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Noell Industries, INC v. Idaho State Tax Commission Respondent's Brief Dckt. 46941

IN THE SUPREME COURT OF THE STATE OF IDAHO

IDAHO STATE TAX COMMISSION,

Appellant,

vs.

NOELL INDUSTRIES, INC., a Virginia corporation,

Respondent.

Supreme Court Docket No. 46941-2019
District Court No. CV01-18-02355

BRIEF OF RESPONDENT NOELL INDUSTRIES, INC.

Appeal from the Fourth District Court, Ada County, State of Idaho
Honorable District Judge Steven Hippler, presiding

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I.
STATEMENT OF THE CASE

A. Nature of the Case.

This is an income tax case. The Idaho State Tax Commission (the "Commission") has sought to extend its jurisdiction to tax not only the income from a business operating in this state, but also the gain earned in the sale of the business by its non-resident corporate owner. This capital gain, earned from many years of operation in many states around the country, is gain from the sale of an intangible asset – a membership interest in a Virginia limited liability company (LLC). As such, the gain is taxable in the state in which the taxpayer resides and to which it reported the gain.

B. Course of Proceedings.

After an audit of the taxpayer Noell Industries, Inc. ("Noell Industries"), the Commission staff proposed a deficiency in tax based on the gain Noell Industries realized from the 2010 sale of its 78.34% interest in an operating company, Blackhawk Products Group Unlimited, LLC ("Blackhawk"). The asserted deficiency was in the amount of $3,431,686, and was based on the assumption that the gain represented "business income" as defined in I.C. §63-3027(a)(1). Noell Industries filed an administrative appeal of that deficiency determination, arguing that neither Idaho law nor the U.S. Constitution allowed the taxation of this income and that, in any event, the staff had erred by not applying a method of apportioning that income to Idaho that varied the normal "default" method prescribed in I.C. 63-3027. In a Decision entered on November 8, 2017, the Commission affirmed the determination that the gain was business income but applied an alternate apportionment factor, pursuant to I.C. §63-3027(s), to reduce the tax to $1,140,489.

Noell Industries filed an appeal to the district court pursuant to I.C. §63-3049. In its Complaint, Noell Industries asserted that the gain in question was not business income as defined by Idaho law, and in any event that the Due Process and Commerce Clauses of the U.S.

Constitution precluded tax on the gain. It also argued that if any of the gain was taxable in Idaho, the Commission was correct in applying an alternate apportionment method, but the method it applied was not correct. R., pp. 000008-000009.

In the district court, Noell Industries filed a motion of summary judgment on the issue of whether the gain on the sale of the Blackhawk LLC interest represented business income and whether the Constitution prohibited Idaho from taxing it. The Tax Commission then filed its own motion for summary judgment, arguing that there was no genuine issue of fact regarding the business income or Constitutional issues, and also asserting that the alternate apportionment method the Commission developed was correct as a matter of law.

In its 23-page Decision entered on February 15, 2019, the district court granted summary judgment to Noell Industries on its statutory claim that the income did not represent business income as defined in I.C. §63-3027(a)(1). R. p. 000462. The court also concluded that Idaho's taxation of the gain in question would also be inconsistent with Due Process and Commerce Clause requirements – that in order to tax income earned outside of Idaho from the sale of an ownership interest held outside the state, the entity holding that interest must be part of a unitary business operating partly in Idaho. The district court did not address Noell Industries' argument that the tax would violate the Due Process Clause prohibitions on taxes where there is an insufficient connection with the state. *See Corrigan v. Testa,* 73 N.E.3d 381 (2016); *N. Carolina Dep't of Revenue v. Kaestner Trust,* 139 S. Ct. 2213 (June 21, 2019). That constitutional principle provides an alternate basis for affirming the district court's decision. Given its holding, it did not need to address the Tax Commission's argument that there was no genuine issue of fact concerning the validity of its alternative apportionment method. After the Decision, the Commission filed a timely appeal.

C. Statement of Facts.

The pertinent facts of the case are well-stated at pages 2-5 of the district court's Decision. The Tax Commission never contends that the facts relied on by the district court are inaccurate and never argues that there is a genuine issue of material fact. Yet, the facts are not accurately stated in the Commission's brief, which frequently conflates or confuses the investments of Noell Industries with the operations of Blackhawk, the business in which Noell Industries held a 78.34% interest. The Commission never argues that the two entities should be collapsed for tax purposes or that their separate existence should be ignored, but seems to seek the same result in *sub silentio* fashion by incorrectly suggesting that one entity is the mirror image of the other.

In 1993, Mike Noell founded Blackhawk Industries, Inc. in Virginia, to develop and sell tactical and combat gear. Mr. Noell was a former Navy Seal. In 2004, Blackhawk Industries, Inc. executed a transaction with new investors that led to the creation of Blackhawk Products Group, LLC, a Virginia limited liability company (hereinafter "Blackhawk"). R., p. 000199. Blackhawk Industries contributed all of its operating assets to the new company, in exchange for a 78.34% interest. The investors obtained the remaining 21.66% interests, and the LLC hired new executives to help operate the business, R., pp. 000202-000204, 000215. Mr. Noell continued to provide high-level leadership to the business, but with a management team that ran the day-to-day operations. (R., pp. 000215, 000278.) Blackhawk Industries Inc. was later renamed Noell Industries, Inc., which from 2004 onward had no operating assets.[1]

Where the Tax Commission's brief refers to "shared executives between businesses," and "shared operations," *see* Brief at pp. 5-6, 26-27 (emphasis added), it is important to recognize that Noell Industries was not a "business" but an investment vehicle, and that it did not have "operations" that did involve or could involve "sharing." It reported its activities in its federal

[1] The Commission's brief refers to Noell Industries, Inc. as Blackhawk Industries, which was its name, according to the Brief, "at all times relevant to this case." Brief, p. 1, note 1. Appellant will use the name "Noell Industries" because it is more accurate, because the district court used that name, and because it avoids confusion.

tax returns as "Investments," and its products as "investment." R, p. 000127. It had no employees, R. p. 0068, so the claim that Noell Industries could rely on and share Blackhawk's human resources department is entirely without merit. *See* Brief, pp. 6, 26. It satisfied the corporate formalities, R. p. 000279, and so elected officers and held meetings, but it did not have an active business which would have needed those officers to perform any operational functions, and they did not. R., pp. 000068, 000279. Noell Industries did use the same legal and accounting firms as Blackhawk, as would be expected, but to call these "shared expenses" would be inaccurate where Noell Industries' needs would be investment-oriented, not operational.[2] In any event, Noell Industries' expenses were so limited as to not even be shown separately on its tax returns. R., p. 000319 (no expenses listed for salaries, or any other business-related expenses, on federal tax return). Indeed, as noted by the Commission, most of Noell Industries' income came from its investment in Blackhawk, so there would be little need for it to incur other expenses. In contrast, not all of Blackhawk's income was payable to Noell Industries, as there was a sizable minority interest.

The operations of Blackhawk from 2004 to 2010 were led by a management team of which Mr. Noell was a part as president of Blackhawk, although he no longer directed the day-to-day operations of the business. R., p. 000278. During that time, Noell Industries' activities were limited to the passive role of an investor, holding 78.34% of the Blackhawk LLC units and not conducting an active business itself. R., pp. 000068, 000279. In 2010, it sold that interest for a gain, which the Tax Commission seeks to tax in this case.

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[2] There is one reference in the record to "shared" services, where Noell Industries' CPA stated that Noell Industries and Blackhawk "shared accounting firms and law firms." R., p. 000199. The use of the term "shared" here was not in the sense that the two companies divided in some fashion all the time available from these professionals, as is usually the situation where different businesses within a unitary group use central administrative personnel, central purchasing, and other services. Instead, the term "shared" in this sense means only that they have something in common; both entities use the same firm. This was relevant because in his Declaration, the CPA was able to provide information about his knowledge of both companies, and their relationship with each other. See Declaration of David Chase, R., p. 000272.

Noell Industries filed tax returns in Idaho and Virginia consistently with the requirements of partnership taxation as described in this brief. It reported the gain on the sale of the Blackhawk LLC membership interests to the state of Virginia. R., p. 000226.

