PepsiCo global mobility transformation project team. Certifications containing documentarily unsupported self-serving conclusions, such as those made here by Mr. Mueller, cannot carry PepsiCo's burden of proof in sustaining its claim for penalty abatement. Balla v. Dept. of Revenue, 96 Ill. App.3d 293 (1982) and PPG Industries v. Illinois Department of Revenue, 328 Ill. App. 3d 16 (2002). Furthermore, there was no detail in the Muelller Certification to support his conclusory assertions that PGM LLC had business purpose and economic substance, when it had no assets, no capitalization, no management nor supervisory employees, no offices, and no business operations that generated or potentially generated any profit. The Department requested that the Mueller Certification be struck in DOR Response Brief and Motion to Strike.

In response to the Department's motion to strike, the Tribunal directed PepsiCo to document the assertions in paragraphs 73 and 74 of the Muller Certification that PGM LLC had business purpose and economic substance by ordering it:

> . . . to provide <u>all documentary evidence</u>, if any, in PepsiCo's possession that was relied on or was available to Charles Mueller <u>in making those determinations that addressed the particular issues of whether or not PGM LLC could be viewed as lacking economic substance or as a sham transaction</u>, as this Court decided in its order of May 4, 2021, including any documentation that addressed the issues or risks that PGM LLC was potentially subject to a substance over form, lack of business purpose, and/or sham transaction arguments/disputes with state taxation agency/departments or state courts.

Tax Tribunal Order, April 22, 2022 (emphasis added). In response to this Order, PepsiCo provided no documentation. Instead, PepsiCo's response referenced a memorandum prepared by PWC memorializing its written advice to Mr. Mueller, required under ASC 740 (Fin 48), in support of PepsiCo's financial statement Illinois income tax accrual, or presumably the lack thereof since PepsiCo took the filing position it owed no Illinois income taxes from 2011 forward. PepsiCo's Response to the Department's Motion to Strike dated May 26, 2022 ("PepsiCo's Motion to Strike Response"), f.n. 1, p. 8. However, PepsiCo declined to produce the PWC memorandum because PepsiCo asserted it was based on facts which "PWC did not independently verify." In response, the Tribunal issued an Order, dated June 1, 2022, stating that there was no factual support for the assertion in Mueller Certification paragraphs 70 and 71 that PepsiCo relied on the advice of PWC in taking the filing position that FLNA was an 80/20 Company. The Order requested that PepsiCo produce "relevant and admissible factual documentation" of its alleged consultation with PWC. PepsiCo again did not produce such documentation. On July 26, 2022 the Tribunal issued an Order striking Mueller Certification paragraphs 73 (business purpose) and 74 (economic substance) as conclusory except where the Joint Stipulations and Exhibits specifically support such conclusions.

PepsiCo's filing position that FLNA is an 80/20 Company did not have just a minimal impact on its Illinois tax liability. Instead, PepsiCo's filing position is that commencing in 2011 it no longer owed *any* Illinois income taxes, and generated massive annual Illinois net losses. Despite the enormous impact this filing position had in wiping out PepsiCo's Illinois income tax liability, PepsiCo is unable to produce a single document to support its assertion that PepsiCo's "tax department followed proper protocols by extensively investigating FLNA's qualification as an 80/20 company, which necessarily included the classification of PGM LLC as the common law employer of the expatriate employees." The lack of *any* contemporaneous documentation supporting the factual and legal basis for PepsiCo's filing position, requires a conclusion, that PepsiCo did not follow proper tax return preparation and review protocols.

