IT 97-18
Tax Type: **INCOME TAX**
Issue: **Reasonable Cause Asserted On Application of Penalties**
Throwback Sales (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)
OF THE STATE OF ILLINOIS,	) **No. 96-IT-0000**
Petitioner	)
	)
v.	) **FEIN: 00-0000000**
	)
XYZ CORPORATION, INC.,	)
Taxpayer	) **Administrative Law Judge**
	) **Linda K. Cliffel**
	)

RECOMMENDATION FOR DISPOSITION

APPEARANCES: H. Randolph Williams for XYZ Corporation, Inc.; Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

There are two major issues presented in this case. The first is whether the Illinois Department of Revenue ("Department") correctly included certain subsidiaries of “XYZ” Corporation ("XYZ" or "taxpayer") in a unitary business group.

The second issue is whether sales made by “SUBSIDIARY #1” to customers in states in which “SUBSIDIARY #1” neither files returns nor pays tax were properly "thrown back" to Illinois and included in the numerator of the sales factor pursuant to 304(a)(3)(B)(ii) of the Illinois Income Tax Act, when the sales were shipped from taxpayer's supplier in Illinois.

On January 31, 1996 the Department issued a Notice of Deficiency ("NOD") to “XYZ” Corporation for the years ended 10/31/91, 10/31/92 and 10/31/93. The Department also issued an NOD to “SUBSIDIARY #2” for the years ended 10/31/91, 10/31/92 and 10/31/93. A third NOD issued against “SUBSIDIARY #3” and showed an overpayment. These Notices were protested by the taxpayer on March 29, 1996. Taxpayer timely filed amended returns and claims for refund for “SUBSIDIARY #3” for all years at issue regarding the above-noted overpayments. The Department subsequently revised the NOD's on January 6, 1997 to recalculate the sales factor. The revised assessment for “XYZ” for the tax years ended 10/31/92 and 10/31/93 is an overpayment of $3,600 and a liability of $86,393, respectively. The revised assessment for “SUBSIDIARY #2” for the tax years ended 10/31/92 and 10/31/93 is in the amount of $68,332 and $42,059, respectively. The revised NOD for “SUBSIDIARY #3” for the tax years ended 10/31/92 and 10/31/93 were for overpayments in the amounts of $12,507 and $10,747, respectively.

On consideration of these matters, it is recommended that as regards the first issue, the NOD's, as revised, be affirmed as including all of the subsidiaries of “XYZ” in the unitary group, but that the NOD's be revised to reflect the fact that “SUBSIDIARY #1” was a part-year member of the unitary group commencing July 12, 1993. Additionally, taxpayer's claims for refund for “SUBSIDIARY #3” should be allowed in the revised amounts.

Regarding the second issue, it is recommended that the NOD be affirmed as the sales made by “SUBSIDIARY #1” were properly included in the numerator of the sales factor.

FINDINGS OF FACT:

Unitary Issue

1. “XYZ” is a producer and marketer of food products. (Tr. pp. 146-155; Taxpayer Ex. No. 2) “XYZ” and its wholly-owned subsidiaries filed consolidated federal income tax returns for the years at issue. (Dept Ex. Nos. 23-25)

2. “XYZ” owned 100% of the stock of the following corporations during the years at issue:

10/31/91	10/31/92	10/31/93
”SUBSIDIARY #1”	“SUBSIDIARY #1”	“SUBSIDIARY #1”
“SUBSIDIARY #2”	“SUBSIDIARY #2”	“SUBSIDIARY #2”
“SUBSIDIARY #3”	“SUBSIDIARY #3”	“SUBSIDIARY #3”
“SUBSIDIARY #4”	“SUBSIDIARY #4”	“SUBSIDIARY #4”
“SUBSIDIARY #5”	“SUBSIDIARY #5”	“SUBSIDIARY #5”
“SUBSIDIARY# 6”	“SUBSIDIARY #6”	“SUBSIDIARY #6”
“SUBSIDIARY #7”	“SUBSIDIARY #7”	“SUBSIDIARY #7”
“SUBSIDIARY #8”	“SUBSIDIARY #8”	“SUBSIDIARY #8”
“SUBSIDIARY #9”	“SUBSIDIARY #9”	“SUBSIDIARY #9”
“SUBSIDIARY #10”	“SUBSIDIARY #10”	“SUBSIDIARY #10”
“SUBSIDIARY #11”	“SUBSIDIARY #11”	“SUBSIDIARY #11”
“SUBSIDIARY #12”	“SUBSIDIARY #12”	“SUBSIDIARY #12”
“SUBSIDIARY #13”	“SUBSIDIARY #13”	“SUBSIDIARY #13”
“SUBSIDIARY #14”	“SUBSIDIARY #14”	“SUBSIDIARY #14”
		“SUBSIDIARY #15”
		“SUBSIDIARY #16”
		“SUBSIDIARY #17”

(Dept. Ex. No. 4)

3. “XYZ” filed a separate company Illinois return for the tax year ended 10/31/91. (Dept. Ex. No. 17) “XYZ” filed a combined Illinois return for the tax year ended 10/31/92 with “SUBSIDIARY #4”. (Dept. Ex. No. 16) “XYZ” filed a combined Illinois return for the tax year ended 10/31/93 with “SUBSIDIARY #4 and “SUBSIDIARY #1”. (Dept. Ex. No. 18) “SUBSIDIARY #4 filed a separate company return for the tax year ended 10/31/91. (Dept. Ex. No.

19) “SUBSIDIARY #3” filed separate company returns in Illinois for the tax years ending 10/31/91 through 10/31/93. (Dept. Ex. Nos. 20-22)

4. “XYZ” and its subsidiaries are engaged in the same line of business. “XYZ” classifies its subsidiaries as either "core" subsidiaries or "stand-alone" subsidiaries. (Tr. pp. 146-155; Taxpayer Ex. No. 2)

5. The core companies are operated as divisions of “XYZ”. Their financial results are included with the results of “XYZ”'s various groups and divisions. The core companies are “SUBSIDIARY #5”, “SUBSIDIARY #4”, “SUBSIDIARY #7”, “SUBSIDIARY #9”, “SUBSIDIARY #15”, “SUBSIDIARY #16”, “SUBSIDIARY #17”, “SUBSIDIARY #14”, and “SUBSIDIARY #1” (after 7/12/93). (Taxpayer Ex. No. 2; Tr. pp. 147, 159-160)

6. The core businesses of “XYZ” are the prepared foods group, the meat products group and the food service group. The divisions within the prepared foods group are grocery products and specialty products. The grocery products division sells products such as “MOTHER’S CREAMED CHIPPED BEEF”, “PAPA’S PICKLES AND LIVER SAUSAGE PATE”, “NO-GAS BEAN SOUP”, “BABY HUEY’S CHIMICHANGAS”, and “NEW YORK CITY SALSA”. The specialty products division sells gelatin products. The meat products group sells (“WHAT ELSE, MEAT PRODUCTS”). The food service group principally provides pork products to the food service trade such as restaurants and colleges. (Tr. pp. 155-158)

7. The taxpayer has admitted that “XYZ” and the core companies, “SUBSIDIARY #4”, “SUBSIDIARY #14”, “SUBSIDIARY #5”, “SUBSIDIARY #13, and “SUBSIDIARY #1”, for the period after July 12, 1993, were all part of the same unitary business group. (Dept. Ex. No. 212, p. 6) “SUBSIDIARY #7”, and “SUBSIDIARY #9” were inactive during this period. (Dept. Ex. No. 212, p. 6)

8. On July 12, 1993, “SUBSIDIARY #17 acquired “CORPORATION A's” manufacturing operation which had been “SUBSIDIARY #1”'s supplier. After the acquisition, “XYZ”, “SUBSIDIARY #17” and “SUBSIDIARY #1” operated as functionally integrated businesses at all operational levels. (Dept. Ex. No. 212, p. 6)