II.
ISSUES ON APPEAL

Whether the district court was correct in granting summary judgment to Noell Industries on the issue of whether the gain on the sale of Blackhawk LLC units represented business income under Idaho law. Alternatively, if the basis on which the district court relied was incorrect, whether the Decision may be affirmed on other grounds, and in particular that Idaho is barred from taxing the gain by the Due Process Clause of the U.S. Constitution, as articulated in *Corrigan.*

III.
ARGUMENT

A. Introduction and Summary.

As an LLC, Blackhawk's annual income is passed through to its owners/members under principles of partnership tax law that have been made applicable to LLCs. *See* I.C. § 63-3006A (LLC classified as a partnership for tax purposes). There is no dispute that part of Blackhawk's income was earned in Idaho, and represented "business income" of that entity subject to apportionment. As a 78.34% owner of Blackhawk, Noell Industries was taxable on that income. This follows the "aggregate" theory of partnership taxation, where owners are taxed on a partnership's/LLC's income as if the entity did not have a separate existence. This is the case even if there are no cash distributions to the owner. *See* Internal Revenue Code, §§ 701, 702, 704. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 1.01 (4th ed. 2017).

But the capital gain on the sale of an LLC ownership interest – an intangible asset – requires an entirely different analysis. Here, the "entity" theory of partnership law is followed in the context of an individual's interests in the partnership, where the partner is recognized as separate from the partnership entity. Each partner has a tax "basis" for his/her interest in the partnership, and when that interest is sold, or when the partnership is liquidated, the partner's gain or loss on the disposition of that interest is not determined by whatever assets the partnership owned, but by the partner's basis in his or her partnership interest. *See* 1 W. McKee, *supra,*, ¶ 1.02[3]; Internal Revenue Code §§ 741-743.

Idaho tax law is generally consistent with the federal taxation of partners and partnerships. I.C. § 63-3002. However, the issues in this case are issues that do not need to be addressed at the federal level: after determining the income that is taxable to a partner, what state is entitled to tax that income? The differences between the taxation of a partnership's income and the partner's gain on the sale of his/her interest <u>are</u> recognized in Idaho law as in the federal tax code. If the income is "business income," as defined in I.C. § 63-3027(a)(1), part of the income is "apportioned" to Idaho by formulas set forth in other subsections of section 63-3027. This generally relates to the annual income of the partnership itself, taxed in accordance with the "aggregate" approach.

If income is "non-business" income, it is "allocated" to a state under a different set of rules consistent with the "entity" theory. For capital gains such as Noell Industries' gain on the sale of Blackhawk LLC units, subsection (f) of section 63-3027 provides that all of the income is allocated to Idaho if the taxpayer's commercial domicile is in this state. However, Noell Industries' commercial domicile is in Virginia. That subsection also provides that the allocation to the state of commercial domicile does not apply if the income is considered "business income," but now the question is whether the income is Noell Industries' business income, not Blackhawk's. Again, the focus is on the owner's characteristics and the relation of that income to the owner, consistent with the aggregate approach, not the underlying business.

In determining whether income represents "business income," the courts have relied on interpretations of the statutory definition of that term and also Due Process and Commerce Clause principles that overlay the application of the statute. The appendix to this Brief summarizes the similar principles that are applied in the statutory and constitutional analysis. When a non-resident corporation owns an interest in a business that operates in the taxing state and also has other businesses or assets, both sets of principles require an examination of whether the corporate owner's income from those other businesses or assets can be taxed along with the income from the business that actually operates in the state. The primary method of conducting this analysis is to determine whether the activities of the corporate owner are "unitary" with the underlying business – whether there are operational and functional connections between the two that might support the taxation of the income of the non-resident corporation.

Noell Industries' complaint in this case alleged, and the facts clearly show, that the gain on the sale of the Blackhawk LLC units did not meet the definition of "business income" because those units were held as an investment and because Noell Industries was not operationally or functionally unitary with or connected to the business operated by Blackhawk. The Tax Commission's brief attempts to avoid that conclusion by arguing that there are facts that support such a connection. But there is no actual factual support for those arguments. The record shows that Noell Industries did not operate a "trade or business" that would support a "business income" characterization; that it held these Blackhawk LLC units as an investment; and that there were no operational or functional ties or synergies between the two entities that could support a finding of unity sufficient to allow taxation on either a statutory or constitutional basis.

An alternate basis for the district court's conclusions, not relied on by the court, is that under another line of Due Process analysis, there were simply insufficient contacts between Noell Industries, as owner of the LLC units, and the state of Idaho that would have justified taxation.

B. Standard of Review.

Appeals from an order of summary judgment are reviewed de novo, and this Court's standard of review is the same standard applied by the trial court. *In the Matter of the Estate of Victoria H. Smith,* 164 Idaho 457, 467, 432 P.3d 6, 16 (2018); *Trotter v. Bank of N.Y. Mellon*, 152 Idaho 842, 845-46, 275 P.3d 857, 860-61 (2012). Summary judgment is proper where there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Rule 56(c). When hearing cross-motions for summary judgment, and when the district court is to be the finder of fact at trial, the court may enter summary judgment even if the court can draw conflicting inferences from the presented facts. *Riverside Dev. Corp. v. Ritchie,* 103 Idaho 515, 518-19, 650 P.2d 657, 661 (1982). While the court must still view conflicting evidence in favor of the non-moving party, the court may draw inferences from the uncontroverted facts which it deems to be the most probable rather than drawing all inferences in favor of the non-moving party. *Loomis v. City of Hailey*, 119 Idaho 434, 437, 807 P.2d 1272 (1991); *see Lockheed Martin Corp. v. Idaho State Tax Comm'n,* 142 Idaho 790, 793, 134 P.3d 641, 644 (2006).

When a taxpayer appeals a determination made by the Commission by filing a complaint against it, "the case shall proceed as other civil cases." "Consequently, we will review this case as an ordinary civil action, and will utilize the administrative determination as merely an articulation of the position of a party to this civil action." *Pratt v. State Tax Comm'n*, 128 Idaho 883, 884, 920 P.2d 400, 401 (1996), *quoted in Lockheed Martin Corp., supra,* 142 Idaho at 793, 134 P.3d at 644.

C. The "Business Income" Issue on Which the District Court Decided the Case Was Not an Unpleaded Issue.

1. The Unitary Business Principle is an Integral Part of the Business Income Analysis in this Context.

The Tax Commission leads off its Argument with a lengthy and confusing discussion of a procedural issue. The Commission contends that the district court erred by allowing Noell

Industries to present an argument in support of its summary judgment motion that was unpleaded. Allegedly, Noell Industries did not plead that it is not "unitary" with Blackhawk and so is now barred from making the argument that the absence of unity is a reason why the gain in question here cannot satisfy the definition of "business income." (Commission Brief, pp. 9-18.)

The Tax Commission's argument fails for many reasons, not the least of which is the reality that Idaho is a "notice pleading" jurisdiction, where pleadings need to be sufficient to introduce the issue but need not be so detailed as to require lengthy analysis in the pleading itself.[3] Noell Industries' pleading was sufficient by whatever standard is applied, but beyond ignoring the fundamental rules of pleading, the Tax Commission's argument betrays a basic misunderstanding of the principles underlying taxation of corporate income. The Commission attempts to construct a narrow framework by which arguments concerning multi-state taxation must be pleaded and proved. Instead, it has put up a straw man that is easily toppled.

As noted above, under the tax regimes of most states, the state is authorized to tax its "apportioned" share of "business income." Non-business income is allocated to the state of the taxpayer's residence. Noell Industries' Complaint asserted that the Tax Commission's Decision erred in taxing the gain on the sale of Blackhawk LLC units as business income. It went on to assert that the Blackhawk interests were in fact an <u>investment</u> in an intangible asset, rather than a

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[3] The Supreme Court has recently spoken on this subject as follows:

> Pleadings must be "[c]oncise and [d]irect[,]" and allegations likewise "must be simple, concise, and direct. No technical form is required." *Id.* 8(d)(1); *accord id.* 8(e) ("Pleadings must be construed so as to do justice."). These rules comport with Idaho's notice-pleading requirement, which inquires whether a pleading suffices to put the adverse party "on notice of the claims brought against it." *Brown v. City of Pocatello*, 148 Idaho 802, 807, 229 P.3d 1164, 1169 (2010) (quoting *Gibson v. Ada Cnty. Sheriff's Dep't,* 139 Idaho 5, 9, 72 P.3d 845, 849 (2003)). Notice pleading does not mandate that a pleading particularly "identify the statutory basis for relief"; rather, it mandates that the pleading provide "*some* indication" of the basis for relief. *Id.*

Hodge v. Waggoner, 164 Idaho 89, 96, 425 P.3d 1232, 1239 (2018) (emphasis in original).

separate <u>business</u> that generates "business income." Complaint, ¶9, R., pp. 000008-000009. The issue of whether, in Noell Industries' hands, the Blackhawk LLC units were an investment or a business asset was clearly presented in the Complaint. Indeed, this is how the Tax Commission's decision characterized the central issue in the case: was the income from a passive investment or was it "directly connected to the taxpayer's business activity." Decision, p. 7, R., p. 000084.

