

IT 04-7

Tax Type: Income Tax

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

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.

XXXXXXXXX CELLULAR HOLDING, INC.  
XXXXXXXXX CREDIT CORP.  
XXXXXXXXX CELLULAR SERVICES (IL)  
XXXXXXXXX CELLULAR SERVICES (CA)  
XXXXXXXXX, INC.,  
Taxpayer

No. 00-IT-0000  
FEIN: 36-1111111  
94-1111111  
36-1111112  
36-1111113  
36-1111114  
Tax Years: 1993, 1994, 1995

Ted Sherrod  
Administrative Law Judge

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Special Assistant Attorneys General David Dorner, Rick Walton, Ralph Bassett and Rebecca Kulekowskis on behalf of the Illinois Department of Revenue; Thomas H. Donohoe, Jane W. May and Melissa A. Graham of McDermott, Will & Emery on behalf of XXXXXXXX, Inc. and subsidiaries.

**Synopsis:**

There are three major issues presented for determination in this case. The first is whether the Illinois Department of Revenue (“Department”) correctly denied refund claims for 1993, 1994 and 1995 by XXXXXXXX, Inc. (“XXXXXXX”) based on the inclusion of certain subsidiaries in its combined returns for these years. The second issue is whether the Department properly assessed additional tax for these years based upon the

inclusion of XXXXXXXX Foreign Sales Corporation, an entity qualified as a foreign sales corporation for federal tax purposes, in XXXXXXXX's combined return. The third issue is whether the Department properly assessed additional tax for 1994 based upon the denial of a replacement income tax investment tax credit for the acquisition of an aircraft during that year.<sup>1</sup>

XXXXXXX, Inc. filed combined returns for the tax years ending 12/31/93, 12/31/94 and 12/31/95. The Department audited these returns and issued a Notice of Deficiency ("NOD") to XXXXXXXX, Inc. for these tax years on June 30, 2000. This NOD was based on the Department's reconfiguration of XXXXXXXX's unitary business group, and its determination that XXXXXXXX improperly claimed research and development, training expense, and investment tax credits. XXXXXXXX timely protested these assessments. Prior to the issuance of this NOD, the Department, on February 9, 2000, issued NODs to the following XXXXXXXX subsidiaries: XXXXXXXX Cellular Service, Inc. (aka XXXXXXXX Cellular Services (IL)), XXXXXXXX Cellular Service Inc. (CA) (aka XXXXXXXX Cellular Services (CA)), XXXXXXXX Cellular Holding, Inc., and XXXXXXXX Credit Corp. The Department determined that all of these subsidiaries, except XXXXXXXX Credit Corp., should have been included in a single combined return. All of these subsidiaries timely protested the Department's findings.

On April 12, 2001, XXXXXXXX filed amended returns (claims for refund) for the above tax years. XXXXXXXX's amended returns included all of the aforementioned

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<sup>1</sup> Assessment issues involving the training expense credit and the research and development credit were resolved by an agreement between the parties prior to this hearing.

subsidiaries that received assessments on February 9, 2000 and over 70 additional subsidiaries.<sup>2</sup>

On consideration of these matters, it is recommended that, with regards to the first issue, the Department’s denial of the taxpayer’s refund claims be cancelled. With regard to the second and third issues, it is recommended that the Department’s determinations be affirmed.

**Findings of Fact:**

**Issue I: Whether XXXXXXXX Properly Included Certain Subsidiaries in its Combined Returns (“Unitary Tax Issue”)**

1. XXXXXXXX, Inc. is a Delaware corporation, headquartered in Illinois, with major facilities in 13 states, and facilities or sales offices in 39 foreign countries. The company is engaged in the business of manufacturing, marketing and servicing high technology electronics focused on communications. Tr. p. 18; Taxpayer’s Ex. 11A, 11B, 11C.<sup>3</sup>
2. XXXXXXXX and its wholly-owned subsidiaries filed consolidated federal income tax returns for the years at issue. Tr. pp. 9, 10, 1161, 1162, 1197, 1200, 1201.
3. XXXXXXXX owned over 50% of the stock of the following domestic corporations during the years at issue:

<b>1993 – NAME OF SUBSIDIARY</b>	<b>1994 – NAME OF SUBSIDIARY</b>	<b>1995 – NAME OF SUBSIDIARY</b>
CCCCCC Corporation	CCCCCC Corporation	

<sup>2</sup> XXXXXXXX Credit Corp. was included in XXXXXXXX’s combined returns for these tax years. However, the parties subsequently agreed that XXXXXXXX Credit Corp. could not properly be included in XXXXXXXX’s combined return for the tax years in controversy.

<sup>3</sup> Unless otherwise noted, findings of fact apply to the tax years 1993, 1994 and 1995.

UUUUUU Data Systems, Inc.	UUUUUU Data Systems, Inc.	
XXXXXXXX International Development Corporation	XXXXXXXX International Development Corporation	XXXXXXXX International Development Corporation
XXXXXXXX International Capital Corporation	XXXXXXXX International Capital Corporation	XXXXXXXX International Capital Corporation
XXXXXXXX de Puerto Rico, Inc.	XXXXXXXX de Puerto Rico, Inc.	XXXXXXXX de Puerto Rico, Inc.
PPPPPP Design, Inc.	PPPPPP Design, Inc.	PPPPPP Design, Inc.
XXXXXXXX Cellular Service Inc. (Illinois)	XXXXXXXX Cellular Service Inc. (Illinois)	XXXXXXXX Cellular Service Inc. (Illinois)
XXXXXXXX Credit Corp.	XXXXXXXX Credit Corp.	XXXXXXXX Credit Corp.
XXXXXXXX International, Inc.	XXXXXXXX International, Inc.	XXXXXXXX International, Inc.
XXXXXXXX Cellular Service Inc. (CA)	XXXXXXXX Cellular Service Inc. (CA)	XXXXXXXX Cellular Service Inc. (CA)
EEEEEE Health Care Systems, Inc.	EEEEEE Health Care Systems, Inc.	EEEEEE Health Care Systems, Inc.
XXXXXXXX China , Inc.	XXXXXXXX China , Inc.	XXXXXXXX China , Inc.
XXXXXXXX SMR, Inc.	XXXXXXXX SMR, Inc.	XXXXXXXX SMR, Inc.
XXXXXXXX Lighting, Inc.	XXXXXXXX Lighting, Inc.	XXXXXXXX Lighting, Inc.
MDI Systems, Inc.	MDI Systems, Inc.	MDI Systems, Inc.
XXXXXXXX Ardis, Inc.	XXXXXXXX Ardis, Inc.	XXXXXXXX Ardis, Inc.
CCCCCC Communications Corporation	CCCCCC Communications Corporation	CCCCCC Communications Corporation
CCCCCC Digital Services Inc.	CCCCCC Digital Services Inc.	CCCCCC Digital Services Inc.
CCCCCC Group, Inc.	CCCCCC Group, Inc.	CCCCCC Group, Inc.
EEEEEE Communication Services, Inc.	EEEEEE Communication Services, Inc.	EEEEEE Communication Services, Inc.
MMMMMM Enterprises, Inc.	MMMMMM Enterprises, Inc.	MMMMMM Enterprises, Inc.
MMMMMM Trunked Radio Communications Systems, Inc.	MMMMMM Trunked Radio Communications Systems, Inc.	MMMMMM Trunked Radio Communications Systems, Inc.
NNNNNN Tower Trunking Systems, Inc.	NNNNNN Tower Trunking Systems, Inc.	NNNNNN Tower Trunking Systems, Inc.
Iridium, Inc.		
AAAAAA Communications Corporation	AAAAAA Communications Corporation	AAAAAA Communications Corporation
OOOOOO TC Corporation	OOOOOO TC Corporation	OOOOOO TC Corporation
CCCCCC International	CCCCCC International	CCCCCC International

XXXXXXXX CVD, Inc.	XXXXXXXX CVD, Inc.	XXXXXXXX CVD, Inc.
CCCCCC, Inc.	CCCCCC, Inc.	CCCCCC, Inc.
XXXXXXXX SF, Inc.	XXXXXXXX SF, Inc.	XXXXXXXX SF, Inc.
ICICIC Holding Company, Inc.	ICICIC Holding Company, Inc.	ICICIC Holding Company, Inc.
CCCCCC Systems, Inc.	CCCCCC Systems, Inc.	
IIIII Enterprises, Inc.	IIIII Enterprises, Inc.	IIIII Enterprises, Inc.
XXXXXXXX Energy Systems, Inc.	XXXXXXXX Energy Systems, Inc.	XXXXXXXX Energy Systems, Inc.
UUUUUU, Inc.	UUUUUU, Inc.	
DDDDDD Investment Corporation	DDDDDD Investment Corporation	DDDDDD Investment Corporation
EEEEEE Communications Consultants, Inc.	EEEEEE Communications Consultants, Inc.	EEEEEE Communications Consultants, Inc.
MMMMMM Communications, Inc.	MMMMMM Communications, Inc.	
IIIII Cellular Communications Inc.	IIIII Cellular Communications Inc.	
XXXXXXXX Automotive Products, Inc.	XXXXXXXX Automotive Products, Inc.	XXXXXXXX Automotive Products, Inc.
XXXXXXXX Communications and Electronics, Inc.	XXXXXXXX Communications and Electronics, Inc.	XXXXXXXX Communications and Electronics, Inc.
XXXXXXXX Military and Aerospace Electronics, Inc.	XXXXXXXX Military and Aerospace Electronics, Inc.	XXXXXXXX Military and Aerospace Electronics, Inc.
XXXXXXXX Semiconductor Products, Inc.	XXXXXXXX Semiconductor Products, Inc.	XXXXXXXX Semiconductor Products, Inc.
XXXXXXXX Communications International, Inc.	XXXXXXXX Communications International, Inc.	XXXXXXXX Communications International, Inc.
XXXXXXXX International Sales, Inc.	XXXXXXXX International Sales, Inc.	XXXXXXXX International Sales, Inc.
XXXXXXXX Information Systems, Inc.	XXXXXXXX Information Systems, Inc.	XXXXXXXX Information Systems, Inc.
CCCCCC International Ltd.	CCCCCC International Ltd.	CCCCCC International Ltd.
FFFFFFF Systems International, Inc.	FFFFFFF Systems International, Inc.	FFFFFFF Systems International, Inc.
XXXXXXXX A.C., Inc.	XXXXXXXX A.C., Inc.	XXXXXXXX A.C., Inc.
LLLLLL Satellite Services, Inc.	LLLLLL Satellite Services, Inc.	LLLLLL Satellite Services, Inc.
XXXXXXXX Cellular Holding, Inc.	XXXXXXXX Cellular Holding, Inc.	XXXXXXXX Cellular Holding, Inc.
XXXXXXXX Core Ventures, Inc.	XXXXXXXX Core Ventures, Inc.	XXXXXXXX Core Ventures, Inc.
XXXXXXXX International	XXXXXXXX International	XXXXXXXX International

Paging, Inc.	Paging, Inc.	Paging, Inc.
XXXXXXXX Pagetel, Inc.	XXXXXXXX Pagetel, Inc.	XXXXXXXX Pagetel, Inc.
XXXXXXXX Paging and Wireless Data, Inc.		
	XXXXXXXX Messaging, Information and Media, Inc.	XXXXXXXX Messaging, Information and Media, Inc.
XXXXXXXX Recovery Services Inc.	XXXXXXXX Recovery Services Inc.	XXXXXXXX Recovery Services Inc.
XXXXXXXX Computer Sales and Service, Inc.	XXXXXXXX Computer Sales and Service, Inc.	XXXXXXXX Computer Sales and Service, Inc.
XXXXXXXX Satellite Communications, Inc.	XXXXXXXX Satellite Communications, Inc.	XXXXXXXX Satellite Communications, Inc.
IIIII Corporation	IIIII Corporation	IIIII Corporation
Lexicus Corporation	Lexicus Corporation	
XXXXXXXX Wireless Service, Inc.	XXXXXXXX Wireless Service, Inc.	XXXXXXXX Wireless Service, Inc.
MMMMMM Mexico Corp.		
	NNNNNN Ventures I, Inc.	NNNNNN Ventures I, Inc.
XXXXXXXX RFID, Inc.	XXXXXXXX RFID, Inc.	XXXXXXXX RFID, Inc.
XXXXXXXX AIEG Holding, Inc.	XXXXXXXX AIEG Holding, Inc.	XXXXXXXX AIEG Holding, Inc.
	SSSSSS Communications, Inc.	SSSSSS Communications, Inc.
	MMMMMM, Inc.	MMMMMM, Inc.
	AAAAAA Communications, Inc.	AAAAAA Communications, Inc.
	MMMM Communications Corporation	
	TTTTT, Inc.	TTTTT, Inc.
	XXXXXXXX Ardis Acquisition Inc.	
	NNNNNNNN Long Distance Mexico Holding, Inc.	NNNNNNNN Long Distance Mexico Holding, Inc.
	NNNNNNNN Telecom Mexico, Inc.	NNNNNNNN Telecom Mexico, Inc.
	XXXXXXXX PCS, Inc.	
	EEEEEE, Inc.	EEEEEE, Inc.
	EEEEEE Sub, Inc.	EEEEEE Sub, Inc.
	NNNNNNNN II, Inc.	NNNNNNNN II, Inc.
	PPPP Holding Corporation	PPPP Holding Corporation
		C, Inc.
		CCCC, Inc.
		XXXXXXXX International

		Network Ventures, Inc.
		XXXXXXXX Iridium Network Investments, Inc.
		XXXXXXXX Caribe Pacifico Limited
		MMMMM Communications Corp.
		MMMM, Inc.
		MMMMMMM Communications, Inc.
		XXXXXXXX Semiconductor Products, Inc.
		NNNNNNNN III, Inc.
		OOO Capital Partners, Inc.
		TTTTTTT Investments International, Inc.
		WWW SP, Inc.
		XXXXXXXX Ardis Acquisition Inc.

Dept. Ex. 6, 7, 8.

4. XXXXXXXX filed combined tax returns for the tax years ended 12/31/93, 12/31/94 and 12/31/95. The combined group included in these returns consisted of the following companies: XXXXXXXX, Inc., XXXXXXXX International Development Corporation, XXXXXXXX International Capital Corporation and XXXXXXXX Credit Corp. Dept. Ex. 3, 4, 5.
5. XXXXXXXX filed amended combined returns for the tax years ended 12/31/93, 12/31/94 and 12/31/95. These returns included all of the domestic companies in which XXXXXXXX directly or indirectly owned over 80% of the stock included in its federal consolidated income tax return (“XXXXXXXX affiliated group”). Subsequently, the parties agreed that XXXXXXXX Credit Corp. should be excluded from XXXXXXXX’s combined returns for these years. Tr. pp. 9, 13, 14, 1197, 1200, 1201; Dept. Ex. 6, 7, 8.