9. The stand-alone companies operate as individual companies and their financial results are separately stated. The stand-alone companies are “SUBSIDIARY #2”, “SUBSIDIARY #10”, “SUBSIDIARY #8”, “SUBSIDIARY #3”, “SUBSIDIARY #6”, “SUBSIDIARY #11”, “SUBSIDIARY #12”, and “SUBSIDIARY #1” (prior to 7/12/93). (Taxpayer Ex. No 2; Tr. pp. 146-147, 159)

10. “SUBSIDIARY #2” processes and sells fresh and frozen whole “CITY PIDGEONS”, “PIDGEON” meat and “PIDGEON” manufactured products. (Tr. pp. 148-149)

11. “SUBSIDIARY #3” imports and sells food casings. (Tr. pp. 149-150) “SUBSIDIARY #3” is a subsidiary of “SUBSIDIARY #8”. (Taxpayer Ex. No. 2)

12. “SUBSIDIARY #10” is a direct mail marketer of specialty food and nonfood items. “SUBSIDIARY #10” produced “CATALOG A”, “CATALOG B” and “CATALOG C” catalogs. (Dept. Ex. No. 36, p. H01252)

13. “SUBSIDIARY #6” grows, processes and markets fresh and frozen fish. (Tr. p. 151)

14. “SUBSIDIARY #12” manufactures and distributes cooked meats, such as roast beef and corned beef. (Tr. pp. 151-152)

15. “SUBSIDIARY #11 manufactures equipment used in the food industry. (Tr. p. 148)

16. “XYZ” has an annual planning process whereby each “XYZ” group and each stand-alone subsidiary present their profit objectives to “XYZ” for the coming year. Presentations are made to the executive committee of the “XYZ” Board of Directors and the committee evaluates each

projection both with a view as to what's reasonable for the division or subsidiary and what the total return will be for “XYZ”. Ultimately, the objectives are determined by “XYZ”. (Tr. pp. 162-168, 202-206)

17. The stand-alone subsidiaries report their financial results to the Board of Directors six times per year. “XYZ” core companies likewise report their results to the Board, but on a divisional basis rather than a separate company basis. (Tr. pp. 159-161)

18. “XYZ” and its subsidiaries have many officers and directors in common. The following is a listing of officers or directors who held office at both “XYZ” or a "core" subsidiary, and a "stand alone" subsidiary.

“Howdy Doody”	Executive Vice President & CFO, “XYZ” (1992 & 1993);
	Group Vice President, “XYZ” (1991)
	Vice Chairman & Director, “SUBSIDIARY #2”
“Gene Autry”	Vice President, “XYZ”
	President, “SUBSIDIARY #8”
	Chairman, “SUBSIDIARY #3”
“Roy Rodgers”	Director, “XYZ”
	Director, “SUBSIDIARY #2”
“Pat Butram”	Chairman & CEO, “XYZ”
	Director, “SUBSIDIARY #8”
“Nelly Bell”	Vice President, “XYZ”
	President, CEO & Director, “SUBSIDIARY #2”
“C. Video	Executive Vice President & Director, “XYZ” (1992 & 1993);
	Group Vice President (1991)
	CEO & Director, “SUBSIDIARY #4”
	Director, “SUBSIDIARY #2”
	Director, “SUBSIDIARY #5” *
	Director, “SUBSIDIARY #8”
	Director, “SUBSIDIARY #1”
	President & Director, “SUBSIDIARY #14” *
	President & Director, “SUBSIDIARY #15” *
	President & Director, “SUBSIDIARY #16” *
	President & Director, “SUBSIDIARY #17” *
“R. Kazooty”	Vice President, “XYZ”
	Director, “SUBSIDIARY #6” *
	Director, “SUBSIDIARY #7” *
	Director, “SUBSIDIARY #9” *

	Group Vice President & Director, “XYZ”
	CEO & Director, “SUBSIDIARY #6”
	Chairman, CEO & Director, “SUBSIDIARY #12”
	CEO & Director, “SUBSIDIARY #1”
B. Cecil	Vice President, “XYZ”
	Director, “SUBSIDIARY #3”
Mary Hartline	Vice President & Treasurer, “XYZ”
	Treasurer & Director, “SUBSIDIARY #12”
Ronald Reagan	Vice President, “XYZ”
	Chairman & CEO, “SUBSIDIARY #11”
Beaver Cleaver	Vice President, “XYZ”
	Treasurer & Director, “SUBSIDIARY #6”
June Cleaver	Secretary, “XYZ”
	Secretary & Director, “SUBSIDIARY #3”
	Secretary & Director, “SUBSIDIARY #6”
	Secretary & Director, “SUBSIDIARY #8”
	Secretary & Director, “SUBSIDIARY #12”
	Secretary & Director, “SUBSIDIARY #1”
E. Haskell	Assistant Secretary, “XYZ”
	Secretary & Director, “SUBSIDIARY #4”
	Secretary & Director, “SUBSIDIARY #11”
	Secretary & Director, “SUBSIDIARY #15”
	Secretary & Director, “SUBSIDIARY #16)
	Secretary & Director, “SUBSIDIARY #17”
M. Dolenz	Assistant Secretary, “XYZ”
	Secretary, “SUBSIDIARY #10”
	Secretary, “SUBSIDIARY #2”
	Secretary, “SUBSIDIARY #14”

* Sole Director
(Dept. Ex. No. 212, pp. 8-11)

19. “SUBSIDIARY #2”'s directors during the tax years at issue were “Roy Rodgers”, “Howdy Doody”, “Nelly Bell”, “E.G. Robinson” and “C. Video”. “Roy Rodgers” is also a director of “XYZ”. “Howdy Doody” is also a Vice President of “XYZ”. “Nelly Bell” is a Vice President of “XYZ”. “C. Video” is a Vice President of “XYZ” and a director in 1992 and 1993. “E.G. Robinson” is the only director not having a dual role. (Dept. Ex. No. 212, pp. 8-11)

20. Of the 5 directors of “SUBSIDIARY #6”, 3 hold dual positions with “XYZ”: :June Cleaver” is the Secretary of “XYZ”, “B. Cecil” is Vice President and director of “XYZ”, “Rooty

Kazooty” is A Vice President of “XYZ”. (Dept. Ex. No. 212, pp. 8-11) “William Clinton” was "loaned" from “XYZ” and transferred back in 1994. (Dept. Ex. No. 45)

21. Four of the five directors of “SUBSIDIARY #8” were officers or directors of “XYZ”: “Gene Autry” is a Vice President of “XYZ”, “Howdy Doody” is a Vice President of “XYZ”, “Pat Butram” is Chairman and CEO of “XYZ”, and “C. Video” is a Vice President of “XYZ”. (Dept. Ex. No. 212, pp. 8-11) The fifth, “David Hasselhoff”, is a loaned employee from “XYZ”. (Dept. Ex. No. 45)

22. Three of the four directors of “SUBSIDIARY #3” held dual positions with “XYZ”: “Gene Autry”, “June Cleaver”, and “Mary Hartline”. (Dept. Ex. No. 212, pp. 8-11) The fourth director, “Ima Hogg”, was a loaned employee and returned to “XYZ” in 1995. (Dept. Ex. No. 45)

23. Three of the five directors of “SUBSIDIARY #12” were officers or directors of “XYZ”. “B. Cecil” is a Vice President and director of “XYZ”. “June Cleaver” is the Secretary of “XYZ”. “Gower Champion” is the Vice President & Treasurer of “XYZ”. (Dept. Ex. No. 212, pp. 8-11)

24. Two of the three directors of “SUBSIDIARY #11” are officers of “XYZ”: “Ronald Reagan” is a Vice President of “XYZ” and “M. Dolenz” is an Assistant Secretary of “XYZ”. (Dept. Ex. No. 212, pp. 8-11)