The importance of a direct connection with the taxpayer's business activity derives from the following definition of "business income" – the income of a non-resident that Idaho may tax:

> … income arising from transactions and activity in the regular course of the taxpayer's <u>trade or business</u> and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes <u>integral or necessary parts</u> of the taxpayer's <u>trade or business operations</u>. (Emphasis added.)

I.C. §63-3027(a)(1). In *Union Pacific Corp. v. Idaho State Tax Commission,* 136 Idaho 34, 39, 28 P.3d 375, 379-80 (2001), the Court held this definition encompasses both income from regular business transactions (the "transactional test"), and income from transactions that may be unusual but are nonetheless closely related to the business the taxpayer conducted in the state (the "functional test"). This case does not involve income derived from the regular course of business, and the question is whether the income meets the functional test as being directly connected to the taxpayer's trade or business.

Noell Industries does not have a trade or business, so the question faced by the district court is whether Blackhawk's business may be attributed to Noell Industries. This is where the "unitary" analysis becomes relevant. If Noell Industries is unitary with Blackhawk, the two entities are effectively treated as sharing, or both operating, the same trade or business. The Tax Commission's Decision focused on whether the two entities were connected in an "operational" way. R., pp. 000084-000085. This is another way of expressing the statutory requirement that the income in question is must "integral or necessary parts of the taxpayer's trade or business operation."

The question of whether two businesses are "unitary" is related to the issue of whether they have "operational" ties. As discussed in greater detail below, the hallmarks of unity are functional integration, economies of scale, and centralized management between the two entities. *See Mobil Oil Corp. v. Comm'r of Taxes of Vermont,* 445 U. S. 425, 438 (1980). If there are such operational ties between two entities, it strengthens the case that they are unitary. *See MeadWestvaco v. Illinois Dep't of Revenue,* 553 U.S. 16, 30 (2008) (evaluation of shared operational functions do not substitute for unitary analysis but are relevant to them). However it is characterized, the district court was forced to address the "unitary" issue because, in this case, that is the only way the Tax Commission could prevail. It could prevail only if Noell Industries did have a trade or business of its own, and Noell Industries' business was integral or necessary to, and unitary with, the business conducted in Idaho.

2. Case Law and Rules Concerning Unity in the "Business Income" Context.

The Tax Commission's position apparently is that "unity" is so separate from the "business income" analysis that it is a required element of pleading. That argument is belied by the case law and by the Commission's own rules. That case law includes a case the Commission cites frequently in its brief for other purposes – a case in which this Court expressly applied a unitary analysis in determining the business income question. *Albertson's, Inc. v. State, Dep't of Revenue, State Tax Comm'n,* 106 Idaho 810, 683 P.2d 846, 850 (1984).

The case law also includes a case that is completely ignored in the Commission's brief even though it is cited in the administrative Decision and even though it is discussed at length by the district court. The case is *American Smelting & Refining v. Idaho State. Tax Commission,* 99 Idaho 924, 592 P. 2d 39 (1979), *rev'd on other grounds* in *ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307 (1982) (cited in the Commission Decision at p. 7). In that case, the taxpayer was involved in various aspects of the mining business, and received income from subsidiaries that were also involved in that business. The taxpayer claimed that the income received from these subsidiaries was not business income under section 63-3027, and that even if it was business income, it could not be subject to tax without violating the Due Process and Commerce Clauses of the U.S. Constitution. This Court held that some of the income did meet the definition of business income, but some did not. With respect to the first question, the Court held that the Constitution did not impose any additional limitations on the state and that the income could be taxed. That part of the decision was overruled by the U.S. Supreme Court.[4]

In addressing the statutory question, this Court set out the following basic principle:

> The state may include as business income only the taxpayer's income arising from a trade or business conducted in this state and is not entitled to apportion income arising from a trade or business having no connection with this state. However, "whether a number of business operations having common ownership constitute a single or unitary business or several separate businesses for tax purposes depends upon whether they are of mutual benefit to one another and on whether each operation is dependent on or contributory to others."

99 Idaho at 931, 592 P.2d at 46 (emphasis added; citations omitted). The Court later tied this statutory analysis of "business income" to the constitutional inquiry of when a state may tax income from a multi-state business:

> We believe that any constitutional limitations upon a state's right to apportion the intangible income, including dividends, of a multistate corporation doing business within the state are satisfied by the Idaho statutory requirement that the acquisition, management or disposition of the underlying asset must be an integral or necessary part of the taxpayer's <u>unitary</u> business, a part of which is conducted in this state.

[4] The Tax Commission argued before the district court that the *American Smelting* case is no longer good law because it was overruled by the U.S. Supreme Court. However, the case was reversed only with respect to the constitutional issues addressed by the U.S. Supreme Court. It was later cited with approval by the Idaho Supreme Court in a way that would be inconsistent with the notion that it was not good law. *Albertson's, Inc. supra,* 106 Idaho at 814, 683 P.2d at 850.

Id. at 938, 592 P.2d at 53 (emphasis added). Thus, the Court acknowledged the link between business income and the unitary business principle.

In general, with respect to investment income, the following analysis in *American Smelting* shows how the business income analysis presupposes that a taxpayer such as Noell Industries has a trade or business with which the particular type of income may or not be "directly connected" as part of a unitary operation:

> … in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and <u>the taxpayer's trade or business</u>. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisition, management or disposition of which constitutes an integral part of the taxpayer's <u>business operations</u>.

Id. at 933, 592 P.2d at 48 (emphasis added).

The district court here realized that *American Smelting* was an important precedent in fleshing out the issue of whether income is derived from an investment or from an integral part of the taxpayer's trade or business. Decision, p. 13, R. p. 000474. The district court transitioned from that issue to the "unitary" question by citing the Tax Commission's own Rule 333. IDAPA 35.01.01.333. Subsection 08 of that Rule makes specific reference to the unitary principle as one way in which "business income" may exist: "where the issuer of the intangible property [Blackhawk in this case] and the taxpayer [Noell Industries] are engaged in the same trade or business, i.e., the same unitary business…." That was the issue in *American Smelting,* and it is an issue here.

Finally, the district court correctly recognized that a finding of unity would be necessary under the Due Process and Commerce Clause analysis required to address the allegations in paragraph 11 of the Complaint. R. , p. 000009. See Memorandum Decision, pp. 14-17. Similar to the statutory analysis, income from a multi-state business may be taxed by a state only where the operations within the state are unitary with the business sought to be taxed. *MeadWestvaco* *v. Illinois Department of Revenue,* 553 U.S. 16, 30 (2008). In that case, the Court rejected the idea that mere "operational" ties can be a basis for constitutionally permitted taxation, and held that a unitary relationship is required.[5]

The Tax Commission offers two additional arguments to support its procedural claim. First, it asserts that the first time Noell presented the "unity" theory was in its motion for summary judgment; prior to that time, it had accepted the benefits of unitary characterization by filing annual tax returns in which it reported income from Blackhawk as business income. (Brief, pp. 12-13.) However, Noell Industries was simply complying with universally applied principles of reporting annual income in the states in which the income was earned, consistent with the aggregate approach to partnership and LLC taxation. That result is compelled by the Idaho Code provisions which require that Sub S corporations, partnerships and LLCs pass-through the results of operations to their owners in proportion to their percentage of ownership. I.C., § 63-3030; Tax Commission Income Tax Rule 280, IDAPA 35.01.01.280. Those principles are not tied to unitary taxation at all. If Blackhawk earned passive income from real estate owned in Idaho, Noell Industries would be required to pay tax on that income regardless of whether the real estate was a part of a unitary business.

The present case, in contrast, involves the income derived from the sale of an ownership interest in the entity – taxed (or not) consistent with the entity approach. This distinction between income flowed-through from the business and income from a sale of the entity interest was recognized by the district court, and by many others. *See* Memorandum Decision, pp. 8-9 and authorities cited therein. *See also; Corrigan, supra* (recognizing important distinction

[5] The Court clarified that an asset may be operationally linked to the business of the taxpayer, and that the income from that asset may be taxed as part of the taxpayer's unitary business. *Id.* at 29. For instance, a futures contract to ensure supplies of materials may be important to the operations, and can be considered as part of the unitary business. However, in this case, the "asset" of Noell Industries is its interest in Blackhawk, and that asset serves no operational purpose; it is merely held as an investment.

between operating income passed through to an owner and capital gain on sale of partnership/LLC interest); *Dupee v. Comm'n of Revenue,* 670 N.E. 2d 176 (Mass. 1996) (gain from sale of S Corporation owning the Boston Celtics not taxable as business income; "The gain was not the corporation's gain. The gain inured to Dupee outside the S corporation, rather than passing through BCI to him…."); *Cohen v. Comm'r of Revenue,* 1995 WL 575131 (Mass. App. Tax Bd. 1995) ("neither the partnerships nor the partners themselves were in the business of selling interests in partnerships. Accordingly, the gain derived from the appellants' sale of their partnership interests is not derived from or connected with a Massachusetts trade or business and therefore not taxable under §5A").

