

**IT 09-9**

**Tax Type: Income Tax**

**Issue: Unitary – Inclusion of Company(ies) In A Unitary Group**

**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.

**ABC, INC.,  
Taxpayer**

**No. 07-IT-0000  
FEIN 00-00000000  
Tax Years 2002, 2003**

**Ted Sherrod  
Administrative Law Judge**

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Special Assistant Attorney General Ronald Forman on behalf of the Illinois Department of Revenue; David A. Hughes, Esq. and Megan Mathias, Esq. of Horwood Marcus and Berk Chartered on behalf of ABC, Inc.

**Synopsis:**

The issue presented for determination in this case is whether the Illinois Department of Revenue (“Department”) correctly denied refund claims for 2002 and 2003 filed by ABC, Inc. (“ABC” or “taxpayer”). These refund claims were based upon the exclusion of certain of ABC’s subsidiaries from its combined return as originally filed for these years. ABC filed combined returns for the tax years ending 12/31/02 and 12/31/03. On December 22, 2006, ABC caused to be filed amended returns (refund claims) for the above tax years on which it reconfigured the unitary business group

originally reported on returns filed for those years into two unitary business groups, one encompassing ABC and its subsidiaries engaged in the filtration business and the other encompassing its subsidiaries that were engaged in the packaging business. It contends that these two groups of companies cannot be combined because the business activities conducted by them are separate and unrelated. The Department audited the aforementioned amended returns and issued notices denying these claims for refund on June 12, 2007, finding these two groups of companies to be related through the exercise of strong centralized management by their common parent. ABC timely protested the Department's notices of denial on July 31, 2007.

A two day hearing to address the issues presented in this case was held on March 31, 2009 and April 1, 2009, during which the taxpayer presented testimony on its behalf and submitted documentary evidence.<sup>1</sup> In addition, both parties have submitted briefs setting forth their respective legal arguments. Upon consideration of the testimony and documentary evidence presented in this case, it is recommended that the Department's determination denying the refund claims at issue be affirmed.

**Findings of Fact:**

1. The Department established its *prima facie* case, inclusive if all jurisdictional elements, by the admission into evidence of a Notice of Denial dated June 12, 2007 denying the taxpayer's refund claim for the taxable years ending 11/30/02 and 11/29/03 and a related Notice of Deficiency covering the tax year 2003 dated November 3, 2006. Stipulation of Documents ("Stipulation") Exhibit ("Ex.") 1, 2.

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<sup>1</sup> The hearing in this matter lasted over a period of two days. The pages of the two transcripts of these hearings are consecutively numbered.

2. ABC, Inc. (“ABC”) is a publicly traded Delaware holding company headquartered in Anywhere, Illinois. Transcripts of Hearing Proceedings (“Tr.”) pp. 30, 167, 168, 355, 356; Stipulation Ex. 11-13. The company, through its wholly-owned subsidiaries is engaged in the business of producing and selling manufactured products, specifically, high-end lithography packaging products and filtration products and solutions. Tr. pp. 30, 31, 44, 45, 73.<sup>2</sup>
3. ABC’s separate lines of business are conducted by two separate groups of corporations, a filtration business group of companies which, with the exception of ABC Specialists, Inc., are owned by ABC Filtration Products, Inc., and a packaging business group consisting of a packaging manufacturing company owned by ABC Consumer Products, Inc. and an affiliated packaging business marketing company. Tr. pp. 44, 45; Taxpayer Ex. 1.
4. ABC owns 100% of the stock of ABC Filtration Products, Inc. Tr. p. 45. ABC Filtration Products, Inc., in turn, owns the following companies that are engaged in the manufacture and distribution of filtration products (“filtration operating companies”)<sup>3</sup>: ABC Air Filtration Products, Inc., XXX Filters, Inc., XXXX Filter, Inc., XXXXX USA, Inc., XXXXXX Products, Inc., XXXXXX Facet, Inc., XXXXXXXX Filtration Services, Inc. and XXXXXXXX Filter Technology. Taxpayer Ex. 1. ABC Filtration Products, Inc. also owns 100% of the stock in XXXXXX, Inc., ABC International, Inc., XXX Technologies, Inc., ABC Total Filtration, Inc., ABC

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<sup>2</sup> Unless otherwise noted, findings of fact apply to the tax years in controversy.

<sup>3</sup> As used herein, “filtration operating companies” also includes ABC Specialists, Inc.

Trading Company, ABC LTD, ABC Foreign Sales Corporation, and XXXXX, Inc. Tr. p. 45; Taxpayer Ex. 1.

5. ABC owns 100% of the stock of ABC Specialists, Inc., an operating filtration products company. Tr. p. 45.
6. ABC owns 100% of the stock of ABC Consumer Products, Inc. *Id.* ABC Consumer Products, Inc. in turn owns 100% of the stock of XYZ, Inc. (“XYZ”), an operating company engaged in the manufacture and sale of specialty lithography packaging products. Tr. pp. 45, 93.
7. ABC filed combined tax returns for the tax years ended 12/31/02 and 12/31/03. Tr. pp. 14, 15; Stipulation Ex. 3, 4. The combined group included in these returns consisted of ABC and all of its domestic subsidiaries except ABC Filtration Products, Inc. Tr. pp. 33, 34.
8. ABC and ABC Consumer Products, Inc. filed amended combined returns for the tax years ended 12/31/02 and 12/31/03. Tr. pp. 34-36; Stipulation Ex. 5-8. One of these amended returns included ABC, all of the companies owned by ABC’s wholly-owned subsidiary ABC Filtration Products, Inc. and ABC Specialists, Inc. in a single combined group. Tr. p. 35; Taxpayer Ex. 1. The amended returns ABC caused to be filed by ABC Consumer Products, Inc. for these years included XYZ, Inc., ABC Consumer Products Inc., a holding company that owns XYZ, Inc. and XYZ Europe, Inc. Tr. p. 35; Taxpayer Ex. 1. These refund claims sought refunds in the aggregate amount of \$162,346 for the years 2002 and 2003. Stipulation Ex. 5-8. The Department denied these refund claims on June 12, 2007. Stipulation Ex. 2.

9. At hearing, ABC conceded that all of the manufacturing companies owned by ABC Filtration Products, Inc., ABC Specialists, Inc., and XYZ are under ABC's common ownership and are engaged in the same line of business, manufacturing. Tr. p. 73.
10. From 1904 until the 1970's ABC was engaged in the packaging business. Tr. p. 74. In the 1970's, it started getting into the filtration business. *Id.* Prior to 1987, ABC's predecessor, XYZ Manufacturing, Inc., was engaged in the packaging business and owned all of the stock in subsidiaries engaged in the filtration business. Tr. p. 76. In 1987, XYZ Manufacturing, Inc. transferred its packaging business assets to a new operating company it formed, formed a new holding company ABC Consumer Products, Inc. to hold this company and became a holding company. Tr. pp. 76, 77. It subsequently created a new holding company, ABC Filtration Products, Inc., and transferred all of its stock in companies engaged in the filtration business to this new holding company. *Id.*
11. Managers of XYZ and the filtration operating companies report to ABC's chief executive officer who also serves as the chief executive officer of XYZ and each of the operating companies. Tr. pp. 205-207, 345, 439, 460, 461. Other ABC executives including XXX, ABC's vice president and controller, XXXX, ABC's general counsel and secretary and XXXX, ABC's chief financial officer, also serve as officers and directors of these subsidiaries. Tr. pp. 173, 174, 206, 207. XYZ and the operating companies do not exercise decision-making authority through functioning Boards of Directors; the decision-making authority legally vested in these Boards of Directors is exercised by the ABC Board. Tr. pp. 227-229.