25. One of the three directors of “SUBSIDIARY #10” was also an officer of “XYZ”. (Dept. Ex. No. 212, pp. 8-11)

26. “XYZ” also "loaned" employees to subsidiaries. While the subsidiaries have the ultimate control over hiring employees, a “XYZ” employee hired by a subsidiary remains on the “XYZ” payroll and is subject to “XYZ”'s benefit plans. (Tr. pp. 169-176; Dept. Ex. No. 213, p. 6) The subsidiary then reimburses “XYZ” for the employees' salaries. (Tr. p. 212) The advantage is two-

fold: employees benefit by remaining in “XYZ” benefit programs and “XYZ” benefits since the movement of qualified employees between companies is facilitated. (Tr. pp. 343-344)

27. “SUBSIDIARY #1” had 20 “XYZ” employees on loan at various times during the 3-year period, including the President & COO, VP & Controller, Director of Procurement, the “State #1” Plant Manager, Sr. VP & General Manager, Retail Area Sales Manager, Northeastern Regional Sales Manager, Southeastern Regional Sales Manager, and Production Manager. (Dept. Ex. No. 45, p. 1)

28. “SUBSIDIARY #8” had 9 “XYZ” employees on loan at various times during the audit period. These employees included the President, Treasurer & Controller, General Sales Manager Asian Sales & Marketing, General Manager Sales & Marketing Mexico & Central America, Export Manager, and Director of Manufacturing & Tech Services. (Dept. Ex. No. 45, p. 2)

29. “SUBSIDIARY #2” had 18 employees on loan from “XYZ” at various times during the relevant period, including the President, Sr. VP Sales & Marketing, Director of Human Resources, Director of Quality Control, VP of Finance, VP Production, and VP Marketing. (Dept. Ex. No. 45, p. 3)

30. “SUBSIDIARY #6” had 12 employees on loan at various times during the three years at issue. These employees included the President & COO, VP & Controller, VP Engineering/Maintenance, Regional Sales Manager, Northeast, Director Foodservice, and Regional Sales Mgr., North Central. (Dept. Ex. No. 45, p. 4)

31. “SUBSIDIARY #3” had two employees on loan from “XYZ”: the President and Controller. (Dept. Ex. No. 45, p. 5)

32. “SUBSIDIARY #11” had 5 employees on loan at various times during this period. They included the President and Manager of Engineering and Manufacturing. (Dept. Ex. No. 45, p. 6)

33. “SUBSIDIARY #10” had 1 employee on loan: the Controller and Office Manager. (Dept. Ex. No. 45, p. 9)

34. “XYZ”'s cash management program applies only to the corporate accounts of the parent company and those of the core business subsidiaries. Cash is swept from lock boxes into the main account and invested on a daily basis. The stand-alone subsidiaries are not part of the cash management program. They handle their own cash and manage their own bank accounts. (Tr. pp. 274-275; Dept. Ex. No. 213, p. 6) The stand-alone subs are not required to maintain a cash balance with “XYZ”. (Tr. p. 280)

35. Generally, the stand-alone subs have their own accounting function. They manage accounts receivable and accounts payable and have their own credit department. (Tr. pp. 278-279)

36. The stand-alone subsidiaries can request cash from “XYZ”. “XYZ” charges interest to them at prime plus 1 percent. The stand-alone subs will also transfer cash back to “XYZ” via a dividend or as a reduction of a loan. (Tr. p. 278) “XYZ” maintains inter-company accounts which reflect the advances and repayments as a net figure. (Dept. Ex. No. 46) The stand-alone subsidiaries are not prohibited from borrowing from other sources, although they never have. (Tr. pp. 278, 285)

37. The stand-alone subsidiaries may invest cash with “XYZ”. They receive interest at the 30-day commercial paper rate. (Tr. pp. 278, 288) The stand-alone subs have never invested money with any party other than “XYZ”. (Tr. p. 285)

38. On an average, “SUBSIDIARY #2” requests loans from “XYZ” 10-15 times a year in the $100,000 to $1,000,000 range. “SUBSIDIARY #6” borrows from “XYZ” 15-20 times per year. “SUBSIDIARY #12” borrows 10 times per year or less. “SUBSIDIARY #3” borrows 5 to 10 times per year. (Tr. p. 282)

39. “XYZ” has the responsibility of consolidating the financial statements from all subsidiaries with the parent company. (Tr. p. 469)

40. “XYZ”'s internal audit department audits the records of all of the subsidiaries. (Tr. p. 469; Dept. Ex. No. 213, p. 6))

41. “XYZ”'s tax department prepares the corporate consolidated tax return. (Tr. p. 474)

42. “XYZ” and its subsidiaries were each engaged in the Quality Improvement Process ("QIP") during this period. The purpose of QIP was to improve the quality of the production process. (Tr. pp. 222-233) All companies based their programs on a model developed by “R. Tooth Fairy”, who acted as a consultant. Although the specifics of the program varied from company to company, the fundamental process was the same. (Dept. Ex. No. 36, p. H01114)

43. “XYZ” provides legal services to all of its subsidiaries. The services provided are charged to the subsidiaries at “XYZ”'s cost. (Dept. Ex. No. 213, p. 6)

44. “XYZ” provides insurance services to all of its subsidiaries, except for “SUBSIDIARY #1”. (Dept. Ex. No. 213, p. 6)

45. “XYZ” provides investment services to all of its subsidiaries. (Dept. Ex. No. 213, p. 6)

46. The stand-alone subs perform their own payroll function. (Dept. Ex. No. 213, p. 6)

47. The stand-alone subs do their own purchasing. (Dept. Ex. No. 213, p. 6)

48. Data processing is done by the individual stand-alone subs except for “SUBSIDIARY #8” whose data processing is performed by “XYZ”. (Dept. Ex. No. 213, p. 6)

49. Personnel matters are handled by the individual stand-alone subs. (Dept. Ex. No. 213, p. 6)

50. The various stand-alone subsidiaries made purchases from “XYZ” as follows:

Subsidiary	1991	1992	1993
“SUBSIDIARY #8”	$23,379,718	$22,999,837	$23,767,829

“SUBSIDIARY #1”	-	-	31,449,530
“SUBSIDIARY #12”	-	-	9,682
“SUBSIDIARY #6”	164	101	482

(Dept. Ex. No. 44)

Inter-company sales between “XYZ” and its subsidiaries fall generally along the product line of the subsidiary. Sales from “XYZ” to “SUBSIDIARY #8” consist primarily of retail products. “XYZ” sales to “SUBSIDIARY #2” consist of ingredients, such as spices, and some finished products based upon a co-packing arrangement between the parties. Sales from “XYZ” to “SUBSIDIARY #6” are typically in the form of products. (Dept. Ex. No. 213, p. 3)

51. Various “XYZ” subsidiaries also made inter-company sales to “XYZ” as follows:

Subsidiary	1991	1992	1993
“SUBSIDIARY #2”	6,142,988	3,879,773	24,374,211
“SUBSIDIARY #1”	27,837,146	17,619,799	11,120,279
“SUBSIDIARY #12”	8,509,117	5,522,306	7,204,886
“SUBSIDIARY #6”	62,359	1,550	-
“SUBSIDIARY #3”	14,170,167	4,499,003	6,762,096
“SUBSIDIARY #11”	1,818,315	2,424,767	2,276,190

(Dept. Ex. No. 44)

Sales from “SUBSIDIARY #1” to “XYZ” consist of products, either in the form of finished goods or raw materials. Sales from “SUBSIDIARY #2” consist of raw materials and finished goods. Sales from “SUBSIDIARY #6” are primarily products. “SUBSIDIARY #3” sales to “XYZ” are primarily casings for sausage. “SUBSIDIARY #11” sales to “XYZ” are equipment. “SUBSIDIARY #12” sells finished goods to “XYZ”. (Dept Ex. No. 213, p. 3)

52. “XYZ” is the only company in the affiliated group which owns and operates its own research and development ("R&D") facilities. “XYZ” contracted with “SUBSIDIARY #6”,