The question in all these cases is whether the income is "business income." Income earned by Blackhawk and passed through to Noell Industries is partnership/LLC income that meets all the tests required to be considered business income, because it is Blackhawk's business income that is flowed through to Noell Industries. But Noell Industries has consistently argued that this gain on the sale of its LLC membership units is not business income for all the reasons explained above.

The Commission's second argument is that the analysis of business income is different from the inquiries required under the unitary business principle. The Commission devotes five pages of argument to the construction of an analytical structure that creates distinct and apparently mutually exclusive categories for (i) business income analysis, (ii) unitary business analysis, and (iii) the question of whether a taxpayer has nexus in the taxing state. Commission Brief, pp. 13-18. But as noted above, the Commission's own Rule 333 recognizes that the unitary business principle is part and parcel of the business income analysis. IDAPA 35.01.01.333. The Rule acknowledges that the unitary business principle is one way to show that two entities are part of the same "trade or business" that might generate business income. It adds that the business income test is also satisfied if the property in question – the Blackhawk LLC units in this case – serve an operational function in the taxpayer's "trade or business." In this case, Noell Industries did not have a trade or business unless its investment activities are collapsed into and with the business activities of Blackhawk. So the court must return to the unitary business principle to determine whether such a combined "trade or business" exists.

In summary, it is disingenuous for the Tax Commission to argue that the "unity" issue was not pleaded, or needed to be specifically pleaded. But even if the pleading rules were not as permissive as they are, the argument is far off the mark. The issue that was specifically pleaded was whether the gain on the sale of the Blackhawk LLC units was business income and also whether it could be taxed in a manner consistent with constitutional requirements. The existence of "unity" or a "unitary relationship" must arise in connection with both the business income and the constitutional analysis.

D. The District Court Correctly Concluded That the Gain was not Business Income.

The Tax Commission asserts that the business income test is satisfied through a simplistic and incomplete analysis, with unwarranted assumptions, and by misinterpreting, inflating, and wrongly applying the clear facts. (Commission Brief, pp. 18-22.) The Commission quotes the relevant statute, I.C. § 63-3027(a)(1), but spends little time parsing the key elements of that definition. Most importantly, it glides over the requirement of the statute that income in question must have been integral or necessary parts "of the taxpayer's trade or business." The Brief repeatedly refers to income Noell Industries received from its Blackhawk LLC units as income from "its business" or "its trade or business." At one point, the Brief does acknowledge that Noell Industries did not have "significant business operations of its own" (see Brief, p. 35), and it never points to credible facts that show that there was any "business." Instead, Noell Industries' sole activity since 2004 was to hold Blackhawk units and other passive investments.

In applying the functional business income test, the Commission suggests that Noell Industries is a business because it has reported annually its share of Blackhawk LLC income in its Idaho tax returns. (Commission Brief, p. 19.) However, investment income is required to be reported and taxed in Idaho regardless of its character as business income as long as it has an Idaho source. And the annual income of Blackhawk that was passed through to Noell Industries was business income in Blackhawk's hands, and so was reported as such by Noell Industries. It does not make Noell Industries a "business" by reporting business income earned by another entity that is passed through to it. *See Dupee, Cohen, supra.*

The Commission next suggests that Blackhawk was "acquired" in 2004, as that term is used in the functional test of I.C. § 63-3027(a)(1). And it asserts that the entire purpose of forming Blackhawk was to serve as an arm of Noell Industries' "business," a "business" that continued after 2004 because Noell Industries received income from it. It then became a "necessary part of its [Noell Industries'] business." (Commission Brief, p. 20.) By the Commission's reasoning, a spin-off of operating assets would never be possible, where the former owner/operator becomes an investor. Yet its own Rules contemplate exactly the situation involved in this case. Rule 333.03 provides that an asset that has been converted to an investment purpose loses its character as a business asset. This applies even to assets that were "integral and necessary" to a trade or business. IDAPA 31.01.01.333. The Rule cautions that merely placing an integral asset for sale does not convert the asset to an investment purpose, but in this case the sale of the Blackhawk LLC units occurred six years after the LLC was formed and after Noell Industries began holding its share of the LLC units as an investment. The Commission continues to assert that Noell Industries was a "business" after 2004; with that facile assumption, naturally any income that is received is business income.

The Commission then argues that in addition to having been "acquired" as a business asset, the Blackhawk LLC units were "managed" as one, again one of the terms used in the functional test in I.C. §63-3027(a)(1). (Commission Brief, pp. 20-22.) Here, the Commission conflates the roles of Mr. Noell as the owner of Noell Industries with his role as CEO of

Blackhawk. It asserts that Noell Industries, through Mr. Noell and another corporate officer Mr. Ferros, "managed Blackhawk LLC indirectly." And it contends these two men were "contributed by" Noell Industries. (*Id.* p. 21.) The fallacy of this argument was recognized by the district court: Noell Industries had no employees or payroll; it was not "loaning" these executives to Blackhawk. Memorandum Decision, pp. 5, 22. Noell Industries was a shell company, with no business activities and no need for the executive expertise the Commission touts for Mr. Ferros at page 21 of its brief.

The Commission's arguments are little more than contentions that the Court should ignore the separate existence of these entities, and ignore the fact that Mr. Noell can be both a shareholder in the investment company and have a role in management of the operating company. The Tax Commission has pointed to no facts suggesting that Mr. Noell operated Noell Industries for any purpose other than for investment. Instead, the facts show that the separation of Mr. Noell's capacities of ownership vs. operation had a legitimate purpose: in 2004, new owners were brought in and now shared in the right to direct the operation of the Blackhawk LLC business as owners. Although Noell Industries retained majority control, that control was subject to all the duties and limitations of Virginia law as it relates to limited liability companies. *See* Virginia Code, §§ 13.1-1000 *et seq.* Further, Idaho courts have not been as willing to ignore the separate existence of legal entities as the Commission's arguments seem to assume. *See Wandering Trails, LLC v. Big Bite Excavation, Inc.* 156 Idaho 586, 594-97, 329 P.3d 368, 375-76 (2014) (affirming summary judgment against party seeking to pierce the corporate veil).

E. The District Court Correctly Concluded that Noell Industries was not Unitary with Blackhawk.

The balance of the Tax Commission's brief covers the main issue in the case – whether Noell Industries is "unitary" with Blackhawk such that Blackhawk's operations can be attributed to Noell Industries' "trade or business" for purposes of I.C. § 63-3027(a)(1). The Commission's arguments here are in two parts: first, arguing that the three-factor test set forth in U.S. Supreme

Court cases is not correct, or sufficient; and second, that whatever test is relevant is not satisfied by the facts here. In the latter effort, it attempts to portray the facts as supporting functional, operational and management ties between Blackhawk and Noell Industries, where none in fact exist.

The Tax Commission's brief discusses three separate tests by which unity may be shown, two adapted from old California cases and one from the constitutional analysis by the U.S. Supreme Court. As the *American Smelting* case shows, the business income analysis is closely tied to the constitutional tests for determining whether unity exists in a way that allows state taxation. *See also Albertson's, Inc., supra*, 106 Idaho at 814-18, 683 P.2d at 850-54 (applying U.S. Supreme Court cases to both statutory and constitutional analysis). Although this brief will address all three tests, the three-factor test from *Mobil Oil* is most relevant, requiring a showing of functional integration, centralized management, and economies of scale.[6] Since that test is most commonly applied in the constitutional analysis, it would be irrelevant if the California cases required a lower threshold for showing a unitary relationship. But in any event, all these tests are simply different ways to articulate the same basic requirements. *See Mole-Richardson Co. v. Franchise Tax Bd.,* 220 Cal. App. 3d 889, 899 (Cal. App. 1990) (functional integration not distinct from California tests; "the analyses employed makes it clear that the determinative factors are the same as those set forth in … the earlier California cases of *Butler Brothers v. McColgan*" and others; discusses economies of scale as a feature of centralized management). The correct outcome in this case is as clear under the California tests as with the constitutional analysis.

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[6] That test has been applied by the U.S. Supreme Court in six cases since *Mobil Oil: Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354, 364 (1982); *ASARCO, Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307 (1982); *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992); and *MeadWestvaco v. Illinois Dep't of Revenue,* 553 U.S. 16 (2008).