6. The business activities of XXXXXXXX and its subsidiaries are organized into 6 major organizational units. These units are structured along lines of business and are designed to serve particular markets. The principal lines of business conducted by XXXXXXXX are the design, manufacture, sale, installation and service of: i) cellular infrastructure and radio telephone equipment, computers and microcomputer boards (conducted by the General Systems Sector); (ii) semiconductors and integrated circuits (the Semiconductor Products Sector); (iii) pagers and paging systems, wireless and wireless data communications products, pager infrastructure and other related products (the Messaging, Information and Media Sector); (iv) analog and digital two way voice and data products and systems (the Land Mobile Products Sector); v) electronic equipment primarily for government, military and aerospace use (the Government and Systems Technology Group); and vi) electronic engine controls and other automotive and industrial electronic equipment (the Automotive, Energy and Controls Group). Sectors are the largest organizational units in XXXXXXXX, and ordinarily have sales exceeding \$1 billion annually. Organizational units having the attributes of sectors but with less than \$1 billion in sales annually are sometimes designated as groups. Sectors and large groups are divided into groups, groups are divided into divisions, and subsidiaries are units of groups and divisions. Sectors and groups are not separate legal entities. They are part of XXXXXXXX, Inc. and are distinct types of organizational units separate from, and not synonymous with subsidiaries. Divisions are units of sectors or large groups, organized based on geographic markets (e.g. Europe, North America, Asia) or particular technologies

(e.g. digital telephones). Tr. pp. 52 - 61, 925, 1035, 1036; Taxpayer’s Brief Ex. 1A; Taxpayer’s Ex. 11A, 11B, 11C, 63, 64, 65.

7. Sectors, groups and divisions are managed by general managers and managers who are executive vice presidents or other officers of XXXXXXXX. Sector chief executives report to XXXXXXXX’s chief executive officer and chief operating officer. The management of XXXXXXXX’s sectors and groups manages XXXXXXXX’s subsidiaries. These managers are officers of XXXXXXXX, Inc. General managers of sectors and groups report to the Office of the Chairman of the Board composed of GT, chief executive officer (“CEO”) and CG, grandson of the company’s founder, the chief operating officer (“COO”) of XXXXXXXX, Inc. Tr. pp. 20, 60, 90, 91, 92, 437, 927, 1035, 1036; Taxpayer’s Ex. 11A, 11B, 11C, 63, 64, 65.
8. XXXXXXXX subsidiaries are either active or inactive subsidiaries. Inactive subsidiaries include subsidiaries established: i) for the sole purpose of giving officer titles to employees engaged in marketing XXXXXXXX products; ii) to facilitate compliance with local laws; iii) to hold business licenses; iv) to hold interests in joint ventures; v) to be spun off; and vi) for tax reasons. Tr. pp. 367, 368, 380, 381, 399, 537, 538, 1022 - 1026, 1041, 1075, 1076, 1104, 1159.
9. Subsidiaries are assigned to sectors and groups based on the products they produce and the markets they serve. The sectors, or groups, and business activities of most of XXXXXXXX’s domestic subsidiaries are indicated below:

<b>NAME OF SUBSIDIARY</b>	<b>SECTOR</b>	<b>BUSINESS ACTIVITY</b>
AAAAA Communications (Tr. p. 1045)	General Systems	Cellular phone technology Licensing
AAAAB Communications (Tr. p. 1046)	General Systems	Cellular phone technology licensing
CCCCC, Inc.	General Systems	Cellular phone technology

(Tr. pp. 1046, 1047)		licensing; marketing
CCCCC International Ltd. (Tr. p. 1048)	Messaging, Information and Media (“MIMs”)	Modem production and distribution
CCC Inc. (Tr. p. 1048, 1114)	Government & Systems Technology	Satellite communications technology development
CCCCC Systems, Inc. (Tr. pp. 1048, 1049, 1069)	MIMs	Paging business
CCCCC Communications Corporation (Tr. pp. 1049, 1114)	MIMs	Paging business
CCCCC Digital Services, Inc. (Tr. pp. 1049, 1115)	MIMs	Paging business
CCCCC Group, Inc. (Tr. pp. 1049, 1115)	MIMs	Paging business
CCC International (Tr. pp. 1049, 1050)	General Systems	Application of computer technology
CCCC, Inc. (Tr. pp. 1050, 1102, 1103)	General Systems	Cellular phone technology licensing
DDDD Investment Company (Tr. p. 1050)	General Systems	Cellular phone technology; holding foreign investments in technology companies
EEEEEE Communications Services (Tr. pp. 1051, 1084)	MIMs	Wireless data
EEE Communications (Tr. p. 1051)	MIMs	Paging business
EEEEEE Health Care Systems, Inc. (Tr. pp. 1051, 1052, 1112)	MIMs	Wireless data business for hospitals (manufacturing of equipment and software)
ESMR Sub, Inc. (Tr. p. 1052)	General Systems	Cellular phone technology licensing
E, Inc. (Tr. pp. 1052, 1053)	General Systems	Cellular phone technology; holding investments in technology companies
FFFFF System International, Inc. (Tr. p. 1053)	General Systems	Computer technology
IIIII Corporation (Tr. pp. 1053, 1111)	Automotive, Energy and Controls Group (“Automotive”)	Wireless data transmission
III Enterprises, Inc. (Tr. pp. 1053, 1117)	Corporate	Joint venture with Texas Instruments

II Cellular Communications, Inc. (Wireless SP, Inc.) (Tr. pp. 1054, 1121, 1122)	Land Mobile Products	Cellular phone and voice and data transmission technology licensing
IIIIII Holding Corporation (Tr. p. 1103)	Not identified	Intellectual property holding company
I, Inc. (Tr. p. 1054)	Government and Systems Technologies	Satellite communications business
I Network Investments, Inc. (Tr. p. 1120)	Government and Systems Technologies	Holding company for insurance investments of companies participating in Iridium spin off – including companies buying components to build cellular infrastructure
IIIIIIII Creek Holding Company, Inc. (Tr. pp. 1054, 1122)	Automotive or XXXXXXXX Headquarters operations (“Corporate”)	Real estate holding company
LLL Satellite Services, Inc. (Tr. pp. 1054, 1123)	Government & Systems Technology	Satellite communications business
LLLLLLLL Corporation (Tr. pp. 1054, 1055, 1115, 1116)	MIMs	Development of handwriting recognition software and technology
MMM Systems, Inc. (Tr. p. 1055)	MIMs	Wireless data business
MMMMMMM Trunked Radio Communications Systems, Inc. (Tr. p. 1056)	General Systems	Application of cellular phone technology
MMMM Communications Corporation (Tr. p. 1070)	General Systems	Application of cellular phone technology
MMM Enterprises, Inc. (Tr. p. 1070)	General Systems	Application of cellular phone technology
MMM Mexico Corp. (Tr. pp. 1056, 1107)	General Systems	Overseas cellular telephone technology development
MMM, Inc. (Tr. pp. 1056, 1127)	General Systems	Overseas cellular telephone technology development
MMM Communications, Inc. (Tr. pp. 1056, 1057, 1125, 1126)	General Systems	Application of personal communications technologies

XXXXXXXX A.C., Inc. (Tr. pp. 1057, 1127, 1128)	Land Mobile Products	Formed to bid on contracts
XXXXXXXX AIEG Holding, Inc. (Tr. pp. 1057, 1116)	MIMs	Development of wireless data transfer; joint venture with French company
XXXXXXXX Ardis Acquisitions (Tr. pp. 1057, 1058)	MIMs	Application of wireless data
XXXXXXXX Ardis, Inc. (Tr. pp. 1057, 1058)	MIMs	Application of wireless data
XXXXXXXX Automotive Products, Inc. (Tr. pp. 1058, 1106)	Automotive	Marketing – company formed to give titles to marketing staff ( “titling company”)
XXXXXXXX Caribe Pacifico Limited (Tr. pp. 1058, 1117)	General Systems	Overseas technology development company formed to hold license to operate cellular systems in Honduras
XXXXXXXX Cellular Holding, Inc. (Tr. pp. 1058, 1059, 1070, 1071, 1112)	General Systems	Joint venture interest holding company; joint venture with Canadian company
XXXXXXXX Celluar Service, Inc. (CA) (Tr. pp. 1059, 1111)	General Systems	Cellular phone service marketing (sale of cellular phone service minutes)
XXXXXXXX Cellular Service, Inc. (IL) (Tr. pp. 1107, 1108)	General Systems	Cellular phone service marketing (sale of cellular phone service minutes)
XXXXXXXX China, Inc. (Tr. pp.1060, 1128)	Corporate	Marketing (titling company)
XXXXXXXX Communications and Electronic, Inc. (Tr. pp. 1060, 1103, 1104)	Land Mobile Products	Marketing (titling company)
XXXXXXXX Communications International, Inc. (Tr. pp. 1060, 1061, 1104, 1105)	Land Mobile Products	Marketing (titling company)
XXXXXXXX Computer Sales and Service, Inc. (Tr. pp. 1061, 1106)	General Systems	Marketing (titling company)
XXXXXXXX Core Ventures,	General Systems	Joint venture to develop

Inc. (Tr. pp. 1061, 1071)		portable energy for cell phones and handsets
XXXXXXXX CVD, Inc. (Tr. pp. 1061, 1071, 1105, 1106)	General Systems	Overseas cellular telephone technology development
XXXXXXXX De Puerto Rico, Inc. (Tr. pp. 1061, 1121)	Corporate	Set up for tax reasons
XXXXXXXX Energy System, Inc. (Tr. pp. 1061, 1062)	Automotive	Manufacture of component parts for Land Mobile Products
XXXXXXXX Information Systems (Tr. pp. 1071, 1072; Taxpayer's Ex. 63, 64, 65)	MIMs	Design, manufacture and distribution of messaging products
XXXXXXXX International Capital Corporation (Tr. pp. 1062, 1108)	Corporate	Overseas lending
XXXXXXXX International Development Corporation (Tr. p. 1062)	Corporate	Holding company for international subsidiaries
XXXXXXXX International Inc. (Tr. pp. 1062, 1109)	Corporate	Titling company
XXXXXXXX International Network Joint Ventures, Inc. (Tr. pp. 1062, 1123, 1124)	General Systems	Overseas development of technology
XXXXXXXX International Paging, Inc. (Tr. pp. 1063, 1123)	MIMs	Holding company for interests in foreign paging companies
XXXXXXXX International Sales, Inc. (Tr. pp. 1063, 1113)	Corporate	Titling company
XXXXXXXX Iridium Network Investments, Inc. (Tr. p. 1063)	Government and Systems Technology	Holding company for interest in foreign technology companies
XXXXXXXX Lighting, Inc. (Tr. pp. 1063, 1109)	Automotive	Manufacturing light and electronic ballast technology based products
XXXXXXXX Messaging, Information, and Media, Inc.	MIMs	Titling company

(Tr. p. 1063)		
XXXXXXX Military and Aerospace Electronics, Inc. (Tr. pp. 1063, 1064)	Government and Systems Technology	Sale of satellite equipment
XXXXXXX Pagetel, Inc. (Tr. pp. 1064, 1094, 1095)	MIMs	Paging joint venture (investment in paging businesses)
XXXXXXX PCS, Inc. (Tr. pp. 1064, 1119; Taxpayer's Ex. 63, 64, 65)	General System	Titling company
XXXXXXX Recovery Services, Inc. (Tr. pp. 1064, 1126, 1127)	General Systems	Cellular infrastructure repair
XXXXXXX RFID, Inc. (Tr. pp. 1064, 1065, 1113)	Government and Systems Technology	Joint venture to develop technology for use in satellite systems
XXXXXXX Satellite Communications, Inc. (Tr. pp. 1065, 1110)	Government and Systems Technology	Activities related to satellite business
XXXXXXX Semiconductor Products, Inc. (Tr. pp. 1065, 1125)	Semiconductor	Titling company
XXXXXXX SMR, Inc. (Tr. pp. 1065, 1110, 1111)	Land Mobile Products	Technology licensing
XXXXXXX SP, Inc. (Tr. pp. 1065, 1072)	Semiconductor	Holding company for investment in semiconductor technology companies
XXXXXXX Wireless Service, Inc. (Tr. p. 1072)	Not identified	Not identified
MMMM, Inc. (Tr. pp. 1066, 1072)	General Systems	Overseas technology development
NNNN Trunking Systems, Inc. (Tr. p. 1066)	General Systems	Overseas technology development
NNNN Ventures I, Inc. (Tr. p. 1066)	General Systems	Overseas technology development
NNNN Ventures II, Inc. (Tr. p. 1066)	General Systems	Overseas technology development
NNNN Ventures III, Inc. (Tr. p. 1066)	General Systems	Overseas technology development

NNNN Ventures Long Distance Mexico Holdings, Inc. (Tr. pp. 1066, 1124, 1125)	General Systems	Investment in overseas companies to assist in marketing and sale of equipment
NNNN Ventures Telecom Mexico, Inc. (Tr. pp. 1066, 1124)	General Systems	Overseas technology development; holding licenses or making investments in companies to seed growth of cellular operating companies overseas
OOOOO Corporation (Tr. p. 1066)	Not identified	Development of new technologies (photo stripping)
OOO Capital Partners, Inc. (Tr. pp. 1066, 1067, 1072, 1128)	General Systems	Investment in overseas technology investment to seed businesses so could sell them equipment
PPPPP Design, Inc. (Tr. p. 1067)	Semiconductor	Development of semiconductor technology
SSSSS Communications, Inc. (Tr. p. 1067)	General Systems	Application of cellular phone technology
TTTTTT Investments International Inc. (Tr. pp. 1072, 1073, 1119, 1120)	General Systems	Holding company for interest in French computer company
TTT, Inc. (Tr. p. 1067)	Not identified	Not identified
UUUUUU, Inc. (Tr. pp. 1067, 1118)	MIMs	Manufacture of paging equipment
UUUU Data Systems (Tr. pp. 1068, 1118, 1119)	MIMs	Application of wireless data technology
WWWWW SP, Inc. (Tr. pp. 1073, 1121, 1122)	Land Mobile Products	Application of wireless technology

- 10.** The heads of XXXXXXXX's sectors meet twice a month as an operating group or operating committee which also includes XXXXXXXX's corporate chief financial officer ("CFO") and corporate vice president of human resources. This group monitors the financial performance of the company (i.e. sales, profits, cash flow, inventory turns) to determine whether financial results are meeting management goals and expectations. Subsidiaries are represented by sector management, i.e. XXXXXXXX, Inc. officers, at these meetings. Tr. pp. 94 - 96, 986.
- 11.** Sector heads, the heads of human resources, finance and other corporate staff functions and regional heads for Asia, Europe, the Middle East, Africa and Latin America, along with the CEO and COO, comprise XXXXXXXX's management board. The management board is responsible for the overall governance of XXXXXXXX and the XXXXXXXX affiliated group. This board meets six times a year at XXXXXXXX's headquarters in "Someplace", Illinois to review business operations and look at significant policy issues affecting XXXXXXXX and the XXXXXXXX affiliated group. Tr. pp. 90 - 94.
- 12.** XXXXXXXX has corporate and sector human resources functions that are responsible for personnel matters.<sup>4</sup> XXXXXXXX's sectors and groups have their own human resources directors who head human resources functions that are separate from XXXXXXXX's corporate human resources function. Each sector's human resources director reports to the chief executive of the sector and to the corporate director of human resources. Sector and group human resources functions develop their own

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<sup>4</sup> XXXXXXXX "corporate" refers to XXXXXXXX Inc. headquarters operations.

human resources policies and procedures. Tr. pp. 101, 123, 129, 130, 131; Taxpayer's Ex. 2.

