

**ILLINOIS INDEPENDENT
TAX TRIBUNAL**

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

ORDER ON MOTION FOR SUMMARY JUDGMENT

International Business Machines Corporation (IBM) is challenging income tax notices of deficiency issued by the Department for tax years 2007 and 2008. According to the Department, it issued the notices following an audit because it determined IBM World Trade Corporation (WTC), a wholly-owned subsidiary of IBM, did not qualify as an “80/20 Company” whose income could be excluded on its parent corporation’s unitary combined return for purposes of calculating Illinois corporate income and replacement taxes. IBM contends that the Department, in making its determination that WTC did not qualify as an 80/20 company, 1) improperly imputed payroll and property to WTC without legal authority, 2) used inaccurate data in making its payroll and property calculations, and 3) assessed late payment penalties on the calculated tax deficiencies even though IBM’s failure to pay the deficiencies was due to reasonable cause.

IBM filed its petition in this case on December 2, 2014. The Department filed its answer on January 7, 2015. This court ordered written discovery to be served by the parties on each other by March 20, 2015. On March 19, 2015, one day before written discovery was to be issued by the parties, IBM filed its current motion for

summary judgment. IBM claims it is entitled to summary judgment as a matter of law as there are no material facts in dispute and that the Department does not have the legal authority to impute payroll and property to WTC. The Department counters that there are material facts in dispute, its notices of deficiencies provide a *prima facie* case as to the correctness of its payroll and property calculations which, to date, is un rebutted, and IBM has failed to show that WTC qualifies as an 80/20 company.

As explained below, IBM's summary judgment motion is denied.

1. Background

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). As a general matter, most unitary business groups file a corporate income tax return with the State of Illinois on an annual basis (Form IL-1120 and Schedule UB).

Illinois 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 regarding its U.S. property and payroll and 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 within the U.S., 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.

According to IBM's petition in this case, WTC, a wholly-owned subsidiary of IBM, has held foreign assets and securities of IBM since 1949. Over the years, WTC and IBM entered into a series of licensing and royalty agreements which allow WTC to operate in foreign countries selling IBM's hardware, software technology, and other services. In the past, IBM has treated WTC as an 80/20 member of its

unitary business group and excluded WTC's income in calculating its overall income for Illinois state tax purposes.

The Audit

The Department audited IBM for tax years 2007 and 2008. For those years, IBM claimed that WTC had worldwide payroll of \$30 million and \$14 million, respectively, and U.S. payroll of approximately \$2 million each year. IBM also claimed that WTC had worldwide property of approximately \$80 million and \$73 million, respectively, and U.S. property of approximately \$1 million to \$1.2 million each year. Using IBM's figures, WTC qualified as an 80/20 company for both years.

IBM claims that, during the audit, it provided the Department with information requested about WTC "to the extent such information was relevant and available" and identified WTC's compensation and property figures for the years in question.¹ The Department denies that IBM responded to all audit information requests "in a timely and efficient manner" in its answer.² In either event, the audit resulted in WTC being disallowed as an 80/20 member of IBM's unitary group. The basis for the disallowance appears to be the auditor's finding of increased WTC U.S. payroll and property figures which were arrived at by including additional amounts to WTC's payroll and property figures that had been recorded by IBM as payroll and property for IBM. For example, IBM alleges that the Department took compensation reported on IBM's books and records for IBM officers and directors and imputed or added that compensation to WTC's payroll figures. Similarly, IBM alleges that certain property owned or rented by IBM was deemed to be WTC's property by the Department for purposes of recomputing WTC's property figures.

The Department's audit findings resulted in notices of deficiency being issued to IBM for tax years 2007 and 2008 assessing a total of \$15,641,342 in tax, interest and penalties. The findings contained in those notices are deemed to be *prima facie* correct and are *prima facie* evidence that the amount of tax and penalties due is correct. 35 ILCS 5/904(a). At this juncture in the proceedings, it is IBM's burden to come forward with clear and convincing evidence as to why WTC qualifies as an 80/20 business and why its income should be excluded from IBM's overall unitary business income. *See Copilevitz v. Dep't of Revenue*, 41 Ill. 2d. 154, 156-157 (1968).

¹ A belated affidavit from IBM's in-house tax counsel is attached to IBM's reply to the response to the summary judgment motion, but it provides little support for IBM at this time as it has not been tested by deposition or trial testimony or agreed to by stipulation by the Department.

² Answer to paragraph 31. Department's Answer p. 6

2. Analysis

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, IBM filed its summary judgment motion shortly after the petition and answer were filed. Rather than relying on a developed record, IBM is asking that this court rule on its motion based on the filings to date. As the Department points out in its response to the summary judgment motion, IBM’s motion on such a sparse record is more akin to a motion for judgment on the pleadings as opposed to a summary judgment motion. “A motion for summary judgment on the pleadings is similar to a motion for summary judgment in that both motions suggest the absence of any material factual issues as a matter of law.” *Brown v Zehnder*, 295 Ill. App 3d 1031, 1031 n. 1 (citing cases) (1st Dist. 1988).