**12.** John Doe (“Doe”) is the chief financial officer (“CFO”) of ABC. Tr. pp. 100, 101.

He also serves as an officer and as CFO of XYZ and ABC’s operating companies.

*Id.*; Tr. pp. 237, 238. Officers of subsidiaries that are responsible for the supervision of operating subsidiary financial affairs report to Doe in order to allow Doe to make sure that financial statements are presented in a manner that conforms with GAAP principles and internal audit guidelines and are otherwise properly assembled and prepared. Tr. pp. 238, 239. Operating subsidiary financial chief executives also report to operating subsidiary presidents with regard to day-to-day operating matters.

*Id.*

**13.** The head of XYZ meets with ABC’s chief executive officer quarterly to review operations and operating results from sales. Tr. pp. 345, 346. He also meets with ABC’s chief executive officer, chief financial officer, controller and Board of Directors annually to present the company’s annual budget. Tr. pp. 331, 345-348. Annual budgets have to be approved by ABC’s management before being implemented. Tr. pp. 280, 281. Filtration operating companies also submit their budgets annually for review and approval by ABC’s management. Tr. pp. 114, 441-447.

**14.** ABC has a human resources function that is responsible for ABC’s personnel matters.

Tr. pp. 84, 85. ABC’s filtration operating companies and XYZ also have their own human resources functions that are separate from ABC’s corporate human resources function. Tr. p. 85. The filtration operating companies’ human resources function and the XYZ human resources function are primarily responsible for hiring, firing and disciplining each of XYZ’s and the filtration operating companies’ employees,

for setting vacation policies and procedures and for administering unique benefits existing before a particular subsidiary was acquired or as provided by local laws. Tr. pp. 396, 425, 426, 455-457. Each subsidiary's human resources function is under the oversight of ABC's human resources function. Tr. p. 85.

**15.** Employee benefits are established by ABC's human resources function. Tr. pp. 203, 204, 338, 339. The same pension plan and other benefits are provided to all employees regardless of which ABC subsidiary they are employed by. Tr. pp. 108 – 110, 359, 360. ABC also centrally administers employee benefits. Tr. pp. 204, 205, 338-340, 456 – 460.

**16.** Each operating company's human resources function and XYZ's human resources function independently sets its own policies and standards governing employee conduct and disseminates these policies and standards through the creation and distribution of employee handbooks. These policies are not uniform and differ from company to company. Tr. pp. 288, 289, 427; Taxpayer Ex. 8.

**17.** ABC, XYZ and ABC's filtration operating companies all have their own accounting departments. Tr. pp. 271, 421. Accounting functions performed at the subsidiary level include the preparation of trial balances, operating statements and other details to support consolidated financial statements prepared by ABC's accounting function. Tr. pp. 81, 120, 121, 271, 421. ABC is responsible for consolidating the operating results of all of ABC's operating subsidiaries. *Id.*

**18.** Subsidiaries are not authorized to handle their own cash and manage their own bank accounts. Tr. pp. 93-97. Authority over operating subsidiary cash and bank accounts is exercised exclusively by ABC. *Id.*; Tr. pp. 215, 216.

- 19.** ABC's corporate treasury function supervises the management of cash generated by all of the company's subsidiaries. Tr. pp. 93-96. Cash generated by subsidiary sales and accounts receivable is deposited in subsidiary bank accounts and then swept from these accounts into a central account and invested by ABC on a daily basis. Tr. pp. 132-135, 215-217, 389-391, 451-453. Cash swept into ABC's account from subsidiary accounts is accounted for as an intercompany loan to ABC (a ABC account payable) from its subsidiaries. Tr. pp. 95, 135. When the corporate treasury function determines that a subsidiary needs cash to cover recurring expenses, cash is transferred back to the subsidiary. Tr. pp. 390, 391. These transfers are accounted for as reductions in corporate loans from subsidiaries. Tr. p. 135. ABC's treasurer maintains intercompany loan account balances which reflect the excess of these loans over repayments as a net figure. Tr. pp. 132-135. The net excess of loans from subsidiaries to ABC resulting from cash sweeps, over loan repayments by ABC to subsidiaries resulting from cash advances to cover subsidiary expenses during each calendar year, is treated as a dividend from the subsidiaries to ABC. *Id.* No interest rate is charged to ABC by subsidiaries on these intercompany loans. *Id.*
- 20.** While subsidiaries prepare separate financials, they report their financial results as part of a consolidated report rather than on a separate company basis for management and financial reporting purposes in order to comply with government reporting requirements. Tr. pp. 186-189, 271, 421.
- 21.** The corporate finance function of ABC has the responsibility of consolidating the financial statements from all subsidiaries with the parent company. Tr. pp. 271, 421.

- 22.** ABC's corporate internal audit department, which is separate from its corporate accounting function, is exclusively responsible for auditing the records of all of ABC's subsidiaries to assure compliance with internal controls and regulatory and accounting rules and procedures, and for verifying the accuracy of information provided by subsidiaries by assuring that procedures used to gather information being reported complies with guidelines and standards prescribed by law. Tr. pp. 83, 178-180, 190-193, 225-227, 235-236. XYZ also has a separate, independent internal audit function that conducts internal audits for purposes of obtaining independent third-party certification of the quality of XYZ's products. Tr. p. 349.
- 23.** Strategic plans for both ABC's filtration operating companies and XYZ are formulated annually, initially by operating subsidiaries under the supervision of ABC's management. Tr. pp. 224, 225, 301-303, 343-345; Taxpayer Ex. 10. Strategic plans normally cover a three-year period. Tr. p. 224.
- 24.** Budgets for subsidiaries are created by XYZ and filtration operating companies subject to review by ABC's chief executive officer and general counsel. Tr. pp. 114, 224. Upon approval by ABC's management, the individual budgets prepared by ABC subsidiaries are consolidated and presented to ABC's Board of Directors for approval. Tr. pp. 219, 224, 225, 327-332, 384-387.
- 25.** The consolidated budgets developed by ABC take into account revenue and expenditure projections developed at the subsidiary level. Tr. pp. 329, 330.
- 26.** ABC and its filtration operating companies and XYZ have officers and directors in common. The chief executive officer, the chief financial officer, the controller and the

general counsel/secretary of ABC serve as officers of XYZ and ABC's filtration operating companies. Tr. pp. 100-102, 173, 174, 205-207.

**27.** ABC provides payroll services to its subsidiaries. The services are performed by ABC's payroll function which consists of four employees, and is separate from ABC's human resources function. Tr. pp. 87, 88, 214, 215, 231, 388, 389, 395.

**28.** ABC's payroll function includes filing payroll tax returns and the processing and payment or deposit of checks to all of ABC's employees and to all employees of ABC subsidiaries. Tr. pp. 119, 395, 454. All parent and subsidiary payroll records are maintained at ABC. Tr. pp. 118, 119.

**29.** ABC has a stock option plan covering ABC and all of its subsidiaries. Stock options are granted and administered by ABC's corporate human resources function. All management and senior level employees of ABC and its subsidiaries are eligible to participate in this plan and receive stock options in stock of ABC. Tr. pp. 226, 227, 311-316, 352, 359, 360, 459, 460.