**13.** XXXXXXXX corporate centrally administers the XXXXXXXX and XXXXXXXX affiliated group loss prevention programs, and is responsible for protecting the XXXXXXXX and XXXXXXXX affiliated group assets from theft. The corporate human resources function provides loss prevention and security related services to all subsidiaries, and sets policies and standards governing corporate secrecy, protection of proprietary information and loss prevention (anti-theft) procedures. These policies are binding on subsidiaries, and the corporate finance function, working with corporate human resources, conducts audits of all of XXXXXXXX's subsidiaries to monitor compliance with these policies and standards. Tr. pp. 175 - 178.

**14.** Benefits and salaries are established by corporate human resources. Pursuant to guidelines established by XXXXXXXX corporate, the same benefits are provided to all employees regardless of sector, group, division, subsidiary or business unit. Corporate human resources also supervises training and education of employees, human resources related legislative compliance, including affirmative action plans, and wage and hour issues. Human resources policies, including the company code of conduct, are developed by corporate, in conjunction with representatives from each of the company's sectors and groups. Most of these policies are disseminated to all segments of XXXXXXXX's business including sectors and subsidiaries through the distribution of the human resources "guidebook" and are used as a basis for establishing policies at the sector level. Tr. pp. 99, 100, 119, 122 - 131, 134, 135, 180; Taxpayer 's Ex. 2.

- 15.** GG is the Executive Vice President of corporate human resources. He reports to GT, the company's chief executive officer, heads the 3000 – 4000 person corporate human resources function, and is responsible for recruitment, compensation matters, training and development of the workforce of XXXXXXXX and all of its subsidiaries. Mr. G is responsible for performance appraisals, rewards administration, management and career movement of sector human resources directors. Tr. pp. 48, 49, 101, 102, 117 - 120, 147 - 149.
- 16.** The training function is conducted in part at XXXXXXXX University, a training facility established and run by corporate human resources. Tr. pp. 148, 149; Taxpayer's Ex. 12.
- 17.** Finance matters, including cash management and treasury functions are handled at the corporate level and by sectors and groups. Tr. pp. 100, 101.
- 18.** Some of XXXXXXXX's subsidiaries have their own accounting departments. Accounting functions performed at the subsidiary level include the preparation of trial balances, operating statements and other details to support consolidated financial statements prepared at the sector or group level. Sectors and groups are responsible for consolidating the operating results of all of their subsidiaries and other operating units. Tr. pp. 397, 561, 562.
- 19.** Subsidiaries are authorized to handle their own cash and manage their own bank accounts. However, this authority is exercised exclusively by, or through, a delegation of authority from the CFO and treasurer of XXXXXXXX, Inc. acting in their capacities as officers and directors of XXXXXXXX subsidiaries. XXXXXXXX's chief financial officer and treasurer, acting in their capacities as officers of

XXXXXXX subsidiaries, are given exclusive authority over subsidiary banking activities and borrowing, and neither the chief executive officer nor any other officer of a subsidiary has any authority over these subsidiary functions. Where the chief financial officer, or the treasurer delegates this authority, it is generally given to someone in accounting or financial planning at a larger subsidiary or to the president or controller of a smaller subsidiary. Tr. pp. 364 - 379, 396, 397, 1038, 1039; Taxpayer's Ex. 18, 46.

20. XXXXXXX's corporate treasury function supervises the management of cash generated by XXXXXXX and by all of the company's active subsidiaries. Cash generated by subsidiary sales and accounts receivable is deposited in subsidiary bank accounts. Cash is swept from these accounts into a central account and invested by XXXXXXX on a daily basis. Cash swept into XXXXXXX's account is accounted for as a loan to XXXXXXX from its subsidiaries. When the corporate treasury function determines that a subsidiary needs cash to make payroll or cover other recurring expenses, cash is transferred back to the subsidiary. These transfers are accounted for as reductions in corporate loans from subsidiaries or as corporate loans to subsidiaries.
- Wire transfers, which are handled by corporate on behalf of subsidiaries, are accounted for as loans or loan repayments. XXXXXXX's treasurer maintains inter-company loan accounts, which reflect these advances and repayments as a net figure. The interest rate charged to XXXXXXX and to subsidiaries on these inter-company loans is the current money market rate plus a small markup, generally around a quarter percent. Tr. pp. 373, 375 - 382, 394, 399, 409 - 412.

- 21.** Subsidiaries are authorized to borrow from sources other than XXXXXXXX, Inc. pursuant to internal borrowing resolutions and agreements with financial institutions. However, with the exception of XXXXXXXX Credit Corp., subsidiaries have never borrowed from such sources. Tr. p. 373; Taxpayer's Ex. 18.
- 22.** XXXXXXXX subsidiaries invest excess cash exclusively through XXXXXXXX, and have no authority to invest excess cash independently. Tr. pp. 376, 384, 385, 409.
- 23.** CK is the chief financial officer of XXXXXXXX. Persons responsible for the supervision of sector financial affairs report to Mr. K. Sector financial chief executives also report to sector "presidents" who are officers of XXXXXXXX, Inc. Mr. K is responsible for performance appraisals, rewards administration, management and career movement of sector financial chief executives. Tr. pp. 101, 102, 427, 428.
- 24.** While subsidiaries prepare separate financials in order to comply with government reporting requirements, they report their financial results as part of a consolidated sector or group report rather than on a separate company basis for management and financial reporting purposes. Tr. pp. 445, 446, 482, 483, 562.
- 25.** The corporate finance function of XXXXXXXX has the responsibility of consolidating the financial statements from all subsidiaries with the parent company. Tr. p. 100.
- 26.** XXXXXXXX's corporate treasury function provides various services to all of its subsidiaries including handling foreign exchange transactions, stock option administration, letters of credit, traveler's checks, bills of lading, wire transfers, and performance bonds. Tr. pp. 374, 375, 381, 390 - 393.
- 27.** XXXXXXXX's corporate controller function has the responsibility of consolidating the financial statements from all XXXXXXXX sectors, groups and subsidiaries with the

parent company and compliance with SEC and other legally mandated financial reporting obligations and standards. Tr. pp. 468, 469, 481, 482.

- 28.** XXXXXXXX's corporate internal audit department, part of its corporate controller's function, audits the records of all of XXXXXXXX's subsidiaries to assure compliance with regulatory and accounting rules and procedures, and asset protection and other policies. Mandatory correction of deficiencies discovered during internal audits at subsidiaries and other units of XXXXXXXX is enforced by XXXXXXXX's Board of Directors. Tr. pp. 476 - 481, 483; Taxpayer's Ex. 34, 35, 37.
- 29.** BS is the chief strategy officer of XXXXXXXX. The corporate strategy office, which Mr. S heads, is part of XXXXXXXX's corporate function, and reports to the chief executive officer. The strategy office is responsible for overseeing XXXXXXXX and XXXXXXXX affiliated group resource budgeting and future planning processes. Tr. pp. 272 - 276, 344.
- 30.** XXXXXXXX has an annual planning process whereby human resources and other corporate functions, and each operating segment of XXXXXXXX and the XXXXXXXX affiliated group including sectors, groups and subsidiaries, present their staffing, marketing, technology and other objectives for the coming year. Presentations are made to the corporate planning function, the chief executive officer and the Board of Directors of XXXXXXXX, each of which evaluates these projections both with a view to what is reasonable for the sector, group or subsidiary and what the total return will be. Ultimately, the objectives of each segment of the business are determined by XXXXXXXX's corporate planning function, subject to the review and approval of XXXXXXXX's chief executive officer and the Board of Directors, and memorialized

in a long range plan, generally covering 5 years. Tr. pp. 448 - 464, 467; Taxpayer's Ex. 15.

**31.** Long-term strategic plans are formulated annually, initially by operating subsidiaries, divisions, groups and sectors pursuant to instructions from, and under the supervision of XXXXXXXX's corporate strategy office. Long range plans normally cover a 5 year period. The structure used to develop long-range plans at the corporate, sector, group, division and subsidiary levels is formulated at the corporate level. The long-range planning process seeks to prioritize the allocation of financial, intellectual property and workforce resources. Long-range plans formulated by groups, divisions and subsidiaries are consolidated by the sectors and discussed with, and modified by, corporate strategic planning. Sector and group plans, as modified, are the basis for a consolidated long range plan developed by the corporate strategic planning function and the office of the CEO. Implementation of long range plans requires the approval of the chief executive officer and the Board of Directors. Subsidiary plans are subject to modification by, or at the behest of, sectors, groups or the corporate strategy function without the approval of subsidiaries. Sector and group plans, as modified, are the basis for a consolidated long-range plan developed by the corporate strategic planning function and the office of the CEO. Tr. pp. 273 - 276, 288, 289, 292 - 294, 297 - 305, 307, 308, 310, 344, 345; Taxpayer's Ex. 15, 17.

**32.** Budgets for every segment of XXXXXXXX's business, including subsidiaries, are created by XXXXXXXX's corporate planning function, and by sectors and groups, subject to review by XXXXXXXX's chief executive officer and Board of Directors. These budgets are based on long range plans developed by XXXXXXXX's corporate

function and approved by its chief executive officer and Board of Directors. Tr. pp. 449 - 451, 526 - 532.

**33.** In implementing the long range plan developed by the corporate strategy function, in conjunction with the sectors, groups and subsidiaries, corporate strategy prepares a budget and strategic targets, which are reviewed and approved by the chief financial officer, the chief executive officer and the Board of Directors. Upon approval, these budgets establish mandatory staffing, expenditure, financing and other targets which each sector, group, division and subsidiary must meet. Accordingly, the budget developed by corporate strategy dictates headcount and other expenditure priorities, and sets mandatory financial targets for all levels of the enterprise including subsidiaries. Tr. pp. 310 - 312.

**34.** Budgets developed by the corporate planning function and the chief executive officer take into account revenue and expenditure projections developed at the subsidiary, group and sector level. Tr. pp. 325 - 329.

**35.** XXXXXXXX and its subsidiaries have officers and directors in common. The treasurer, the chief financial officer and the secretary of XXXXXXXX serve as officers or directors of every XXXXXXXX subsidiary. RD, the vice president of taxes, also serves as an officer of XXXXXXXX's subsidiaries. The chief executive officers of each of XXXXXXXX's business sectors or lines of business also serve as officers of XXXXXXXX subsidiaries. Officers and directors of XXXXXXXX domestic subsidiaries are elected directly or indirectly by XXXXXXXX by virtue of its status as a direct or first tier sole or majority shareholder. Tr. pp. 365 - 367, 397, 1036 - 1039, 1151 - 1153.

- 36.** XXXXXXXX corporate provides payroll services to subsidiaries. These services are performed by XXXXXXXX's corporate finance function. Tr. pp. 181, 182.
- 37.** XXXXXXXX provides workmen's compensation services to its subsidiaries. Workmen's compensation is centrally administered by the corporate human resources function. It is managed and outsourced by corporate human resources. Tr. pp. 206, 207, 390.
- 38.** XXXXXXXX corporate provides insurance services to subsidiaries. This function includes the provision of property, automobile and officer and director liability insurance covering all domestic and foreign subsidiaries. Tr. pp. 387 - 390.
- 39.** Stock options are granted and administered by XXXXXXXX's corporate human resources function. All employees of XXXXXXXX and its subsidiaries receive stock options in stock of XXXXXXXX. Tr. pp. 391, 392.
- 40.** XXXXXXXX has one pension and profit sharing plan covering employees of XXXXXXXX and all of its domestic subsidiaries. Management of retirement funds for XXXXXXXX and all of its subsidiaries is the exclusive responsibility of the XXXXXXXX corporate treasury function. Tr. pp. 385 - 387.
- 41.** All XXXXXXXX subsidiaries use patents, trademarks, service marks, logo-types, trade secrets, copyrights, or other proprietary materials owned by XXXXXXXX. Responsibility for protecting and preserving XXXXXXXX patents, trademarks and other intellectual property rights through legal action, and by monitoring the use of these assets is an exclusively, corporate function. XXXXXXXX's corporate legal department is responsible for legally protecting XXXXXXXX's trademark and intellectual property rights. JW is the director and manager of corporate identity. He

is responsible for developing and implementing plans to train and monitor personnel regarding the proper marketing and other use of the XXXXXXXX trademark. Policies regarding the use of intellectual property (e.g. proper use of trademarks or patents) are formulated by Mr. W, subject to the review and approval of the law department and the chief executive officer, and disseminated to all employees of the XXXXXXXX organization, including employees of subsidiaries through the “corporate identity manual.” These policies are made applicable to subsidiaries. Compliance with these policies at all levels of XXXXXXXX and the XXXXXXXX affiliated group, including the subsidiary level, is mandatory and enforced through the intervention of the chief executive officer where necessary. Tr. pp. 579 - 600, 602, 603, 609 - 611, 628, 632, 1073 - 1075; Taxpayer’s Ex. 41.

**42.** XXXXXXXX operating subsidiaries have their own advertising departments and conduct advertising functions autonomously. Directors of subsidiary advertising departments report to subsidiary, group or sector management. Advertising is also conducted by XXXXXXXX’s corporate function through its corporate advertising department. Autonomously developed subsidiary advertising is required to comply with corporate identity policies established by XXXXXXXX’s corporate function, some of which specifically cover advertising. Some subsidiaries are allowed to use their own trademarks in conjunction with XXXXXXXX trademarks. Tr. pp, 602 - 611, 627, 628.

**43.** The XXXXXXXX organization has a technology planning process, referred to as a technology review, whereby XXXXXXXX sectors, groups and subsidiaries meet periodically during the year to devise and review their technology objectives and

strategies. This process includes consideration of what components and systems might be needed in the future. At these technology review meetings, presentations are made to the chief executive officer, the chief operating officer, the head of corporate technology, and the director of corporate planning by sector and group technology officers. Meeting participants evaluate the evolution of technology and its impact on XXXXXXXX's long term plans, staffing and expenditure requirements necessary to bring new products on-line within a particular time frame, potential long term sales, profitability, gross margins, and pre-tax profits. The ultimate objective is to consider the impact of technology on the XXXXXXXX and XXXXXXXX affiliated group long term plans, and modify those plans to meet technology needs where necessary. Tr. pp. 651 - 654, 658 - 662, 668 - 688.

**44.** To facilitate technology planning, various technology steering committees and councils have been established. Technology steering committees are multi-sector groups sharing a common interest in a particular type of technology. Steering committees are responsible for recommending to the chief executive officer what XXXXXXXX and the XXXXXXXX affiliated group should be doing in a particular area of technology. Councils are also composed of representatives from differing sectors, groups and subsidiaries and are established to focus attention on fundamental disciplines related to the competitiveness of XXXXXXXX and the XXXXXXXX affiliated group. Tr. pp. 694 - 699, 711.

**45.** XXXXXXXX councils afford a vehicle to disseminate information concerning common technologies and disciplines across sectors, groups and subsidiaries. The Project Development Institute, and the Science Advisory Board, which are composed

of representatives from differing sectors and groups, help facilitate this function. Tr. pp. 711 - 718.

