

Shark Tank - Be Aware of the Deadly Creatures in the State and Local Tax Waters

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Earlier this year, the Idaho Supreme Court, in *Noell Industries, Inc. v. Idaho State Tax Comm'n*, — P.3d — (2020), ruled that gain from the sale of membership interests in a limited liability company that had business operations in Idaho by a taxpayer domiciled outside of Idaho was not business income. As a result, the gain was not taxable in Idaho.

The court, in a 3-2 decision, upheld the district court's reversal of the Idaho Tax Commission's determination to tax the income. The sharks were circling the taxpayer, ready to attack, but the majority of the justices on the Idaho Supreme Court intervened, saving the taxpayer from a savage death (or at least a boatload of taxes).

Background

In 1993, Mike Noell ("Noell") formed Noell Industries, Inc., a Virginia corporation ("Noell Industries"), which developed and sold military equipment. Noell was the sole shareholder of Noell Industries.

Ten years later, Noell Industries transferred its assets to a newly formed Virginia limited liability company ("Blackhawk") in exchange for a 78.54 percent membership interest in Blackhawk. Noell was President and CEO of Blackhawk and part of a six-member management team, but he did not make day-to-day operational or marketing decisions.

Blackhawk had real property and business operations located in Idaho.

After its transfer of assets to Blackhawk, Noell Industries had no assets other than its interest in Blackhawk and an interest in another business that leased real property to Blackhawk. Aside from interest income, the vast majority of Noell Industries' income was derived from these two entities. Noell Industries had no employees, did not share assets or expenses with Blackhawk, and did not perform services for Blackhawk. The two entities did, however, use the same legal and accounting firms.

In 2010, Noell Industries sold its entire interest in Blackhawk for a gain of \$120 million. It reported the gain on its Idaho tax return but did not apportion any income to the state.

After an audit, the Idaho Tax Commission concluded that the gain was "business income" under Idaho's version of the Uniform Division of Income for Tax Purposes Act ("UDITPA") and a significant portion of the gain should have been apportioned to Idaho, ultimately concluding that more than \$1.4 million in taxes were due to Idaho. On appeal, the district court reversed the tax commission, finding that the gain was not business income. Thus, the taxpayer was correct in apportioning none of the gain to Idaho. The Idaho Tax Commission appealed the decision to the Idaho Supreme Court.

Majority Opinion

The Idaho Supreme Court affirmed the district court's finding that the gain did not constitute business income.

Nonbusiness Income

Under Idaho's UDITPA, business income is subject to apportionment while nonbusiness income from the sale of intangible personal property is allocated only to the taxpayer's domicile (which in this case was Virginia).

Idaho's UDITPA rules contain two definitions of business income: one under what is called the transactional test and another under what is called the functional test. As discussed below, the Idaho Supreme Court found that neither test was met. Thus, Idaho could not tax the gain.

Transactional Test

Under the transactional test, income is business income if it arises from transactions in the regular course of a taxpayer's trade or business. While the transactions do not need to occur frequently, they must be customary in the type of trade or business conducted or otherwise reasonably within the scope of the trade or business.

The court cited case law from other jurisdictions providing that gain from a holding company's sale of its subsidiary can meet the transactional test if the holding company regularly engages in the business of buying and selling companies, but a single sale will not satisfy the transactional test.

The court found that, while Noell Industries described itself on its tax returns as a being in the business of making investments, it did not regularly engage in the business of buying and selling subsidiaries. As such, the transactional test was not met.

Functional Test

In order to satisfy the functional test under Idaho's UDITPA, both of the following two tests must be met: (1) the operational-function test; and (2) the unitary-business test.

Operational-Function Test

To satisfy the operational-function test, an intangible interest must serve an operational function, rather than a passive one, as an integral, functional, or operative component to the taxpayer's trade or business.

Where property is held solely for investment, the operational-function test will not be met. Pursuant to Idaho case law, incidental benefits to a company from holding stock in another, such as enhanced credit standing and additional revenue, will not rise to the level of serving an operational function.

According to the court, Noell Industries was merely a holding company. Its only business activities were holding interests in Blackhawk and a business that leased real property to Blackhawk. As such, the operational-function test was not met.

Unitary Business Test

Under Idaho's UDITPA rules, a unitary business is defined as "a single economic enterprise" where a group of entities are commonly controlled and are "sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value" between them, as well as a "significant flow of value to the separate parts."

Such flow of value provides the requisite "definite link and minimum connection" to satisfy the Due Process Clause of the U.S. Constitution in order for Idaho to apportion business income of a unitary business, particularly where income from activities conducted outside of Idaho is concerned. The sharing or exchange of value may require that the operation of one part of a business be "dependent upon, or contribute to," the operation of another part of the business. Under U.S. Supreme Court jurisprudence, and as encapsulated in Idaho's UDITPA rules, the hallmark of a unitary business is the significant flow of value evidenced by the following factors: functional integration, centralization of management and economies of scale.