**2. If PepsiCo *Had* Followed Proper Tax Preparation and Review Protocols It Would Have Been Alerted to Its Misapplication of Law**

If PepsiCo had followed the appropriate return preparation and review protocols in attempting to determine its proper Illinois tax liability, it undoubtedly would have discovered its misapplication of law. Corporate taxpayers focused on determining their proper tax liabilities use every tool at their disposal to reach the correct result. In this regard, returns are reviewed by a skilled professional to ensure the return makes sense in light of the laws it interprets and applies to the facts. Corporate taxpayers frequently employ checklists to identify potential return trouble spots meriting further in-depth review. Such checklists include comparing current year's income to previous year's income. See e.g. What to Review Before Signing Your Corporate Tax Return | Vistra, https://www.vistra.com/insights/what-review-signing-your-corporate-tax-return (corporate return checklist includes "1. Review changes to tax attributes from last year to this year . . . 8. If the [tax return] P&L net income differs significantly from the financial statement net income, do you know why?"). If the current year's taxable income differs significantly from the previous year's taxable income or from financial statement net income for the same year, reviewers typically reconcile and confirm the validity of such differences. Id. If PepsiCo tax department personnel had critically reviewed its Illinois returns, even just to compare the ($1.35) billion taxable loss in 2011 to $1.4 billion of taxable income in 2010, they would have been alerted that the exclusion of FLNA as an 80/20 Company merited in-depth investigation:

| **Tax Year** | **IL 1120 Line** | **2010** | **2011** | **2012** | **2013** |
|---|---|---|---|---|---|
| **Federal Consolidated Income - Per Audit** | 1 | $1,438,691,738 | $1,395,652,666 | $1,397,889,650 | $1,574,642,751 |
| **PepsiCo's Exclusion of FLNA Income from Federal Consolidated Income under the 80/20 test.** | N/A | N/A | ($2,743,739,901) | ($2,822,348,294) | ($2,374,671,181) |
| **Federal Consolidated Income – Per PepsiCo's Original Return.** | 1 | $1,438,691,738 | ($1,348,087,235) | (1,424,458,644) | (800,028,430) |
| ********* | | ********* | ************ | ********** | ********** |
| **Total Net Income and Replacement Taxes - Per Audit** | 52 | $ 6,251,010 | $ 4,696,736 | $ 3,355,864 | $ 2,623,354 |

| | | | | | |
|---|---|---|---|---|---|
| **Total Net Income and Replacement Taxes – Per PepsiCo's Original Return** | 52 | $ 5,350,035 | $0 | $0 | $0 |

Factual Stipulation ¶ 131 (emphasis added). If PepsiCo were attempting to ensure that it was determining its proper Illinois tax liability from 2011 forward, the fact that FLNA's exclusion as an 80/20 company wiped out PepsiCo's Illinois tax liability from 2011 forward would have led it to conduct a thorough analysis to ensure that the facts and law actually supported this filing position.

As a good business practice, in order to avoid any misunderstandings, tax advice involving substantial dollar amounts or complicated fact sensitive determinations are invariably memorialized in writing. See e.g. AICPA Statement on Standards No. 7, Form and Content of Advice to Taxpayers ( . . 6. Although oral advice may serve a taxpayer's needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar value, or complicated transactions."); and Applying the AICPA's Professional Standards to Tax Practice,Best Practices for Minimizing Risk and Penalties, The CPA Journal, March 2017 Issue ("Tax advice varies widely. It should be delivered in written form, both for good business practice and to ensure that there are no misunderstandings.") Such written advice evaluates all facts, determines which facts are relevant, and examines the reasonableness of any assumptions or representations. The advice identifies relevant facts, as well as explains the law applicable to the facts in arriving at the legal advice. Treasury Department Regulations Governing Practice before the IRS Circular No. 230 (Rev. 6-2014) § 10.37 "Requirements for Written Advice." Taxpayers rely on outside tax advisors for written opinions regarding tax treatment of transactions with a substantial impact on their tax returns.

See ASC 740 (Fin. 48) ; and 2022 Tax Opinion Policies and Procedures, Linda Galler, School of Law at Hofstra University, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4105841. This advice invariably includes a general statement that changes in factual circumstances may change the legal conclusions on which the advice is based. AICPA Statement on Standards No. 7, Form and Content of Advice to Taxpayers ("10. Taxpayers should be informed that . . . advice is based on facts as stated and authorities that are subject to change.")

