

**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 FOR
REASONABLE CAUSE PENALTY ABATEMENT AND DEPARTMENT’S
CROSS-MOTION FOR SUMMARY JUDGMENT-80/20 ISSUE PENALTIES**

Following earlier summary judgment motions by the parties, this court decided that PepsiCo’s subsidiary, PepsiCo Global Mobility (“PGM LLC”), should be disregarded for having no economic substance and, as a consequence, Frito-Lay North America (“FLNA”) could not be considered an 80/20 company for tax years 2011 to 2013. That results in FLNA’s income, approximately \$2.5 billion each year, being added to PepsiCo’s unitary group’s income for purposes of calculating its State of Illinois income taxes. Order May 4, 2021.

When the Department made its initial assessments of tax related to the 80/20 issue, it also assessed late penalties on those amounts. The late penalty assessments and whether those penalties should be abated are the subject matter of the current summary judgment motions.¹

¹ This court’s order of May 4, 2021 is incorporated in this order in its entirety and provides a factual background and this court’s factual determinations and legal analysis of the underlying 80/20 issue germane to the present penalty abatement issue.

The penalties, identified in Count X of 16 TT 82 and Count XV of 17 TT 16, are premised on 35 ILCS 735/3-3(b-20) which, in general, applies a penalty for the failure to pay an amount of tax due or required to be shown on a return. Penalties are calculated as varying percentages of the underpayment depending on the applicable subsection of 35 ILCS 735/3-3(b-20). A failure to pay penalty based on an assessed tax deficiency calculated when a tax audit is conducted is calculated at “20% of any amount that is paid after the date the Department has initiated an audit or investigation of the taxpayer.” 35 ILCS 735/3-3(b-20)(2).

The Department assessed a 20% late penalty at the conclusion of each audit for the tax periods at issue based on the amount of tax due and owing if PepsiCo’s subsidiary, PGM LLC, was disregarded and FLNA’s income was included in PepsiCo’s income. PepsiCo is challenging that penalty assessment.

PepsiCo argues that it acted in good faith and exercised ordinary business care and prudence when it determined to classify FLNA as an 80/20 company, it has a strong history of federal, state/local, and international tax compliance, and it relied on tax professionals and tax authority when it made its 80/20 determination. Based on those factors, PepsiCo requests a full abatement of the Department’s assessed late payment penalties.²

1. Background

This court ruled that PepsiCo’s decision to create PGM LLC to ostensibly be the corporate home for its expatriates lacked economic substance and business purpose and that PGM LLC was nothing more than a shell company. That ruling was premised on finding that the creation of PGM LLC was a sham transaction that violated judicial anti-abuse doctrine and that PepsiCo improperly classified its expatriates as employees of PGM LLC. Order May 4, 2021.

Prior to the formation of PGM LLC, 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

² In its current summary judgment filings, PepsiCo made certain arguments relating to a decision in an 80/20 case, *Zebra Technology Corp. v. Illinois Department of Revenue*, 344 Ill. App.3d 474 (1st Dist. 2003), premised on the claim that the Department did not assess penalties at the conclusion of the audit in that case. Because it turns out that the relevant penalty statute during the time of *Zebra* did not allow for such penalty assessments, PepsiCo has withdrawn its arguments.

year in state income tax savings in 13 states. Joint Stip. ¶¶ 58,59 and Ex. 6. That objective was planned by PepsiCo's internal tax department.

The parties agree that PepsiCo reported approximately between \$1.3 billion and \$1.5 billion in consolidated income for federal tax purposes for each of the three tax years, 2011 through 2013. By excluding the FLNA income by virtue of the creation of PGM LLC, aggregate reported income was reduced to \$0 and the exclusion further generated net operating loss carry forwards of approximately \$19.5 million, \$48.5 million, and \$35 million in those three years, respectively, for purposes of PepsiCo reporting income on its State of Illinois income tax returns. Joint Stip. ¶ 131, Joint Ex. 43.

