This Week in State Tax (TWIST)

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Illinois: Appellate Court Affirms Tribunal on Including 80/20 Entity

An Illinois appellate court recently affirmed an Illinois Tax Tribunal ruling that a member of the unitary group could not be excluded from an Illinois return as an 80/20 company. Immediately prior to the tax years at issue (2016-2017), the taxpayer, a manufacturer of food and beverage products, underwent a reorganization in which certain foreign activities, including the secondment of expatriate employees to foreign host companies, were centralized under a single disregarded entity. The disregarded entity was then placed below the taxpayer's domestic subsidiary in the organizational structure. After the change, "employees" of the disregarded entity were treated as foreign employees whose compensation was included in foreign payroll when determining whether the domestic subsidiary would be considered an 80/20 corporation. Under Illinois law, a unitary business group excludes the income of a member whose business activity outside the U.S., as measured by its property and payroll factors, exceeds 80 percent of its total business activity. On audit, the Illinois Department of Revenue (Department) disallowed the 80/20 treatment and included the domestic subsidiary in the taxpayer's unitary group. The Department's determination was first upheld by the Illinois Tax Tribunal, and then by a circuit court. The Tribunal and the circuit court both agreed that the payroll of expatriate personnel should not have been charged to the domestic subsidiary through the disregarded entity, and (as such) the domestic subsidiary could not include expatriate personnel payroll in its payroll factor in determining if it meets the requirements of an 80/20 company excluded from the unitary group.

In upholding these determinations, the Appellate Court of Illinois, First District focused on the disregarded entity's relationship with the expatriate employees. The court agreed that the disregarded entity was not the bona fide employer of expatriate personnel because the foreign host companies (not the disregarded entity) had "the right to direct, control, and supervise the day-to-day services performed" and to prepare annual performance reviews for final compensation determinations. The disregarded entity had no such control or supervision because it had no managerial or supervisory personnel of its own, and thus, had no ability to ensure expatriates complied with their secondment agreements. In addition, the court found that the foreign host companies truly bore the costs of expatriate services because any amounts paid to expatriates by the disregarded entity were reimbursed by the foreign host companies. Because these employees were not truly employees of the disregarded entity, payroll paid to those employees could not be considered foreign payroll in determining whether it met the 80 percent payroll threshold. Contact Bradley Wilhelmson with questions about PepsiCo, Inc. v. Department of Revenue. See the January 25, 2025, TWIST for a review of the circuit court decision in this matter.

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