In determining from 2011 forward that PepsiCo would no longer owe any Illinois income taxes, Mr. Mueller apparently without any written analysis: i) researched legal principles governing the determination of common law employees, 80/20 companies, and substance over form determinations; ii) reviewed PGM LLC's facts and applied these legal principles in his determination that the expatriates were PGM LLC's common law employees; and iii) concluded that FLNA was an 80/20 Company. He confirmed, again apparently without any written record, that his intensely fact-sensitive conclusions were correct in discussions with PepsiCo's state tax counsel, other tax department personnel, and its global mobility team. He also confirmed these conclusions in discussions with PWC and received a memorandum from PWC, which has, however, not been entered into evidence because it appears to have addressed the wrong facts.

If PepsiCo had followed proper tax protocols its misapplication of law would have been flagged for further review. In light of the massive impact on PepsiCo's tax liability, Mr. Mueller and his advisors would have memorialized in writing the facts and law supporting their conclusion that that FLNA was an 80/20 company, and this written memorialization would been further reviewed by PepsiCo tax department personnel. Upon such review, presumably one of the "130 tax individuals, including certified public accountants and attorneys who are well-versed in tax laws and corresponding compliance requirements" that comprise PepsiCo's "world class tax department" would have determined that use of a paper company, PGM LLC, to exclude FLNA from PepsiCo's combined return violates one of the most basic principles of taxation – economic realities, not legal abstractions, determine tax consequences. While PepsiCo was required by ASC 740 to receive written tax advice from outside advisor PWC for financial statement tax accrual purposes, according to PepsiCo this advice does not appear to have addressed PepsiCo's facts. If the assertions in the Mueller certification are accepted at face value, it is clear that there was a complete breakdown in PepsiCo's tax return review procedures that caused it to take an Illinois tax return filing position contrary to both facts and long-standing law.

### 3. PepsiCo's Actions Preclude It from Qualifying for Reasonable Cause for Abatement of Penalties

As discussed above, one explanation for PepsiCo's failure to document its attempt to make a good faith effort to determine its Illinois tax liability is that there was simply a gargantuan failure by PepsiCo to exercise proper tax return review protocols. It appears, though, instead that the more likely explanation is that PepsiCo, from its initial formation of PGM LLC, was instead focused simply on tax avoidance by eliminating its Illinois income tax liability from 2011 forward. Unlike PepsiCo's unsupported claims that it followed all the appropriate tax return review protocols, PepsiCo's tax avoidance purposes are documented. A summary of PepsiCo presentation made in September 2010 entitled, "PepsiCo Global Mobility, LLC - Background to the Change in Entity (Sept. 2010)" does not address using PGM LLC to better reflect PepsiCo's financial statement or taxable income. This presentation instead focused on use of PGM LLC to save $14 million per year in state taxes under the 80/20 Rule adopted by 13 different states. Factual Stipulation, Exhibit 6 (PepsiCo Global Mobility, LLC - Background to the Change in Entity (Sept. 2010) (PEP000002880-2888)) at PEP 000002883. PepsiCo was not attempting to determine its proper Illinois tax liability, but instead appears simply to have been seeking to avoid payment of any Illinois income taxes.

As described above, if the tax return review assertions in Mr. Mueller's certification are deemed credible, at the very least there was a major failure by PepsiCo to follow proper return review procedures in determining its Illinois tax liability. However, it appears more likely that from the outset of its organization of PGM LLC, PepsiCo was simply focused on avoiding payment of its proper Illinois tax liability. Either way, PepsiCo clearly did not make a good faith effort to determine its proper tax liability. PepsiCo therefore has not demonstrated reasonable cause for abatement of penalties. Illinois Income Tax Regulation 700.400.