**46.** Research and development is undertaken at the corporate level, as well as in sectors, groups and subsidiaries. XXXXXXXX corporate provides research and development services to subsidiaries, sectors and groups. Tr. pp. 718 - 721, 758, 759.

**47.** The development of new technology is an integral part of XXXXXXXX and the XXXXXXXX affiliated group's business of manufacturing and marketing technology based products. XXXXXXXX officers and employees conduct the function of acquiring, managing, protecting and licensing patents, trademarks and other intellectual property at the corporate level. XXXXXXXX's domestic subsidiaries do not have their own separate patent, trademark and technology licensing departments. Tr. pp. 751 - 753, 755, 756, 758.

**48.** XXXXXXXX owns all patents, trademarks and other intellectual properties related to XXXXXXXX's businesses, whether or not developed or acquired by subsidiaries. None of these assets are the property of XXXXXXXX subsidiaries. Since XXXXXXXX has 25,000 to 30,000 patents, vesting exclusive ownership with XXXXXXXX is necessary to properly manage XXXXXXXX patents and trademarks and defend them from infringement. Tr. pp. 766 - 768.

**49.** Patent and trademark services are provided to all segments of XXXXXXXX and the XXXXXXXX affiliated group, including subsidiaries, by the corporate patent, trademark and technology function headed by JWG, the director of patents, trademarks and technology. Corporate responsibilities include managing the acquisition, registration, protection and licensing of patents, trademarks and other

intellectual property. Mr. G reports to XXXXXXXX's corporate strategy officer (Director of Strategy and Operations). All patent attorneys, patent agents and other patent professionals assigned to or employed by XXXXXXXX sectors, groups and subsidiaries, along with their support staff (approximately 225 people), report to Mr. G. Group and sector patent professionals are part of XXXXXXXX's corporate function. Tr. pp. 751 - 757.

**50.** Research engineers from throughout XXXXXXXX's sectors, groups and subsidiaries invent new products and technologies. Research engineers inventing new products or technologies submit them to subsidiary, sector or group patent committees composed of senior engineers, senior management of the subsidiary, sector or group and patent attorneys assigned to the subsidiary, sector or group, which decide whether a patent application should be filed. By virtue of terms contained in XXXXXXXX's employment agreements, all inventions created by any employee of XXXXXXXX or the XXXXXXXX affiliated group become the property of XXXXXXXX, and these inventions cannot be patented by any person other than XXXXXXXX without XXXXXXXX's approval. Tr. pp. 758 - 767, 771; Taxpayer's Ex. 58, 59.

**51.** The use of XXXXXXXX technology by both related and unrelated parties, and the use of technology acquired by XXXXXXXX from unrelated parties is governed by XXXXXXXX's technology transfer policy. Pursuant to this policy, any domestic sector, group or subsidiary is entitled to use any XXXXXXXX patent, trademark or other intellectual property without charge. This policy applies to technology developed internally and technology acquired or licensed from third parties. Tr. pp. 781, 783 - 786, 788 - 791; Taxpayer's Ex. 62.

- 52.** All decisions regarding the transfer of technology outside of the XXXXXXXX organization are made by a technology transfer review board composed of representatives from XXXXXXXX corporate, sectors, groups and subsidiaries, subject to the approval of the chief executive officer. Subsidiaries are not permitted to transfer technologies outside of the company without the approval of this board. Tr. pp. 790 -795.
- 53.** The corporate patents, trademarks and technology function is exclusively responsible for the negotiation of agreements to transfer technology to unrelated third parties. XXXXXXXX is a party to all such agreements, including the transfer of technology invented by a subsidiary. Fees for licensing patents, trademarks and other intellectual property developed by XXXXXXXX units or subsidiaries are negotiated exclusively by, and paid to XXXXXXXX. These revenues are allocated back to the sector, group or subsidiary that originally developed the product or technology being licensed. Tr. pp. 793 - 795.
- 54.** Filing patent and trademark applications, protecting patents against infringement or unauthorized usage and defending XXXXXXXX against accusations of patent infringement is the exclusive responsibility of XXXXXXXX's corporate patents, trademarks and technology group. In resolving disputes concerning patent usage, XXXXXXXX's corporate patents, trademarks and technology group is authorized to license or cross-license (i.e. "swap") licenses to use intellectual property developed by a subsidiary to unrelated parties without the subsidiary's permission. Tr. pp. 771, 795 - 803.

- 55.** All costs related to the corporate patents, trademarks and technology function, including the cost of preparing and filing patents for inventions developed at subsidiaries, are allocated back to subsidiaries. Tr. pp. 809, 810.
- 56.** Each sector, group and operating unit (including operating subsidiaries) has its own real estate function. The sector, group and subsidiary real estate personnel are responsible for facilities maintenance and the day-to-day management and administration of real estate. Where facilities are shared, ultimate responsibility for day-to-day maintenance and management is established by the corporate real estate function, with the major responsibility being assigned to the subsidiary or other unit having the most space at the facility. Tr. pp. 861, 862, 898, 899, 938 - 944.
- 57.** Real estate services are provided to sectors, groups and subsidiaries by the corporate real estate function. These services include the acquisition and lease of real estate. The cost of acquiring or leasing facilities, provided by corporate, is allocated to sectors, groups and subsidiaries that use these facilities. Tr. pp. 899, 900.
- 58.** EL is the vice president and director of real estate design and construction. He is on the staff of, and reports to XXXXXXXX's chief financial officer, and is under the direct supervision of XXXXXXXX's chief executive officer and chief operating officer. Mr. L supervises a staff of 14 people. The corporate real estate function, which Mr. L heads, is responsible for acquiring, leasing and the disposition of real estate. These responsibilities include compiling data bases showing the location, amount of space, lease terms for leased property, and original land cost, construction cost and depreciation for owned property, for all facilities owned or leased by XXXXXXXX and its wholly-owned subsidiaries. This function is also responsible for

projecting XXXXXXXX's long-term real estate requirements, identifying potential locations for new facilities and establishing criteria for design and construction of facilities, joint uses by multiple XXXXXXXX units and site selection. Tr. pp. 858, 859 - 867, 869, 870 - 874.

**59.** The corporate real estate function is responsible for site selection and for negotiating the acquisition or lease of real properties on behalf of all units of XXXXXXXX and the XXXXXXXX affiliated group including domestic subsidiaries. Subsidiaries are required to share facilities with other units of the XXXXXXXX organization including other subsidiaries, (called "cohabitation"), under policies established by the corporate real estate function. This function also sets other policies and procedures governing how the costs of such properties are allocated between subsidiaries and other units sharing space in them. These policies also cover the design and construction of facilities. The corporate real estate function is assisted in developing these policies by a Real Estate Construction Council, which includes representatives from the corporate real estate function, and from sectors, groups and subsidiaries. Tr. pp. 485, 486, 866 - 880, 883 - 889, 899, 900; Taxpayer's Ex. 67.

**60.** Each operating unit of XXXXXXXX and the XXXXXXXX affiliated group (sector, group and operating subsidiary) has its own procurement function. These purchasing functions are authorized to act autonomously, to make purchases of materials and supplies without corporate approval, to negotiate bids and to determine their own purchase and inventory needs. Tr. pp. 1007 - 1009.

**61.** RP is corporate vice president of XXXXXXXX and director of supply and environmental management. Mr. P assumed this title in 1990. He reports to

XXXXXXXX's Executive Vice President and Director of Corporate Staff. Mr. P is responsible for encouraging and managing joint purchasing of supplies and component parts by XXXXXXXX sectors, groups and subsidiaries. Councils consisting of representatives from sectors, groups and subsidiaries assist Mr. P Tr. pp. 950 - 952, 956- 959.

**62.** XXXXXXXX's corporate purchasing function, headed by Mr. P, supplies purchasing services to XXXXXXXX and its active domestic subsidiaries. These services include bringing together experts from throughout XXXXXXXX's business to identify potential suppliers, aggregating purchasing requirements, negotiating bids for materials and supplies and identifying inventory already available within XXXXXXXX and the XXXXXXXX affiliated group. These services have produced quantifiable benefits to subsidiaries by reducing inventory costs and decreasing excess materials and supplies inventory. Tr. pp. 962 - 972.

**63.** While subsidiaries are not required to obtain or accept procurement services from XXXXXXXX corporate, and are authorized to perform procurement autonomously and independently, all active subsidiaries voluntarily agree to receive corporate procurement services in order to reduce operating costs. Tr pp. 973, 1008.

**64.** XXXXXXXX corporate provides travel services to XXXXXXXX and all of the company's subsidiaries including identifying and assisting representatives of business units (the travel council) in negotiating bulk travel discounts with airlines, rental car companies and hotels. It also sets policies concerning travel, governing approval of expense reimbursements, which are binding on subsidiaries. XXXXXXXX corporate

conducts audits to enforce compliance with these corporate policies. Tr. pp. 973 - 979.

**65.** XXXXXXXX corporate is responsible for promulgating, obtaining CEO approval of, implementing and enforcing environmental policies regarding compliance with environmental laws. XXXXXXXX corporate shares responsibility for these functions with the executive committee of the environmental council, which includes representatives from XXXXXXXX corporate and XXXXXXXX domestic subsidiaries. Environmental policies promulgated by corporate and the environmental council are binding on all units of XXXXXXXX and the XXXXXXXX affiliated group including subsidiaries. Compliance with these policies is enforced through the conduct of compliance audits, conducted jointly by XXXXXXXX corporate and XXXXXXXX sectors and groups, and through the intervention of the CEO, where necessary. Tr. pp. 980, 981, 984, 985, 988 - 996.

**66.** The cost of XXXXXXXX's corporate purchasing and environmental compliance functions is allocated to its business units and its subsidiaries. Tr. p. 1009.

**67.** The XXXXXXXX corporate legal department, headed by XXXXXXXX's corporate general counsel, provides legal services to all units of XXXXXXXX and the XXXXXXXX affiliated group including sectors, groups and subsidiaries, which do not have separate legal functions. This department is responsible for commercial transactions, securities law matters, labor law, corporate governance (preparing minutes, resolutions, etc.), litigation and the formation, merger (with XXXXXXXX) and dissolution of subsidiaries. Law department duties related to the organization, maintenance and dissolution of subsidiaries are under the supervision of CF who is

the senior counsel for transactions, securities and corporate in the law department and who reports to the general counsel. Ms. F is also responsible for the preparation of unanimous consents memorializing actions taken by shareholders and directors of subsidiaries. Tr. pp. 105, 106, 1013 - 1015, 1017 - 1022, 1028 - 1034, 1092, 1096; Taxpayer's Ex. 46, 47.

**68.** XXXXXXXX lawyers assigned to sectors and groups report to the general counsel of XXXXXXXX rather than to sector or group managers. XXXXXXXX's general counsel is responsible for hiring, or authorizing the hiring of, all XXXXXXXX legal personnel. Tr. pp. 1016, 1018 - 1020, 1099.

**69.** XXXXXXXX and the XXXXXXXX affiliated group reports federal income tax on a consolidated basis, and the corporate tax department prepares the federal consolidated return. The consolidated return includes the profit and loss of XXXXXXXX and all of its domestic subsidiaries. Some of the information concerning subsidiaries contained in the consolidated return is prepared by subsidiary controllers and accounting departments. The corporate tax department performs this function where subsidiaries are not large enough to have their own accounting staff. The consolidated return is executed and filed by XXXXXXXX's vice president for taxes. In addition to preparing and filing XXXXXXXX's consolidated tax return, XXXXXXXX's corporate tax department is also responsible for filing all federal, state and local tax returns (including unemployment returns, payroll withholding tax returns and federal excise tax returns) for XXXXXXXX and all of its subsidiaries. The corporate tax department is also responsible for tax planning for XXXXXXXX and all of its subsidiaries. Tr. pp. 1160 - 1171, 1181, 1182; Dept. Ex. 3, 4, 5, 6, 7, 8.

- 70.** RD is the senior vice president and director of worldwide taxes, heads XXXXXXXX's corporate tax department, and supervises a staff of approximately 50. He reports to XXXXXXXX's chief financial officer. He is responsible for supervising the filing of returns, tax planning, tax audits and tax litigation for XXXXXXXX and its subsidiaries. All corporate and subsidiary returns are reviewed and signed by Mr. D. Employees of XXXXXXXX's domestic subsidiaries have no authority to sign these returns. Tr. pp. 107, 1160 - 1171.
- 71.** Three of XXXXXXXX's subsidiaries have their own separate tax function. Duties performed by these subsidiaries include the preparation and filing of sales tax and property tax returns, and the preparation of information for inclusion in XXXXXXXX's payroll tax, unemployment tax and federal consolidated tax returns. Accounting and tax professionals performing these functions at subsidiaries report to the management of the subsidiary for which they work. Tr. pp. 1164, 1167, 1168, 1170 - 1173, 1184 - 1187.
- 72.** While IRS and other tax agency audits are conducted in whole or in part at subsidiaries, all audit activity, whether at the corporate or subsidiary level, is supervised by XXXXXXXX's corporate tax department. The corporate tax department has exclusive authority to settle and compromise all assessments including those solely related to subsidiaries. Subsidiary employees have no authority over such matters. Tr. pp. 1174 - 1178; Taxpayer's Ex. 78.
- 73.** Tax planning strategies are formulated by both subsidiaries, the corporate tax department and by other units of XXXXXXXX's business. The corporate tax department has the authority to require subsidiaries to cooperate by making changes

in their businesses necessitated by corporate tax planning strategies. Tr. pp. 1181 - 1186.

74. The conduct of tax litigation is the exclusive responsibility of the corporate tax function. Subsidiaries have no authority to decide whether or how litigation should be conducted even where such decisions affect a subsidiary. Tr. pp. 1179, 1180.
75. Services provided to subsidiaries by XXXXXXXX corporate are provided at XXXXXXXX's cost of performance, or without charge. Tr. pp. 493 - 496.
76. XXXXXXXX corporate has developed and implemented uniform quality control standards, known as "six sigma" which are applicable to XXXXXXXX and all of its subsidiaries. Six sigma sets a quality standard requiring procedures to insure less than three mistakes or defects for every million operations. Tr. pp. 149 - 152, 209, 598, 961, 1406; Taxpayer's Ex. 44, 64.
77. Sales between segments of XXXXXXXX and the XXXXXXXX affiliated group, including sales involving subsidiaries, principally, are sales of component parts for communications devices (e.g. chips for handsets, batteries for paging devices). Internal production of product components, and resulting inter-company sales are necessitated by limitations on the availability of such components from unrelated third party suppliers and concerns about sharing proprietary information with unrelated parties. Decisions by the CEO regarding the allocation of resources between sectors, groups and subsidiaries are binding on all segments of XXXXXXXX's business. XXXXXXXX had inter-company sales, including sales between XXXXXXXX and its subsidiaries, eliminated in accordance with

XXXXXXXX's internal accounting procedures, of \$1.4 billion in 1993, \$2.3 billion in 1994 and \$2.78 billion in 1995. Tr. pp. 497 - 501, 520 - 525; Taxpayer's Ex. 64.