“SUBSIDIARY #8”, “SUBSIDIARY #2”, “SUBSIDIARY #3”, and “SUBSIDIARY #1” to perform research and development. The nature of the R&D activities which “XYZ” performed for “SUBSIDIARY #2” consisted primarily of the development of a fat removal process and the development of potential new products, such as a “digestible plastic hot dog”. (Dept. Ex. No. 213, pp. 4-5; Dept. Ex. No. 36, p. H01181) “SUBSIDIARY #2” also used “XYZ”'s R&D group to conduct nutritional analyses of “SUBSIDIARY #2” products to comply with USDA labeling requirements. (Tr. pp. 378-382) The companies paid “XYZ” the following amounts in total for the three year period for R&D services:

Subsidiary	Total
“SUBSIDIARY #2”	$279,673
“SUBSIDIARY #8”	63,599
“SUBSIDIARY #6”	6,845
“SUBSIDIARY #3”	5,436
“SUBSIDIARY #1”	824

(Dept. Ex. No. 213, pp. 4-5)

53. “XYZ” has marketing expertise which it shares with “SUBSIDIARY #6” and “SUBSIDIARY #2”. (Tr. pp. 190, 238) “XYZ” was engaged in at least one joint marketing endeavor with its subsidiaries. The “How to Fricassee Your Hamster” Book, which was free with the purchase of any 3 “XYZ” products, included advertisements showing “SUBSIDIARY #2” products and “SUBSIDIARY #6” products. (Dept. Ex. No. 214, pp. 3, 22, 46, 80) The cookbook also provided information regarding “SUBSIDIARY #2” and “SUBSIDIARY #6” products, and recipes in which they might be used. (Dept. Ex. No. 214, pp. 18, 35) Finally, the cookbook included a coupon for “SUBSIDIARY #2” “Turkey Waddle”, and provided a form for an $8.00 rebate if 8 “XYZ” products were purchased from three specified groups. The third group required one purchase from a list of seven items including a “SUBSIDIARY #2” “Turkey Waddle”, “SUBSIDIARY #2” Turkey Express, or “SUBSIDIARY #6” Fillets. (Dept. Ex. No. 214, p. 82)

54. “XYZ” shared with its subsidiaries the knowledge of its engineering staff in maintaining plants, keeping a food plant clean and how to keep the plant in top operating condition. (Tr. p. 190)

55. The accounting function for “SUBSIDIARY #8” is performed by an employee of “XYZ”. (Tr. p. 576) The insurance function for “SUBSIDIARY #8” is performed by “XYZ”. (Tr. p. 578) “SUBSIDIARY #8” hires its own lawyers overseas. “SUBSIDIARY #8” locates these lawyers either from references made by the companies that it deals with overseas or by references made by “XYZ”'s legal department. (Tr. pp. 578-580) “SUBSIDIARY #8”'s offices are located at the “XYZ” offices in (Someplace USA) and “SUBSIDIARY #8” pays rent for them. (Tr. pp. 585-586) “XYZ” formulates some products differently for international trade. (Tr. pp. 586-587) “SUBSIDIARY #8” personnel participated in certain aspects of “XYZ”'s QIP program, such as ZD (Zero Defect) Day, the same employee survey, and the same 10-step program, although the appreciation lunch for employees was held separately. (Tr. pp. 601-602) “SUBSIDIARY #8”'s payroll is done by “XYZ” and then “SUBSIDIARY #8” reimburses “XYZ” for the salaries that are paid. (Tr. pp. 577, 603)

56. “SUBSIDIARY #2” was acquired by “XYZ” in 1986. “SUBSIDIARY #2” founder, “Roy Rodgers”, remains as Chairman of the Board of Directors and is also on the “XYZ” Board. (Tr. pp. 312-313; Dept. Ex. No. 212, pp. 8-11) Day-to-day operations of “SUBSIDIARY #2” are conducted by employees of “SUBSIDIARY #2”, with no reporting responsibilities to “XYZ”. (Tr. pp. 314-320)

57. “SUBSIDIARY #6”'s operations were run independently of “XYZ”, and no one at “SUBSIDIARY #6” reports to anyone at “XYZ”. (Tr. pp. 478-479)

58. “SUBSIDIARY #11” originally was owned jointly by “XYZ” and “Buddy Holly” in the early 70's. Sometime during the '80's, “XYZ” bought out “Holly” and is now the sole owner of

“SUBSIDIARY #11”. (Tr. pp. 522-523) “SUBSIDIARY #11” never uses the “XYZ” trademark on its equipment. (Tr. p. 528)

59. “SUBSIDIARY #12” was acquired by “XYZ” in August 1991. (Tr. p. 640) “SUBSIDIARY #12” is a private label packer; it produces products for companies and puts their label on it, in what is called "co-packing." “SUBSIDIARY #12” co-packs roast beef, corned beef, and pastrami for “XYZ”. (Tr. pp. 643-644) Sales to “XYZ” make up roughly 18% of total sales. (Tr. p. 649) “SUBSIDIARY #12” did not have the same QIP program as “XYZ”. (Tr. pp. 656-657)

60. “SUBSIDIARY #3” sells casings to “XYZ” as well as other manufacturers in the meat, poultry or cheese industry. (Tr. pp. 612-613) The only trademark on “SUBSIDIARY #3” casings is the trademark of the customer. (Tr. pp. 618-619)

61. “CATALOG A”, one of the catalogs of “SUBSIDIARY #10”, Inc., included selections of “XYZ” products, such as “100-YEAR SHELF LIFE SOUPS”, prepared packaged chicken, and “XYZ” barbecue spare ribs. (Dept. Ex. No. 36, p. H01252)

Throwback Issue

1. “SUBSIDIARY #1” (formerly known as (Some Other Name), Inc.) is a wholly owned subsidiary of “XYZ”. (Dept Ex. No. 3) “SUBSIDIARY #1”'s corporate headquarters is in “State #2”. (Tr. p. 81) “SUBSIDIARY #1” has sales offices throughout the United States, including one in Chicago. (Tr. p. 89) Taxpayer's Chicago office's sales area is limited to Illinois. (Tr. p. 100)

2. “SUBSIDIARY #1” was formed by “XYZ” and “CORPORATION A”. “XYZ” was involved in a strike which required it to seek out other sources of pork for its products. “XYZ” looked to “CORPORATION A”, one of its competitors, who also produced pork products. At the same time, “CORPORATION A” was looking to expand its market. Most of “CORPORATION A”’s sales were in a three-state area, “State #1, State #2 and State #3”, whereas “XYZ” had a

national marketing and distribution structure. “CORPORATION A” was able to produce its products more cheaply than “XYZ” and “XYZ” had a stronger marketing program. In order to utilize both companies strengths, they formed “SUBSIDIARY #1”. (Tr. pp. 84-85, 95)

3. “CORPORATION A” had two processing plants: one in “State #1” and one in “State #2”. The “State #2” plant produced a full line of deli products. The “State #1” plant concentrated on producing “ham hocks” and “bean curd” items. (Tr. pp. 104-105)

4. “XYZ”, “CORPORATION A” and “SUBSIDIARY #1” entered into a Marketing and Distribution Agreement ("Agreement") on July 26, 1985. The Agreement governed, inter alia, the manner in which “SUBSIDIARY #1” operated with “CORPORATION A”. (Dept. Ex. No. 7, Tr. pp. 40-41)

5. “SUBSIDIARY #17”, a wholly-owned subsidiary of “XYZ”, acquired “CORPORATION A” food manufacturing operations on July 12, 1993. (“XYZ” Dept. Ex. No. 212, p. 6) The Agreement, therefore, is in effect only until July 12, 1993.

