

Practice Update

Illinois Pepsi Case Puts Spotlight on 80/20 Rule Modernization

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States have for years allowed a domestic “80/20 company” to be excluded from combined reporting based on a straightforward calculation of property and payroll factors. Such rules had rarely been in the spotlight, in part because of the seemingly noncontroversial test. But last month’s [ruling in *PepsiCo Inc. v. Illinois Department of Revenue*](#) raises the question of whether taxpayers and state policymakers should take a fresh look at the rules.

In state water’s-edge combined filing groups, an 80/20 company can be either domestic or foreign-based. While state definitions differ, a domestic 80/20 company generally is a corporation that conducts at least 80% of its business activity outside the US and is excluded from a water’s-edge combined return.

Illinois’ 80/20 rules measure business activity based on a company’s average property and payroll factors located in a foreign jurisdiction. But Sangamon County Circuit Court [recently](#) looked behind the state’s bright-line test, pulling from federal judicial principles of economic substance to hold that a related company must be included in a combined

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group—despite that company reporting more than 80% of its property and payroll outside the US.

The court ruled that PepsiCo Inc.'s snack food affiliate Frito-Lay North America Inc. didn't qualify as an excluded 80/20 company. It concluded that the expatriates reported as foreign payroll of the single-member limited liability company (PepsiCo Global Mobility LLC) weren't common-law employees of the LLC.

A 2021 Illinois Tax Tribunal ruling on the same issue for the same taxpayer—but different tax years—reached the same conclusion, and appeal is pending before the Illinois Appellate Court. Another similar case is pending before the tribunal.

While it's premature to assess the impact of this particular case, and PepsiCo likely will appeal the decision, businesses should anticipate that Illinois and other states may try to reduce application of the 80/20 exclusion by challenging more taxpayers and seek to limit what constitutes foreign payroll and property. Taxpayers should further expect to see more revenue department audits of multinational businesses.

It would be prudent for multinationals to continually reevaluate their reporting in all states. The *PepsiCo* litigation shows the importance of documenting the substance of foreign operations to ensure the structure will be respected. These 80/20 exclusions were enacted when the global footprint of most companies was far less expansive. In today's more remote environment, businesses must carefully track employees' presence.

The *PepsiCo* decision extended the economic substance doctrine to the mechanical 80/20 exclusion test, signifying a potential expansion of this federal doctrine in future state and local tax cases. The economic substance doctrine historically has been mainly limited to federal income tax cases rather than state and local tax cases. The Illinois

ruling could encourage other revenue departments to seek to expand use of the doctrine (potentially retroactively) or simply disregard their own published guidance in an attempt to challenge other types of transactions or arrangements.

Modernization of the 80/20 rules could help better align the application of the exclusion with its original intent and ensure taxpayers have meaningful guidance on when companies should be included or excluded from a combined group. The concept of business activity has shifted since these rules were enacted, as reflected in the trend away from a three-factor property, payroll, and sales apportionment formula to a single-sales factor formula.

Regardless of the PepsiCo case's ultimate outcome, we can expect renewed focus on the 80/20 exclusion and the economic substance doctrine. It's also possible that this heightened attention could organically lead to modernization of the 80/20 rules through additional guidance or reform to better reflect the reality of today's multinational businesses.

The case is PepsiCo Inc. v. Illinois Department of Revenue, Ill. Cir. Ct., No. 2022TX000155, decided 1/9/25.

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