**Issue II: Whether XXXXXXXX Foreign Sales Corporation Must Be Excluded from the XXXXXXXX Unitary Business Group ("80/20 Issue")**

- 78.** XXXXXXXX Foreign Sales Corp. ("XFSC") was formed in 1984, under the laws of the Virgin Islands, a United States possession, to receive sales commissions from XXXXXXXX for exporting goods manufactured in the United States that qualify for federal income tax benefits. Tr. pp. 1156, 1157, 1316, 1317, 1335, 1336.
- 79.** XFSC is qualified to conduct business operations as a Foreign Sales Corporation ("FSC"), as that term is defined in sec. 922 of the Internal Revenue Code (the "IRC" or "Code"), 26 USCA sec. 922. Tr. p. 1316; Taxpayer's Ex. 79A, 79B, 79C, 80, 81.
- 80.** On January 4, 1985, XFSC and XXXXXXXX contracted with CT, Inc. ("CT"), a Delaware corporation doing business in St. Thomas, U.S. Virgin Islands, for services required to be performed by a FSC, as contemplated by sections 924(d) and 925(c) of the IRC. CT or its affiliates, or third parties selected by CT, perform these services. Tr. pp. 1214 - 1216, 1269, 1270, 1272, 1279, 1280, 1285, 1287, 1288, 1335 - 1337; Taxpayer's Ex. 80, 82.
- 81.** Under the terms of a Foreign Sales Corporation Service Agreement between CT, XXXXXXXX and XFSC, CT charges XFSC annual fees. XFSC was billed for, and paid annual fees during 1993, 1994 and 1995 in the following amounts; management fee - \$3,500; storage fee - \$1,500; license fee - \$100. The management fee charged XFSC by CT covers annual license fee renewals, maintenance of customer records and related data bases, communications services, and use of office space owned or

leased by CT. CT manages over 1000 foreign sales corporations, and the management fee charged XFSC is the standard fee charged other large FSCs for the same services provided XFSC. Tr. pp. 1216 - 1218, 1238 - 1240, 1259 - 1261, 1281, 1286, 1292; Taxpayer's Ex. 82, 85.

**82.** XFSC owns no tangible personal property other than its books and records, owns no real property either within or outside of the United States, and has no property of any kind in the U.S. Tr. pp. 1261 - 1263, 1323, 1363, 1364, 1372.

**83.** CT maintains an office in St. Thomas, U.S. Virgin Islands, which is used by XFSC. While CT is listed as a tenant occupying this office on the office door and in the tenant directory, XFSC is not, and only CT employees are authorized entry to this office. No one at XXXXXXXX has a key to this facility. Tr. pp. 1216, 1284, 1285, 1290, 1291, 1298.

**84.** The size of CT's office is approximately 2000 to 3000 square feet. This office space is used to provide space to XFSC and over 1000 other FSCs. CT owns all of the furniture and equipment in this office, and phone lines to this office, which are in the name of CT, do not identify XFSC or any other FSCs provided space, as office occupants. Tr. pp. 1291 - 1293, 1297.

**85.** XFSC keeps its books and records, including its corporate documents, minutes of directors annual meetings, licenses, financial records and tax return information in CT's office in the Virgin Islands, and at a warehouse in the Virgin Islands owned or rented by CT. Access to this warehouse is limited to CT employees. Tr. pp. 1293 - 1295, 1323.

**86.** XFSC holds its Board of Directors meetings at the offices of CT in the Virgin Islands.  
Tr. pp. 1265, 1266.

**87.** XFSC acts as a commission agent for XXXXXXXX exports, and has entered into a contract titled Foreign Trade Commission, Sale, Lease and Services Agreement which indicates the services that XFSC will provide to XXXXXXXX in exchange for commissions. Pursuant to the terms of this contract, XFSC agrees to advertise, promote and otherwise assist XXXXXXXX in making export sales by:

- acting as the agent for XXXXXXXX in connection with designated sales by XXXXXXXX of export property;
- performing sales and leasing activities in furtherance of sales and leases of export property by XXXXXXXX that include: i) transportation; ii) receipt of payments; and iii) assumption of credit risk; and
- performing sales and leasing activities only in a manner that will result in “foreign trading receipts” as defined in section 924(a) of the Code.

Tr. pp. 1316 - 1318; Taxpayer’s Ex. 80.

**88.** Under sections 7 and 8 of the Foreign Trade Commission, Sale, Lease and Services Agreement, XXXXXXXX has agreed to pay XFSC sales commissions, as determined under section 925 of the Code, for sales activities XFSC performs in furtherance of sales and leases of export property by XXXXXXXX. Taxpayer’s Ex. 80.

**89.** XFSC reports its total sales commissions as “foreign trading gross receipts” under section 924 of the Code. Taxpayer’s Ex. 80.

**90.** XFSC has also entered into a contract entitled “Export Related Services Agreement” with XXXXXXXX which sets out a number of services XXXXXXXX provides to

XFSC. These services include advertising and sales promotion, processing customer orders, transportation of export property, and determination and transmission of final invoices. Pursuant to this service agreement, XXXXXXXX agrees to provide the following types of services: solicitation of sales, advertising and promotion of sales. These are the same services XFSC provides to XXXXXXXX under its Foreign Trade Commission, Sale, Lease and Services Agreement with XXXXXXXX. Tr. pp. 1317-1320, 1339, 1340, 1342-1345; Taxpayer's Ex. 80, 81.

**91.** XFSC has no employees and pays no compensation. XXXXXXXX employees perform all contractual and administrative functions XFSC has contracted to provide to XXXXXXXX. Tr. pp. 1321, 1323, 1335, 1338-1340, 1342-1345; Taxpayer's Ex. 79A, 79B, 79C, 81.

**92.** XXXXXXXX provides tax and accounting services to XFSC, and XXXXXXXX corporate tax and accounting function employees prepare XFSC's corporate tax returns and maintain XFSC's bank general ledger account. Tr. pp. 1320 - 1322, 1333.

**93.** Each sector is responsible for supplying and shipping merchandise sold using XFSC as its agent, and for preparing invoices to customers purchasing these products. XXXXXXXX also provides advertising services (e.g. conduct of trade shows by XXXXXXXX employees) to XFSC outside of the U.S. Tr. pp. 1349 - 1354, 1357 - 1363.

**94.** XFSC maintains a bank account at Chase Manhattan Bank in the Virgin Islands to which sales commissions it receives and reports on its federal income tax returns are regularly credited and deposited. Bank statements covering this account are sent to XXXXXXXX. Tr. pp. 1323 - 1326; Taxpayer's Ex. 83.

95. XFSC's bank account is regularly debited for the following expenses: payments to XXXXXXXX pursuant to the Export Related Services Agreement, payments of federal income taxes to the Internal Revenue Service, payments of franchise taxes to the Virgin Islands, and miscellaneous legal fees and bank charges. Tr. p. 1324; Taxpayer's Ex. 83.
96. XFSC's federal income tax return balance sheets for the tax years in controversy recorded no rent payments, no depreciation, and no payments for salary or wages. These balance sheets show trade accounts receivable (representing commissions receivable from XXXXXXXX less expenses charged XFSC by XXXXXXXX) as XFSC's principal asset. XFSC's books and records were not indicated as assets on XFSC's income tax return balance sheets for the tax years in controversy, and its books and records were not depreciated. Tr. pp. 1360, 1372 - 1374; Taxpayer's Ex. 79A, 79B, 79C.

**Issue III: Whether XXXXXXXX's Aircraft Qualified for an Investment Tax Credit ("Investment Tax Credit Issue")**

97. XXXXXXXX claimed a replacement tax investment tax credit on a CanadaAir Challenger aircraft, Serial No. 5113 ("aircraft") purchased from CanadaAir Challenger, Inc. on May 12, 1994 for \$14.6 million. Stipulation Regarding Corporate Aircraft, Feb. 27, 2003 ("Stip.") ¶¶ 1, 2.
98. XXXXXXXX registered the aircraft with the Illinois Department of Transportation, Division of Aeronautics, and paid Illinois use tax on the aircraft in the amount of \$912,500. Stip. ¶¶ 3, 4.

99. The aircraft is kept and maintained at an aircraft hanger located at Palwaukee Airport in Wheeling, Illinois. Stip. ¶ 5.

100. The aircraft is used in XXXXXXXX's business, to transport XXXXXXXX employees headquartered in Illinois and its customers. A XXXXXXXX employee based at the company's corporate headquarters in Someplace, Illinois schedules flights and usage of the aircraft. Stip. ¶¶ 6, 7.

101. More than fifty percent of the miles flown by the aircraft were outside of Illinois during the tax periods in controversy. Stip. ¶ 9.

102. Upon completion of scheduled flight operations, the aircraft is returned to Illinois, and is kept in this state when not in operation. Stip. ¶ 10.

**Conclusions of Law:**

**Unitary Tax Issue**

XXXXXXXX timely filed its 1993, 1994 and 1995 IL-1120s on combined unitary tax returns. Dept. Ex. 3, 4, 5. Attached to each return was a schedule UB listing all members of the unitary business group. *Id.* These members included XXXXXXXX, XXXXXXXX International Development Corporation, XXXXXXXX International Capital Corporation and XXXXXXXX Credit Corporation. Subsequently, on or about April 23, 2001, XXXXXXXX filed amended returns, which included additional members in its unitary business group. Dept. Ex. 6, 7, 8. The unitary tax issue in this case is whether these additional members included in XXXXXXXX's returns for 1993, 1994 and 1995 are properly included in a single unitary group with XXXXXXXX, Inc.

This matter is a result of the Department's denial of taxpayer's claims for refund based on its amended returns. Dept. Group Ex. 1. The Department also issued Notices

of Deficiency making other adjustments, that were also protested. *Id.* XXXXXXXX, Inc. contends that it was a manufacturer of high technology electronics during the tax years in controversy, and that all of its subsidiaries either engaged in similar manufacturing or “played a significant role in getting ... [XXXXXXX and XXXXXXXX affiliated group] ... high technology products to the marketplace.” Taxpayer’s Brief p. 19. During the tax years at issue, XXXXXXXX owned over 50 percent of the stock in the corporations included in its amended returns and identified in my findings of fact. See Findings of Fact no. 3.

The Department asserts that XXXXXXXX has failed to prove that any of these subsidiaries are properly included in XXXXXXXX’s unitary business group. Dept. Brief pp. 35 – 52. Absent such proof, it maintains, the Department’s prima facie conclusion that XXXXXXXX and each of these entities operate as discrete business enterprises 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)), its NODs and its determination denying taxpayer’s claims for refund based upon the inclusion of these entities in its unitary business group, are prima facie correct. Dept. Brief p. 38. 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 Illinois Income Tax Act, 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).

The Department vigorously maintains that the statutory tests for demonstrating the existence of a unitary business set forth in section 1501(a)(27) have not been met in this case. Dept. Brief pp. 35 – 50. It contends that the taxpayer failed to show that it and each of its over 70 subsidiaries are engaged in the same general line of business or that the activities of all of these entities are steps in a vertically integrated business operation. 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 ...
- 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 Department maintains that the evidence presented is woefully insufficient to demonstrate the criteria showing XXXXXXXX and its subsidiaries were engaged in the same general line of business. Dept. Brief pp. 38 – 49. “XXXXXXX” it notes “attempted to meet its burden of proof” regarding subsidiary lines of business exclusively through the testimony of CF, who was XXXXXXXX’s senior counsel for transactions, securities and corporate, and responsible for organizing, maintaining and dissolving XXXXXXXX’s subsidiaries during only a portion of the tax years (beginning in late 1995) at issue. Tr. pp. 1015, 1016, 1098; Dept. Brief p. 47. It initially attacks her testimony on the grounds that her knowledge pertains to only a small portion of the tax period in controversy and therefore is highly suspect since based on second-hand information. Dept. Brief pp. 39, 40, 47, 48. The Department also notes that her testimony was based almost completely upon an information sheet provided to her by the taxpayer’s counsel. Dept. Brief pp. 39, 47, 48, 49. Because this document was prepared in anticipation of litigation, it maintains, her testimony based on this document is entitled to little weight.

Dept. Brief pp. 40, 42, 48, 49.<sup>5</sup> Moreover, it argues, this testimony was incomplete since it did not cover all of the subsidiaries included in XXXXXXXX's unitary business group on its amended returns. Dept. Brief p. 38. Even more fatal to the taxpayer's claims is the Department's contention that XXXXXXXX failed to meet the legally mandated burden necessary to rebut the Department's case. It notes that the taxpayer presented "only oral, uncorroborated testimony" to attempt to establish the general line of business in which it and all of the subsidiaries were engaged. Dept. Brief pp. 49, 50. This proof, it argues, does not meet the standards enunciated in the cases noted earlier requiring that testimony be substantiated by documentary evidence. Mel-Park Drugs, *supra*; PPG Industries, *supra*.

86 Ill. Admin. Code, ch. I, sec. 100.3010(c), and 86 Ill. Admin. Code, ch. I, sec. 100.9700(h) prescribe the evidence that must be produced to show that a parent and its subsidiaries are engaged in a vertically structured enterprise. These regulations enumerate the evidentiary tests to be met as follows:

(6) A person will not be a step in a vertically structured enterprise or process unless it is connected to one or more other persons that are steps in the vertically structured enterprise or process by a flow of goods or services, including management services, to itself or from itself. However, if such a flow of goods or services is present with respect to a particular person, that person's status as a step in the vertically structured enterprise or process shall not depend on the relationship between the price at which such flow exists and the fair market price at which such flow would exist in an arm's length transaction.

86 Ill. Admin. Code, ch. I, sec. 100.9700(h)(6)

(B) Steps in a vertical process. A trade or business carried on by more than one person is unitary in nature when the various members are

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<sup>5</sup> See also In Re A.B., 308 Ill. App. 3d 227 (2<sup>nd</sup> Dist. 1999) holding that evidence produced in anticipation of litigation is entitled to little weight.

engaged in a vertically structured enterprise. For example, assuming that the common ownership requirement is met, a trade or business that involves the exploration and mining of copper ore by one of the related persons; the smelting and refining of the copper ores by another of the related persons; and, the fabrication of the refined copper into consumer products by another of the related persons, is unitary in nature regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from one of the persons.

86 Ill. Admin. Code, ch. I, sec. 100.3010(c)(1)(B)

The Department rejects the evidence in the record to support the taxpayer's claim of vertical integration as completely inadequate. The Department maintains that "[T]he witness testified from her memory when asked about each of the subsidiaries in turn, and with many subsidiaries, her memory was non-existent or so superficial as to be worthless." Dept. Brief p. 47. The witness had no knowledge of many of the companies included in XXXXXXXX's unitary business group on its amended returns, and could not recall vital details regarding several other companies. Dept. Brief p. 39. Again, it argues, even if her testimony had not been deficient in these respects, it was based on documents prepared in anticipation of litigation, and most importantly, was completely uncorroborated by documentary evidence.