## III. PepsiCo's Assertion that PGM LLC Exists for Non-Tax Reasons Does Not Demonstrate Reasonable Cause for Abatement of Penalties

PepsiCo next asserts that PGM LLC serves a variety of non-tax business reasons. PepsiCo's Response p. 9. This assertion, *even* if it were true, does not advance PepsiCo's request for abatement of penalties. Taxpayers typically have non-tax business purposes for legal entities they form. Having a non-tax business purpose is not amongst the factors referenced in Illinois Income Tax Regulation 700.400, which the Department examines in considering reasonable cause, nor has it been relied on by Illinois case law, cited by the parties, in considering whether a taxpayer has demonstrated reasonable cause for abatement of penalties.

PepsiCo appears instead to be using its assertion that PGM LLC serves non-tax business purposes to bolster its argument that PGM LLC was not "created simply to avoid tax." Id. It accuses the Department of ignoring the facts in arguing that PGM LLC was formed for tax avoidance purposes. However, it is not the Department that is ignoring the facts, but PepsiCo.

PepsiCo asserts that PGM LLC has the following business purposes: i) the limitation of U.S. entity legal liability; ii) to minimize permanent establishment exposure; iii) ease tax, business, and other government compliance requirements; iv) employ expatriates in one centralized entity; and v) to support high performing executives sent outside the U.S. to perform temporary key services for foreign subsidiaries. At the very best, as the Tribunal held in its 80/20 Decision, one could say these alleged PGM LLC business purposes were aspired to but never realized based on PepsiCo's failure to give PGM LLC any substance:

> 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.
>
> . . .
>
> 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.

Tribunal 80/20 Decision pp. 22-23 (emphasis added). In summary, despite PepsiCo's assertion of PGM LLC's business tax purpose, as the Tribunal ruled based on PGM LLC's lack of substance it never achieved those purposes. The Tribunal held that PGM LLC existed "only on paper in order for PepsiCo to avoid certain states' income taxes. Tribunal's 80/20 Decision p. 32. PepsiCo was not attempting to determine its proper Illinois tax liability. PGM LLC's tax avoidance purpose precludes the Tribunal from granting PepsiCo relief from penalties for reasonable cause. Illinois Income Tax Regulation 700.400(a).

## IV. Case Law Cited by the Department Is Directly on Point in Requiring That the Tribunal Uphold Penalties Imposed Against PepsiCo

PepsiCo's final argument is that the reasonable cause cases cited by the Department in support of its position that PepsiCo has not demonstrated reasonable cause for abatement of penalties are inapposite. PepsiCo's Response p. 10. In support of this argument PepsiCo reiterates its assertions that: i) PGM LLC exists for non-tax business reasons; ii) PepsiCo's exclusion of FLNA as an 80/20 Company was consistent with existing case law; and iii) the Tribunal's decision that FLNA was not excludible from PepsiCo's unitary group as an 80/20 company was a decision on a "narrow legal issue of first impression." PepsiCo's Response p. 11.

All these assertions have been previously rebutted in this brief. The non-tax reasons for which PepsiCo asserts PGM LLC exists are illusory. As addressed in Section III. of this brief, these business purposes were never achieved due to PGM LLC's lack of office, assets, employees, capitalization or any other type of substance with which to accomplish these purposes. As addressed in Section II. of this brief, PepsiCo's exclusion of FLNA as an 80/20 Company was *contrary* to existing law. The parties agreed that the federal income tax common law interpretation of the employer-employee relationship controlled here. A long line of case law interpreting the employee-employee relationship dictates that PGM LLC cannot be PGM LLC employees based on its lack of control over the expatriates due to its lack of management employees directing and controlling their work. As addressed in Section I. of this brief, rather than a narrow legal issue of first impression, the substance over form principles applied by the

Tribunal in ruling that the expatriates could not be PGM LLC's common law employees was a factual determination that "carries out perhaps the most basic principle in taxation: economic realities determine tax consequences" as previously applied by courts in Illinois. JI Aviation vs. Dept. of Revenue, 335 Ill. App. 3d 905, 918 quoting Estate of Weinert, 294 F.2d 750, 752 ( 5th Cir. 1961).