**30.** ABC has one pension and 401(k) plan covering employees of ABC and all of its subsidiaries. Tr. pp. 108-110, 143.

**31.** XYZ and some of ABC's operating companies have their own logos and other intellectual property which are not shared with ABC or other ABC subsidiaries. Tr. pp. 267, 379, 428. However XYZ was allowed to use the ABC trade name without charge. Tr. pp. 304, 305. Responsibility for protecting and preserving operating subsidiary intellectual property rights through legal action is the responsibility of each operating subsidiary. Tr. pp. 278, 279, 334.

- 32.** XYZ and ABC's filtration operating companies have their own sales and advertising departments and conduct these functions autonomously. Tr. pp. 260, 261, 292, 293, 295, 297, 299, 300, 378, 379, 427, 428, 436.
- 33.** ABC, XYZ and each of the filtration operating companies have their own separate IT functions. Tr. pp. 341-343, 355.
- 34.** ABC and its operating subsidiaries do not utilize identical computer and other business related technology. Tr. pp. 185, 186, 283, 429-431.
- 35.** Each operating subsidiary has its own procurement function. These purchasing functions are authorized to make purchases of inventory without ABC's approval. Tr. pp. 136, 137, 374, 375.
- 36.** XYZ is independently responsible for its own compliance with environmental laws and the conduct of its federal and state compliance audits. Tr. pp. 297-299, 335.
- 37.** ABC's corporate legal department, headed by ABC's corporate general counsel, David XXXX, provides legal services to ABC and all of its subsidiaries, which do not have separate legal functions. However, XYZ and filtration operating companies are authorized to retain outside counsel independently. Tr. pp. 84, 112, 113, 278, 279, 379, 380, 401, 402, 428.
- 38.** ABC reports federal income tax on a consolidated basis, and the corporate tax department prepares the federal consolidated return. Tr. p. 154. In addition to preparing and filing ABC's consolidated federal income tax return, ABC's corporate tax department is also responsible for filing all federal, state of local returns (including payroll withholding tax returns) except sales tax returns, for ABC and all

of its subsidiaries.<sup>4</sup> Tr. pp. 45, 46, 118, 119. Sales tax returns are handled independently by each subsidiary. Tr. p. 46.

39. ABC's tax compliance function is headed by ABC's vice president of tax and is supervised by ABC's chief financial officer and controller, one of whom ordinarily reviews and signs all ABC and subsidiary income and property tax returns. Tr. pp. 26, 27, 208-212.
40. Pension plan services provided to subsidiaries by ABC are provided by ABC at ABC's cost of performance. Tr. pp. 110,111.
41. XYZ and ABC have independently developed and implemented uniform quality control standards. Tr. pp. 349, 350. These quality control standards are not uniform throughout the companies. *Id.*
42. Sales between XYZ and filtration operating companies constituted less than one percent of total sales between ABC subsidiaries during 2002 and 2003. Taxpayer's Ex. 3. XYZ received preferential pricing on intercompany purchases from filtration operating companies. Tr. p. 58.
43. There were no employee transfers between XXX and filtration operating companies during the tax years at issue. Tr. p. 50.
44. There was only one transfer of an employee from XXXXX to ABC during the tax years at issue. Tr. p. 49; Taxpayer Ex. 2.
45. XYZ's warehouses and distribution centers are completely separate from the filtration operating companies' warehouses and distribution centers. Tr. pp. 277, 278.

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<sup>4</sup> While property tax returns are prepared by ABC's tax department, paying property taxes is the responsibility of each subsidiary. Tr. pp. 45-47.

46. XYZ and each operating company decide which products it will sell and set its own prices for them. Tr. pp. 177, 178, 267, 268, 373, 420, 421. ABC does not review these operating subsidiary product selection and pricing decisions. *Id.*
47. With the exception of their senior management, XYZ and each operating subsidiary is responsible for hiring and firing its own employees. Tr. pp. 180, 283, 284, 376, 425, 426. Hiring decisions with regard to senior management are subject to review by ABC. Tr. pp. 309, 310.
48. With the exception of senior management, XYZ and operating companies decide upon job classifications, pay and wages for their employees. Tr. pp. 180, 284-288, 310-316, 426; Taxpayer Ex. 7. Their decisions regarding these matters do not require prior approval from ABC. *Id.*
49. ABC requires all of its filtration operating companies and XYZ to get approval from ABC's chief executive officer and management before making capital expenditures exceeding \$25,000. Tr. pp. 98-100, 136, 177, 178, 218-220, 232, 324, 354, 394. ABC's Board of Directors is required to approve subsidiary capital expenditures exceeding four million dollars. Tr. pp. 99, 100.
50. In addition to intercompany receivables resulting from cash advances to cover recurring expenses, ABC also loans money to its subsidiaries to cover non-recurring expenses, principally for acquisitions. Tr. pp. 96-98.
51. Subsidiary decisions to acquire new companies must be approved by ABC's management. Tr. pp. 97, 98.

**Conclusions of Law:**

ABC, a publicly traded Delaware corporation having its commercial domicile in Anywhere, Illinois, is engaged, through its subsidiaries, in the business of manufacturing and selling filtration products and high-end lithography packaging products. Tr. pp. 30, 31, 44, 45, 73, 167, 168, 355, 356; Stipulation Ex. 11-13.<sup>5</sup> ABC timely filed its 2002 and 2003 IL-1120s on combined unitary tax returns. Stipulation Ex. 3, 4. Attached to each return was a schedule UB listing all members of the unitary business group. *Id.* These members included all of ABC's domestic subsidiaries except ABC Filtration Products, Inc. *Id.*; Tr. pp. 33, 34. Subsequently, on December 22, 2006, ABC and ABC Consumer Products, Inc., a wholly-owned subsidiary of ABC (Tr. p. 45), filed amended returns/refund claims for 2002 and 2003 seeking refunds of tax originally reported on ABC's unitary tax returns for these years. Stip. Ex. 5-8. On these returns, the business operations of ABC and its subsidiaries were separated into two separate unitary groups and each group filed a separate Illinois unitary return for each of these years. *Id.* One of these unitary business groups included ABC, all of its subsidiaries engaged in the manufacture of filtration products ("filtration operating companies") and other subsidiaries related to this business. Tr. p. 35; Taxpayer Ex. 1; Stipulation Ex. 3, 4. The other unitary business group consisted of three companies: ABC Consumer Products, Inc., a holding company holding all of the stock of XYZ, Inc. ("XYZ"), XYZ, a company

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<sup>5</sup> Unless otherwise noted, statements of fact set forth in the conclusions of law pertain to the tax years in controversy.

engaged in the manufacture of packaging products, and XYZ Europe, Inc., a company created to sell XYZ's products in Europe. Tr. p. 35; Taxpayer Ex. 1. The Department denied these refund claims and the taxpayer timely filed a protest contesting the Department's claim denials. Stipulation Ex. 2. The issue in this case is whether all of ABC's filtration products business and packaging business subsidiaries must be included in a single unitary business group with ABC as indicted on ABC's original returns for 2002 and 2003 rather than in two separate unitary business groups -a filtration products business group and a packaging business group- as reflected in amended returns filed by ABC and ABC Consumer Products, Inc. for these years.