A review of the documentary evidence contained in the record supports the Department's claims. None of these documents discuss the actual business activities in which each of the subsidiaries were engaged. The company's annual reports and form 10-Ks discuss XXXXXXXX and the XXXXXXXX affiliated group as a whole and contain little mention of any subsidiaries. See Taxpayer's Ex. 11A, 11B, 11C, 63, 64, 65. Moreover, the voluminous pages of subsidiary minutes that are in the record contain no discussion of anything pertinent to showing subsidiary "lines of business" or "vertical integration." See Taxpayer's Ex. 46.

There is, indeed, substantial evidence in the record to show that XXXXXXXX sectors were either engaged in the same lines of business or vertically integrated. However, as cogently noted by the Department, the sectors were simply divisions of XXXXXXXX, Inc. rather than separate legal entities. Dept. Brief p. 36. Moreover, the Department further notes that “[T]he Department did not exclude any sectors, divisions or groups from the Illinois unitary business group.” *Id.*

In sum, I find that the Department is correct in concluding that the critical evidence necessary to show that XXXXXXXX and its subsidiaries are engaged in a the same lines of business or vertically integrated has not been produced. The testimony of one of numerous witnesses produced at trial, that cannot be supported by any documents that are in the record, cannot possibly meet the heavy burden borne by the taxpayer under Illinois law. Accordingly, I must conclude that the taxpayer has failed to show that XXXXXXXX and its subsidiaries were engaged in the same line of business or were steps in a vertically structured enterprise.

However, XXXXXXXX’s failure to establish that its subsidiaries were engaged in similar lines of business or vertically integrated with XXXXXXXX does not necessarily preclude a finding that XXXXXXXX and its subsidiaries were engaged in a unitary business. According to section 1501(a)(27), unitary business activity can ordinarily be illustrated where the activities of members are in the same general line of business or vertically integrated. The statute, therefore, has left open the distinct possibility that a unitary business may be one where the companies are neither in the same line of business or vertically integrated. Indeed, the Department has acknowledged this possibility by combining companies on audit that are not horizontally or vertically integrated under

criteria enumerated in the Department's regulations noted above. See Department of Revenue v. "Apex, Inc.", Administrative Hearing Decision No. IT 01-13, Ill. Dept. of Revenue, Office of Admin. Hearings, October 24, 2001; Department of Revenue v. "Consol Inc.", Administrative Hearing Decision No. IT 98-0298, October 25, 2001.

While section 1501(a)(27) does not require a showing of parent-subsidiary operations in the same line of business or that are vertically integrated, it clearly does require that functional integration through strong centralized management 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, insurance, 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). Accordingly, the issue to be decided in this case is whether the record supports a finding of pervasive functional integration throughout the XXXXXXXX organization, including all of its active and inactive subsidiaries, during the tax periods in controversy.

During trial proceedings in this case, the taxpayer introduced testimony and documentary evidence that established the following facts:

1. XXXXXXXX managed or supervised all subsidiary accounting functions. Tr. pp. 468 - 471, 476 - 481; Taxpayer’s Ex. 34, 35, 37.
2. XXXXXXXX’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 XXXXXXXX subsidiaries. Tr. pp. 476 - 481; Taxpayer’s Ex. 47.
3. XXXXXXXX’s tax department prepared tax returns and handled all other tax matters for all subsidiaries and XXXXXXXX’s tax director had authority to approve and

execute subsidiary tax returns. Tr. pp. 1160 - 1190; Dept. Ex. 3 - 8; Taxpayer's Ex. 78.

4. All XXXXXXXX subsidiaries participated in a centralized cash management system, which was controlled by XXXXXXXX, and cash generated by subsidiaries not immediately needed for subsidiary operations was returned to XXXXXXXX. Tr. pp. 373 - 382, 384, 385, 394, 409 - 412.
5. XXXXXXXX's corporate legal function provided services to all XXXXXXXX subsidiaries. Tr. pp. 104 - 106, 1015, 1017 - 1019, 1021, 1022, 1026 - 1032; Taxpayer's Ex. 46.
6. XXXXXXXX's corporate insurance function managed all insurance programs for all segments of XXXXXXXX's business including subsidiaries. Tr. pp. 387 - 390.
7. XXXXXXXX's corporate human resources function administered employee benefits for all XXXXXXXX subsidiaries. Tr. pp. 381, 385 - 387, 391, 392.
8. XXXXXXXX subsidiaries were required to comply with XXXXXXXX's affirmative action policies. Tr. pp. 182, 183.
9. Operating budgets of subsidiaries required the approval of XXXXXXXX's CEO and Board of Directors. Tr. pp. 309 - 312.
10. XXXXXXXX controlled the election of officers and directors of all XXXXXXXX subsidiaries. Tr. pp. 1036 - 1038; Taxpayer's Ex. 46.
11. XXXXXXXX determined the compensation and benefits paid to employees of XXXXXXXX and its subsidiaries. Tr. pp. 99, 119, 135, 136, 180, 181; Taxpayer's Ex. 2.

12. XXXXXXXX managed and administered benefit plans covering employees of XXXXXXXX and all of its subsidiaries. Tr. pp. 206, 207, 385 - 387, 390 - 392.
13. XXXXXXXX approved all capital and operating expenditures by all XXXXXXXX subsidiaries. Tr. pp. 452 - 455, 485, 486, 527 - 530, 532.
14. XXXXXXXX's CFO, Treasurer, Secretary, Vice-President and Director of worldwide taxes, and heads of XXXXXXXX's sectors and groups simultaneously served as officers of all XXXXXXXX subsidiaries. Tr. pp. 365, 397, 1036 - 1039, 1152, 1153; Taxpayer's Ex. 46.
15. XXXXXXXX subsidiaries were allowed to use patents and trademarks granted XXXXXXXX or its subsidiaries and owned by XXXXXXXX without charge. Tr. pp. 781 - 783, 789, 790.
16. Centralized services provided to subsidiaries by XXXXXXXX were provided at cost or without charge. Tr. pp. 493 - 496.

The above relationships, shown to be present during the tax periods in controversy, are significant because these are the very factors Illinois courts have looked for in making a decision whether a parent company and its subsidiaries constitute a unitary business group. In finding proof that a unitary business existed 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

...

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 showed the existence of a unitary business 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 corporate services, (sales and marketing support), at cost.

See A.B. Dick at 234 -5. Again, factors relied upon by the court in concluding that a unitary business existed have been shown in this matter.

In A.B. Dick, the court explains why these indicia of shared operational benefits 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 each member of an affiliated group of companies as a separate and distinct entity 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.

In this case, the record shows that all of the services provided by XXXXXXXX to its subsidiaries were provided at cost or without charge. Moreover, subsidiaries were not charged anything for using XXXXXXXX’s patent and trademarks, even though these are described in the record as among XXXXXXXX’s most important assets. The record also shows between \$1.4 billion and \$2.78 billion in inter-company sales during the tax years in controversy. Moreover, there is evidence in the record that these inter-company sales were at less than the normal “arms-length” charge to customers having no affiliation with XXXXXXXX because there was no mark-up for the use of XXXXXXXX patents. Tr. p. 789. These are 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 each subsidiary as a distinct and separate operation for tax purposes. Thus, treating XXXXXXXX and 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 taxpayer has established the existence of a number of key factors relied upon in prior Illinois court decisions in finding the existence of functional integration, or centralized management. Although the taxpayer has not shown that its subsidiary operations are horizontally or vertically integrated, such a showing is not a prerequisite, since these attributes are not conditions precedent, but only “ordinary characteristics” of a unitary business group.

The Department contends that not all of the factors indicative of functional integration identified during testimony are supported by documentary evidence. Dept. Brief pp. 49-50. Admittedly, not every testimonial assertion establishing functional integration made during the trial proceedings is verified by documentary proof. However, there is no indication in the Illinois case law that documentation is the only evidence that will be accepted to rebut the Department’s case. The courts have not said that testimony will be ignored in determining whether the taxpayer has met its burden. Rather, it has only required that testimony be corroborated in some fashion by books and records or other documentation. Mel-Parks, *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”).

The documentary evidence supporting testimony establishing functional integration principally consists of two volumes of minutes from selected XXXXXXXX subsidiaries, covering shareholders meetings and board meetings that took place during

the tax periods in controversy. See Taxpayer's Ex. 46. While the Department correctly points out that minutes have not been produced for all of the subsidiaries (Dept. Brief pp. 35, 36, 39), the minutes that are contained in the record are clear evidence of a common system of management throughout the XXXXXXXX operation. In most respects, all of these minutes (which are in the form of unanimous written consents) are identical. While these minutes do not corroborate every scintilla of testimony, they clearly support the presence of centralized management over all of XXXXXXXX's business enterprise.

The minutes show the exercise of exclusive control over all subsidiary financial affairs by XXXXXXXX's chief financial officer and its treasurer. They also document the existence of shared officers and directors throughout the organization. Proof of centralized management and control over subsidiary finances by shared officers and directors without more, has been viewed as sufficient evidence to establish the existence of a unitary business. See Citizens Utilities Company v. Illinois Department of Revenue, 111 Ill. 2d 32, 50 (1986) wherein the 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 subsidiaries income is increased by eliminating the interest expenses. This flow of value is, in itself, strongly indicative of a unitary business.

In addition to the minutes of subsidiaries, the taxpayer has produced other documentary evidence to support its assertion that the entire XXXXXXXX enterprise was functionally integrated. As noted above, control over subsidiary human resource functions is an indicia of a unitary business. The record contains testimony from GG, the taxpayer's executive vice president of corporate human resources, that XXXXXXXX's

corporate human resource function “had broad authority to manage ... all XXXXXXXX employees, including those of subsidiaries ... [.] ” Taxpayer’s Brief p. 46; Tr. pp. 118, 119. Mr. G testified that the corporate human resources function exercised authority over recruiting, wages, benefits and training, and monitored compliance with employment related laws and regulations. Tr. pp. 118, 119, 120, 183. This testimony is corroborated by Taxpayer’s Exhibits 2 (Personnel Guide), and 6 (Salary Structure for Professional Employees), which enumerate compensation and other policies applicable throughout XXXXXXXX and the XXXXXXXX affiliated group.

Parent control over subsidiary capital and operating expenditures and operating budgets has also been recognized as an indicia of a unitary business operation. Borden, *supra*; A.B. Dick, *supra*. Mr. WS, the taxpayer’s chief strategy officer during the tax periods in controversy, and Carl FK, XXXXXXXX’s CFO, testified that budgets initially developed at the subsidiary, group, or sector level of the company were subject to parent approval. Tr. pp. 293, 294, 296 - 305, 453 - 455. Through this budgeting and planning process, the parent company effectively controlled each subsidiary’s expenses and head count. Tr. pp. 310 - 312. This testimony is corroborated by Taxpayer’s Exhibits 16 and 17, that detail the involvement of subsidiaries in the long-range planning process and the comprehensive nature of the plans that were developed.

Centralized control over subsidiary tax planning and compliance has been identified as an indicia of a unitary business in the Illinois case law. Borden, *supra*; A.B. Dick, *supra*. RD, XXXXXXXX’s senior vice president and director of worldwide taxes, testified that control over subsidiary tax compliance was exercised by XXXXXXXX’s

corporate tax function. Tr. pp. 1160 - 1165, 1173 - 1176, 1180 - 1184. This testimony is also corroborated. See Dept. Ex. 3 - 8.

In sum, there is a considerable amount of documentary evidence to support the testimony in the record regarding the operational integration of parent and subsidiary functions within the XXXXXXXX enterprise. Not every factor pointed to as evidence of operational or functional integration is documented. However, documentary evidence corroborating the existence of interconnections between XXXXXXXX and its subsidiaries noted above lends credibility to all of the taxpayer's assertions concerning the centralized control exercised by XXXXXXXX's corporate function. Moreover, the Illinois appellate court has rejected the notion that a taxpayer must conclusively prove the existence of each and every factor germane to a unitary business determination in order to establish the existence of a unitary business. In Hornel, *supra* at 1210, the court rejected the taxpayer's assertion that a finding of "centralized management" necessitated proof that the taxpayer exerted authority over every function enumerated in the statute. The court concluded, instead, that "to find the existence of strong centralized management over the subsidiaries, one must examine the entire operation as a whole." *Id.* Accordingly, I find testimony establishing the existence of key characteristics of a unitary business enterprise recognized by the Illinois courts sufficiently corroborated by the documentary evidence identified above to carry the taxpayer's burden.

A finding that XXXXXXXX and its subsidiaries are not engaged in a unitary business would also ignore the extensive testimony and documentary evidence contained in the record showing inter-company sharing of knowledge and technology. The Illinois appellate court has recognized that transfers of know-how are key indicators of a unitary

business enterprise. See Hormel, *supra*. Factors indicative of synergies resulting from knowledge transfers relied upon by the courts include evidence of inter-company sales, standard quality improvement procedures, sharing of technological know-how and use of common research and development facilities. *Id.* The record shows that all of these unitary indicia are present here.

Testimony regarding inter-company sales within the XXXXXXXX affiliated group was presented by CK, XXXXXXXX's Chief Financial Officer. Tr. pp. 497 - 501, 520 - 525, 532, 533. Documentary evidence corroborating this testimony included accounting records showing between \$1.4 billion and \$2.78 billion in inter-company sales between XXXXXXXX affiliated group members during 1993, 1994 and 1995. Taxpayer's Ex. 65.

Numerous witnesses testified that XXXXXXXX corporate developed a uniform quality improvement process known as "six-sigma" that applied to XXXXXXXX and all of its subsidiaries. Tr. pp. 149 - 152, 209, 598, 961, 1406. The record also shows that XXXXXXXX deliberately established numerous formal structures to encourage the exchange of technological know-how and information throughout XXXXXXXX's affiliated group of companies. Tr. pp. 694 - 699, 711, 713, 715 - 718. Moreover, patents and trademarks, XXXXXXXX's most valuable assets, were shared by all domestic members of XXXXXXXX's affiliated group without charge. Tr. pp. 783 - 786, 788 - 792; Taxpayer's Ex. 62. The record also provides that XXXXXXXX corporate shared its research and research facilities with its subsidiaries. Tr. pp. 718 - 721. In sum, the very factors that led the appellate court in Hormel to conclude that Hormel and its affiliated group members were unitary are present here.

The Department points to the concept of “instant unity” as a bar to the inclusion of certain subsidiaries that were acquired or incorporated during the tax years in controversy. The concept of “instant unity”, which has been embraced by at least one other state (California), requires some evidence of a preexisting relationship between a newly acquired subsidiary and its parent before the subsidiary can be included in a unitary business group. Appeal of Dr. Pepper Bottling Company of Southern California , et al, 90-SBE-015, December 5, 1990; Appeal of Atlas Hotels, Inc. et al, Cal. St. Bd. of Equal., 85-SBE-001, January 8, 1985; Appeal of ARA Services, Inc., Cal. St. Bd. of Equal., 93R-0262, 96R-1013, May 8, 1997. The Department argues that the record in this case contains no evidence of the nature of the relationship between XXXXXXXX and its newly acquired subsidiaries. Dept. Brief pp. 50, 51. Therefore, it concludes, the taxpayer has failed to carry its burden of proof showing that such entities were “instantly unitary” when acquired, and therefore properly combinable. *Id.*

The record shows that most of the new subsidiaries the Department seeks to exclude based upon the “instant unity” principle are passive or inactive companies. The Illinois appellate court has rejected the idea that passive or inactive entities lack sufficient operational and other interconnections to be included in a unitary business group. In Shaklee Corp. v. Dept. of Revenue, 298 Ill. App. 3d 1165 (1<sup>st</sup> Dist. 1998), app. den. 181 Ill. 2d 589 (1998)<sup>6</sup>, the court held that holding companies, having as their primary function holding securities, were unitary with their parent, which manufactured and sold nutritional, household and personal care products. The court’s holding in Shaklee was

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<sup>6</sup> Non-published opinion pursuant to IL ST S. Ct. Rule 23. “An unpublished order of the court is not precedential and may not be cited by any party except to support contentions of double jeopardy, res judicata, collateral estoppel or law of the case.” S. Ct. Rule 23(e).

based on evidence that the inactive subsidiaries included in the unitary business group were in the same line of business as their parent, and that their assets were operationally connected to the parent's business. As noted above, there is insufficient evidence in the record to reach the same conclusions here.