1. The Three-Factor Unitary Business Test is not Satisfied.

The district court applied the factors sufficiently well that all that is necessary here is to summarize the analysis and respond to the Tax Commission's critique of it. Memorandum Decision, pp. 21-23. Probably the most important of the three factors is functional integration: did the two entities function together essentially as one unit? Did they sell the same product, as in *Mobil Oil?* Were they able use one entity's operations in one state to assist the other entity in another? *See Mole-Richardson, supra.* Were the separate entities part of the same vertical operation, as in *Mobil Oil* or *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 221 (1980)? None of that occurred here. As the district court noted, the only transaction between Noell Industries and Blackhawk was a lease of certain property at market value. (R., p. 000483.) That lease did not create a "flow of value" from one entity to another that is a common feature of all these three factors and the key to unitary characterization. *See Container Corp. v. Franchise Tax Bd.,* 463 U.S. 159, 162–163, 178 (1983).

In examining whether there was functional integration, or whether any of the other factors were present for the three-factor test or the two California tests, it is important to bear in mind the extremely limited scope of Noell Industries' activity. It existed solely to hold investments. There was no need for employees, a human relations department, IT, or even a physical office. As will be seen, the Tax Commission inflates the role of Noell Industries in this structure so as to portray it as an active member in a pairing of companies that pool their resources toward a common goal of more efficient operations between two active businesses. This attempt to create a picture of robust combined operations must be met with the reality that Noell Industries was a shell, with no employees and no physical assets. If Noell Industries was really integrated with and necessary to Blackhawk's operations, it would have been necessary to sell Noell Industries' operations to the new buyer of Blackhawk, yet only the Blackhawk LLC interests were sold.

One example of the Tax Commission's desperate re-characterization of these two entities is with respect to the issue of functional integration. The Tax Commission asserts that Noell Industries and Blackhawk "transferred between, or pooled among themselves, technical information, trade secrets, processes and formulas, know how, research, or development." Commission Brief, p. 31. Although it acknowledges that this intellectual property was transferred – not shared – six years prior to the sale in question here, it goes on to assert that there was continued "sharing" because Mr. Noell and Mr. Ferros held "executive staff" roles with Noell Industries. *Id.* p. 32. Noell Industries did not have an executive "staff," much less one that was "responsible for product development." It had corporate officers in order to satisfy the "corporate formalities." R., p. 000279. There is no support in the record or anywhere else that Noell Industries shared operational or management duties with Blackhawk.

With respect to the centralized management factor in the unitary business test, the Commission again focuses on the functions of Mr. Noell and Mr. Ferros in participating in the management of Blackhawk as an operating business, without linking those roles to their functions as corporate officers of the passive Noell Industries investment vehicle. (Commission Brief, pp. 34-35.) The Commission again cites to "shared executive functions" as if the Noell Industries' investment decisions were the same as Blackhawk's operational ones. In fact, the only activity shown by the record from the Noell Industries' officers were those associated with maintaining the formalities of the corporation (Noell Decl., R., p. 000068, and Second Noell Dec., R., p. 000279), and the sale of the 78.34% interest in Blackhawk.

Centralized management typically allows a "flow of value" between entities where a single management team controls diverse activities of subsidiaries, and where essential corporate services needed by all the operations can be provided by that centralized management. *See Exxon, supra,* 447 U.S. at 224 (management provided "the coordination of the refining and other operational functions"). In *F.W. Woolworth Co. v. Taxation and Revenue Department,* 458 U.S.

354 (1982), the Supreme Court held there was no centralized management over subsidiaries even though the subsidiaries' boards of directors included one or more parent company employees, there were frequent communications between management of parent and subsidiary, and the parent required approval of major financial decisions. The Court found that "each subsidiary operated as a distinct business enterprise at the level of fulltime management." *Id.* at 366. So too in this case, Blackhawk had a full slate of management personnel who were fully capable of operating that business. R., pp. 000202-000204, 000278-000279.

The administrative rules the Tax Commission cites support Noell Industries' position more than the Commission's. (Commission Brief, p. 33.) Centralized management must have "an ongoing operational role with respect to the business activities," which manifests as "mandates, consensus building, or an overall operational strategy of the business." *Id.,* citing Rule 342.02, IDAPA 35.01.01.342.02. There is no dispute that Noell Industries did <u>not</u> have an operational role with respect to Blackhawk's activities.

The final prong of the three-factor test is economies of scale. This factor is related to the other two, since if there is functional integration and/or centralized management, there are probably economics of scale because more than one business operation can typically leverage the use of the management team or operating assets (such as IT). In *Exxon,* the Supreme Court pointed to the advantages of centralized purchasing, 447 U.S at 224, and in *Container Corp.,* the parent company assisted the subsidiaries "in obtaining used and new equipment and in filling personnel needs that could not be met locally." 463 U.S. at 179. On the other hand, in *F.W. Woolworth* and *ASARCO,* there was little evidence of economies of scale because there was virtually no centralized purchasing or other cost-saving factors. *F.W. Woolworth,* 458 U.S. at 366; *ASARCO,* 458 U.S. at 322-25. For Noell Industries and Blackhawk, there were no cost-reduction synergies available to reduce costs. This was due in part to the fact that they were involved in separate activities – investment vs. an operating business. Noell Industries had no costs it could share with Blackhawk. In addition, there was no additional "scale" that would have resulted in reduced costs from shared activities. Blackhawk's geographic and product reach was the same regardless of whether it is considered a distinct business or whether it is combined with Noell Industries.

In attempting to satisfy this prong of the unitary business test, the Commission again tortures the facts. It refers to "joint business operations of Blackhawk and Noell Industries" and "shared administrative functions," including a "full human resources department." (Commission Brief, p. 35.) As noted earlier, there were no shared administrative functions; Noell Industries had no employees and no payroll, and a human resources department would not have been relevant. All that the Commission can point to specifically is that Noell Industries and Blackhawk had the same accounting firm and legal counsel, but there is no indication there were any significant cost savings here, if any. The legal or accounting services in advising an investment company such as Noell Industries would be different from those in performing services for an operating business. This is not a case where the costs of providing HR, legal, accounting, IT or other services to two or five or 10 operating divisions are reduced because the services for any one as them are similar to those of any other.

With respect to all these factors, the Commission's overarching point seems to be that Noell Industries had no other corporate purpose than to receive income from Blackhawk, and so ought to be part of it. But it is logical that in making or deciding to retain an investment (which Noell Industries did in Blackhawk from 2004 and until 2010), an investor would place its money with a business or industry it knew well. In other words, the history Noell Industries had with the Blackhawk operation made this a good investment. Noell Industries could have sold its 78.34% interest in Blackhawk in 2004 and invested the cash proceeds somewhere else, but as it turned out, the decision to retain the Blackhawk investment was a sound one. The Tax

Commission ignores that investment motivation, and its arguments echo the argument Idaho made before the Supreme Court in *ASARCO:*

> Idaho's proposal is that corporate purpose should define unitary business. It argues that intangible income should be considered a part of a unitary business if the intangible property (the shares of stock) is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business."

458 U.S. at 326. The Court rejected this position in strong terms:

> This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the [corporation's] business." When pressed to its logical limit, this conception of the "unitary business" limitation becomes no limitation at all. When less ambitious interpretations are employed, the result is simply arbitrary.

Id. Although this reasoning is fully applicable to this case, the facts here are even more compelling than those in *ASARCO.* At least the parent company in *ASARCO* had an operating business to which the subsidiaries in question were allegedly a unitary part. Here, Noell Industries had no business at all, only an investment in another company.

2. The California Tests for Unity are not Satisfied in this Case.

The Tax Commission's brief also argues that there are two other tests for determining whether two businesses are unitary, from two California cases: *Butler Bros. v. McColgan*, 17 Cal.2d 664, 111 P.2d 334 (1941), *aff'd,* 315 U.S. 501 (1942), and *Edison California Stores v. McColgan*, 30 Cal.2d 472, 183 P.2d 16 (1947). Although counsel is unaware of any case in which a court has held these tests are satisfied where the *Mobil Oil* test is not, we will address each test.

The *Butler* test has three elements that must be satisfied: the subject business entities are unitary when they (1) share joint "ownership;" (2) share operations, such as "central purchasing, advertising, accounting, and management divisions;" and (3) have a "unity of use in its centralized executive force and general system of operation." *Butler Bros.*, 17 Cal. 2d at 678, 111 P.2d 334. These factors are very similar to the functional integration, centralized management and economies of scale already discussed. And as the Commission's brief concedes, the district court concluded that Blackhawk and Noell Industries did not have shared operations. (Brief, p. 25.) The Commission attempts to show that conclusion was wrong because of the "centralized" services it pointed to at other portions of its brief, including a "full human resources department." (*Id.,* p. 26.) However, as noted above, Noell Industries had no "operations" that needed such services. It had no employees. And it did not "share" legal or accounting services in an operational sense; it simply used the same law firm and accounting firm for what minor services an investment firm would require. It did not share executives as the Commission argues; Mr. Noell and Mr. Ferros simply acted as officers of both companies, with the different duties that would be required in managing an operating business compared to those of an entity holding investments.