6. Article II of the Agreement provided that “SUBSIDIARY #1” will be the sole and exclusive distributor for “CORPORATION A”'s products. (Dept. Ex. No. 7)

7. “CORPORATION A” had no ownership interest in “SUBSIDIARY #1”. (Tr. p. 84)

8. Article III of the Agreement provided that “SUBSIDIARY #1” would sell “CORPORATION A” products at a price determined by Article XI of the Agreement. “SUBSIDIARY #1” was to arrange for shipping and distribution of “CORPORATION A” products from “CORPORATION A”'s producing plant or storage facility. “SUBSIDIARY #1” was to consult with “CORPORATION A” regarding “CORPORATION A”'s costs and methods of production and make such recommendations as necessary to modify the cost and quality characteristics of “CORPORATION A”'s products to meet market requirements. (Dept. Ex. No. 7)

9. “SUBSIDIARY #1” was responsible for collecting its accounts receivable as well as “CORPORATION A”'s accounts receivable which were outstanding prior to the effective date of the Agreement. (Dept. Ex. No. 7)

10. An amendment ("Amendment") was made to the Agreement on August 28, 1987. The Amendment changed Article VII of the Agreement to read: "ABC” [“SUBSIDIARY #1”] will purchase and sell PRODUCTS produced by “CORPORATION A” pursuant to production schedules provided for in Article VI. “CORPORATION A” will sell such PRODUCTS to “ABC” on a delivered to “ABC”'s customers basis." (Dept. Ex. No. 8)

11. “Alfred E. Neuman”, Vice President and Controller of “SUBSIDIARY #1” during the audit period, testified that the Amendment merely conformed the Agreement to what had been the understanding of the parties from the beginning. (Tr. p. 114) “Neuman” also testified that “CORPORATION A” bore the risk of loss or damage until it was delivered to the purchaser's location and title passed to “SUBSIDIARY #1”. (Tr. pp. 116-117)

12. “SUBSIDIARY #1” reimbursed “CORPORATION A” for all services performed under the Agreement (Dept. Ex. No. 7).

13. “SUBSIDIARY #1” and “CORPORATION A” shared evenly in all profits generated by “SUBSIDIARY #1”. (Tr. pp. 115-116; Dept. Ex. No. 11)

14. “SUBSIDIARY #1” rented its office space from “CORPORATION A” which owns the building. “CORPORATION A” occupied part of the same building. (Tr. p. 92)

15. “SUBSIDIARY #1” had no employees of its own. Instead, its personnel consists of employees who were loaned from either “XYZ” or “CORPORATION A”. Approximately 14 “XYZ” employees and 130 “CORPORATION A” employees were on loan to “SUBSIDIARY #1” during this period. “SUBSIDIARY #1” reimbursed “XYZ” and “CORPORATION A”,

respectively, for their compensation and benefits. While on loan, all of the “XYZ” employees acted solely on “SUBSIDIARY #1”'s behalf, but some of the “CORPORATION A” employees had dual functions with “SUBSIDIARY #1” and “CORPORATION A”. (Tr. pp. 90-92) “CORPORATION A” employees were used in the areas of sales, credit, traffic and sales administration. (Dept. Ex. No. 7) “XYZ” employees were used in the areas of accounting, cost accounting, quality control, and marketing. (Dept. Ex. No. 7)

16. When orders were made, “SUBSIDIARY #1” marketing representatives entered the orders into the computer system. (Tr. pp. 50-51) One main frame computer was used by both “SUBSIDIARY #1” and “CORPORATION A”. Both companies had access to some of the information on the computer, but “CORPORATION A” was unable to access all of “SUBSIDIARY #1”'s information and likewise, “SUBSIDIARY #1” was unable to access all of “CORPORATION A”'s information. (Tr. pp. 51-52)

17. “CORPORATION A” product managers reviewed orders on the computer screen in “SUBSIDIARY #1” and recapped them to gear their production capacity to fill the orders. The production managers provided this information to the production people in either plant by means of the computer. (Tr. pp. 102-103)

18. “SUBSIDIARY #1” grouped the orders by geographic area for shipment. A handwritten traffic sheet showed a suggested list of trucks and what orders were to be on each truck. The traffic sheet was given to “CORPORATION A” and used as a guideline for loading the trucks. “CORPORATION A” was supposed to follow the traffic sheet to the best of its ability, but the availability of the product or the availability of the trucks may have changed it. (Tr. pp. 53-54)

19. For orders produced in “State #1”, an “CORPORATION A” traffic employee reviewed the orders and made sure trucks were available to ship the products the day before shipment. (Tr. p. 106)

20. “CORPORATION A”'s shipping crew loaded the trucks. They pulled a manifest off of the computer system which gave them a list of products to be loaded on the truck and the customer's name. The shipping crew physically pulled the product and put it on the truck. When the truck was loaded, “CORPORATION A”'s shipping people noted how many boxes or pounds of each product were being placed on the truck. That information was given to the billing department in “State #2” by means of the computer, which then issued the invoice. (Tr. pp. 57, 106-107)

21. “CORPORATION A”'s billing department prepared the bills of lading for shipments out of the “State #1” plant. “SUBSIDIARY #1”'s billing department prepared the bills of lading for shipments out of the “State #2” plant. (Tr. p. 55)

22. The customer had the option of having the invoice shipped with the product or mailed to them. For shipments originating at the “State #1” plant where the invoice was to go along with the shipment, the invoice was printed in “State #1”. Invoices that were mailed to the customer were printed in “State #2”. (Tr. pp. 108-109)

23. “SUBSIDIARY #1”'s sales people in the field could check by computer whether the products ordered were put on the truck. (Tr. p. 55) In some circumstances, if “CORPORATION A” knew the production scheduling wouldn't allow them to produce products that a customer had ordered, they would notify “SUBSIDIARY #1” that they couldn't fill the order. (Tr. pp. 58-59)

24. For large shipments to an individual customer, “CORPORATION A” arranged for an over-the-road carrier to make the delivery directly to the customer. “CORPORATION A” paid for the shipping and was reimbursed by “SUBSIDIARY #1”. (Tr. pp. 70, 106)

25. For smaller shipments going to several customers in a general geographic area, “SUBSIDIARY #1” contracted with a drayman to furnish delivery to the individual customers. (Tr. pp. 68-69)

26. During this period, “SUBSIDIARY #1” invoices bore the name “CORPORATION A” Foods, Inc. along with “SUBSIDIARY #1”. (Dept. Ex. No. 9) “Neuman” testified that the reason “SUBSIDIARY #1” used invoices with “CORPORATION A”'s name was that “CORPORATION A” had a surplus of invoice forms. (Tr. p. 110)

27. “SUBSIDIARY #1” handled all customer complaints relating to shipping. (Tr. p. 121)

28. “CORPORATION A” billed “SUBSIDIARY #1” weekly for services performed by it, equipment used by “SUBSIDIARY #1”, and for freight charges incurred by it. (Tr. p. 71, Dept. Ex. No. 11)

29. “Neuman” testified that while he was Vice President and Controller of “SUBSIDIARY #1”, he had daily communications with “CORPORATION A” people and was on several committees for “CORPORATION A”: The Employee Relations Committee, which established the rules governing the employees of “CORPORATION A” regarding things such as holidays; salary administration program for “CORPORATION A”; Cost Accounting Committee; Data Processing Committee. (Tr. pp. 93-94)

30. Under Article X of the Agreement, “SUBSIDIARY #1” and “CORPORATION A” had full access to their respective books and records. (Dept. Ex. No 7)

31. Article XXI of the Agreement recited that the parties agreed that they were independent contractors, and that "there is no joint venture, partnership or other such relationship." (Dept. Ex. No 7)

32. “SUBSIDIARY #1” filed Illinois income tax returns which only included sales made to Illinois customers in the numerator of the sales factor. (Tr. p. 32)

33. Taxpayer did not present any evidence that it was taxable in the states from which the Department has "thrown back" sales.