The Department asserts that ABC has failed to prove that any of its subsidiaries are properly excludable from a single ABC unitary business group. Department Brief pp. 11, 12. Absent such proof, it maintains, the Department's *prima facie* conclusion that ABC and each of these entities operate as a single unitary business enterprise must be sustained. *Id.* This is true, it argues, because pursuant to section 904(a) of the Illinois Income Tax Act ("IITA") (35 ILCS 5/904(a)), the Department's notices of denial denying taxpayer's claims for refund based upon the inclusion of all of these entities in a single unitary business group, are *prima facie* correct. Department Brief pp. 11, 12. The Illinois courts have consistently held that the burden of rebutting the Department's *prima facie* case falls squarely upon the taxpayer. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1<sup>st</sup> Dist. 1981). Moreover, mere testimony is not sufficient to meet this burden. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217 (1991); PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 34 (1<sup>st</sup> Dist. 2002). The taxpayer must rebut the Department's *prima facie* case by producing

testimony that can be corroborated by its books, records and other documentary evidence.

*Id.*

The statutory definition of a unitary group is found in section 1501(a)(27) of the IITA, 35 ILCS 5/1501(a)(27) (“section 1501(a)(27)”). Section 1501(a)(27) provides in pertinent part as follows:

The term “unitary business group” means 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 ...; and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).

Department regulation 86 Ill. Admin. Code, ch. I, sec. 100.9700(h) prescribes, in pertinent part, the evidence that must be produced to show that a taxpayer and its subsidiaries are engaged in the same general line of business as follows:

h) General line of business and vertically structured enterprises ...

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2) IITA Section 1501(a)(27) recites that two persons will ordinarily be considered to be in the same general line of business if they are both involved in one of the following activities:

- A) manufacturing
- B) wholesaling
- C) retailing
- D) insurance
- E) transportation, or
- F) finance

3) IITA Section 1501(a)(27) does not contemplate that the above list be exclusive. For example, two persons that are both involved in rendering services to the public would ordinarily be considered to be in the same general line of business. In this regard, a retailer that renders services that are incidental to its retail business will not be in the same general line of business as a person that is primarily a service dispenser.

4) It is not a requirement of IITA Section 1501(a)(27) that the activities of the two persons in whichever category is applicable relate to the same product or product line in order for the two persons to be in the same general line of business.

86 Ill. Admin. Code, ch. I, sec. 100.9700(h)(2)(3)(4)

The record in this case clearly indicates that XYZ, ABC's packaging manufacturing subsidiary, and ABC's operating filtration companies are engaged in the same general line of business, manufacturing. Indeed, the taxpayer has expressly conceded this point. Tr. p. 73. The record also indicates that the "common ownership" prerequisite to a unitary business group finding prescribed by section 1501(a)(27) has been met in this case. The taxpayer has expressly admitted that ABC's packaging and filtration operating companies are commonly owned by ABC. Tr. p. 73.

However, while section 1501(a)(27) and the regulations noted above state that a showing of subsidiary operations in the same line of business that are under common ownership is strong evidence of a unitary business group, such evidence is insufficient to conclusively establish the existence of such unless functional integration through the exercise of strong centralized management of all of a company's subsidiaries can be shown. This is made clear by 86 Ill. Admin. Code, ch. I, sec. 100.9700(g) which provides in part as follows:

g) Strong centralized management. Under IITA Section 1501(a)(27), no group of persons can be a unitary business group unless they are

functionally integrated through the exercise of strong centralized management. It is the exercise of strong centralized management that is the primary indicator of mutual dependency, mutual contribution and mutual integration between persons that is necessary to constitute them members of the same unitary business group.

This regulation also enumerates the tests to be met in order to show strong centralized management as follows:

The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member. Thus, some groups of persons may properly be considered as constituting a unitary business group under IITA Section 1501(a)(27) when the executive officers of one of the persons are normally involved in the operations of the other persons in the group and there are centralized units which perform for some or all of the persons functions which truly independent persons would perform for themselves.

86 Ill. Admin. Code, ch. I, sec. 100.9700(g) clearly makes a showing of centralized authority over such matters as accounting, personnel, legal, purchasing, tax compliance, advertising and financing, the “litmus test” for establishing strong centralized management. Moreover, the concept that centralized management can be established through a clear demonstration of operational or functional integration has been completely endorsed by the Illinois Appellate Court. In A.B. Dick Company v. McGraw, 287 Ill. App. 3d 230 (4<sup>th</sup> Dist. 1997), the Illinois Appellate Court rejected the notion that functional or operational integration is a separate concept from centralized management. The court posits that “whenever there is functional integration of operations there is also strong centralized management and vice versa.” A.B. Dick at 233; see also Borden, Inc. v. Whitley, 295 Ill. App. 3d 1001, 1009 (1st Dist. 1997).

The record in this case strongly supports a finding of pervasive functional integration throughout the ABC organization during the tax periods in controversy. During the trial proceeding, testimony and documentary evidence was introduced that established the following facts:

1. ABC's chief financial officer supervised all subsidiary accounting functions. Tr. pp. 237-239.
2. ABC's corporate audit function enforced compliance with corporate policies and regulatory and accounting rules and procedures by monitoring the activities and accounting procedures of all ABC subsidiaries. Tr. pp. 83, 178-180, 190-193, 225-227, 235-236.
3. ABC's tax department prepared tax returns (including payroll withholding tax returns) and handled all other tax matters for all subsidiaries except sales tax returns and the payment of property taxes. Tr. pp. 45, 46, 118, 119, 290, 291. ABC's management had exclusive authority to approve and execute subsidiary tax returns. Tr. pp. 208-212.
4. All ABC subsidiaries participated in a centralized cash management system which was controlled by ABC, and all cash generated by subsidiaries not immediately needed for subsidiary operations was returned to ABC. Tr. pp. 93-97, 132-135, 215-217, 389-391, 451-453.
5. ABC's corporate payroll and legal functions provided payroll and legal services to all ABC subsidiaries. Tr. pp. 84, 112, 113, 118, 119, 278, 279, 380, 395, 401, 402, 428, 454.

6. Operating budgets of XYZ, ABC's only packaging manufacturing company, and the filtration operating companies required the approval of ABC's chief executive officer and Board of Directors. Tr. pp. 114, 219, 224, 225, 280, 281, 327-332, 384-387, 441-443.
7. ABC exercised control over all subsidiary Board of Directors decision-making functions. Tr. pp. 227-229.
8. ABC had authority over who was hired as officers of its subsidiaries. Tr. pp. 309, 310. It also had authority over the compensation and benefits paid to these employees. Tr. pp. 180, 316.
9. ABC selected benefits, and managed and administered benefit plans covering employees of ABC and all of its subsidiaries. Tr. pp. 108-110, 203, 204, 338-340, 359, 360, 456-460.
10. ABC approved all capital expenditures above \$25,000 by all ABC subsidiaries. Tr. pp. 98-100, 136, 177, 178, 218-220, 232, 324, 354, 394. ABC's Board of Directors was required to approve all capital expenditures exceeding four million dollars (\$4,000,000). Tr. pp. 99, 100.
11. ABC's chief executive officer, chief financial officer, general counsel/corporate secretary and controller simultaneously served as the highest ranking executive officers of XYZ and all of ABC's filtration operating companies. Tr. pp. 100-102, 173, 174, 205-207.
12. XYZ was allowed to use ABC's trade name without charge on all of its products and promotional materials. Tr. pp. 304-306.
13. ABC provided some services to its subsidiaries at cost. Tr. pp. 110, 111.