The Department assessed PepsiCo a total of approximately \$2.1 million in late penalties for the three years. The great preponderance of late payment penalties, and those currently at issue, were the penalties attributable to the billions of dollars of FLNA business income properly apportionable to Illinois according to the Department. Dept. Br. in Supp. Of Mot. For Summ. J. at 4.

A. The Mueller Certification

When PepsiCo filed its Memorandum in Support of its Motion for Summary Judgment for Reasonable Cause Penalty Abatement, it attached as Exhibit A, the Certification of Charles Mueller ("Mueller Cert."). Mueller, now retired, was employed at PepsiCo for over 35 years and was Senior Director of State and Local Tax (from August 2002 to January 2012) and Vice President of State and Local Tax (from January 2012 to May 2021). Mueller was at PepsiCo during the time when PGM LLC was created and when PepsiCo initially claimed that FLNA was an 80/20 company on its State of Illinois Income Tax Returns. Mueller Cert. ¶¶ 2, 35, and 76.

In his certification, Mueller generally describes PepsiCo's tax department, characterizes PepsiCo's tax compliance history with the State of Illinois during his tenure, lays out the steps PepsiCo undertook to form PGM LLC, offers an intended business purpose justification for PGM LLC, and states that he determined FLNA was properly classified as an 80/20 company when PepsiCo claimed as much on its Illinois state income tax returns by, *inter alia*, his review of tax cases and statutes and conferring with tax professionals. Mueller Cert. ¶¶1-77.

According to Mueller, PepsiCo maintains a sophisticated tax department, comprising approximately 130 individuals, including certified public accountants and attorneys, who are well versed in tax laws and corresponding compliance

requirements. The tax department handles complex U.S. federal, state/local, and international tax compliance. Mueller Cert. ¶¶ 11, 12. According to Mueller, PepsiCo had an excellent compliance record with the State of Illinois regarding corporate income tax and non-income tax filing requirements during Mueller's tenure. Mueller Cert. at ¶ 16.

According to Mueller, when PepsiCo internally evaluated PGM LLC as an entity to house the expatriates, it was Mueller, in consultation with others, who made the decisions that it was appropriate for tax purposes to create PGM LLC and treat it as a legitimate business entity, to categorize PepsiCo's expatriates as employees of PGM LLC, and, consequently, to treat FLNA as qualified 80/20 company. Mueller Cert. at 11-15.

Upon the filing of the Mueller Certification, the Department incorporated in its Response brief a Motion to Strike all or a portion of the Mueller Certification as being as being "self-serving, unsupported by documentary evidence, and not based on personal knowledge." Dep't. Resp. Brief. at 2-3.

In this court's order providing PepsiCo an opportunity to respond to the Department's Motion to Strike, this court specifically highlighted two paragraphs in that certification and asked for PepsiCo to supplement the assertions made and the conclusions drawn with any factual documentary support:

2. In Mueller's certification, and in particular paragraphs 73 and 74, he states he determined PGM LLC had business purpose and economic substance. In addition to addressing the Department's arguments in its Motion to Strike, the Court specifically orders PepsiCo to provide all documentary evidence, if any, in PepsiCo's possession that was relied on or was available to Charles Mueller 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, 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. This should not include any "Best Global Mobility Practices" documentation or any documentation relating to structurally or mechanically setting up PGM LLC unless that documentation addresses the particular issues outlined above;

Order April 22, 2022.

PepsiCo did not provide any support for paragraphs 73 and 74.

PepsiCo's Response to the Motion to Strike claims, *inter alia*, that Mueller's Certification is based on his personal knowledge and that the entire factual and documentary record previously admitted into evidence on the 80/20 issue was available to Mueller in making his determinations contained in his Certification. PepsiCo Resp. to Motion to Strike at 3-5, 6-8.