34. Taxpayer did not dispute the calculation of the sales which were shipped from the “State #1”, plant.

CONCLUSIONS OF LAW:

Unitary Issue

“XYZ” filed a separate corporate income tax return in Illinois for the year ended 10/31/91, and it filed combined returns for the years ended 10/31/92 and 10/31/93 with “SUBSIDIARY #4”, and “SUBSIDIARY #4” and “SUBSIDIARY #1”, respectively. The question here is whether “XYZ” and various of its subsidiaries are a unitary business group for purposes of the corporate income tax.

In the case of a unitary business group, it is extremely difficult to determine the taxable income generated within a state by an individual corporation since the actions of the various members of the group contribute to the income of each member. Therefore, the unitary business group is treated as one taxpayer and its income and apportionment factors are combined in order to arrive at the amount of taxable income properly attributed to the State of Illinois. Caterpillar Tractor Co. v. Lenckos, 84 Ill.2d 102 (1981). Corporations conducting a unitary business in Illinois are required to report their income using the combined reporting method. Citizens Utilities Co. v. Department of Revenue, 111 Ill.2d 32 (1986)

A unitary business group is defined by Illinois statute to mean:

> a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other...Unitary business

> activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over matters such as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member)....

35 ILCS 5/1501(a)(27).

The determination of whether certain corporations constitute a unitary business group is a factual determination. Citizens Utilities Co. v. Department of Revenue, 111 Ill.2d 32 (1986). In the case at hand there is no dispute by the parties that "XYZ" and its subsidiaries are in the same general line of business, i.e., manufacturing. Also, it is clear that there is common ownership. The question is, therefore, whether these entities are functionally integrated through the exercise of strong centralized management.

Taxpayer has conceded that "XYZ" and its subsidiaries are involved in the same general line of business: manufacturing. Even more importantly, however, all of the companies are involved in some aspect of manufacturing in the food industry. "XYZ" produces fresh and processed pork products, "SUBSIDIARY #2" produces fowl, "SUBSIDIARY #6" produces fish, "SUBSIDIARY #1" produces processed pork products, "SUBSIDIARY #11" manufactures equipment used in the food industry, "SUBSIDIARY #3" produces food casings, "SUBSIDIARY #8" sells "XYZ" products abroad, and "SUBSIDIARY #10" sells food products by mail order. "XYZ", "SUBSIDIARY #1", "SUBSIDIARY #2" and "SUBSIDIARY #6" produce what is called "center of the plate" products, that is, entrees. Knowledge that "XYZ" has in running its operations and marketing its products can benefit its subsidiaries. In fact, it is just such a fit that "XYZ"'s management looks for in acquiring subsidiaries.

"Howdy Doody", Executive Vice President and Chief Financial Officer of "XYZ", and Vice President of "SUBSIDIARY #2", testified that he was actively involved in "XYZ"'s acquisition program. In discussing how "XYZ" decided on companies to acquire he stated:

> And there we're looking for companies that we think -- that some way we can -- that will add to what we're doing or that can help in some way or another add to what they're doing.
>
> An example of something we looked at at one time that we ended up saying no it was maybe too far afield from what we were doing is when we looked at one time getting into the restaurant business...We looked at that and decided that that was not something that would fit with us, that would give the returns we'd be looking for, or that would add on, the restaurant business.
>
> We likely will not go out and buy an electronics company or make radios or television sets. But we are interested in anything in the food business because we think that's where our expertise is, and that's where our knowledge and skills are.
>
> So what we're looking for are ways to expand the company to get returns to our shareholders, especially in those areas and in those functions where there is some knowledge and some additions can be made both ways, and also that are consistent with the reason that our shareholders have invested in your company. In other words we're in the food business. (Tr. pp. 145-146) (emphasis added)

A term that was used both by Department counsel and "Doody" to describe the interrelationship between the operations of "XYZ" and its subsidiaries was "synergies." Synergism is defined by Webster's New World Dictionary as "the simultaneous action of separate agencies which, together, have greater total effect than the sum of their individual effects." "Doody"'s testimony above refers to "those areas and in those functions where there is some knowledge and some additions can be made both ways" which typifies the synergies between the companies, and it is just those synergies which are emblematic of a unitary group.

One sign of a unitary business group is a flow of goods between members. However, in A.B. Dick v. McGaw, 287 Ill. App. 3d 230 (4th Dist. 1997), the court found that:

> the flow of value must be significant, that it must be more than de minimis, but we disagree that exact proof of value is required. The justification for combined reporting is that there are 'many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.' (citing Container and Citizens Utilities)...It would be impossible to provide exact proof of 'largely unquantifiable transfers of value.'
> 287 Ill. App. 3d at 239.

While there are some inter-company transfers of raw materials and finished product between

“XYZ” and its subsidiaries, which represent a flow of value, more significant here is the flow of knowledge among the companies. The transfer of know-how is equally a flow of value and is a key indicator of the economic interrelationship between the companies.

This flow of knowledge is typified by the transfer of “XYZ”'s employees from one subsidiary to another. “XYZ” imparts its expertise to its subsidiaries regarding marketing. “XYZ” institutes a quality improvement process that becomes the standard for all companies. “XYZ”'s engineers instruct the other subsidiaries on plant maintenance and operating a clean food processing plant. “XYZ”'s R&D facility is used by the other subsidiaries. These activities are all indicative of functional integration. When the statute speaks of "a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other" it is referring to the synergies which are at work between “XYZ” and its stand-alone subsidiaries.

One indication of strong centralized management is common officers. *See*, for example, F.W. Woolworth v. Taxation & Revenue Department, 458 U.S. 354, 365 (1982); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 172 (1983); Citizens Utilities, 111 Ill.2d 32, 51 (1986). Although the officers and directors are not identical at each corporation, every one of the subsidiaries have officers or directors who have dual titles as both an officer of “XYZ” and as an officer or director of a stand-alone subsidiary. In some instances this has been explained as merely reflecting the need to name an officer or director of the subsidiary as an officer of “XYZ” in order for them to participate in the stock options program. In all of the stand-alone subsidiaries, however, there has been significant movement of highly-placed personnel from “XYZ” to the subsidiaries, and, oftentimes, back to “XYZ”. In addition to benefitting the employee by allowing them to remain in the benefits program at “XYZ”, “XYZ” has been able to offer advancement opportunities to key personnel and also to export the “XYZ” way of doing business to the subsidiaries.

The statute also indicates that the exercise of strong centralized management exists where authority over certain corporate functions is not left to the individual corporation. “XYZ” provides a number of services to its subsidiaries: internal audit services, legal services, insurance services and investment services.

“XYZ” prepares the consolidated financial statements and prepares and files consolidated tax returns. The stand-alone subsidiaries generally perform their own payroll function and their own accounting function. Data processing is done by the stand-alone subsidiaries except for “SUBSIDIARY #8” whose data processing is performed by “XYZ”. The stand-alone subsidiaries do their own purchasing, but for large dollar amounts, “XYZ”'s approval may be required.

“XYZ”'s stand-alone subsidiaries do not obtain their own financing. All monies come from “XYZ” as an intercompany loan. “XYZ” charges them interest at favorable terms: 1 percentage point over prime, and while the subsidiaries are not prohibited from obtaining financing elsewhere, in practice it never occurs. Each stand-alone subsidiary is also involved in the financial planning process. All of the presidents of the stand-alone subsidiaries meet with the executive committee of the “XYZ” Board of Directors and present their profit plan for the coming year. The committee evaluates the projections and determines the profit goal for the coming year. In addition, the stand-alone subsidiaries report their financial results to the “XYZ” Board at every Board meeting which occurs every two months.

As “XYZ” concedes, there can be no dispute as to whether the core businesses are unitary with “XYZ”. Their operations are so interrelated that “XYZ” doesn't even recognize them as independent legal entities for internal purposes. Granted, there are differences between “XYZ”'s core businesses and the "stand-alone subsidiaries," but to find that companies belong to the same unitary group, it is not necessary to find that they have no independent existence. *See* A.B. Dick v. McGaw, 287 Ill. App. 3d 230 (4th Dist. 1997).