The above relationships, shown to be present during the tax years in controversy, are significant because these are the very factors Illinois courts have cited as a basis for a finding that functional integration existed within an affiliated group of companies and that the affiliated group, therefore, constituted a unitary business.

In finding proof of functional integration between Borden and its Pepsi bottling subsidiaries, the court, in Borden, states the following:

In support of its conclusion that Borden and the Pepsi Subs were functionally integrated, the Director cited the following stipulated facts...

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2. Borden's Internal Audit Department monitored the activities and accounting procedures of Borden's subsidiaries, including the Pepsi-Subs;
3. Borden's Controller managed and oversaw the accounting functions of all Borden subsidiaries including the Pepsi-Subs. The Pepsi-Subs used the same outside accounting firm that Borden used. Borden managed the way the Pepsi-Subs reported their financial data to Borden to facilitate the preparation of consolidated financial reports.
4. Borden's Tax Department prepared tax returns for the Pepsi-Subs.
5. All of Borden's subsidiaries, including the Pepsi Subs, participated in a centralized cash management system that was controlled by Borden's Treasurer;
6. Borden's Employee Relations and Legal Departments provided services to all of the Borden subsidiaries, including the Pepsi-Subs;
7. Borden's [I]nsurance Department administered various insurance programs for all Borden's domestic subsidiaries, including the Pepsi-Subs;
8. Borden's Employee Benefits Department administered employee benefit programs for Borden's domestic subsidiaries, including the Pepsi-Subs;
9. The Pepsi-Subs participated in Borden's minority purchasing program and were required to follow Borden's affirmative action program and television advertising policy.
10. Borden approved the Pepsi-Subs' operating budget and capital expenditures.
11. Borden appointed the officers of the Pepsi-Subs;

12. Borden determined the compensation and benefit packages for the officers of the Pepsi-Subs;
13. Two officers of the Pepsi-Subs later became officers of a Borden division. One of these officers approved the budgets and capital expenditures of the Pepsi-Subs;
14. The centralized services provided to the Borden subsidiaries were provided at cost or without charge[.]

These facts demonstrate that Borden treated the Pepsi Subs as it did its other subsidiaries, which Borden conceded were part of its unitary business. Further, the Tax Act states that functional integration is demonstrated 'where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member'. ... The stipulated facts make clear that Borden retained control over financing, tax compliance, and at least some aspects of purchasing, personnel, and marketing. Thus, we cannot accept Borden's conclusion that the Pepsi Subs were autonomous. Borden at 1006 -7.

It is readily apparent from the foregoing that the court in Borden was persuaded that the record in that case showed the existence of functional integration by presenting evidence of many of the very factors that have been shown to be present in this case.

In A.B. Dick, the court based a finding that a parent and its subsidiary were unitary on evidence demonstrating functional integration including the following factors:

1. The parent approved all major expenditures.
2. The parent set salary levels.
3. Cash generated by the subsidiary not immediately needed for subsidiary operations was returned to the parent.
4. The parent company's tax director had authority to approve all subsidiary tax returns.
5. The subsidiary used parent company patents without charge.
6. Parent provided some corporate services to all of its subsidiaries at cost.

A.B. Dick at 234 -5. Again, the same factors relied upon by the appellate court in finding functional integration indicative of a unitary business have been shown in this matter. In sum, given the facts established during the evidentiary hearing in this matter, the record in this case fully supports a determination that ABC's entire business was functionally integrated during the tax years in controversy.

Further, as noted above, under regulation 86 Ill. Admin. Code, ch. I, section 100.9700(g), groups of persons may properly be considered as constituting a unitary business group under IITA section 1501(a)(27) "when the executive officers of one of the persons are normally involved in operations of other persons in the group." Evidence of the exercise of management control over major subsidiary functions by ABC's central management is abundantly clear from the record in this case.

The record in this case clearly demonstrates that ABC's chief financial officer exercised exclusive control over all subsidiary financial affairs including the use of subsidiary revenues which were swept from subsidiary accounts daily. Tr. pp. 93-96, 132-135, 215-217, 389-391, 451-453. The record also evidences the existence of shared officers throughout the ABC organization and centralized control over subsidiary Board of Directors functions by the ABC Board of Directors. Tr. pp. 100-102, 173, 174, 205-207, 227-229. Proof of centralized management and control over subsidiary finances, including the investment and use of revenues generated by subsidiary operations that are transferred to the parent company by shared officers and directors, without more, has been viewed as sufficient evidence to establish the existence of a unitary business. In Citizens Utilities Company v. Illinois Department of Revenue, 111 Ill. 2d 32, 50 (1986), the Illinois Supreme Court states:

Both the borrowing and lending corporations are governed by the same directors, officers and management strategies, so the lender controls how the loan is used and the investment cannot be considered passive within the meaning of Container Corporation. By these transfers, the revenue producing subsidiary loses income from the time-value of its revenues, and the borrowing subsidiary's income is increased by eliminating interest expenses. This flow of value is itself, strongly indicative of a unitary business.

The record also indicates that the management of ABC effectively controlled all subsidiary expenditures through its oversight of subsidiary budgets which, although developed by subsidiaries, required approval by ABC's management and Board of Directors before being implemented. Tr. pp. 114, 219, 224, 225, 327-332, 384-387. XXX, XYZ's president, and XXXX, XXX Filters' controller, both testified that budgets initially developed at the subsidiary level of the company were subject to parent approval. Tr. pp. 280, 281, 441-443.

Through the budgeting and planning process, ABC effectively controlled each subsidiary's expenditures. This type of parental control over subsidiary capital and operating expenditures has been recognized by the Illinois courts as an indicia of a unitary business operation. Borden, supra; A.B. Dick, supra.

With respect to the conduct of ABC's tax matters, XXXX, ABC's vice president of taxes and XXX, ABC's controller during the tax years at issue, testified that control over subsidiary tax planning and compliance was exercised by ABC's corporate tax function which was under the direct supervision of ABC's chief financial officer. Tr. pp. 208-212. Centralized control over subsidiary tax planning and compliance has been identified as an indicia of a unitary business by the Illinois courts. Borden, supra; A.B. Dick, supra.

The foregoing evidence establishes both the existence of a strong centralized management authority within the ABC organization and the exercise of control over subsidiary operations by this centralized management. Of particular significance is evidence in the record that ABC's Board of Directors also acted as the *de facto* Board for all of ABC's subsidiaries. Tr. pp. 227-229. The ABC Board exercised all of the Board functions normally undertaken independently by companies that are truly separate and autonomous. The entire record in this case makes it reasonable to conclude that ABC exercised this authority by placing its own officers, including its own chief executive officer and chief financial officer, at the apex of each subsidiary and conferred upon them ultimate authority and control over all subsidiary affairs. Regulation 100.9700(g) indicates that this is the typical organizational structure found in a functionally integrated unitary business group and ABC completely matches this typical pattern.

A finding that ABC and all of its filtration and packaging business subsidiaries are not engaged in a single unitary business would ignore the extensive evidence summarized above of the existence of centralized operations and of a strong centralized management that exercised direct control over subsidiary expenditures, including taxes, and over the use of subsidiary revenues. Both regulation 100.9700 noted above, and the Illinois case law, have recognized that where functional integration and both strong centralized management and the exercise of this management evidenced through direct control over major subsidiary functions is present, the existence of a unitary business must be found.