The application of the *Butler* factors is best illustrated by comparing this case with the facts in the *Butler* case itself, which provides a fact pattern common to unitary business cases. The taxpayer owned seven wholesale distributing houses, and each enjoyed the benefits of a central buying division that allowed lower product costs because of greater combined purchasing power. 17 Cal. 2d at 665, 669. In addition, there were central advertising, accounting, and management divisions that provided services to each of the warehouses. In applying both California and constitutional law principles, the court noted that these shared services linked the various businesses, justifying unitary business treatment.

In *Edison California*, the court endorsed the *Butler* factors as still relevant, and added the following test: "If the operation . . . of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary." 30 Cal.2d at 481 The Commission first notes that the Idaho operations of Blackhawk contributed to the nationwide operations of Blackhawk, but that fact is irrelevant to the question of the integration between Blackhawk and Noell Industries. (Brief, p. 28.) The Commission then focuses on the "contribution" of Noell Industries to the operations of Blackhawk in two ways. The first is the "contribution" of property and personnel back in 2004 when the Blackhawk LLC was reconstituted as the operating business. This is not evidence of an ongoing contribution to a continuing business that was sold six years later. The second is that Noell Industries depended on Blackhawk for its revenue. But again, this is no different than any other investment: an investor depends on the underling investment to provide the hoped-for returns. As noted above, the U.S. Supreme Court rejected such arguments in *ASARCO*, and it did so again in *F.W. Woolworth:*

> The state court's reasoning would trivialize this due process limitation by holding it is satisfied if the income in question "adds to the riches of the corporation…." Income, from whatever source, always is a 'business advantage" to a corporation.

458 U.S. at 363, quoting *Wallace v. Hines,* 253 U.S. 66, 70 (1920).

Again, the facts of the *Edison California* case are instructive. There, the taxpayer had 15 subsidiaries operating in various states. The St. Louis office provided "[a] central management division, a central purchasing department, a central distribution department, a central store operations department, a central advertising department, and various other central administrative departments." 30 Cal. 2d at 474. The court concluded that there were contributions to and from and dependency among the various entities, but "… if there is no such dependency, the business within the state may be considered to be separate." *Id.* at 481. In this case, setting aside the fact that Noell Industries had no business operations, there was no dependency or contributions between these two companies from 2004 to 2010. Blackhawk did not need to rely on Noell Industries for anything. For instance, Blackhawk could have obtained the services of Mr. Noell and Mr. Ferros even if Noell Industries was not a part owner of the business.

As pointed throughout this brief, the Tax Commission has no actual facts to support its argument that there is an operational connection here. It asserts repeatedly that there were "joint business operations," but even in its brief it concedes that Noell Industries "did not have significant business operations of its own." (Brief, p. 35.) In fact, Noell Industries did not operate a business at all. Indeed, later in its Brief, the Commission seems to acknowledge that Noell Industries had no business operations when it argues that Noell Industries had no business activity separate from Blackhawk's. (*Id.*, p. 40.) When the Commission does attempt to portray Noell Industries as operating a business that is the mirror image of Blackhawk's, it has pointed to no facts that it did. The operations it cites – managerial, human resources, intellectual property, etc. – are all operations conducted at the Blackhawk level.

F. Noell Met Its Burden of Proof.

The Tax Commission points out that the party seeking to avoid unitary treatment of business income characterization bears the burden of proof, and Noell Industries certainly concedes that rule. (Brief, pp. 37.) It met that burden easily, with Declarations showing that Noell Industries was not a business; that it had no employees; that it had no operating assets; that it had no income other than from its investments. See R., pp. 000067, 000279.

These facts made this case appropriate for entry of summary judgment. When any party moves for summary judgment supported by affidavits, the opposing party cannot rest of speculation or ask the Court to draw inferences unsupported by facts. The court is obliged only to draw "reasonable inferences" in favor of the non-moving party. *H-D Transport v. Pogue,* 160 Idaho 428, 431, 374 P.3d 591, 594 (2016). Indeed, in a non-jury case such as this, and where both parties move for summary judgment, the Court can arrive at the most reasonable inferences from the undisputed facts. *Loomis, supra,* 119 Idaho at 437, 807 P.2d at 1274. In its Brief, the Tax Commission never argues that there are genuine issues of material fact, or argues that the facts as recited and relied on by the district court were incorrect. Instead, it accepts those facts and simply argues that, based on those facts, the district court was wrong as a matter of law. A consistent theme of the Commission's brief is the attempt to have the Court draw inferences from the fact that Noell Industries owned 78.34% of Blackhawk and shared two officers and directors; thus, *ipso facto,* there <u>must</u> be an operational connection between the two. But there are no facts supporting such a connection. The Commission had the ability to identify such facts through discovery, and in opposing a motion for summary judgment it must come forth with specific facts that show a genuine issue of fact.

In support of its burden of proof arguments, the Tax Commission cites the Tennessee case of *Blue Bell Creameries, LP v. Roberts,* 333 S.W.3d 59 (Tenn. 2011). That case is not focused on the burden of proof but on unitary issues, with a holding based on facts that are distinguishable from this case and, and as the district noted, on legal analysis that is faulty. (Decision, pp. 20-21.) The case involved a three-tiered business structure, with two levels of corporate owners of an operating ice cream business. A complicated reorganization transaction resulted in a large capital gain, which the court held to be business income. The court accepted the taxpayer's position that the corporate owner of the operating entity did not conduct any separate business. It then recited the tests of unity from cases such as *MeadWestvaco* (i.e., centralized management, functional integration and economies of scale), but because the holding company had no business operations, it reasoned that "[t]hese tests are ill-suited for assessing Taxpayer and [the holding company's] relationship because all three tests require a comparison of the relationship of the separate business entities' business operations." 333 S.W.3d at 71-72. It held that the businesses were unitary because there was no evidence that the holding company was a discrete business enterprise.

Thus, although stating that it was necessary to determine whether the businesses were unitary, and after articulating the tests necessary for that determination, the court arbitrarily concluded that the two entities were unitary without applying those tests. The court required the taxpayer to show the existence of two businesses and then also show they were not unitary. *Id.* at 72 (taxpayer must show "that Taxpayer and BBC USA are discrete business enterprises"). The court failed to recognize that an entity can be a discrete enterprise without being a business. The Tax Commission here incorrectly asserts that, like the taxpayer in *Blue Bell,* Noell Industries has relied on the fact that it is not a separate "business entity" from Blackhawk (Brief, p. 39). Instead, the point is that Noell Industries is not a business at all. The Commission ignores the fact that the lack of unity may be established either by the fact that the taxpayer's business is separate from the business from which income is sought to be taxed, or by the fact that the taxpayer did not have a business at all but instead held its assets as investments.

The fact that Noell Industries is not a business should reinforce the conclusion that its one-time income from the sale of Blackhawk cannot be taxed in Idaho either under the Constitution or the relevant statute. Indeed, section 63-3027(a)(1) provides that business income is produced when assets are sold that are "integral or necessary parts of the taxpayer's trade or business operations." (Emphasis added.) The focus is on the "trade or business" of the taxpayer, not its investments.

The *Blue Bell* case is also factually distinguishable. The Court focused on the "reduced expenses" that would accompany the reorganization, the elimination of "costly public reporting requirements," and the removal of one level of federal taxation." 333 S.W.3d at 68-69. In addition, the gain at issue in *Blue Bell* was a gain from an internal corporate transaction that occurred in the year in which the tax was assessed. By contrast, the reorganization that Noell Industries effected in 2004 was for entirely different reasons, was tax-free, and was six years before the straightforward sale transaction that occurred when Noell Industries sold its 78.34% interest in Blackhawk LLC. As noted earlier, that six-year delay is significant in evaluating whether Noell Industries' interest was converted from an active business operation to a passive investment. *See* Tax Commission Income Tax Rule 333.03, IDAPA 35.01.01.333.03.

