

**IT 99-13**

**Tax Type: Income Tax**  
**Issue: Business/Non-Business (General)**  
**Discretionary Relief Under Section 304(f) (Distortion)**  
**Unitary – Inclusion of Company(ies) In A Unitary Group**  
**Throwback Sales (General)**  
**Replacement Tax Investment Credit/Property Used In Retailing**  
**Job Training Expense Credit (Disallowed)**

**STATE OF ILLINOIS**  
**DEPARTMENT OF REVENUE**  
**OFFICE OF ADMINISTRATIVE HEARINGS**  
**CHICAGO, ILLINOIS**

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**THE DEPARTMENT OF REVENUE**  
**OF THE STATE OF ILLINOIS**

v.

**“PDQ CORPORATION”,**  
**and subsidiaries,**  
**Taxpayers**

**No. 96-IT-0000**  
**FEIN: 00-0000000**  
**Tax yrs.: 1988 – 1994**

**Charles E. McClellan**  
**Administrative Law Judge**

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**RECOMMENDATION FOR DECISION**

Deborah H. Mayer, Special Assistant Attorney General, for the Department of Revenue. Fred M. Ackerson of D’Ancona & Pflaum, for the Taxpayer.

**Synopsis:**

This matter came on for an evidentiary hearing on February 22, 1999. On the day of the hearing, the parties filed a Stipulation of Fact with the Administrative Law Judge. Due to a death in the family, one of taxpayer’s witnesses was unable to appear, so the hearing was continued to and concluded on April 7, 1999. Following the hearing, both parties filed briefs.

This case involves a deemed denial of a claim for refund filed by “PDQ Corporation” and subsidiaries (“PDQ” and subsidiaries collectively referred to herein as “taxpayer”) on March 28, 1994 for the year 1988.<sup>1</sup> Originally, the case also involved a Notice of Deficiency for the years 1990 and 1991 issued by the Department on June 12, 1996, and a Notice of Deficiency for the years 1992, 1993, and 1994 issued on October 15, 1997, to which the taxpayer filed timely protests. The Notices of Deficiency for the years 1990 through 1994 were originally docketed under docket numbers 96-IT-0000 and 98-IT-0000. These two cases were consolidated with this case by orders entered on November 17, 1997 and February 23, 1998, respectively.

A pre-trial order was entered on September 30, 1998 setting forth the issues to be addressed at hearing to be as follows:

1. For 1998, whether the Department properly classified as business income a \$400 million pension reversion received by “PDQ” from one of its pension funds and reported as taxable income on its 1988 federal income tax return.
2. For the years 1990 through 1994:
  - a. Whether the Department properly included certain subsidiaries, including “Subsidiary #1” in the “PDQ” unitary business group.
  - b. Whether the Department properly included interest income reportable by “Subsidiary #1” as business income.
  - c. Whether the Department properly included as “throwback sales” in the numerator of the Taxpayer’s sales factor, sales made by “Subsidiary #2”

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<sup>1</sup> Taxpayer files its federal and Illinois income tax returns on a calendar year basis.

- d. Whether the Department properly disallowed the investment tax credit claimed by taxpayer.
- e. Whether the Department properly disallowed the training expense credit claimed by taxpayer.
- f. Whether the penalties asserted by the Notices of Deficiency should be abated due to reasonable cause.

At the hearing, taxpayer conceded issues 2(a), 2(c), and 2(e), and 70% of the interest income issue referred to in 2(b). Tr. p. 6, Stip. Ex. 32. The Department conceded issues 2(d), 2(f), and 30% of the interest income referred to in 2(b). *Id.* As a result, the only issue for decision is whether the Department properly classified as business income a \$400 million pension reversion received by “PDQ” from one of its pensions funds during 1988 and reported as taxable income on its 1988 federal income tax return.

My recommendation is that the Department’s partial denial of the claim for refund for 1988 be made final and that the Notices of Deficiency for the years 1990 through 1994 be revised to reflect the concessions of the parties, and, as so revised, the Notices of Deficiency should be made final.

**Findings of Fact:**

1. The taxpayer filed its Illinois income tax return (Form IL-1120) for 1988 on a combined basis with numerous corporations that are members of its unitary group. Stip. ¶ 1.
2. Taxpayer filed an amended Illinois income tax return (Form IL-1120-X) for 1988 on March 28, 1994 claiming a refund of \$745,874. Stip. ¶ 2.