One point of specific contention in those filings was whether Mueller's claim that PepsiCo had an excellent compliance history with the Department was supported by an adequate factual basis. Ultimately, the parties agreed to certain underlying facts concerning PepsiCo's compliance history for roughly a ten-year period preceding the tax years at issue which were incorporated into a stipulation. *See* Joint Stipulation of Fact Historic Penalties dated July 26, 2022. That stipulation reflects that PepsiCo was not assessed any negligence or fraud penalties, and the penalties that were assessed were isolated penalties and not out of the ordinary from those that one would expect to see in viewing the compliance history of a large multi-national corporation with complex tax filings.

In ruling on the Motion to Strike, this court referenced the well-settled law on what an affidavit provided in support of a summary judgment motion should, and should not, contain:

Illinois Supreme Court Rule 191 provides the requirements for an affidavit that is presented in conjunction with a summary judgment motion. Such an affidavit "shall be made on the personal knowledge of the affiants; shall set forth with particularity the facts upon which the claim, counterclaim, or defense is based; shall have attached thereto sworn or certified copies of all documents upon which the affiant relies; shall not consist of conclusions but of facts admissible in evidence; and shall affirmatively show that the affiant, if sworn as a witness, can testify competently thereto." *Id.*

Affidavits in support of and in opposition to motions for summary judgment must consist of facts admissible in evidence as opposed to conclusions, and conclusory matters may not be considered. *Woolums v. Huss*, 323 Ill. App. 3d 628, 635 (4th Dist. 2001). That is because such affidavits are a substitute for admissible trial testimony and must meet the same rules of admissibility. When an affidavit contains unsupported assertions, opinions, or conclusory statements, it should not be considered by a

court. *See Geary v. Telular Corp.*, 341 Ill. App. 3d 694, 699, (1st Dist. 2003).

Order On Motion to Strike July 26, 2022.

This court ruled on the Motion to Strike stating:

PepsiCo is entitled to make its arguments as to the weight and relevancy of any factual statement in the Joint Stipulation with regard to the penalty abatement issue. The weight and relevancy of any factual statement made in the Mueller Certification which is consistent with and supported by facts in the Joint Stipulation may also be argued by PepsiCo. Unsupported factual statements or conclusory statements will not be considered by this court.... This also applies to any exhibits that were offered and admitted in conjunction with the Joint Stipulation.

Id. at 3 and n. 2.

B. Penalty Abatement

Penalties imposed by the Department on assessments will not apply when the taxpayer shows the failure to pay a tax at the required time was due to reasonable cause. 86 Ill. Adm. Code 700.400. Pursuant to that regulation:

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

c) A taxpayer will be considered to have made a good faith effort to determine and file and pay the proper tax liability if the taxpayer exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor does reliance on incorrect facts such as an erroneous information return.

d) A taxpayer's history of compliance is also a factor to be considered in determining whether the taxpayer acted in good faith in determining and paying the tax liability. Isolated computational or transcriptional errors will not generally indicate a lack of good faith in the preparation of a taxpayer's return.

86 Ill. Adm. Code 700.400 (b)-(d).

II. Analysis

The parties agree that there are no material facts in dispute and that the penalty abatement issue can be resolved through summary judgment motions. 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)).

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

Accordingly, the assessed penalties on the 80/20 issue are presumed to be correct and due and it is PepsiCo’s burden to come forward with clear and convincing evidence as to why those penalties should be abated.

A. PepsiCo’s Compliance History

As noted above, the parties agreed to a stipulation chronicling the assessment of penalties for approximately a decade prior to the tax years at issue. Despite several penalty assessments, the stipulation reflected nothing particularly out of the ordinary for a large multi-national company with complex filing requirements. I find that the tax years reported in the stipulation reflect an overall good compliance history for PepsiCo in filing and paying its State of Illinois tax liabilities prior to the creation of PGM LLC .