Other cases are consistent with this analysis, and with a framework of determining whether the relationship between the selling investor and the operating entity is that of a unitary business. In *McKesson Water Products Co. v. Director, Div. of Taxation,* 23 N.J. Tax 449 (N.J. Tax Ct. 2007), *aff'd,* 974 A.2d 443 (2009), *cert. denied*, 200 N.J. 506 (2009), the court addressed a corporate transaction involving the sale of a bottled water subsidiary by a pharmaceutical company.[7] Although New Jersey had not adopted the specific definition of "business income" from UDITPA, the court noted that the difference between the state's "operational income" definition and the UDITPA definition of "business income" was one of terminology, not substance. *Id.* at 454. The court reviewed cases from other jurisdictions, as well as New Jersey. It concluded that the extraordinary nature of the sale involved in that case was not one that involved property the "acquisition, management, and disposition" of which constitute an integral part of the taxpayer's trade or business.[8]

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[7] The form of this transaction was a sale of assets of the bottled water subsidiary, but the actual transaction involved a sale of the stock of the subsidiary with an election to treat the sale as a sale of assets by the subsidiary under section 338(h)(10) of the Internal Revenue Code.

[8] There is a line of cases in which the court examined how to apply the functional test to liquidations of a business. Those cases are generally based on situations where (i) the subsidiary or division or group of assets was an operating division or segment of the taxpayer, (ii) the taxpayer was engaged in an active trade or business, (iii) the assets sold were part of that business, and (iv) the segment of the business that was sold was unitary with the parent. That was not the case in *McKesson* and is not the case here. However, these cases are further support for Noell's position. *Texaco-Cities Serv. Pipeline Co. v. McGaw*, 695 N.E.2d 481 (Ill. 1998); *Blessing/White, Inc. v. Zehnder*, 768 N.E.2d 332 (Ill. App. Ct.), *leave to appeal denied*, 786 N.E.2d 180 (Ill. 2002); *The May Dep't Stores Co. v. Ind. Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax Ct. 2001); *Kemppel v. Zaino*, 746 N.E.2d 1073 (Ohio 2001); *Lenox, Inc. v. Tolson*, 548 S.E.2d 513 (N.C. 2001); *ABB C-E Nuclear Power, Inc. v. Director,* 215 S.W.3d 85 (Mo. 2007 (*en banc*)). Cases holding that the functional test is satisfied in the liquidation context include *Glatfelter Pulpwood Co. v. Commonwealth,* 19 A.3d 572, 578 (Pa. Commw. Ct. 2011); *Harris Corp. v. Arizona Dep't of Revenue,* 312 P.3d 1143 (Az. App. 2013); and *Jim Beam Brands Co. v. Franchise Tax Bd.,* 34 Cal. Rptr. 3d 874, 882 (Cal. App. 2005). In *Glatfelter,* the court noted that an earlier case holding that a business liquidation was not business income was decided under a statute in which the language of the functional test was that the "acquisition, management *and* sale" of the assets must be integral or necessary to the taxpayer's business, while the statute in Idaho uses the term "acquisition, management <u>or</u> sale." The Pennslyvania statute was later amended to the "or" version, leading to the different result under *Glatfelter,* although that case did not involve the liquidation of an entire business but only the sale of

In *E.I. DuPont de Nemours and Co. v. Indiana Department of Revenue,* 79 N.E.3d 1016, 1021-24 (Ind. Tax Ct. 2017), DuPont's sale of 100% interest in pharmaceutical subsidiary did not produce business income under a somewhat different statutory definition, and also could not be taxed constitutionally because the two companies were not unitary. There was no relevant flow of value; "occasional oversight" and 100% ownership did not constitute centralized management; and there were no economies of scale. *See also First Nat'l Bank of Manhattan v. Kansas Dep't of Revenue,* 779 P.2d 457 (Kan. 1989) (taxpayers denied opportunity to file consolidated return because holding company was not unitary with operating company; holding company had no employees and no other assets; "The businesses do not comprise a homogeneous entity but rather are distinct enterprises lacking a centralized executive force and unity of operations."); Final Agency Decision No. 09 REV 5669, N. Carolina Dep't of Rev., Apr. 21, 2011, CCH N. Carolina State Tax Reporter, ¶ 202-510 (non-resident taxpayer holding company of 32.9% interest not taxable on gain on sale as business income); *American Smelting, supra,* 99 Idaho at 935-36, 592 P.2d at 50-51 (ASARCO provided a number of management services to the Lake Asbestos company in which it held a 52.7% ownership interest; it also provided employees and gave direction and approval on major policy decisions, but because its asbestos mining activity is "distinct, separate and unrelated to ASARCO's general mining and smelting business," the income from the investment activity was non-business income); *Dupee v. Commissioner of Revenue, supra,* 670 N.E.2d 176 (Mass. 1996) (gain from sale of S Corporation owning the Boston Celtics not taxable as business income; "The gain was not the corporation's gain. The gain inured to Dupee outside the S corporation, rather than passing through BCI to him....").

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timberland. The distinction was held not be relevant in *Jim Beam,* where the California statute contained the "and" term, and it did not appear to be relevant to the analysis in *McKesson.* The Oregon Supreme Court touched on but did not decide the liquidation issue in *Crystal Communications v. Department of Revenue*, 297 P.3d 1256, 1260-63 (Ore. 2013).

Another case that warrants emphasis is *F.W. Woolworth Co. v Department of Taxation and Revenue Dep't of New Mexico, supra,* 458 U.S. 354, 364 (1982). In that case the record established a number of close contacts between parent and subsidiary companies that were owned 100% by the parent. Those contacts included some common directors among the companies, and "[d]ecisions about major financial decisions, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt, had to be approved by the parent." *Id.* at 368-69. That level of control and the potential to do more were not sufficient to create unity. Here, although Mr. Noell held roles as both owner of Noell Industries and president of the operating company, the two roles are entirely distinct, and his decisionmaking authority as a representative of Noell Industries was tempered and controlled by the duties to minority owners of Blackhawk, owners who have significant powers to hold majority owners accountable to take actions in the best interests of the company. There is nothing in the record to show that Noell Industries acted in any way other than as a passive investor, or that it even engaged in the types of high-level decisionmaking noted by the Court in *F.W. Woolworth* as insufficient to show centralized management.[9] And even if there were centralized management in this case, there are no facts showing functional integration or economies of scale in the dealings between Noell Industries and Blackhawk LLC.

All of these cases are better authority than another case relied on by the Tax Commission, *Albertson's, Inc., supra,* 683 P.2d 846. There, a 100% owned subsidiary was held to be unitary with the Albertson's parent on the following facts: the subsidiary's only asset was a 50% interest in a business comprised of the grocery stores of Albertson's that were operating under the same roof as Skagg's drug stores; every decision of the subsidiary was actually made by Albertson's

[9] Noell Industries' federal income tax return states that its "Business Activity" was "Investment, and the "Product or Service" was also described as "Investment." R., p.000320. This is consistent with the Declarations on file that Blackhawk LLC was a manager-managed LLC, not a member-managed LLC. *See* Second Declaration of Michael M. Noell, R., p. 00278-00279 (Blackhawk managed by a management team).

employees; and Albertson's employees kept the subsidiaries' books, prepared its tax returns, paid its officers and directors, and prepared corporate meeting documents. *Id.* at 848, 853. Noell Industries did not perform these functions, or any others, for Blackhawk.

Noell Industries has met its burden of proof that it is not unitary with Blackhawk.

G. Tax Policy and the Prevention of Loopholes Do Not Justify Taxation.

At pages 40-46 of its brief, the Commission invokes considerations of tax policy, essentially asking the Court to err on the side of taxation. It should be noted that where ambiguous tax statutes are concerned, the tax policy considerations are exactly the opposite. Statutes imposing taxes are construed strictly in favor of taxpayers and against the state. *See Canty v. Idaho State Tax Comm'n,* 138 Idaho 178, 182, 59 P.3d 983, 987 (2002); *Goodman Oil Co. v. Idaho State Tax Comm'n,* 136 Idaho 53, 55, 28 P.3d 996, 998 (2001). This principle comes into play if tax statutes are ambiguous, and section 63-3027(a)(1) meets that condition.

The plea to give the benefit of the doubt to taxation and in particular to a finding of unity between Blackhawk and Noell Industries must also be met with citation to the string of U.S. Supreme Court cases in which such arguments were rejected. *See MeadWestvaco, Allied-Signal, ASARCO,* and *F.W. Woolworth.*

Finally, the Commission argues that affirming the district court would lead to approval of a loophole, since individual non-residents arguably are taxed on the types of income at issue here under I.C. §63-3026A(3)(a)(vii), while corporations would not be. We must keep in mind that the income here has been reported in full to the state of Virginia. There has been no suggestion anywhere that this taxpayer is attempting to avoid state taxation. The question of whether a tax is fair for individuals is not before this Court, although we note in the next section of this brief that taxation in this setting should be unconstitutional for all taxpayers. In any event, the fact that the Idaho statutes provide specifically for taxation of individuals and do not address corporations in the same way is an indication that non-resident corporations are not subject to tax in Idaho on this income.