3. The refund claim was based primarily on reclassifying the \$400 million pension reversion from business income to non-business income. *Id.*
4. Taxpayer filed a protest to the deemed denial of its refund claim on December 7, 1995. Stip. ¶ 3.
5. The Department audited taxpayer's refund claim and issued a notice of partial denial on June 6, 1997 denying \$623,038 of the claim due to the Department's classification of the pension reversion as business income. *Id.*
6. Taxpayer filed an amended protest to the reclassification on July 7, 1997. *Id.*
7. "PDQ" is incorporated under the laws of the state of "Someplace, USA" wherein it maintains its commercial domicile. Stip. ¶ 4.
8. At all relevant times, "PDQ" was a public company listed on the New York Stock Exchange. *Id.*
9. At all relevant times, "PDQ" was qualified to do business in Illinois and conducted business in Illinois and other states. *Id.*
10. "PDQ" is primarily engaged in the business of manufacturing tires and rubber, plastic and chemical products for the transportation industry and various industrial and consumer markets throughout the world. Stip. ¶ 5.
11. "PDQ" also provides automotive repair and other services and sells other products. *Id.*
12. The principal subsidiaries of "PDQ" engaged in the manufacture and distribution of tires during 1988 were the "Subsidiary #2" ("Sub-2") and the "Subsidiary #3" ("Sub-3"). Stip. ¶ 6.

13. Taxpayer's business operates in three segments: (1) tires and related transportation products (which accounted for 86% of revenues in 1988); (2) industrial rubber, chemical and plastic products (which accounted for 13% of revenues in 1988); and (3) oil transportation (which accounted for about 1% of revenues in 1988). Stip. ¶ 7.
14. "Sub-2" owned and operated a tire manufacturing facility in "Someplace", Illinois during 1988, which was the only manufacturing facility taxpayer had in Illinois during that year. Stip. ¶ 8.
15. Taxpayer owned several retail stores in Illinois during 1988 under the name "PDQ" or "XYZ" which engaged in the business of selling tires and related products at retail as well as in providing automotive services. Stip. ¶ 9.
16. In 1967 "PDQ" created a pension plan for its employees Stip. ¶¶ 10, 23.
17. This plan, entitled the "PDQ Retirement Plan for Salaried Employees", was qualified under Section 401 of the Internal Revenue Code (26 U.S.C. § 401) and designated "Retirement Plan 002" in filings with the Internal Revenue Service. Stip. ¶ 10, Tr. p. 30.
18. Retirement Plan 002 was established for the benefit of "PDQ's" employees as part of "PDQ's" compensation package for its employees and to provide retirement benefits for employees. Stip. ¶¶ 23, 24.
19. "PDQ" maintained this pension plan from June 1967 until December 1988. Stip. ¶ 10.
20. The funds contributed to Retirement Plan 002 by "PDQ" were held in a trust "PDQ" established for the benefit of beneficiaries of the plan. Stip. ¶ 11.

21. “Subsidiary #1”, a wholly owned subsidiary of “PDQ”, was the trustee of the trust at all relevant times. *Id.* Tr. p. 50.
22. The trustee held the trust assets in its name as required for qualification under Section 401 of the Internal Revenue Code. Stip. ¶ 21.
23. “PDQ” hired a number of financial organizations — J.P. Morgan, Prudential, Equitable, Chemical Bank Citibank — to invest the funds on behalf of the trustee. Tr. p. 48.
24. “PDQ” hired Northern Trust Company to act as custodian for the trustee. *Id.*
25. “PDQ” hired Wilshire Associates to act as investment advisor to for the trust assets. Tr. pp. 51, 52.
26. No one at “PDQ” made actual investments for the trust but they reviewed the performance of the investment managers. Tr. p. 55.
27. “PDQ” controlled the hiring and firing of the investment managers. Tr. p. 62, 65.
28. “PDQ” set the guidelines that the investment managers had to follow. *Id.*
29. No plan assets were ever used in the business of “PDQ”. Tr. p. 58.
30. “PDQ’s” contributions to Retirement Plan 002 were funded from “PDQ’s” cash flow from its business operations or from borrowing. Stip. ¶ 22.
31. The contributions “PDQ” made to Retirement Plan 002 were ordinary and necessary business expenses in the nature of compensation to its employees and were deducted by “PDQ” on its consolidated federal income tax returns. Stip. ¶ 25.
32. “Joe Doakes” (“Doakes”), who has been employed by “PDQ” for almost 35 years, was involved in accounting for all the employee benefit programs as well as