However, the Department's regulation cited above states that a taxpayer's compliance history, while necessarily being taken into account, is just one factor to consider, and the primary factor is whether a taxpayer made a good faith effort to determine and file and pay the proper tax liability by the taxpayer exercising ordinary business care and prudence in doing so. "A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education...." 86 Ill. Adm. Code 700.400 (c); *see also Horsehead Corp. v. Illinois Department of Revenue*, 2019 IL 124155, ¶ 51. (Penalty abatement appropriate due to a lack of clarity in existing case law relating to the use tax chemical exemption definition regarding a unique manufacturing process).

B.

The creation of PGM LLC was an Unjustified Sham Transaction

In its effort to provide support for penalty abatement, PepsiCo relies upon the stipulations and exhibits referencing the formation of PGM LLC and the classification of FLNA as an 80/20 company agreed to and used by both parties in their 80/20 Summary Judgment Motions. Pet'r Response to the Department's Motion to Strike the Certification of Charles Mueller at 6-8. PepsiCo argues that those stipulations and exhibits, along with Mueller addressing certain of them in his certification, reflect that PepsiCo exercised ordinary business care and prudence when it created PGM LLC and when it took its position that FLNA was an 80/20 company in determining its State of Illinois income tax liabilities for the tax periods at issue.

In the Order of May 4, 2021, this court previously reviewed the stipulations and exhibits and made a factual determination that PGM LLC was a sham corporation and drew the legal conclusion that FLNA could not be treated as an 80/20 company for State of Illinois income tax purposes. This court drew the same conclusion on the related issue of the expatriate's classification and ruled that they could be not considered employees of PGM LLC. Those rulings were premised on finding that PGM LLC had no economic reality or business purpose and was deployed solely for PepsiCo to save state income taxes as highlighted in Exhibit 6 which was created by PepsiCo's internal tax department. The legal bases for the ruling that PGM LLC must be disregarded were the almost century-old substance over form doctrine and the lack of a true employer/employee relationship

between PGM LLC and the expatriates when viewing common law factors used to determine such a relationship.

In its current motion for penalty abatement, PepsiCo has chosen to ignore this court's May 5, 2021 ruling and simply reargues the same facts and its legal analysis as it did in its 80/20 Summary Judgment Motion that was rejected by this court. Simply restating those facts and arguments and having Mueller draw conclusions in his Certification that it is his view that creating PGM LLC and treating FLNA as an 80/20 company was appropriate at the time does not lend support to PepsiCo's current motion considering the true nature of PGM LLC and the existing case law at that time.

C.

PepsiCo's Lack of Ordinary Business Care and Prudence in Creating PGM LLC

FLNA is PepsiCo's core domestic snack food line. 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.

PepsiCo's tax department calculated that by forming PGM LLC, PepsiCo would save \$14 million a year in state tax savings in 13 states, including Illinois, as those states allow the non-recognition of certain income through an 80/20 tax provision. After PepsiCo created PGM LLC, FLNA's income approximately \$2.5 billion each year, was subtracted from PepsiCo's unitary group's income for purposes of calculating its State of Illinois income taxes. That meant FLNA's domestic income was not recognized for State of Illinois income taxes. Those machinations resulted in PepsiCo reducing its Illinois tax liability for 2011, 2012, and 2013 to \$0 in all three years. It also generated net operating losses in each year that equaled \$103,964,510, in the aggregate. Dep't Brief in Support of Cross Motion for Summ. J. at 3-5.

As this court stated in its ruling on the 80/20 issue, a taxpayer should take advantage of every legitimate tax-savings strategy to reduce taxes. If PepsiCo found a legitimate way to reduce its Illinois income taxes to zero for a tax year (and beyond through NOLs), this court would have no qualms about ruling in PepsiCo's favor. But PepsiCo chose an illegitimate path by creating its shell company, PGM LLC.