In sum, the record in this case contains sufficient evidence to persuade that functional integration and strong centralized management were the primary

characteristics of ABC's entire affiliated group of companies during the tax years in controversy. For this reason, I conclude that the taxpayer has failed to rebut the Department's *prima facie* showing that a single unitary business group consisting of ABC and all of its domestic subsidiaries existed during those years.

ABC's primary argument is that its packaging manufacturing subsidiary, which ABC included in a separate unitary business group, operated with almost complete independence from ABC and ABC's filtration company subsidiaries. Taxpayer's Brief pp. 16-32. For example, it notes, XYZ and the filtration operating companies did not exchange personnel. Tr. p. 23. ABC and the filtration operating companies included in ABC's unitary business group did not have any control over XYZ's hiring and firing of non-executive personnel and did not approve their salaries or fringe benefits at this company. Taxpayer's Brief p. 24. Neither ABC nor its filtration company subsidiaries had any control over opening and closing business operations or which products XYZ decided to sell. *Id.* Certain key purchasing, accounting, marketing, information technology, personnel and product patent and development functions were under the exclusive control of XYZ's management and neither ABC nor its filtration group subsidiaries had any involvement in these areas. Taxpayer's Brief pp. 19-32. Most importantly, the taxpayer maintains, ABC's management knew nothing about the packaging business and, therefore, although serving as its senior officers, made no decisions regarding XYZ's day-to-day operations. Taxpayer's Brief pp. 27-32. Based on these facts, the taxpayer concludes that there was a lack of functional integration between ABC and its filtration group on the one hand and the packaging group of companies

(principally XYZ) on the other. For this reason it concludes ABC's packaging and filtration companies could not properly be included in a single unitary business group.

Taxpayer's principal argument fails, however, because it circumvents the purpose of combined reporting. In A.B. Dick, the court explains why the indicia of shared operations evidenced by the record in this case, and relied upon in Borden, A.B. Dick and the Illinois income tax regulations (at 86 Ill. Admin. Code, ch. I, sec. 100.9700(g)) are critical in discerning the existence of a unitary enterprise. The court notes the basic rationale for combined reporting as follows:

“[T]he justification for combined reporting is that there are ‘many subtle and largely unquantifiable transfers of value that take place among components of a single enterprise.’ A.B. Dick at 239 (quoting Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 164-65 (1983)).

But for these unquantifiable transfers of value, taxation of members of an affiliated group of companies as two or more separate and distinct unitary business groups would be a perfectly acceptable method to determine the correct amount of tax due. This point is noted in Hormel Foods Corporation v. Zehnder, 316 Ill. App. 3d 1200, 1203-4 (1<sup>st</sup> Dist. 2000), wherein the court states:

When a single-taxable entity owns and operates separate and distinct businesses in different states, the entity must determine and account for the amount of income that is attributable to the operations in each taxing state. In such a case, because each operation is separate and distinct, the entity can accurately determine income earned in each state by utilizing the “separate accounting” method. ... In the case of a unitary business, the separate accounting method does not accurately divide the income among the various taxing states. ... So, to provide for a more exact accounting, many states, including Illinois, employ some variation of “formula apportionment.” ... In the case of a unitary business group, Illinois uses the “combined apportionment” method to

determine the income attributable to Illinois by any member of the group.

Thus, where there are extensive indicia of functional integration as is shown by the record presented in this case, treating the entire business operation as anything other than a single business enterprise would thwart the purpose of combined reporting identified in A.B. Dick. Accordingly, the Illinois Supreme Court has instructed that, where indicia of functional integration indicate that an associated group of entities are engaged in the operation of a single business enterprise, formula apportionment on a combined basis must be used because a group of assets is being used by what is essentially a single entity for the generation of income through the operation of a single business. Citizen Utilities, *supra*.

The taxpayer contends that Borden and A.B. Dick, wherein the courts found functional integration based upon facts similar to those presented in the instant case, are distinguishable from the instant case because, in the instant case, services provided by the parent company to XYZ and its other subsidiaries were provided at an “arms-length” charge, i.e., a charge that approximated what ABC’s subsidiaries would pay to obtain these services from an unrelated company. Taxpayer’s Brief pp. 29, 30. The Department contends that the taxpayer’s testimonial assertions that services were provided at “arms-length” to its affiliates including those treated as non-unitary in its amended returns (principally XYZ) are not supported by documentary evidence and, therefore, have not been established in a manner sufficient to rebut the Department’s *prima facie* case. (“[T]he testimony provided by the Taxpayer’s witnesses regarding the 1% and 1.6% fee charged to the packaging and filtration businesses, respectively, was unsupported by any

documents. The self-serving testimony that the corporate fees were reasonable is not credible and should be disregarded by this Tribunal.”). Department’s Brief p. 12.

During the evidentiary hearing, XXXX, the taxpayer’s vice president of taxes testified as follows:

Q. Okay. Going back to the charges for these. So if there was a specific charge, let’s say, for the pension plan, they would charge each individual entity for their portion of it, correct?

A. Yes.

Q. And how would they bill them? Would they send them a bill, or how would they communicate what they owed?

A. There was some sort of communication by the parent of, “Here are your direct charges with support of how it was calculated,” given to each company.

Q. Was that done by journal entry, or was there a specific transfer of cash?

A. It would have been done by journal entry to a particular company payable account.

Q. Now, as far as the variable cost, can you define what that means in this context?

A. Okay. The variable charge was an intercompany charge for services provided by the parent company. It was calculated at 1.6 percent of revenue to the filtration companies and 1 percent of revenue charged to the packaging, XYZ.

Q. And for this charge what type of services were provided the various entities that made up this charge?

A. There is a list of services. We would have provided income tax compliance services in my function, payroll functions for processing payroll for the companies, providing benefit plans to all the companies, and assistance with legal matters by the in-house counsel.

Q. The assistance by legal counsel, was that a direct charge or was that part of the variable charge?

A. It would be part of the variable charge.

Q. Okay. Was there any instance where Mr. XXX [in-house counsel] specifically did work for an operating entity where it would be considered a direct charge?

A. Well, generally the way it would work is Mr. XXXX would have some oversight of the legal matter, and the operating company would hire outside counsel to directly handle the matter. If for some reason the outside counsel sent the bill to Mr. XXXX, he would have passed the cost along directly to the individual operating company.

Tr. pp. 110-112.

Mr. XXXX further testified as follows:

Q. You testified previously, Mr. XXXX, that there is an intercompany charge that is imposed by the parent to the operating companies, and I believe you testified that the fee that is imposed with respect to XYZ is 1 percent of XYZ's budgeted revenue; is that correct?

A. That's correct.

Q. And I believe you testified that the fee that is imposed on the filtration companies is 1.6 percent of their budgeted revenue; is that correct?

A. That's correct, yes.

Q. Have you had the opportunity, Mr. XXXX, to examine those fees to determine whether or not they're appropriate?

A. Yes, I have.

Q. And when exactly did you do that investigation? ...

A. In 2006.

Q. And what was the purpose of the investigation? ...

A. We did an internal transfer pricing study to establish whether or not the management fee was appropriate in accordance with treasury regulations. ...