- managing the investment managers for the benefit programs, doing the annual filings and participating in the plan designs. Tr. pp. 28, 29.
33. “Doakes” has a business administration degree from Michigan State University and a MBA from the University of Akron. Tr. p. 27.
  34. “Doakes” started his employment in the general accounting Department and was transferred to the benefit area after five years. Tr. p. 28.
  35. In the benefit area, “Doakes” was involved in the investment of employee benefit plan assets and managing the investment managers. *Id.*
  36. “Doakes” began focusing on the possibility of a pension reversion in 1986 when the chief financial officer of “PDQ” asked if there was any way to transfer the pension surplus back to the company to pay off some of its debt. Tr. p. 45.
  37. “Doakes” proposed that “PDQ” look at reverting the excess pension plan assets back to the corporation. Tr. p 32.
  38. During 1986, in connection with a restructuring of the “PDQ Retirement Plan for Salaried Employees” (Retirement Plan 002), the trust purchased a group annuity from Metropolitan Life Insurance Company for \$958,910,735 to settle pension obligations to the beneficiaries of Retirement Plan 002 for retirees which had vested through April 30, 1986, and for active employees vested through December 31, 1995. Stip. ¶¶ 14, 15.
  39. During 1988, “Doakes” spent about 50% of his time working with and reviewing the activities of the investment managers for all of “PDQ’s” benefit plans. Tr. p 56.
  40. During 1988, “Doakes” was involved in plan accounting as well as managing the investment managers, preparing the annual filings of Form 5500 for the U.S.

Department of Labor, and participating in plan design for all the employee benefit programs, including the retirement plan for salaried employees. Tr. p. 29.

41. The driving force for doing the reversion was to pay down corporate debt which was extremely high. Tr. p. 45.
42. “Doakes” worked with the actuary and consultants to come up with “PDQ”’s overfunded position. Tr. p. 32.
43. “Doakes” worked through the whole reversion process spending hundreds of hours on the project. *Id.*
44. On May 31, 1988, the benefits of any participant in Retirement Plan 002 who had applied for retirement or ceased employment with “PDQ” with vested benefits by May 1, 1986 were transferred from Retirement Plan 002 to a new qualified plan known as Retirement Plan for certain Retired and Former Salaried Employees which was identified in filings with the Internal Revenue Service as “Retirement Plan 009”. Stip. ¶ 15, Tr. p. 34.
45. After obtaining the approvals required of the governmental regulatory agencies, the Internal Revenue Service and the Pension Benefit and Guaranty Corporation, Plan 009 was terminated as of June 30, 1988 and its obligations to its beneficiaries were settled through the purchase of group annuities from Metropolitan Life Insurance Company and Prudential Life Insurance Company of America. Stip. ¶¶ 16, 19; Tr. pp. 31, 34, 35.
46. Also on June 30, 1988, a group annuity was purchased to settle the benefits accrued through June 30, 1988 by active employees who remained participants in Retirement Plan 002. Stip. ¶ 16.



47. After the purchase of the group annuities to satisfy the pension obligations to the beneficiaries of Retirement Plan 009, that plan had \$400 million remaining which was distributed to “PDQ”. Stip. ¶ 17.
48. Taxpayer reported the \$400 million reversion as ordinary income on its consolidated federal income tax return for 1988. Stip. ¶ 18.
49. “PDQ” deposited the \$400 million pension reversion with corporate funds and used the reversion funds to pay down its corporate debt. Stip. ¶ 20, Tr. p. 69.

### **Conclusions of Law**

Section 1501(a)(1) of the Illinois Income Tax Act, 35 ILCS 5/101, *et seq.*, (IITA) defines “business income” as being “income arising from transactions and activity in the regular course of the taxpayer’s trade or business, . . . and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations. . . .” IITA Section 1501 (a)(13) defines “non-business income” as being “all income other than business income or compensation.”

A taxpayer’s income is business income unless the income is clearly non-business income and the burden of proof is on the taxpayer to prove that the income in question is non-business income. Kroger Company v. Department of Revenue, 284 Ill. App.3d 473, 479 (1<sup>st</sup> Dist. 1996). The statute provides for a two-pronged test to determine if income is business income. The tests are described as the transactional test and the functional test. If the income satisfies either test, it is business income. Dover Corporation v. Department of Revenue, 271 Ill. App.3d 700, 711. (1<sup>st</sup> Dist. 1995). The transactional test classifies income as business income if the income is derived from the types of business transactions

that the taxpayer normally conducts in the enterprise. *Id.* The functional test classifies income as business income if the property involved in the transaction was used in the taxpayer's regular trade or business operations. *Id.*

In this case, the pension reversion is not the type of transaction the taxpayer normally conducts in its enterprise. Therefore, I agree with the taxpayer that it is not business income under the transactional test. However, I do not agree that the taxpayer has carried its burden of proving that the pension reversion is not business income under the functional test.