Although “XYZ” argues that the stand-alone subsidiaries are relatively autonomous as regards day-to-day management, the fact that “XYZ” makes a practice of placing its high-level officers in high-level positions at the stand-alone subsidiaries and that the stand-alone subs must report their financial results to the “XYZ” Board six times a year, indicates a significant level of control which “XYZ” exerts over its stand-alone subsidiaries' operations. The facts show a flow of knowledge and a flow of personnel from “XYZ” to all of its subsidiaries and the centralization of a number of corporate services at “XYZ”. These factors taken together show that “XYZ” and all of its subsidiaries are functionally integrated through the exercise of strong centralized management, and therefore constitute a unitary business group pursuant to 35 **ILCS** 5/1501(a)(27).

By the introduction of the Notice of Deficiency the Department has established its prima facie case that taxpayers are unitary. The burden shifts to the taxpayer to show that the companies are discrete business enterprises. The taxpayer has failed to introduce sufficient evidence to rebut the Department's prima facie case and therefore has failed in its burden of proof.

There remains the issue of whether “SUBSIDIARY #1” should be included in the unitary business group, and if so, as of what date. The Department did not include “SUBSIDIARY #1” in the unitary group for the tax years ending 10/31/91 and 10/31/92, following the recommendation in the administrative hearing case, Department of Revenue v. “Peter B. XYZ & Co.”,, Dkt. No. 91-IT-0045 and 91-IT-0055, which dealt with the inclusion of “SUBSIDIARY #1” in the “XYZ” unitary group in earlier tax years. Taxpayer voluntarily included “SUBSIDIARY #1” in a combined return with “XYZ” for the tax year ended 10/31/93 apparently operating under the mistaken belief that if a company is unitary at the end of the tax year it is includable in the unitary group for the entire tax year. The Department's auditor likewise presumed that if a company is a member of the unitary group for a part of the year, it is unitary for the entire year. In fact, whether a company is a member of the unitary group may change due to events occurring during the year and the company therefore may be a part-year member. 86 Admin. Code ch. I, Sec. 100.3320(f)(2).

A change occurred during 1993 which altered "SUBSIDIARY #1"'s relationship with "XYZ". "SUBSIDIARY #1" had been the sole and exclusive distributor of "CORPORATION A" Foods, Inc.'s (a third party) products. "CORPORATION A" Foods was also "SUBSIDIARY #1"'s sole supplier. On July 12, 1993, "SUBSIDIARY #17", a wholly-owned subsidiary of "XYZ", acquired the manufacturing operations and trademarks of "CORPORATION A" Foods. After this acquisition, therefore, "SUBSIDIARY #1" became functionally integrated with "XYZ". Based on this change of circumstances, "XYZ" filed a unitary return including "SUBSIDIARY #1" for the entire year.

Based on the recommendation in Department of Revenue v. "Peter B. XYZ & Co.", I find that "SUBSIDIARY #1" was not unitary with "XYZ" for the period November 1, 1992 to July 11, 1993, and I find that as a result of this transaction, on July 12, 1993, "SUBSIDIARY #1" became a part-year member of the unitary group.

<u>"SUBSIDIARY #1" Throwback Sales</u>

For Illinois income tax purposes, the business activity of a corporate taxpayer in Illinois is measured by the property, payroll and sales in the State as compared to these factors everywhere. 35 **ILCS** 5/304. The issue here is whether sales made by "SUBSIDIARY #1" to customers in states in which "SUBSIDIARY #1" neither files returns nor pays tax should be thrown back to Illinois and included in the numerator of the sales factor.

“SUBSIDIARY #1” is a marketer of meat products. It is the exclusive distributor of “CORPORATION A”'s products, and “CORPORATION A” is its sole supplier. “CORPORATION A” has processing plants in “State #1”, and “State #2”. “SUBSIDIARY #1” is headquartered in “State #2”, with sales offices throughout the United States. One office is located in Chicago, and its sales territory is limited to the state of Illinois. “SUBSIDIARY #1” files Illinois income tax returns which include only the sales to customers located in Illinois in the sales numerator. The sales at issue in this case are sales which are shipped from “CORPORATION A”'s “State #1” plant to states in which “SUBSIDIARY #1” is not taxable.

Generally speaking, sales are located in the destination state for apportionment purposes. Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act provides an exception to the general rule by what is commonly referred to as the throwback rule:

> (B) Sales of tangible personal property are in this State if:
> ...
> (ii) The property is shipped from an office, store, warehouse, factory or other place of storage in this State and either the purchaser is the United States government or the person is not taxable in the state of the purchaser....

35 **ILCS** 5/304(a)(3)(B)(ii).

That is, where the taxpayer is not subject to tax in the destination state, sales are "thrown back" to the state of origination.

The purpose of the throwback rule is to ensure that 100% of sales will be assigned to some state so that there is neither a gap nor overlap in taxing income. *See* GTE Automatic Electric v. Allphin, 68 Ill. 2d 326 (1977); Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995).

Taxpayer relies on the terms of its Marketing and Distribution Agreement with “XYZ” and “CORPORATION A” to determine the state of origin. By amendment, the Agreement provides that “CORPORATION A” will sell the product to “SUBSIDIARY #1” on a "delivered to “ABC”'s [“SUBSIDIARY #1”'s] customers basis." Taxpayer argues that the title to the goods does not pass to “SUBSIDIARY #1” until the product reaches the customer, at which point title is then passed from “SUBSIDIARY #1” to the customer. Taxpayer concludes that the sale occurs on the customer's dock, wholly outside of Illinois, and cannot be included in Illinois sales.

By the plain language of the statute, sales are thrown back if "[t]he property is shipped from an office, store, warehouse, factory or other place of storage in this State." 304(a)(3)(B)(ii) by its terms does not require that the taxpayer itself ship the product from its own Illinois facility or that the taxpayer takes title or possession of the product in Illinois. All of the sales at issue are shipped from the “CORPORATION A” plant in Illinois.

In GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326 (1977), the taxpayer's supplier shipped tangible personal property from supplier's inventory in Illinois to the purchaser in a state in which the taxpayer was not taxable, that is, a "drop shipment." The Illinois Supreme Court held that "drop shipment" sales were within the language of 304(a)(3)(B)(ii). Although in this case it is argued that “SUBSIDIARY #1” takes title before the purchaser takes delivery, the property is shipped from Illinois, and therefore, the result is the same. Whether title passes FOB “CORPORATION A”'s dock or the customer's dock is immaterial.

In New Yorker Magazine, Inc. v. Department of Revenue, 187 Ill. App. 3d 931 (1st Dist. 1989), the appellate court considered a similar fact situation. The New Yorker is headquartered in New York and has a branch office in Illinois for soliciting advertising. Some of the magazines were sold to Illinois consumers through newsstand or subscription sales. The magazine is printed in Illinois and shipped from the printer to wholesalers in various parts of the country pursuant to the instruction of an independent contractor who sells the magazines. While the New Yorker included the sales of the magazines sold to consumers in Illinois in its Illinois sales numerator, the Department included the sales of magazines shipped from Illinois to states in which the New Yorker wasn't taxable. The court affirmed the circuit court, stating that the New Yorker contracted with the printer not only for the printing of the magazine but also for the shipping of the magazine, and therefore, the finding that the magazines were "shipped from an office, store, warehouse, factory or other place of storage in [Illinois]" is not against the manifest weight of the evidence.

The facts in “SUBSIDIARY #1” are substantially the same. “SUBSIDIARY #1” has contracted with “CORPORATION A” to produce the meat products for sale. “SUBSIDIARY #1” specifies who is to receive shipment and schedules the deliveries. “SUBSIDIARY #1” monitors the shipments to ensure that the product is available and that it will be shipped timely. “SUBSIDIARY #1” pays for all of “CORPORATION A”'s costs. “SUBSIDIARY #1” has established nexus with Illinois through its sales office which makes sales to Illinois purchasers. According to New Yorker, it is not required that the office, store, warehouse, factory, or other place of storage from where the product is shipped belong to the taxpayer, or that the title to the property passes to the taxpayer in Illinois, and since “SUBSIDIARY #1” has contracted with “CORPORATION A” for the shipping of the product, “SUBSIDIARY #1”'s sales shipped from the Illinois plant should be included in Illinois' sales factor.