Q. Who else was involved in preparing the study?

A. I did it myself.

Q. How did you go about preparing the study?

A. I took a departmental expense summary, you know, outlining all the various departments within ABC and looked at the cost incurred by the department under the relevant treasury regulation, federal treasury regulation, following their service regs, regulations on service charges, service charges, to determine that the departments that could be charged or should be charged out as services departments, once you added their total cost and a markup, a profit markup, that the 1 percent and 1.6 percent of the total dollars collected roughly approximated the appropriate charges in total dollars for the various departments that should have been charged out under the services regs.

Q. So did you conclude that those charges are consistent with the services transfer pricing rules?

A. Yes.

Q. And did you conclude that these charges would have a profit component to them?

A. Yes.

Q. And can you explain that?

A. Well, the treasury regulations and the discussions with, I guess, various advisors as to the appropriate rates, we had a profit – you took the total cost for a department, added a profit percentage, and that should have been the amount the department charged for its services that were rendered on behalf of subs.

Tr. pp. 137-141.

The record in this case reveals that none of the invoices, billing statements or journal entries, lists of services covered by intercompany charges, or other documentary evidence mentioned by Mr. XXXX during his testimony as the basis for computing and imposing

the alleged “arms-length” charge levied for services by ABC, have been submitted into evidence in these proceedings.<sup>6</sup>

The Illinois courts have repeatedly stated that testimony will be ignored in determining whether the taxpayer has met its burden of proof necessary to rebut the Department’s *prima facie* case if it cannot be corroborated in some fashion by books and records or other documentation. Mel-Park Drugs, *supra* at 217. (“To overcome the Department’s *prima facie* case, a taxpayer must present more than its testimony denying the accuracy of the assessments, but must present sufficient documentary support for its assertions.”). Since there is no documentary evidence supporting testimony regarding the taxpayer’s alleged arms-length charge for services it provided to its subsidiaries, I find that the taxpayer’s claim, that the instant case is distinguishable from A.B. Dick and Borden on this basis, has not been substantiated.

The taxpayer further contends that, unlike the Illinois cases in which the existence of a unitary business group has been found, the facts in the instant case do not establish a sufficient flow of value between ABC’s packaging business and its filtration business to support such a finding in this case. Taxpayer’s Brief pp. 18, 22, 23. The taxpayer points to the absence of significant intercompany sales between ABC’s filtration group and XYZ to support its claim. Taxpayer’s Brief p. 22 (“The lack of integration between XYZ and the filtration companies is also demonstrated by the noticeable absence of

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<sup>6</sup> Stipulation Exhibit 15, the only document referenced as support for the taxpayer’s claim that an “arms-length” charge was levied (Taxpayer’s Brief p. 11), does not document the taxpayer’s claims. While this Exhibit concerns the allocation of parent overhead to subsidiaries, it does not indicate that this charge was intended to be “arms length.” Specifically, it does not indicate the manner in which the allocated charge is determined to be “arms-length.” For this reason, I find that it does not support any of the testimony concerning “arms-length” intercompany charges given by Mr. XXXX.

intercompany sales.”). While the record indicates a low level of intercompany sales between XYZ, ABC’s only packaging business manufacturing company, and ABC’s filtration operating companies, there is also evidence in the record that these intercompany sales were at less than the normal “arms-length” charge to customers having no affiliation with ABC because there was no mark-up from cost on these sales. Tr. p. 58.

Moreover, this is not the only evidence of uncompensated transfers of value between the filtration business unitary business group which included ABC and the packaging business unitary business group. The record also indicates that XYZ was not charged anything for using ABC’s trade name, one of ABC’s most valuable intangible assets, on its products and in its advertising literature. Tr. pp. 304, 305. Furthermore, as previously noted, the taxpayer has admitted that ABC provided some services to all of its subsidiaries at cost (tr. pp. 110, 111), that all excess cash generated by subsidiaries is loaned to ABC, the parent company, interest free, (tr. pp. 133-135), and that ABC and all of its subsidiaries benefited from cheaper payroll processing and benefits costs due to the centralization of this function at ABC (tr. p. 360). The foregoing are examples of types of the very “unquantifiable transfers of value” that the combined apportionment method is designed to address. These types of exchanges clearly created values resulting from economies of scale and operational interdependencies that cannot realistically be measured viewing ABC’s packaging subsidiaries and its filtration products subsidiaries as distinct and separate operations for tax purposes. Thus, treating ABC and all of its subsidiaries as a unitary business fulfills the ultimate objective of combined reporting to properly reflect income reportable to each taxing state.

In sum, the Department has established the existence of a number of key factors relied upon in regulation 100.9700(g) and in Illinois court decisions in finding the existence of functional integration, or centralized management. Moreover, since the taxpayer has admitted that all of its subsidiaries are engaged in the same line of business and are commonly owned, the record clearly demonstrates the existence of all of the factors deemed to show the presence of a unitary business enterprise pursuant to section 1501(a)(27) and in regulation 100.9700(g).

The taxpayer's argument that ABC's filtration group of companies and its packaging group of companies were not engaged in a single unitary business is heavily premised upon the federal Appellate Court's ruling in In Re Envirodyne Industries, Inc., 354 F. 3d 646 (7<sup>th</sup> Circuit 2004). In this case, the United States Court of Appeals for the Seventh Circuit ruled that a taxpayer could not file a combined return involving two subsidiaries engaged in the manufacture of unrelated products that it actively managed, because the subsidiaries did not contribute to or depend upon each other. The parent company in this case, Envirodyne, owned a number of subsidiaries, some of which were involved in making food-packaging materials and others in manufacturing steel. The steel manufacturing subsidiaries incurred losses, and the taxpayer filed a combined return in order to offset these losses against income from its profitable food-packaging enterprise. The court refused to allow this despite evidence that the parent company actively managed both subsidiaries because there was no showing that the operations of these two businesses were interdependent in any way.

In Envirodyne, the federal court consciously departs from established Illinois case law by holding that a showing of strong centralized management is insufficient to

establish functional integration between affiliated enterprises. Envirodyne at 652 (“Particularly troublesome is the language in two decisions of the Illinois Appellate Court ... that, in the teeth of the statute, equates common management to functional integration, which if taken literally—since wholly owned management—would imply unconstitutionally that all such affiliated groups were unitary business enterprises.”). This holding is directly contrary to the holding of the Illinois Appellate Court in A.B. Dick, wherein the court states: “whenever there is functional integration of operations there is also strong centralized management and vice versa.” A.B. Dick at 233. See also Borden at 1009.

The holding in Envirodyne is one of the unusual instances in which a federal court, other than the U.S. Supreme Court, has addressed the scope of a unitary business enterprise as defined by state law (in this case, section 1501(a)(27)). With respect to the precedential significance to be accorded federal cases that construe Illinois statutory law, the Illinois Supreme Court stated the following:

Although we are always open to consideration of cases from other jurisdictions in order that we might glean wisdom found therein, and while federal court decisions interpreting a federal act are actually *binding* upon our Illinois courts (citations omitted), we are not bound by those decisions insofar as their applicability is argued on issues relating solely to state law. Hanrahan v. Williams, 174 Ill. 2d 268, 277 (1996).  
Sundance Homes, Inc. v. County of DuPage, 195 Ill. 2d 257, 266 (2001).

Accordingly, the Envirodyne case is not binding on this tribunal.