While there is no evidence of horizontal or vertical integration, the record in this case is sufficient to establish functional integration throughout XXXXXXXX's business during the tax years in controversy. As noted above, there is sufficient documentary evidence in the record to corroborate testimony that the operations of XXXXXXXX and the entire XXXXXXXX affiliated group were characterized by operational integration resulting from centralized control over key operational functions. The record contains evidence that all of XXXXXXXX's subsidiaries ceded authority over major aspects of their operations to XXXXXXXX and shared, or were eligible to share common technology and expertise. For the reasons enumerated above, testimony concerning functional integration at all levels of XXXXXXXX is adequately supported by documentary evidence contained in the record. The type of functional integration identified here has repeatedly been held to warrant the filing of a combined return. Borden, *supra*; A.B. Dick, *supra*; Homel, *supra*. Since the taxpayer has produced credible evidence addressing the manner in which the entire XXXXXXXX affiliated group operated, and since this evidence demonstrates strong centralized management through functional integration, it supports the conclusion that newly acquired or organized subsidiaries were properly included in XXXXXXXX's combined returns.

For the reasons discussed above, the evidence presented in this case shows strong centralized management of XXXXXXXX's entire business. While horizontal or

vertical integration are common characteristics of unitary business groups, establishing the existence of these factors is not a precondition to a unitary business finding. The only factual prerequisite besides common ownership for establishing the existence of a unitary business in Illinois is strong centralized management. The Illinois courts have made it abundantly clear that strong centralized management can be shown by evidence of functional integration. Functional integration exists where “authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member.” 86 Ill. Admin. Code, ch. I, sec. 100.9700(g). The record in this case contains sufficient testimony and documentary evidence to persuade the finder of fact that strong centralized management was a primary characteristic of XXXXXXXX’s entire affiliated group of companies during the tax years in controversy. For this reason, I conclude that the taxpayer has shown that it properly included additional members of its affiliated group in its amended Illinois combined returns for 1993, 1994 and 1995.

**80/20 Issue**

The issue presented is whether XXXXXXXX Foreign Sales Corporation (“XFSC”), a foreign (non-U.S.) corporation incorporated in the Virgin Islands, and qualified as a foreign sales corporation (“FSC”) under sections 921-927 of the Internal Revenue Code <sup>7</sup>, is part of XXXXXXXX’s unitary business group. Illinois law contains no special provisions relating to the taxation of foreign sales corporations. Accordingly, rules governing the inclusion of an FSC in a combined return are the same as for any other

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<sup>7</sup> Sections 921-927 of the IRC were repealed by the Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. 106-519, Nov. 15, 2000.

corporation. Department of Revenue Letter Ruling (“LR”) 91-IT-0039-PLR; LR 97-0017-PLR.

Section 1501(a)(27) provides that a unitary business group “will not include those members whose business activity outside of the United States is 80 percent or more of any such member’s total business activity.” (This provision is hereinafter referred to as the “80/20 rule”). For corporations other than financial organizations, insurance companies and transportation service businesses, business activity is measured by an equally weighted payroll and property factor as defined at 35 **ILCS** 5/304 (“section 304”). Section 1501(a)(27); 86 Ill. Admin. Code, ch. I, sec. 100.9700(c).<sup>8</sup> Although these apportionment provisions are ordinarily used to determine the extent of a taxpayer’s activity inside Illinois, in the context of qualifying as an 80/20 company the apportionment provisions are used to determine the extent of the taxpayer’s activity inside the United States rather than in a single state.

Regarding the property factor, 35 **ILCS** 5/304(a)(1)(A) provides as follows:

The property factor is a fraction, the numerator of which is the average value of the person’s real and tangible personal property owned or rented and used in the trade or business in this State during the taxable year and the denominator of which is the average value of all the person’s real and tangible personal property owned or rented and used in the trade or business during the taxable year.

Regarding the payroll factor, 35 **ILCS** 5/304(a)(2)(A) provides:

The payroll factor is a fraction, the numerator of which is the total amount paid in this State during the taxable year by the person for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year.

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<sup>8</sup> The property factor is prescribed at sec. 304 (a)(1) of the IITA, 35 **ILCS** 5/304(a)(1), and the payroll factor is prescribed at sec. 304(a)(2) of the IITA, 35 **ILCS** 5/304(a)(2).

The Department has promulgated regulations to administer and enforce the 80/20 rule provisions of section 1501(a)(27). See 86 Ill. Admin. Code, ch. I, sec. 100.9700(c) (“regulation 100.9700(c)”). This regulation specifies how an 80/20 rule determination is to be made, and what a person’s payroll and property factors are intended to measure. Specifically, regulation 100.9700(c), as in effect during the tax years in controversy, provided as follows:

(c) The 80-20 U.S. business activity test for prospective members. The factors to be used in determining whether 80% or more of a person’s business activity is conducted outside the United States shall be gross figures without eliminations premised on the person’s membership in any unitary business group. However, the factors should relate to the common accounting period, as defined in Section 100.3310, of the unitary business group of which the person being tested could become a member were the person’s business activity found to be less than 80% outside the United States. The factors used are as follows:

- 1) persons required to apportion business income under IITA Section 304(a) will use property and payroll,
- 2) persons required to apportion business income under IITA Sections 304(b), 304(c) or 304(d) will use the respective factors prescribed in those provisions.
  - A) In accordance with IITA Section 102 and 26 USC 7701 (b)(9), the phrase “United States” as used in IITA Section 1501(a)(27) shall include only the fifty states and the District of Columbia.
  - B) Mechanically, the computation of the 80-20 U.S. business activity test requires the formation of one or two fractions, as the case may be, and the subsequent averaging of those fractions to arrive at an overall U.S. business activity in relation to world-wide business activity. The numerators of the fraction represents U.S. property, U.S. payroll, U.S. revenue miles, insurance premiums on property or risk in the U.S. or financial organization business income from sources within the U.S.; the respective denominators are the world-wide figures.

This regulation, and section 1501(a)(27), specify that, in applying the 80/20 rule test, the first step requires a determination whether the prospective unitary group member’s

payroll factor is zero. If so, the prospective member's business activities must be measured using only a property factor. Regulation 100.9700(c)(2)(B). In the instant case, both parties agree that XFSC had no payroll factor. Neither party disputes the evidence in the record indicating that XFSC had no employees during the years at issue and reported no wage or salary expenses in its financial reports and income tax returns. Tr. pp. 1321, 1323, 1335, 1338; Taxpayer's Ex. 79A, 79B, 79C, 81. Accordingly, pursuant to section 1501(a)(27), and regulation 100.9700(c), XFSC's business activities must be measured using only a property factor.

Section 304(a)(1) indicates that the property factor is supposed to measure the value of property that is either owned or rented by the person whose income is being apportioned, rather than by the value of property that is owned or rented by some other person. This conclusion is confirmed at 86 Ill. Admin. Code, ch. I, sec. 100.3350(a), which provides as follows:

In general. The property factor of the apportionment formula for each trade or business of a person shall include all real and tangible personal property owned or rented by such person and used during the tax period in the regular course of such trade or business. The term "real and tangible personal property" includes land, building, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency. Property used in connection with the production of non-business income shall be excluded from the property factor. Property used both in the regular course of a person's trade or business and in the production of non-business income shall be included in the factor only to the extent the property is used in the regular course of the person's trade or business. The method of determining that portion of the value to be included in the factor will depend on the facts in each case. The property factor shall include the average value of property includable in the factor ... [.] (emphasis added)

Other parts of this regulation validate this conclusion. Specifically, subparts (d) through (f) provide:

- (d) Numerator. The numerator of the property factor shall include the average value of real and tangible personal property owned or rented by the person and used in this State during the tax period in the regular course of the trade or business of the person. ...
- (e) Valuation of owned property. Property owned by the person shall be valued at its original cost. ...
- (f) Valuation of rented property
  - (1) Property rented by the person is valued at eight times the net annual rental rate. The net annual rental rate for any item of rented property is the annual rate paid by the person for such property, less the aggregate annual subrental rates paid by subtenants of the person. (emphasis added)

86 Ill. Admin. Code, ch. I, sec. 100.3350(d) – (f)

Hence, the decisive issue presented in this case is whether XFSC owned or rented any real or tangible personal property during the tax years in controversy, and if so, whether it proved that 80% or more of this property was located outside of the U.S.

As noted above, XFSC was formed by XXXXXXXX to be a Foreign Sales Corporation as defined in section 922 of the Internal Revenue Code. This section provides that a foreign (non-U.S.) corporation that meets certain statutory requirements under the Internal Revenue Code will qualify as a FSC. By meeting these statutory requirements, XFSC's income is eligible for a partial exemption from U.S. taxation. See IRC sec. 921.

To qualify as an FSC under the IRC, XFSC had to be incorporated under the laws of, and maintain an office in, a qualified foreign country or U.S. possession. IRC sec. 922. An FSC must also be managed outside of the U.S. IRC sec. 924. In order to meet these IRC requirements, XFSC entered into a Foreign Sales Corporation Service Agreement (“service agreement”) with CT, Inc., (“CT”), a Delaware corporation having a place of business in the U.S. Virgin Islands. Taxpayer's Ex. 82. XXXXXXXX argues that, under the terms of its service agreement with CT, XFSC rented, or should be

deemed to have rented, property in the Virgin Islands either as office space or space in which to store its books and records. Taxpayer's Brief pp. 82, 83.<sup>9</sup>

XXXXXXX conceded during administrative hearing proceedings that XFSC did not own or rent any real or tangible personal property in the U.S. and did not own any real property outside of the U.S. Tr. pp. 1323, 1363, 1364. Accordingly, its sole basis for claiming relief under the 80/20 rule provisions of section 1501(a)(27) is that it must be deemed to have rented real property outside of the U.S. during the tax periods in controversy.

As noted above, rental property is included in the property factor of the Illinois income tax apportionment formula. See 35 **ILCS** 5/304(a)(1); 86 Ill. Admin. Code, ch. I, sec. 100.3350(a). Section 304(a)(1)(B) of the IITA, 35 **ILCS** 5/304(a)(1)(B), provides that property rented by the taxpayer must be valued at 8 times the net annual rental rate paid.

The taxpayer's contention that it must be deemed to have "rented" property in the Virgin Islands finds little support in the record. The only evidence presented to support this claim was the service agreement with CT. Pursuant to the terms of this agreement,

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<sup>9</sup> While the taxpayer also argued during the hearing that its books and records constituted tangible personal property, this argument is not included in the taxpayer's post hearing brief and I conclude that it has been abandoned. Moreover, as cogently noted in the Department's brief, the Department has previously rejected this argument in Department of Revenue v. "Shanghai, Inc.", Administrative Hearing Decision No. IT 02-1, Ill. Dept. of Revenue, Office of Admin. Hearings Feb. 7, 2002 ("(N)o part of the applicable statute or the Department's regulations indicates that, for purposes of apportioning business income or when performing the 80/20 test, the General Assembly intended the Department to consider a person's books and records when measuring the value of the real or tangible personal property that the person owned or used in the regular course of its trade or business").

CT charged XFSC a management fee of \$3,500, a storage fee of \$1,500 and a license fee of \$100. Tr. pp. 1239, 1259 - 1261, 1281; Taxpayer's Ex. 82, 85. Conspicuously absent from the service agreement is anything resembling a rental or lease agreement or fee. Indeed, the service agreement and the related invoice for service charges (Taxpayer's Ex. 85) contains no separate line item for rental payments of any kind. Moreover, the terms of the service agreement comport with the taxpayer's tax return and tax accounting records. As noted by the Department, these records contain no entries for lease or rental expense paid by XFSC. Dept. Brief p. 20. These omissions support the inference that XFSC never intended for its agreement with CT to cover rental charges.

Moreover, both parties expressly recognized that the Virgin Islands office used by XFSC to fulfill its obligations under the service agreement was owned or rented by CT. Dept. Brief p. 21. Furthermore, the record shows that characteristics normally attendant to a lease arrangement were not present in this case. As pointed out by the Department:

(E)xclusive possession and control or the right to CT's property never passed to XFSC. Specifically, Ms. Clarke testified to the following: (1) in excess of a thousand clients all used CT's address, phone number and facsimile (R. at 1286-1293); (2) the phone number listed as XFSC would be answered 'CT Inc., how may I help you?' (R. at 1292); (3) the building directory listed only the office of CT (R. at 1290); (4) CT's office only had CT's name on the office door (R. at 1291); (5) only CT employees were allowed onto the floor where CT was located (R. at 1290); (6) only CT employees had authorization to get into CT's offices (R. at 1291); (7) CT's offsite storage facility could only be accessed by CT's senior management (R. at 1294); (8) only CT employees had keys to the file cabinets where XFSC's books and records were stored (R. at 1295); (9) CT could move XFSC's documents where ever CT deemed appropriate, without XFSC's knowledge or consent (R. at 1296); (10) all utilities were paid by CT (R. at 1307) ... (12) no one from XFSC had access to CT's office or offsite storage facility (R. at 1298).  
Dept. Brief pp. 20, 21.

The gravamen of the taxpayer's claim is that part of the service charge paid by XFSC to CT should be considered a rental charge because CT employees performed services on XFSC's behalf and kept XFSC's books, records and other documents in this space. The taxpayer's interpretation of IITA section 304 would allow all taxpayers receiving storage and other services at the same location to use the identical property for apportionment purposes. For example, in the instant case, services for over 1000 corporations were provided from space in the Virgin Islands owned or rented by CT. Were the taxpayer's position correct, over 1000 corporations that CT provides services to at this location could use this space in determining their respective property factors. Since the property factor is part of a formula to assign income to Illinois for tax years ending before December 31, 2000,<sup>10</sup> a taxpayer could understate the amount of income apportionable to Illinois in this manner.

In short, interpreting section 304(a)(1) to allow multiple use of the same property by many different taxpayers to apportion income to this state clearly creates a grave risk of distorting the amount of income properly included in this state's tax base. Such an apportionment scheme is manifestly inconsistent with the purposes of section 304 to accurately apportion income to this state. See GTE Automatic Electric v. Allphin, 68 Ill. 2d 326, 335, 336 (1977). Accordingly, the taxpayer's interpretation of the property factor of the Illinois apportionment formula must be rejected. *Id.*

Moreover, as noted by the Department, the taxpayer's argument also fails to take into account Illinois statutory and case law defining the term "rent" for real estate law and other purposes:

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<sup>10</sup> See 35 ILCS 5/304(h) which provides for the use of a three factor formula including a property factor to apportion income to Illinois for tax years prior to December 31, 2000.