The designation by the taxpayer of where title passes cannot control the determination of state of origin. To hold otherwise would render the throwback rule a nullity, since anytime a taxpayer sought to avoid the throwback rule, it would merely take title FOB the customer's dock. That is, if where title passes controls the determination of the state of origin, taxpayer would not be taxable in either the destination state or the state of origin, since they would be one and the same. This would result in "nowhere sales" which is contrary to the purpose of apportionment. <u>Dover</u>

Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995). The Illinois Supreme Court found that the intent of the General Assembly in enacting the throwback rule was to apportion income in such a manner that there is neither overlap nor gap in taxing the income of a multistate business. GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326 (1977). The Department's inclusion of the sales at issue in the numerator of “SUBSIDIARY #1”'s sales factor is consistent, therefore, with the plain language of the statute and the legislative intent as articulated by the Illinois Supreme Court in GTE. *Id*.

Taxpayer makes several constitutional arguments. Taxpayer contends that the Department's actions violate both the Due Process Clause and the Commerce Clause of the U. S. Constitution.

The Due Process Clause imposes two restrictions on the power of a state to tax income generated by a multistate business. First, there must be a minimal connection between the activities of the multistate business and the taxing state, and second, the income attributed to the state must be rationally related to those activities. Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978).

Whether “SUBSIDIARY #1” has nexus with Illinois is not at issue here. The parties agree that there is sufficient connection between the activities of the taxpayer and Illinois to subject it to tax, and “XYZ” has included “SUBSIDIARY #1” in the Illinois income tax return for its unitary group. Taxpayer contends, however, that there must be nexus with the individual sales which the Department seeks to throw back. Taxpayer is suggesting a method akin to separate accounting, even though it is well settled that the three-factor formula is a constitutionally acceptable method of calculating the proportion of a taxpayer's business activity in a given state. Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983); Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) (formulary apportionment does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State). Thus, it is not necessary to examine each sale so long as there is a rational relationship between taxpayer's activities in Illinois and the income apportioned to the State. No evidence was presented by the taxpayer to support the proposition that the State's application of the throwback rule here has unreasonably allocated extraterritorial income to Illinois.

Assuming, arguendo, that taxpayer is correct that there must be a showing of business activity in Illinois for every sale that is thrown back, the operations of “CORPORATION A” and “SUBSIDIARY #1” are so interrelated that “CORPORATION A”'s actions can be attributed to “SUBSIDIARY #1”. All of “CORPORATION A”'s product is sold to “SUBSIDIARY #1”. “SUBSIDIARY #1”'s only supplier is “CORPORATION A”. “SUBSIDIARY #1”'s employees are all loaned from either “XYZ” or “CORPORATION A”. “CORPORATION A” employees are responsible for the sales activity of “SUBSIDIARY #1”. “CORPORATION A” remains responsible for their salary structure, their benefits, and pension. “SUBSIDIARY #1” and “CORPORATION A” share the same computer system, so that employees of “SUBSIDIARY #1” can access “CORPORATION A” information and vice versa.

Further, “CORPORATION A” production managers review orders that were entered by “SUBSIDIARY #1” employees in the computer system and gear their production capacity to fill the orders. “SUBSIDIARY #1” employees can check whether the products that they had ordered are being shipped by means of the same computer system.

In addition, “SUBSIDIARY #1” organizes orders by geographic area and prepares traffic sheets which indicate what products should be shipped on which truck. The traffic sheet is a guideline and “CORPORATION A” attempts to follow it as much as possible although the availability of either the product or the trucks might alter it.

Also, “SUBSIDIARY #1”'s invoices bear the name “CORPORATION A” Foods, Inc. in addition to “SUBSIDIARY #1”. “SUBSIDIARY #1” rents its offices from “CORPORATION A” in the same building that “CORPORATION A” offices are located. “SUBSIDIARY #1” acted as “CORPORATION A”'s agent in collecting old accounts receivable. Although “CORPORATION A” arranges for over-the-road carriers for large shipments, where small shipments are sent to a general geographic area, “SUBSIDIARY #1” hires draymen to provide delivery to the individual customers.

Finally, “SUBSIDIARY #1” reimburses “CORPORATION A” for all expenses relating to the product. It was the intention of the parties to the Agreement that “CORPORATION A” would be a "zero profit company," and “SUBSIDIARY #1” and “CORPORATION A” would then split equally all profits relating to “SUBSIDIARY #1”'s marketing efforts. Thus, “SUBSIDIARY #1” and “CORPORATION A” are engaged in a joint undertaking for mutual profit. As such, the actions of “CORPORATION A” are sufficient to provide nexus for the sales made by “SUBSIDIARY #1” which originate at the “State #1” plant.

The other constitutional limitation to a state's taxing authority is imposed by the Commerce Clause. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), imposes a four-step test on whether an out-of-state corporation's activities in interstate commerce may be subject to state taxation without violating the Commerce Clause: 1) the activity sought to be taxed has sufficient nexus with the State; 2) the tax does not discriminate against interstate commerce; 3) the tax is fairly apportioned; and 4) the tax is related to services provided by the State.

As discussed above, not only does “SUBSIDIARY #1” voluntarily file income tax returns in Illinois indicating nexus, but its joint activities with “CORPORATION A” in Illinois are sufficient to meet the nexus requirements. To successfully attack the State's apportionment scheme under the Commerce Clause, the taxpayer must show that the imposition of tax duplicates the imposition of tax by another state. GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326 (1977); Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995); Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978). In GTE, the Illinois Supreme Court rejected the taxpayer's claim that the throwback rule was unconstitutional under the Commerce Clause, stating that "[i]t is only those out-of-State...sales in which plaintiff is not taxable either in the State of origin or destination that are being assigned to Illinois, and this obviously cannot result in double taxation." 68 Ill.2d at 341. Logically, the inclusion of these sales by the State of Illinois in the sales numerator cannot be duplicative since they are only being thrown back by reason of the fact that they are not being taxed in the destination state. Furthermore, there is nothing in the record to suggest that any other state is seeking to include these sales in the apportionment factor thereby subjecting the same income to tax.

Based upon the above, in my opinion the throwback sales were properly included in the numerator of taxpayer's sales factor.

Penalties

Penalties were imposed against “SUBSIDIARY #2” for failure to file (Section 1001) and failure to pay estimated tax (Section 804). “SUBSIDIARY #2” has conceded the nexus issue which was at the heart of the non-filing controversy. Inasmuch as “SUBSIDIARY #2” has conceded the issue, and has offered no evidence as to reasonable cause, the Section 1001 penalties must stand. As to the Section 804 penalties, there is no exception for reasonable cause, so they must stand as well.

WHEREFORE, for the reasons stated above, it is my recommendation that:

1) as regards the unitary issue, the Notices of Deficiency should be affirmed as revised for the tax years ending 10/31/91 and 10/31/92; and the Notice of Deficiency for the tax year ended 10/31/93 should be revised to include "SUBSIDIARY #1" Foods, Inc. for the period 7/12/93 to 10/31/93, only.

2) the Notice of Deficiency should be finalized as to the throwback sales issue.

3) the Notice of Deficiency should be finalized as to all penalties.

4) "SUBSIDIARY #3"'s claim for refund should be granted for the tax year ended 10/31/92 as revised by the Department, and "SUBSIDIARY #3"'s claim for refund for the year ended 10/31/93 should be granted after all appropriate recalculations regarding the composition of the unitary group have been made.

Date:

Linda K. Cliffel
Administrative Law Judge