It is abundantly clear that there are material factual issues in this case based on a reading of the petition and the Department’s denial of many of IBM’s allegations in its answer, including repeated denials that IBM’s payroll and property tax figures as reported by IBM are correct. After the Department pointed out in its response to the summary judgment motion that IBM had failed to provide any affidavit attesting to “undisputed material facts,” IBM provided a sworn affidavit of its Tax Counsel. IBM also noted that it had attached a copy of the Department’s auditor’s work papers to its petition and its motion. An affidavit which has not been contested and work papers for which there is no properly admitted testimony to explain them just highlight the need for this case to proceed to a point where the facts in this case can be developed for purposes being presented as undisputed facts in a proper summary judgment motion or to be presented as disputed facts at a hearing. Regardless of whether or not IBM’s current motion is thought to be a summary judgment motion or a motion on the pleadings, it is premature.

A. The Department has the authority to determine the correct payroll and property tax figures for WTC

IBM argues in its motion that the Department is precluded by law from imputing payroll and property from one company (IBM) to another (WTC).

Assuming, *arguendo*, that there were no factual disputes in this case and that this court could proceed on IBM's issue as a matter of law, that argument would fail.

To support its position that the Department is precluded by law from imputing payroll and property figures, IBM cites to a singular case, *Ill. Dep't of Revenue v. Shanghai, Inc.*, IT 02-1(Office of Administrative Hearings (Feb 7, 2002)).

In *Shanghai*, the Department determined that the Shanghai Trading Company (STCI), a foreign sales corporation, needed to be included in the unitary business group of Shanghai, Inc. as it failed to qualify as an 80/20 exempt member of that group. In making its calculations of STCI's payroll and property factors during an audit, the Department attributed some of Shanghai's payroll to STCI for Shanghai employees the Department claimed worked on STCI matters. Similarly, the Department also attributed property of Shanghai and other Shanghai subsidiaries to STCI in its attempts to measure STCI's business activities both within and outside the United States. As a result of the Department's attribution, its final audit calculations resulted in both higher U.S. payroll and property determinations for STCI, which had the consequence of disqualifying STCI as an exempt 80/20 business.

In proceeding before the administrative law judge in *Shanghai*, the Department stipulated that "STCI had no employees" and entered into a similar stipulation that "STCI owned no real or tangible personal property during the years at issue." *Id.* at 23 and 24-25. The ALJ seized upon those stipulations and found the Department's arguments to recognize any attributed payroll or property to be at odds with those stipulations. The ALJ concluded there were no factual or statutory bases for reallocating any of Shanghai's payroll or property to STCI. *Id.* at 43.

Because *Shanghai* is an agency decision from the Department of Revenue, it has no precedential value to the Tribunal and need not be followed. Of course, this court can look to *Shanghai* for its legal analysis and reasoning. I do not find *Shanghai* to be persuasive or to stand for the proposition that IBM advances, that is, that the Department is precluded by law from imputing payroll and property from IBM to WTC. The ALJ in *Shanghai* simply foreclosed argument by the Department by holding the Department to its literally-true stipulations regarding the payroll and property of STCI and refused the Department to advance contrary positions.

The Illinois Appellate Court did have an opportunity to address whether or not payroll figures (and by logical extension, property figures) could be imputed from a parent corporation to a claimed 80/20 member of a unitary group. In *Zebra*

Technologies Corp. v. Topinka, 344 Ill. App. 3d. 474 (1st. Dist. 2003), the Department attempted to attribute certain payroll of Zebra relating to quality control activities to two subsidiaries in disqualifying those subsidiaries from being exempt under the 80/20 rule. The Appellate Court looked at the evidence introduced at trial regarding the protection of Zebra patents and trademarks, both within and outside the United States, by Zebra and its subsidiaries and commented particularly on quality control committee meeting minutes of Zebra where those intellectual property issues were discussed:

This situation requires a look of substance over form. These monthly meetings of the quality control committee evince a considerable amount of business activity taking place in the U.S. for Domestic and International. The Department's witness stated there was no statute that allowed the Department to impute a payroll figure for these services. However, Zebra knew the amount of time spent by the committee on quality control issues and was capable of allocating this expense to the Bermuda companies because it was this committee which was protecting the license for these companies.

Id. at 483.

The Appellate Court ultimately ruled that Zebra failed to meet its burden by clear and convincing evidence that the two subsidiaries should be excluded from the unitary group and found that the activities for those subsidiaries in the United States was substantial. *Id.* at 492.

In the present case, IBM suggests that the rationale in *Zebra Technologies* which allowed a reallocation of expenses from one company to another is limited to cases where there is a finding of a complete lack of economic substance for one of the companies, and because WTC has economic substance, its payroll and property figures cannot be challenged.³ *Zebra Technologies* did not hold that a company must have a complete lack of economic substance before a specific intercompany transaction can be analyzed for its own lack of economic substance. The doctrine of "substance over form" is applied to transactions and does not necessarily mean that a party to a questioned transaction must have no business purpose or lack economic reality. Whether or not the "substance over form" doctrine is even applicable or

³ The court in *Zebra Technologies* did not have to reach the economic substance argument, a point IBM concedes in its reply to the response to its summary judgment motion. The court in *Zebra Technologies* accepted the Department's recalculation of payroll as an initial matter and shifted the burden to Zebra to prove its two Bermuda subsidiaries qualified as exempt 80/20 businesses. *Id.* at 484.

relevant in the present case is a question best left for another day as it cannot be answered on the undeveloped record before the Tribunal.

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).

Conclusion

Whether IBM was correct in treating WTC as an exempt 80/20 company or whether the Department was correct in denying the exemption cannot be determined until a factual record concerning WTC's U.S and worldwide business activities is developed. Accordingly, IBM's current summary judgment motion is denied.

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

Date: June 30, 2015