The term “rent” has a very specific definition which has been articulated by the Illinois Supreme Court in Midland Management Co. v. Helgason, 158 Ill. 2d 98, 630 N.E. 2d 836 (1994). The Illinois Supreme Court stated in Midland that “rent is given in consideration of a lease. As we [the Illinois Supreme Court Justices] have already stated, a lease gives rise to the landlord-tenant relationship. In order to establish the relation to landlord and tenant, the possession and control or right thereto of the property must pass to the tenant.” Midland at 105; See also Shanghai at 29. Another Illinois court has held that, “[r]ent is compensation paid for the use of land, and what the tenant pays for is quiet enjoyment of beneficial enjoyment.” Application of Rosewell, 69 Ill. App. 3d 996, 1002, 387 N.E. 2d 866, 870 (1<sup>st</sup> Dist. 1979). Additionally, a lease contains “a definite agreement as to the extent and the bounds of the property; a definite agreed term; and a definite agreed rental price and manner of payment.” Jackson Park Yacht Club v. Illinois Department of Local Government Affairs, 93 Ill. App. 3d 542, 546-547 (1981).  
Dept. Brief pp. 19 – 20.

There is no evidence in the record that XFSC ever entered into any agreement having the attributes described in the above case law, or that XFSC ever had possession or control over the purported rental property. Therefore, the payments XFSC made to Chase were not legally classifiable as rent under Illinois case law.

In sum, there is no evidence in the record of any agreement expressly providing for the payment of a rental charge for property outside of the United States. Moreover, to allow a taxpayer to include space that is not rented by the taxpayer, but only used for the benefit of the taxpayer by the actual owner or lessee, creates an apportionment scheme that risks improperly assigning income to Illinois for tax purposes. Finally, the claim that the service agreement included a rental charge ignores Illinois case law defining the term “rent”. For the foregoing reasons, I conclude that the taxpayer has failed to show that it rented property outside of the United States.

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In Shaklee Corp., *supra*, the appellate court held that a company with no property or payroll within or outside of the United States cannot meet the burden of proof necessary to show that it is an 80/20 rule company. Given the facts contained in the record showing that XFSC had no payroll or measurable property, the decision in Shaklee is completely applicable to XFSC.

Moreover, the Illinois appellate court has held that, even where there is property and payroll outside of the United States, an 80/20 rule company will not be proven if the record contains evidence of activities performed in the United States on behalf of the off shore company. Zebra Technologies Corp. v. Topinka, Nos. 1-01-2861 and 1-02-0386, Ill. App. Ct., Aug. 11, 2003; modified upon denial of rehearing, Nos. 1-01-2861 & 1-02-0386, Ill. App. Ct., October 27, 2003. The holding in this case is based on the court's finding that the taxpayer failed to prove what proportion of services deemed performed by the taxpayer's Bermuda holding companies were actually performed in the United States. As a consequence, the Bermuda companies failed to prove that 80% or more of their business activities were outside of the U.S.

The record in the instant case shows that this holding is also applicable to the facts presented here. Pursuant to XFSC's Export Related Services Agreement with XXXXXXXX, XXXXXXXX agreed to perform various services on XFSC's behalf. See Taxpayer's Ex. 81. XFSC presented no evidence quantifying the extent of services performed in the U.S. by XXXXXXXX under the Export Related Services Agreement for purposes of applying the 80/20 rule. Under the court's holding in Zebra Technologies, it therefore failed to prove that it was entitled to exclusion from XXXXXXXX's Illinois unitary business group under the 80/20 rule. Accordingly, XXXXXXXX would not prevail

even if the record allowed one to conclude that it made *de minimis* rental payments for property outside of the U.S.

As noted in Zebra Technologies, a taxpayer claiming exemption from tax based on the 80/20 rule “has the burden of proving clearly that it comes within the statutory exemption.” Zebra Technologies, *supra* at 5 (citing United Air Lines, Inc. v. Johnson, 84 Ill. 2d 446, 455-56 (1981)). Like any other exemption provision, the 80/20 rule exemption must be strictly construed, and all doubts concerning the applicability of the exemption must be resolved in favor of taxation. United Airlines, *supra*. In this case, the facts presented by the taxpayer do not support the taxpayer’s exemption claim. Moreover, the taxpayer has cited no case law that supports its position. Accordingly, I find that the taxpayer has failed to rebut the Department’s prima facie determination that XFSC was properly included in XXXXXXXX’s unitary business group.

### **Investment Tax Credit Issue**

On May 12, 1994, XXXXXXXX purchased a CanadaAir Challenger aircraft (“aircraft”), Serial No. 5113 for \$14.6 million. The taxpayer claimed a credit against its Illinois replacement income tax for the aircraft pursuant to section 201(e) of the IITA, 35 ILCS 5/201(e) (“section 201(e)"). Section 201(e) provides, in part, as follows:

- (e) Investment credit. A taxpayer shall be allowed a credit against the Personal Property Replacement Income Tax for investment in qualified property. ...
- (2) The term “qualified property” means property which:
  - (A) is tangible, whether new or used, including buildings and structural components of buildings and signs that are real property, but not including land or improvements to real property that are not a structural component of a building such as landscaping, sewer lines, local access roads, fencing, parking lots, and other appurtenances;

- (B) is depreciable pursuant to Section 167 of the Internal Revenue Code, except that “3-year property” as defined in Section 168(c)(2)(A) of the Code is not eligible for the credit provided by this subsection (e);
- (C) is acquired by purchase as defined in Section 179(d) of the Internal Revenue Code;
- (D) is used in Illinois by a taxpayer who is primarily engaged in manufacturing, or in mining coal or fluorite, or in retailing; and
- (E) has not previously been used in Illinois in such a manner and by such a person as would qualify for the credit provided by this subsection (e) or subsection (f).

To administer and enforce this measure, the Department has promulgated 86 Ill. Admin. Code, ch. I, sec. 100.2101 (“regulation 100.2101”) which provides in part as follows:

(a) A taxpayer shall be allowed a credit against the Personal Property Replacement Income Tax for investment in qualified property (“the investment credit”). The qualified property must be used in Illinois by a taxpayer who is primarily engaged in manufacturing, retailing, coal mining or fluorite mining. ...

(6) Used in Illinois. Mobile property such as vehicles must be used predominantly in Illinois. Removal of such property from Illinois for a temporary or transitory purpose will not disqualify the property so long as it continues to be used predominantly in the Illinois operation of the taxpayer. For purposes of this Section, mobile property is considered to be predominantly used in Illinois if usage in Illinois exceeds usage outside of Illinois. Example: A retailer sometimes uses its trucks based in Illinois to deliver goods both in Illinois and to out-of-State buyers. Such temporary absence of its trucks from Illinois does not disqualify them.

86 Ill. Admin. Code, ch. I, sec. 100.2101(e)(6)

On audit, the Department determined that the aircraft was “qualified property” under section 201(e), but was not used in Illinois more than 50% of the time, and therefore did not satisfy the prerequisites of regulation 100.2101(a)(6) noted above. The taxpayer contests the Department’s denial of an investment tax credit pursuant to this regulation.

Subsection (7) of section 201(e) of the IITA provides in part as follows:

- (7) If during any taxable year, any property ceases to be qualified property in the hands of the taxpayer within 48 months after being placed in service, or the situs of any qualified property is moved outside Illinois within 48 months after being placed in service, the Personal Property Tax Replacement Income Tax for such taxable year shall be increased. Such increase shall be determined by (i) recomputing the investment credit which would have been allowed by ... eliminating such property from such computation, and (ii) subtracting such recomputed credit from the amount of the credit previously allowed. (emphasis added)

This provision plainly limits the replacement tax investment tax credit (“ITC”) to property that is “situated” in Illinois. In Canteen Corp. v. Department of Revenue, 123 Ill. 2d 95, 105 (1988), the Illinois Supreme Court states that “(A)n undefined statutory term must be given its ordinary and popularly understood meaning.” The legal term “situs” is defined in Black’s Law Dictionary as follows:

Situation; location ... site, position; the place where a thing is considered, for example, with reference to jurisdiction over it, or the right or power to tax it.  
Black’s Law Dictionary, Fifth Edition, p. 1244 (1979)

The dictionary definition of “situs” makes this term synonymous with the term “location.” Accordingly, section 201(e)(7) denies ITC benefits whenever the location of otherwise qualified property ceases to be in Illinois within 48 months after being located here. Were section 201(e)(7) applied literally, mobile or movable property would seldom qualify for the ITC because in many cases it is constantly being moved outside of the state.

The Illinois Income Tax Act authorizes the Department “to make, promulgate and enforce ... reasonable rules and regulations ... relating to the administration and enforcement of the provisions ... ” of the IITA. 35 ILCS 5/1401(a). In the exercise of

this authority, and in an attempt to avoid an unduly harsh application of section 201(e)(7), the Department has decided to construe the term “situs” as applied to mobile property to mean property that is predominantly used in Illinois. This construction of the term “situs” for purposes of assigning a tax location for mobile property to a particular state has been embraced in at least one other state. See Pa. Code 61 § 155.10(d)(1)(ii).

On its face, this regulation would appear to be a rational interpretation of section 201(e)(7), since a more literal application of this section would exclude most mobile property from replacement tax ITC benefits. However, the taxpayer contests the Department’s interpretation of the term “situs” on the following grounds:

The Department has enacted a regulation requiring that “[m]obile property such as vehicles must be used predominantly in Illinois ... Mobile property is considered to be used predominantly in Illinois if usage in Illinois exceeds usage outside of Illinois.” ... In the past, the Department has interpreted the regulation’s requirement that property is used predominantly in Illinois to mean that at least fifty percent or more of the use occurs in Illinois. The Department’s interpretation of the regulation is incorrect. ... If the Department’s interpretation were accepted, most if not all jet aircraft would not qualify for the investment tax credit. Aircraft, unlike trucks and cars, are not typically used for transport within a state, but instead for transport to other states and countries. The General Assembly could not have intended that the investment tax credit would be limited in this manner. Therefore, in the event that the Department’s interpretation of the regulation is correct, the regulation is void. The statute does not require any specific percentage of use in Illinois before property can qualify for the investment tax credit. Instead, Section 201(e) requires only that the property be used in Illinois by a manufacturer.  
Addendum to Taxpayer’s Brief Regarding the Replacement Tax Investment Tax Credit at pp. 3, 4.

The position of the taxpayer must be rejected because it is contrary to the plain language of the Illinois Income Tax Act. The taxpayer essentially argues that the mere use of property in Illinois is sufficient to qualify the property for ITC benefits. Under this interpretation, any in-state use of property, however brief or transitory, is sufficient to

obtain ITC benefits. To construe section 201(e) in this manner would nullify the obvious intent of section 201(e)(7) to confine the ITC to property having its “situs” or location in Illinois for at least 48 months. If all that was required to qualify was the temporary location of property in Illinois, there would be no reason to deny ITC benefits when property is located outside of the state “within 48 months” after being acquired and placed in service.

While the taxpayer contends that the practical effect of the Department’s “predominant use” test is to deny ITC benefits to most aircraft, which are primarily used in interstate commerce, there is no indication that the legislature intended to treat aircraft different from any other property under section 201(e). Where the legislature has seen fit to treat aircraft differently from other mobile property for tax purposes, it has done so in express and unambiguous terms. See 35 **ILCS** 505/2(d). The Illinois courts have consistently stated that revenue statutes are to be construed strictly, and “their language is not to be extended or enlarged by implication beyond its clear import.” Canteen Corp. at 105; Illinois Bell Tel. Co. v. Allphin, 93 Ill. 2d 241, 256 (1982); Oscar Paris Co. v. Lyons, 8 Ill. 2d 590, 598 (1956). Since the taxpayer has cited no statutory or other legal authority for its claim that aircraft must be treated differently, I find this position to be without merit.

The Department’s construction of the term “situs” to mean the place where mobile property is predominantly used in Regulation 100.2101(a)(6) is not only reasonable but, as pointed out by the Department, best effectuates the purposes for which the ITC was created. As noted by the Department:

The legislative history or background of a statute also may be instructive. ... In the case at bar, IITA § 201(e) was enacted to

encourage new businesses to locate to Illinois and to encourage existing businesses to expand and stay in Illinois, thereby reducing unemployment in the State. (SB No. 477 Debate, May 21, 1981, pp. 18-19). Therefore, the reason for IITA Section 201(e) was to increase economic growth whereas unemployment was the evil to be remedied. (SB No. 477 Debate, May 21, 1981, pp. 18-19). As then Senator Davidson stated, SB No. 477 would inform the “people who do furnish the employment for our unemployed [ ] that we are interested in them ... This is your chance to do something to help do away with unemployment in Illinois ... ” (SB No. 477 Debate, May 21, 1981, p. 23). ... To implement the goal of Senate Bill No. 477, an employer is allowed a tax credit for certain tangible personal property placed in service in Illinois. 35 ILCS 5/201(e). When an employer invests in real property (e.g., manufacturing facilities), such property is located solely within Illinois. As such, the expansion in business activities and any resulting employment occurs completely within Illinois. ... In contrast, when an employer invests in mobile property, the employer does not necessarily use the property predominantly within Illinois. Therefore, the resulting employment derived from such mobile property may not occur solely (or even predominantly) within Illinois. In the instant matter, although XXXXXXXX stored the airplane in a hanger in Illinois, XXXXXXXX flew the plane to other states in the U.S. and to countries around the world. Therefore, although some employment producing activities such as refueling, equipment inspections, de-icing, cleaning the plane and providing food and beverage services might have occurred in Illinois, many of those activities actually occurred outside of the State, thereby increasing employment outside of Illinois. Since the majority of the miles XXXXXXXX’s airplane flew were outside of Illinois and certain employment producing activities also occurred outside Illinois, it is apparent that the airplane was **not used predominantly** within Illinois. ... Thus, XXXXXXXX’s operation of the airplane does not effectuate the legislative intent of IITA § 201(e), namely to reduce unemployment in Illinois. (emphasis in the original)  
Dept. Brief pp. 26, 27.

For the reasons enumerated above, I conclude that the Department properly denied the taxpayer a replacement income tax investment tax credit for the purchase of the aircraft because it was used predominantly outside of Illinois.

### **Conclusion**

As noted above, as recited in my order entered on May 20, 2003, the parties have reached an agreement settling the amount of the training expense credit and research and

development credit to be allowed the taxpayer for the tax years in controversy. This opinion, therefore, does not address these issues.

**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 1993, 1994 and 1995 be cancelled. It is further recommended that the NODs issued for 1993, 1994 and 1995, as they pertain to the inclusion of XXXXXXXX Foreign Sales Corporation in XXXXXXXX's combined return, and to the denial of a replacement tax income tax credit for the aircraft acquired in 1994, be affirmed.

Ted Sherrod  
Administrative Law Judge

Date: December 31, 2003