The functional test contains three elements. First, the property is acquired as an integral part of taxpayer's business. Second, it is managed as an integral part of taxpayer's business. Third, it is disposed of as an integral part of taxpayer's business.

"PDQ" created Retirement Plan 002 and funded it by cash flow from its business operations or borrowing. It was established and maintained as part of its employee compensation program and to provide retirement for the benefit of its employees. "PDQ" deducted contributions to the pension plan on its federal income tax returns thereby taking the position with the Internal Revenue Service that the contributions were "ordinary and necessary" expenses incurred in carrying on its business and, as such they were deductible business expenses under Section 162 of the Internal Revenue Code. 26 U.S.C § 162.

"PDQ" managed the plan as an integral part of its business. To be qualified, that section of the Internal Revenue Code requires that the pension plan be funded by contributions to a trust which must hold the contributions for the sole benefit of the beneficiaries of the trust. "PDQ" created the trustee, "Subsidiary #1", which it maintained as a wholly owned subsidiary, and thereby maintained ultimate management control over

the trust. “PDQ” hired a number of financial organizations to invest the trust funds. “PDQ” chose the custodian for the trust funds. “PDQ” hired investment advisors and established guidelines which it required them to follow. A “PDQ” employee, “Doakes”, managed the investment managers and reviewed their performance. “PDQ” stipulated that it maintained the plan from 1967 until 1988, a period of about 19 years. These facts show that “PDQ” retained absolute control over the management of Retirement Plan 002 during its existence as an integral part of its business.

Finally, when the plan became over funded, at the urging of “PDQ’s” chief financial officer, “Doakes” recommended that the company put together a pension reversion plan. The pension program was restructured by purchasing annuities to fund benefits of beneficiaries which had vested through April 30, 1986, for retirees, and for active employees through December 31, 1995. Then the benefits of any participant who had applied for retirement or ceased employment with “PDQ” with vested benefits by May 1, 1986 were transferred from Retirement Plan 002 to Retirement Plan 009. The obligations to the beneficiaries of Retirement Plan 009 were satisfied by the purchase of annuities and the plan was then liquidated resulting in the reversion of \$400 million to “PDQ” in 1988.

“PDQ” used the retirement plan to compensate the covered employees and to provide them with retirement benefits from 1967 to 1988, a period of 19 years. “PDQ” used the reversion of the funds to pay off corporate debt which had become exceedingly high.

These facts show that the creation, management of the pension plan and the expenditure of the \$400 million pension reversion to pay off its debt were an integral

aspects of its business and that the plan and the reversion were “organically joined or linked” to taxpayer’s business operations. See Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill.2d 262 (1998) Thus, all three elements of the functional test have been satisfied to establish that the pension reversion is business income.

“PDQ” argues that the Department’s regulations support the conclusion that the pension reversion is non-business income. On analysis, this argument fails. The regulation supports the presumption that the reversion is business income. The applicable regulation, in relevant part, provides as follows:

Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of trade or business operations. Accordingly, the critical element in determining whether income is "business income" or "non-business income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general, all transactions and activity which are dependent upon or contribute to the operations of the economic enterprise as a whole will be transactions and activity arising in the regular course of a trade or business. 86 Admin Code ch. I, § 100.3010(a).

As noted, the plan was an element of taxpayer’s employee compensation plan, the contributions to the plan were deducted as ordinary and necessary business expenses on taxpayer’s federal income tax return, and the pension reversion was included in federal taxable income and used to pay off corporate debt. The creation, management and disposition of Retirement Plans 002 and 009 and the \$400 million pension reversion were certainly activities which contributed to the operation of taxpayer’s economic enterprise as a whole. As such, the pension reversion was business income as described in the regulation.

Taxpayer argues that under the functional test as applied by the court in Texaco-Cities Service Pipeline Co. v. McGaw, *supra*, “Neither the investment of the Pension Plan

assets over the period 1967-1988 nor the Pension Reversion itself were ‘essential to the taxpayer’s business operations’.” The stipulated facts and testimony belie that argument. Retirement Plan 002 was established for the benefit of “PDQ’s” employees as part of “PDQ’s” compensation package for its employees and to provide them with retirement benefits. Stip. ¶¶ 23, 24. The facts that “PDQ” deducted the contributions to the plan as ordinary and necessary business expenses, maintained absolute control over the plan, terminated the plan to obtain the reversion and used the reversion to pay its corporate debt all demonstrate the speciousness of this argument.