The court reviewed cases finding a unitary business relationship. In one such case, the parent and subsidiary had the same directors and officers, and the parent made decisions for the subsidiary and performed functions for it, including bookkeeping, tax return preparation and preparation of corporate meeting minutes.

In contrast, according to the majority of the court, Noell Industries did not control the operations of Blackhawk. In its view, there was no centralized management because Noell Industries had no employees, payroll or offices. While Noell was the sole shareholder of Noell Industries and was also the President and CEO of Blackhawk, the court found determinative that Noell was only one part of Blackhawk's six-member management team and he did not manage its daily operations. Furthermore, Blackhawk's officers and employees were not involved with Noell Industries' operations. Therefore, there was no centralized management.

For these reasons, the court concluded that Noell Industries was not part of a unitary business with Blackhawk. As such, Noell Industries' gain from the sale of its Blackhawk interest was not business

income. Since Noell Industries was domiciled in Virginia, such nonbusiness income was allocated solely to Virginia. Thus, Idaho could not tax the gain.

Dissent

The dissent (comprising 40 percent of the court) declared that Noell Industries and Blackhawk were parts of a unitary business because, in the dissent's opinion, the two entities were functionally integrated and had centralized management.

Regarding functional integration, the dissent cited an Idaho UDITPA rule providing that functional integration includes transfers or pooling of technical information or intellectual property such as know-how. Without further discussion of the contours of the term "know-how," the dissent declared that Noell, as creator of both entities, "provided the 'know-how' for their mutual success."

With respect to centralized management, the dissent discussed a rule providing that centralized management can exist where centralization is effected from a parent to a subsidiary even where day-to-day management responsibility is decentralized, as long as management has an ongoing operational role with respect to the business activities. Noell was sole owner of Noell Industries and President and CEO of Blackhawk, and his role in Blackhawk included directing its vision and overseeing all aspects of the business. Because of these roles, the dissent argued that Noell was intimately involved in decision-making for both entities. As such, Noell exercised control over both entities and thus there was centralized management.

The dissent also found that Noell Industries' gain from the sale of its Blackhawk interest was business income. It did so by stating that Noell Industries' investment in Blackhawk was not that of passive investor. It hung its hat on the fact that Noell controlled and managed both entities.

Interestingly, in a footnote, the dissent characterized Noell Industries as a "straw man." In its view, if Noell Industries did not exist and Noell had sold a direct interest in Blackhawk, the income would have been business income. This treatment was avoided only by inserting Noell Industries between Noell and Blackhawk. The dissent declared that the majority's conclusion that the gain at issue was not business income by virtue of this fact was to find the gain "magically not taxable," which is "not how the tax code operates."

Comments

While the Idaho Supreme Court's decision in *Noell Industries, Inc. v. Idaho State Tax Comm'n* was a good and well deserved victory for the taxpayer, other taxpayers need to pause for cause. The case was narrowly decided in favor of the taxpayer in a 3-2 decision.

The majority opinion and the dissent at times proceeded from different starting points, with the majority starting with the definition of business income and the dissent starting with the unitary business analysis. As a result, the two sides sometimes did not expressly argue the same points (for example, the majority did not really address functional integration).

However, it seems that the two main places where the majority and dissent differed were whether there was centralized management such that a unitary business resulted, as well as whether or not Noell Industries' interest in Blackhawk was a passive investment such that the sale of it did not constitute business income.

The majority's determination that there was no centralized management is interesting, particularly in light of the rule cited by the dissent that centralization can be effected from a parent to a subsidiary even where day-to-day management responsibility is decentralized, as long as management has an ongoing operational role with respect to the business activities of the subsidiary. It certainly seems that Noell had a significant management role with respect to each entity. Furthermore, as sole shareholder of Noell Industries, which held a controlling interest in Blackhawk, Noell likely could have indirectly controlled all of Blackhawk's business decisions. While we are told that Noell did not manage day-to-day operations of Blackhawk, that does not appear to be fatal under the law.

On the other hand, the dissent's statement that tax consequences should be no different depending on the choice and number of entities ignores the reality that taxpayers are generally free to choose the way to conduct their businesses and that tax consequences often differ depending on the entities and structures chosen. That most certainly is the way the tax code generally works. Of course, if there is a tax avoidance motive, courts may be able to collapse a transaction by use of an anti-avoidance rule. But simply choosing to operate a business by using two entities will generally not permit a court to ignore the choice and concomitant tax treatment.

Conclusion

Taxpayers with multiple entities and affiliates who operate in different states should be aware that state tax authorities may be lurking, waiting to assert claims that income from a major transaction, including the sale of an intangible, should be apportioned to their state, even when that state may appear to have no connection to the transaction. In a win for the taxpayer, the Idaho Supreme Court in *Noell Industries, Inc. v. Idaho State Tax Comm'n* stopped the Idaho state taxing authorities from taking a piece of the transaction when it told them: "not so fast." That decision will not likely stop the sharks from circling the unaware taxpayer, waiting to strike. Taxpayers cannot ignore state and local tax implications when planning a major transaction.

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