Forgetting Mueller's conclusion in his certification that PepsiCo's internal tax department employs "best" business practices and procedures, that department employed tax professionals, with Mueller at the helm, when it created PGM LLC. The numbers referenced above about estimated tax savings and PepsiCo's claimed tax savings on the 2011-2013 Illinois income returns and the elimination of paying any state income tax on FLNA's income should have set off alarm bells in the tax department that the structure of PGM LLC should, at a minimum, be scrutinized in-depth to insure it was a viable strategy. It sounded, and was, too good to be true.

So where is PepsiCo's documentary evidence of ordinary business care and prudence that reflects it made a factual determination that PGM LLC was an operational company that had economic substance as opposed to being just a shell company?

None has been produced.

Where is PepsiCo's documentary evidence, other than Mueller's conclusory statements that he determined the strategy of creating PGM LLC and taking the resulting tax benefits was reasonable despite ignoring almost a century of settled law employing the substance over form doctrine and ignoring sham transactions?³

None has been produced.

Despite the sophistication of the tax department and Mueller, not a single internal memorandum, document, or even a scribbled note reflecting any deliberative process or legal research was generated that questioned or tested PGM LLC's viability considering its lack of economic reality. The same holds true for any in-depth or even superficial legal analysis that touched upon the substance over form doctrine and whether PGM LLC could pass muster. Additionally, PepsiCo provided no documentation reflecting any opinion or advice from any outside law firm or accounting firm on these matters.^{4 5}

³ The same holds true for any analysis of whether PGM LLC could arguably be considered the common-law employee of the expatriates in light of the underlying facts and existing case law.

⁴ As noted above, when PepsiCo filed its current summary judgment motion, relying solely on the stipulations and exhibits previously admitted and used for the 80/20 summary judgment motions along with the Mueller Certification, this court offered PepsiCo an additional opportunity to present such evidence. Order April 22, 2022.

⁵ Mueller claims to have consulted others in determining FLNA qualified as an 80/20 company, both internally and externally, but those claims are not supported by any documentary evidence nor was any other affidavit or certification for the flip side of those purported discussions provided. Those barebone conclusions are rejected as lending any support for PepsiCo's position. Mueller Cert. 68-71.

It is astounding that a sophisticated tax department, like PepsiCo's, would create such an aggressive tax strategy to create a non-operational shell company, PPM LLC, whose sole purpose was to make billions of dollars of FLNA's domestic snack line income, previously recognized for State of Illinois income tax calculations,⁶ disappear with a few strokes of a pen, without addressing the merits of such an endeavor with in-depth factual and legal analyses.

At the end of the day, PepsiCo's legal arguments in its summary judgment motion on the 80/20 issue were rejected by this court. In its current attempt to abate penalties relating to that issue, it chooses to ignore this court's ruling on the 80/20 issue and does not address it. PepsiCo simply repeats its same arguments on the 80/20 issue overlaid with Mueller's untested certification that he concluded PepsiCo's course of action was reasonable without any further documented support or legal analysis that touches upon this court's 80/20 ruling. Having rejected those arguments once before, they are rejected again as support for penalty abatement.

PepsiCo created a shell company to avoid state income taxes and ignored the reality of the sham transaction it structured and the existing case law that forbade the use of such a strategy. PepsiCo did not exercise ordinary business care and prudence in creation of PGM LLC and in taking the position that FLNA's income could be ignored for certain states' tax purposes.

III. Conclusion

PGM LLC is a shell corporation with no legitimate business purpose or economic reality. Considering all facts and circumstances, PepsiCo did not exercise ordinary care and business prudence based on the clarity of existing law and its tax department's experience, knowledge, and education in creating PGM LLC and the resulting tax positions it took with regard its State of Illinois income tax determinations and liabilities.

⁶ As well as for a dozen other states according to Exhibit 6.

The Department's Notices of Deficiency, as they pertain to late penalty assessments related to the 80/20 issue, are upheld.

For the reasons stated above, PepsiCo's Motion for Summary Judgment for Reasonable Cause Penalty Abatement is DENIED, and the Department's Cross Motion for Summary Judgment-80/20 Issue Penalties is GRANTED.

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

Date: September 12, 2022