Even if this tribunal was required to follow the court’s ruling in Envirodyne, the holding in this case would not dictate a finding in favor of the taxpayer. I concur with the Department’s analysis of the factual distinctions between the instant matter and Envirodyne. As pointed out by the Department in its brief:

\*\*\* The facts in the *Envirodyne* case are clearly distinguishable from those in the instant case. Envirodyne was involved in producing food packaging material for the food industry. *Envirodyne* at 647. It operated its business in several states, including Illinois, through several subsidiaries. *Id.* In 1977, Envirodyne purchased the assets of the Wisconsin Steel companies from International Harvester which included steel works, coal mines and railroads. *In Re: Envirodyne Industries, Inc.*, 2002 WL 32305185 \*6 (C.A. 7). In 1980, Envirodyne filed a bankruptcy petition for its Wisconsin Steel subsidiaries. *Id.* at \*7.

The food processing subsidiaries and the Wisconsin Steel subsidiaries did not share common benefit plans and did not have the financial integration that is present in the instant case. *Envirodyne*, 354 F. 2d 646, 649-650 (2004). The *Borden* court considered similar factors as those in the present case. *Borden v. Illinois Department of Revenue*, 295 Ill. App. 3d 1001 (1998). In *Borden*, the Taxpayer purchased a series of Pepsi franchises which were included in Borden's food division. *Id.* at 1006. The *Borden* court determined that Borden treated the Pepsi subsidiaries the same as other subsidiaries it owned and that it provided centralized services to the Pepsi subsidiaries such as participation in common benefit programs, accounting services and cash management services. *Id.* at 1007. Borden also had significant oversight of the Pepsi subsidiaries' operations such as approval of the Pepsi subsidiaries' budget and approval of capital expenditures. *Id.* The *Borden* court found that the facts in that case indicated that strong centralized management existed and that functional integration had occurred. *Id.* at 109. While there is a clear indication of common management in the *Envirodyne* case, there is no indication of services such as payroll, treasury and employee benefits, being provided the Wisconsin steel subsidiaries by Envirodyne. Additionally, there is no indication that the Wisconsin Steel business is clearly designated as a division of Envirodyne. Lastly, there is no indication that the management of Envirodyne allocated corporate resources to its two businesses based on the available resources of the entire company. The clear indication is that Envirodyne was operating two businesses separately, and was attempting to combine the two distinct businesses in order to take advantage of Wisconsin Steel's losses on its Illinois corporate return. Given the two distinct sets of facts in *Envirodyne* and the instant case, the Department's positions in the two cases are completely reconcilable.

Department's Brief pp. 19, 20.

The Department has cited A.B. Dick, Borden and Hormel Foods Corp. v. Zehnder, 316 Ill. App. 3d 1200 (1<sup>st</sup> Dist. 2000) in support of its contention that ABC and its filtration group of companies and its packaging group of companies constituted a single unitary business group during the years at issue in this matter. As previously noted, the Illinois Supreme Court's decision in Citizens Utilities also supports the Department's claims. For the reasons indicated herein, I find that the Department's determination is fully supported by these precedents.

Unlike federal case law construing state statutes, decisions of the Illinois Supreme Court and the Illinois Appellate Courts are binding on all inferior courts and tribunals. See Schmidt v. Ameritech Illinois, 329 Ill. App. 3d 1020, 1027 (1<sup>st</sup> Dist. 2002), Friendship Manor of Ranch of King's Daughters and Sons, Inc. v. Department of Revenue, 91 Ill. App. 3d 91, 95 (3d Dist. 1980). The Illinois Appellate Court or Supreme Court may indeed, at some future date, embrace the reasoning in Envirodyne as the law of this state and overrule prior holdings that a showing of functional integration between a parent and its subsidiaries or strong centralized management exercised by the parent over its subsidiaries is sufficient to establish the existence of a unitary business even if the subsidiaries themselves operate independently of one another. Absent such a determination, however, I am constrained to follow the guidelines for determining the scope of a unitary business set out in A.B. Dick, Borden, Hormel Foods and Citizens Utilities which, as pointed out above, are distinctly different from the reasoning in Envirodyne. Consequently, I must reject the taxpayer's attempt to rely upon Envirodyne as a basis for its claims since that federal precedent is not the governing law in this case.

The taxpayer, at page 33 of its Brief, makes the following argument:

**The Comparative Gross Receipts Method Should Apply if it is Determined that ABC and XYZ are Functionally Integrated**

If this Tribunal determines that XYZ and the filtration companies are not functionally integrated, but further determines that it must analyze the relationship between XYZ and ABC and concludes that XYZ and ABC are functionally integrated, then XYZ and the filtration companies still cannot be included in the same unitary business group. Instead, XYZ and the filtration companies would continue to form their own separate, independent unitary business groups. However, instead of including ABC exclusively in the filtration unitary business group, which was done on ABC's amended returns, ABC would effectively be included in both unitary business groups using the comparative gross receipts method.

The Department contends that the applicability of the comparative gross receipts method is not properly before this Tribunal since this issue was not included in the taxpayer's protest or enumerated as an issue in the pre-trial order entered in this matter. See 86 Ill. Admin. Code, ch. I, section 200.120 ("Protests, upon notice to the Department's representative and by leave of the presiding Administrative Law Judge, may be amended to include additional grounds not previously cited at any time prior to the entry of a final pre-trial order which designates the issues to be considered at hearing."). Department's Brief p. 20.<sup>7</sup> The pre-trial order entered in this case describes the issue to be decided as follows:

The issue before this Tribunal is whether the Taxpayer should be treated as one or two unitary business groups for purposes of filing its form IL-1120.

Since the applicability of the comparative gross receipts method is neither enumerated as an issue in this matter, nor a necessary consequence of the agreed upon

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<sup>7</sup> ABC, in its Reply Brief, does not contradict the Department's claim that the applicability of the comparative gross receipts method was not raised as an issue in the taxpayer's protest or pre-trial order.

issue in this matter, I decline to address the taxpayer's alternative argument that, if the issue set forth in the pre-trial order is decided in the Department's favor the comparative gross receipts method should, nevertheless, be applied in this case.<sup>8</sup>

**WHEREFORE**, for the reasons stated above, it is my recommendation that the notice of denial denying the taxpayer's refund claim based upon amended returns filed for 2002 and 2003 be affirmed. The taxpayer has also protested a Notice of Deficiency in the amount of \$574 including interest, dated November 3, 2006, on the identical grounds raised in its protest of the Department's notice of denial. For the reasons set forth herein, it is also recommended that this Notice of Deficiency be affirmed in its entirety.

Ted Sherrod  
Administrative Law Judge

Date: August 24, 2009

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<sup>8</sup> ABC also contends that the Department is precluded from proceeding in this case by the doctrine of judicial estoppel, stating as follows: "The position taken by ABC in this case is the exact same position taken by the Department in *Envirodyne*. In his decision, Judge Posner noted that the Department's litigation position "may be shortsighted" because it would make it harder for the state to reach the income of non-Illinois affiliates. *Envirodyne*, 354 F. 3d at 649. Under the doctrine of judicial estoppel, a party who assumes a particular position in a legal proceeding is stopped from assuming a contrary position in a subsequent legal proceeding. (Citation omitted)." Taxpayer's Brief p. 16. For the reasons noted above, I decline to address this issue since this issue has not been included in the taxpayer's protest or enumerated in the pre-trial order governing the issues to be decided in this case.