H. Taxation of the Income in Question Violates Due Process of Law.

There are two due process arguments involved in this case. The first has been discussed throughout this brief – that the Due Process clause, in combination with the Commerce Clause, limits a state's ability to tax the income of multi-state businesses. This principle prevents a state from taxing a business unless the taxpayer either operates in the state or conducts a business outside the state that is unitary with another business conducted in the state. *See* cases cited in note 6 above.

The second branch of the constitutional arguments is a pure Due Process claim. This issue was not addressed by the district court, but is a basis for affirmance by this court as an alternative to the district court's reasoning. *See Swafford v. Huntsman Springs,* 163 Idaho 209, 409 P.3d 789, 792 (1976) (where an order of a lower court is correct but is based upon an erroneous theory, the order will be affirmed upon the correct theory). The principle involved here is best illustrated by the case of *Corrigan v. Testa,* 73 N.E.3d 381 (2016). In that case, Mr. Corrigan was a 79.29% owner of an LLC, Mansfield Plumbing. An Ohio statute provided that if a non-resident investor owned more than 20% of a pass-through entity, any gain on the sale of an interest in that entity would be apportioned to and taxed in Ohio based on a three-year average of the entity's business activity (apparently based on payroll, property and sales factors).

It appears that Mr. Corrigan was actively involved in the operation of the Mansfield Plumbing business in Ohio, and attended meetings and personally engaged in business in Ohio. However, the Court held that the imposition of tax on Corrigan violated the Due Process Clause of the United States Constitution. It pointed to the distinction discussed earlier in this brief, between the distributive share of the income of a business where the source of that income is from activities and transactions partly within the taxing state – which a state may tax – from the gain on the sale of an interest in the business by a non-resident – which the state may not tax. In Due Process terms, the state can tax the former activity because it is providing protections and benefits to the taxpayer that allow the taxpayer to earn income in the state; but "Corrigan's sale of his interest in Mansfield Plumbing did not avail him of Ohio's protections and benefits in any direct way." 73 N.E.3d at 390.

Viewed another way and applied to Idaho, Idaho has ample justification to impose a tax on the share of annual income generated in Idaho, because Idaho is providing the protections and benefits of roads, police and fire protection, good schools, and the related services that contribute to a healthy economy and that allow the production of that income by the taxpayer. But Idaho is providing no services with respect to out-of-state passive ownership of the entity, and is giving nothing in return for the tax it seeks to impose. *See Blangers v. Dep't of Revenue & Taxation,* 114 Idaho 944, 763 P. 2d 1052 (1988) (transitory presence of railroad employees not sufficient to impose tax consistent with Due Process requirements).

It is useful to point to an analogy involving investments by non-residents in corporate stock. If Noell Industries owned stock in Idaho-based companies like Albertsons or Idaho Power, instead of the investment in Blackhawk LLC, and sold that stock at a gain, there is no question that it would not be taxed on that gain. From a constitutional standpoint, the answer should be no different if it owns an investment in an LLC that does business in Idaho.

The *Corrigan* decision was distinguished but upheld in a later Ohio case, *T. Ryan Legg Irrevocable Trust v. Testa,* 75 N.E.3d 184 (2016). Here the Court allowed taxation of the gain on S Corporation shares held by a non-resident trust, but only because the grantor of the trust (and owner of the business) was himself an Ohio resident.[10]

[10] The *Corrigan* case was criticized by the author of a treatise on state taxation, but the author also noted that the case "reaffirms the general rule regarding treatment of a nonresident's income from the disposition of an interest in a flow-through entity with no business situs in the state." Hellerstein & Hellerstein, STATE TAXATION, ¶ 20.08[3], at p. 20-195 (3d ed. 2017). In other words, Hellerstein notes the traditional view that unless a statute specifically states otherwise, a

The reasoning of the court in *Corrigan* is consistent with a recent holding in the U.S. Supreme Court case in *North Carolina Department of Revenue v. Kaestner Trust,* 139 S. Ct. 2213 (June 21, 2019). In that case, the state attempted to impose an income tax on a trust. The beneficiaries of the trust resided in North Carolina, but the trust was established in New York, the trustee was in New York, no assets were located in North Carolina; no distributions were made to the beneficiaries in the years at issue, and the beneficiaries had no power to compel distributions. The Court noted that Due Process requires some minimum connection between the state and the taxpayer from which it can be shown that the state has provided "benefits and protections" that justify taxation. *Id.* at 2220. It confirmed prior case law that a trust is a legal entity in this context separate from the beneficiaries it serves, just as the owner of LLC interests is separate from the business operated by the LLC itself. The Court rejected the state's argument that the trust and its beneficiaries were "inextricably intertwined," and also that the benefits and protections to the beneficiaries could be imputed to the trust because they obviated the need for the trust to make distributions (which would have been taxed). *Id.* at 2224-26.

There are some differences between *Kaestner* and this case, including the fact that some of Blackhawk's annual income is taxable to Noell Industries even though the latter has no connection with Idaho in a given year. But that is because that annual Blackhawk income is earned partially in Idaho and is taxed to Noell Industries only because of the pass-through nature of income from the Blackhawk LLC structure. What is important about *Kaestner* is its recognition, like *Corrigan,* of the entity theory of taxation, and the distinction between the

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non-resident's gain on the sale of intangible assets will not be taxable. As discussed earlier, Idaho does not have a statute that imposes tax on non-resident corporations owning interests in flow-through entities; Idaho's statute applies only to non-resident individuals and trusts. I.C. § 63-3026A(3)(vii). As for the author's criticism of the Constitutional analysis, Idaho's case law supports a careful application of Due Process issues and a restrained approach in extending its taxing jurisdiction, and suggests it would follow the Ohio analysis rather than Hellerstein's. *See* the *Blangers* case discussed in the text. Hellerstein also criticized the *Blangers* decision, at ¶ 20.05[4](c), p. 20-57, which shows that his views are obviously not aligned with those of Idaho courts.

benefits and protections a state offers to an in-state entity and those (or the absence of them) that are provided to the non-resident owner of the property. The *Kaestner* case held that income may not be taxed to a non-resident entity under some theory that the benefits provided by the state to the in-state resident (the beneficiaries, Mansfield Plumbing, or Blackhawk) can be imputed to the out-of-state party with an interest in that asset (the trust, Corrigan or Noell Industries).

IV. CONCLUSION

For the reasons set forth herein, Noell Industries respectfully requests that the Court affirm the judgment of the district court.

DATED THIS 16th day of September, 2019.

HAWLEY TROXELL ENNIS & HAWLEY LLP

By ______________________________
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I caused to be served a true copy of the foregoing BRIEF OF RESPONDENT NOELL INDUSTRIES, INC. by the method indicated below, and addressed to each of the following:

Lawrence G. Wasden Attorney General Nathan H. Nielson, ISB No. 9234 Phil N. Skinner, ISB No. 8257 Deputy Attorneys General State of Idaho P.O. Box 36 Boise, Idaho 83722-0410 *Attorneys for Appellant*	☐ U.S. Mail, Postage Prepaid ☐ Hand Delivered ☐ Overnight Mail ☑ E-mail ☐ Facsimile ☑ iCourt

Dated: September 16, 2019

Richard G. Smith

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APPENDIX - TAXATION OF MULTI-STATE CORPORATE NON-RESIDENT INCOME

Business Income per § 63-3027		***Constitutionally permitted taxation***	
Income must be from a business, not an investment AND	***Income must satisfy transactional or functional test. Transactional test is not applicable here. For functional test:*** ***Must be from transaction where acquisition, management or disposition of asset constitute "integral or necessary parts of taxpayer's trade or business"*** ***There must be a direct relationship between the underlying asset and the taxpayer's trade or business. American Smelting, 592 P.2d at 48*** ***Tax Commission Rule 333.03: income must be derived from "integral, functional or operative component used in the taxpayer's trade or business operation, or materially contributed to the production of income of the trade or business…"***	***Income must be from a business, not an investment*** AND	***Income must be from a business that operates in the taxing state, or be from another business that is unitary with business in taxing state*** ***Key Tests of Unitary: Functional integration; centralized management; economies of scale*** ***These factors show whether there is a "flow of value" between two businesses beyond income from a passive investment or discrete business. Container Corp. 463 U.S. at 166, 178*** ***Related formulations of unity: (i) two businesses must have joint ownership, shared operations, and centralized executive force and system of operation; or (ii) operation of in-state business is dependent on or contributes to business outside state***