The Illinois reasonable cause cases cited by the Department are directly on point. See PPG Indus. Inc. v. Dep't of Revenue, 328 Ill. App. 3d 16, 26 (1st Dist. 2002); Kroger Co. v. Dep't. of Revenue, 284 Ill. App. 3d 473, 484 (1st Dist. 1996); and Tyson v. Illinois Dep't of Revenue, 312 Ill. App. 3d 64 (1st Dist. 1996). The courts in those decisions refused to abate penalties where the law clearly supported the Department's position. Similarly longstanding case law clearly supports the Department's position here that PGM LLC cannot be the expatriates' employer based on PGM LLC's lack of substance. Also, contrary to PepsiCo's assertion the federal income tax cases, such as Stobie Creek Invs.LLC v. United States, 608 F.3d 1366 (Fed. Cir. 2010), cited by the Department in its brief supporting its motion for summary judgment clearly support imposition of penalties. PepsiCo seeks to distinguish these cases by asserting that they involved transactions lacking economic substance, which were entered to create a tax benefit. Contrary to PepsiCo's arguments the Tribunal has held that PGM LLC was created to generate a tax benefit and that the business reasons alleged for its formation were mere aspirations due to PGM LLC's lack of substance.

Finally, PepsiCo asserts that because penalties for whatever reason were not assessed against the taxpayer in Zebra Tech Corp. 344 Ill. App. 3d 474, that it also should not be subject to penalties. PepsiCo bears the burden of proving reasonable cause for abatement. PepsiCo cites no legal authority for its assertion that the fact that penalties were not assessed in Zebra carries any weight here. While it is unclear why penalties were not at issue in Zebra, what is clear is that the court in Zebra did not address abatement of penalties in its decision. The decision in Zebra consequently constitutes neither binding nor even persuasive legal authority regarding the application of penalties against PepsiCo. Compare 1 Illinois Civil Procedure § 31.04 Stare Decisis (under stare decisis doctrine a final court judgment on a question of law becomes binding precedent when the same legal question arises in a later case before the same court and persuasive authority when decided by a different court); and University of Illinois College of Law, Law 627: Legal Research: Unit 3: Courts, https://libguides.law.illinois.edu/Law627/courts (defines binding legal authority as including constitutional provisions, legislation, and binding case law in the same jurisdiction addressing same legal issue, and persuasive legal authority as including case law from another jurisdiction addressing the same legal issue); with Stengel v. Commissioner, IRS, T.C. Memo 1992-570 , aff'd. 1993 U.S. App. LEXIS 16101, 996 F.2d 1227 (court held in income tax case that binding legal authority did not include informal administrative publication).

## CONCLUSION

PepsiCo has not proved reasonable cause for abatement of penalties here. The tax assessed against PepsiCo was not based on a good faith legal dispute, but instead was supported based on decades of case law of which PepsiCo as a sophisticated taxpayer counseled by a sophisticated outside tax advisor, PWC, should have been aware that the employees at issue were not PGM LLC employees and accordingly that FLNA was not an 80/20 Company. PepsiCo did not apply even the most basic tax return review procedures in attempting to determine its proper

Illinois tax liability. PepsiCo was focused from the outset on employing a sham transaction, using PGM LLC, a paper corporation, to avoid paying Illinois income taxes . . . ever again. PepsiCo has failed to demonstrate reasonable cause for abatement and penalties imposed against PepsiCo' accordingly must be upheld.

Respectfully submitted,

**Illinois Department of Revenue**

By:/s/Alan V. Lindquist

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## CERTIFICATE OF SERVICE

The undersigned counsel of record certifies that a copy of **Illinois Department Of Revenue's Reply Brief In Support Of Its Cross Motion For Summary Judgment – 80/20 Issue Penalties,** was served on August 11, 2022, to the following persons:

| | |
|---|---|
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