Contrary to taxpayer’s averments, the record shows the creation, management and disposition of the plan and the pension reversion were closely related to taxpayer’s “whole process of operating its business”. 182 Ill.2d at 271. Furthermore, the fact that the driving force for doing the reversion was to pay down corporate debt which was extremely high indicates that obtaining the reversion was “organically joined or linked” and therefore essential to taxpayer’s business operations. *Id.* Applying the principles set forth by the court in Texaco-Cities Service Pipeline Co. to the facts of this case leads to the conclusion that the reversion was business income.

Taxpayer next asserts that there was “no unitary, operational or other business connection between “PDQ’s” tire and rubber business and the excess investment income of the trust which produced the \$400 million Pension Reversion.” This assertion has been shown above to be contrary to the evidence of record. Nevertheless, based on this assertion, taxpayer concludes that there was insufficient nexus between Illinois and the pension reversion. The facts show this conclusion to be incorrect.

Taxpayer stipulated that “PDQ” established, maintained, and had overall control over Retirement Plan 002 as part of its employee compensation plan. A “PDQ” employee managed the plan and the plan investment program. Taxpayer stipulated that it had operations in Illinois. The trustee was a wholly owned subsidiary of “PDQ”. “PDQ” hired the investment advisors, managers and custodians. The record shows that the plan was maintained for 19 years. The surplus funds were generated in a trust that was an integral part of taxpayer’s business including the business conducted in Illinois. The stipulated facts and testimony of record contradict taxpayer’s assertion that the excess funds generated in the plan trust were not connected to taxpayer’s business in Illinois.

Taxpayer cites two North Carolina cases in support of its position, Union Carbide Corporation v. Offerman, 513 S.E.2d 341 (N.C. Ct. of App. 1999), and Polaroid Corporation v. Offerman, 349 N.C. 290, 507 S.E.2d 284 (1998). Decisions from other states are not binding on courts in Illinois. Kroger Company v. Department of Revenue, 284 Ill.App.3d at 481. However, they should be examined if they are relevant for whatever value they may offer. *Id.* The court in Union Carbide Corporation held that a pension reversion was non-business income. However, a well reasoned dissent argued to the contrary. In my opinion, the dissent in Union Carbide is the correct application of the statute. In Polaroid, the court adopted the Texaco-Cities Service Pipeline interpretation of the functional test to find that funds received in connection with a patent infringement dispute were business income. It does not support taxpayer’s position in this case. The facts in that case are distinguishable from this case, but, in any event, it is more supportive of the Department’s position.

Taxpayer's next argument is that the Department's regulations support the classification of the pension reversion as non-business income. Taxpayer based this conclusion on examples in the regulations, which provide as follows:

A corporation is engaged in a multi-state glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the corporation's trade or business operations. The dividends and interest income received are non-business income.

86 Admin Code ch. I, § 100.3010(d)(5) Exhibit F.

A corporation is engaged in a multi-state manufacturing and selling business. The corporation usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

86 Admin Code ch. I, § 100.3010(d)(4) Example E.

These examples do not support the taxpayer's case because the factual situations addressed are distinguishable. Example F deals with a situation in which a corporation maintains an investment portfolio "unrelated to the corporation's trade or business operations." The taxpayer has stipulated that Retirement Plan 002 was part of "PDQ's" employee compensation plan for about 19 years. An employee of "PDQ", "Doakes", testified that he supervised the investment managers, and was involved in the plan accounting and preparation of the annual filings for the regulatory agencies. The employee compensation plan was an element in taxpayer's business of manufacturing and selling tires and related products as it was an integral part of its employees' compensation plan. Without a compensation plan acceptable to taxpayer's employees it is unlikely that taxpayer would have been manufacturing and selling anything. These facts and the facts previously mentioned show that the plan was, in fact, related to the taxpayer's trade or business operations.

Example E deals with a situation in which excess working capital is temporarily invested in short term interest bearing securities. This situation is also factually distinguishable from taxpayer's situation which involves contributions to a pension plan that is part of taxpayer's employee compensation plan. The instant matter does not involve temporary investments of excess working capital. Once "PDQ" put the reversion plan into effect, the \$400 million became part of working capital as demonstrated by the fact that it was used to liquidate "PDQ" debt.

In summary, taxpayer has the burden of proving that the income in question is non-business income. In this case, taxpayer has failed to meet its burden of proof. The evidence and testimony of record show that the pension reversion was business income under the functional test. Therefore, I recommend that that the Department's partial denial of the claim for refund for 1988 be made final and that the Notices of Deficiency for the years 1990 through 1994 be revised to reflect the concessions of the parties. As so revised, the Notices of Deficiency should be made final.

**ENTER: November 8, 1999**

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**Administrative Law Judge**