IN THE SUPREME COURT OF THE STATE OF IDAHO

Docket No. 46941

NOELL INDUSTRIES, INC., a Virginia corporation,	**Boise, January 2020 Term**
Plaintiff-Respondent,	**Opinion filed: May 22, 2020**
v.	
IDAHO STATE TAX COMMISSION,	**Karel A. Lehrman, Clerk**
Defendant-Appellant.	

Appeal from the District Court of the Fourth Judicial District of the State of Idaho, Ada County. Steven Hippler, District Judge.

The judgment of the district court is affirmed.

Lawrence G. Wasden, Idaho Attorney General, Boise, for Appellant. Nathan H. Nielson argued.

Hawley Troxell Ennis & Hawley, LLP, Boise, for Respondent. Richard G. Smith argued.

MOELLER, Justice.

This case concerns a straightforward issue of tax law: whether the gain from the sale of an ownership interest in a legal entity constituted "business income" under Idaho Code section 63-3027. In 2010, Noell Industries, Inc. sold its interest in a limited liability

company for a net gain of $120 million. Noell Industries reported the income to Idaho, but paid all of the resulting tax on the gain to the Commonwealth of Virginia, its commercial domicile. Following an audit, the Idaho Tax Commission concluded the net gain was "business income" pursuant to Idaho Code section 63-3027(a)(1) and, thus, apportionable to Idaho. Noell Industries sought judicial review before the Ada County District Court pursuant to Idaho Code section 63-3049(a). The district court ruled that the Commission erred when it (1) determined that Noell Industries paid insufficient taxes in 2010 and (2) assessed additional tax and interest against it. The Commission appealed. We affirm.

I. FACTUAL AND PROCEDURAL BACKGROUND

In 1993, Mike Noell incorporated Noell Industries, Inc., ("Noell Industries")[1] in Virginia to develop and sell combat and tactical gear. The company was inspired by Noell's service as a U.S. Navy SEAL. Following his military service, Noell started the corporation in his garage, designing and manufacturing a variety of gear for military, law enforcement, and recreational use. For about a decade, Noell Industries manufactured and sold tactical gear until 2003 when Noell transferred the net assets of Noell Industries to a new

[1] While Noell Industries was originally named Blackhawk Industries, Inc., it will be referred to as "Noell Industries" to reflect its 2010 name change and avoid confusion with a similarly named entity.

company of his creation, Blackhawk Industries Products Group Unlimited, LLC ("Blackhawk"), in exchange for a 78.54% membership interest. Blackhawk's remaining ownership units were conveyed to persons other than Noell Industries. Blackhawk is a Virginia limited liability company that operated across multiple states, including Idaho. Blackhawk also maintained its own human resource department. Noell served as Blackhawk's President and CEO and was part of a six-member management team. However, as a "high level executive" Noell did not manage Blackhawk's day-to-day operations, marketing decisions, and other ordinary business and sales decisions.

Blackhawk established a physical presence in Idaho in 2004 when it purchased and developed real property, commenced sales of its products, and hired employees in Idaho. Then, in 2007, Blackhawk leased a factory in Boise to serve as its "operation center" for the West Coast. The Boise factory was one of four U.S. factories that produced duty gear, body armor, holsters, and other outdoor and hunting products. By 2010, Blackhawk "operated in substantially all of the states" and held approximately $20 million worth of real and personal property in Idaho. In contrast, Noell Industries never owned any real property in Idaho.

Ultimately, Blackhawk became the company that manufactured and sold the combat and tactical gear while Noell Industries only held a majority interest in Blackhawk. After the 2003 reorganization, Noell Industries' activities "were limited to owning the 78.34% investment in Blackhawk [LLC]" and another business

that leased real property to Blackhawk within Virginia. Almost all of Noell Industries' income came directly from Blackhawk. For example, in 2009, Blackhawk "generated $10,496,500 in income for Noell Industries." Noell Industries' remaining income for 2009 was $18,948 in accumulated interest. The company also reported a loss of $396,394 from the other entity in which Noell Industries held an interest. In its tax returns, Noell Industries' reported "investment" as its business activity, as well as its "product or service." Noell Industries did not have any employees between the 2003 reorganization and the 2010 sale. In addition, Noell Industries did not share any assets or expenses with Blackhawk, nor did it provide financing or other services to Blackhawk. However, Blackhawk and Noell Industries utilized the same professional firms for their respective legal and accounting services.

In 2010, Noell Industries sold its 78.54% interest in Blackhawk for a net gain of $120 million. Noell Industries reported the gain from the sale on its 2010 Idaho tax return, but it did not apportion any of the gain to Idaho and reported "nearly all of the gain to goodwill." Instead, Noell reported and paid the taxes on the gain on the sale to Virginia. Idaho's state auditors, however, concluded the gain was "business income" pursuant to Idaho Code section 63-3027, and the Idaho Tax Commission affirmed this decision. In its initial Notice of Deficiency Determination ("NODD"), the Commission calculated the total tax owed to be $4,481,875, but later reduced the total to $1,423,520

after removing the penalty assessments in its final decision of November 8, 2017.

Noell Industries contested the Commission's decision by filing a "complaint" for judicial review with the district court "pursuant to Rule 84(d)(5) of the Idaho Rules of Civil Procedure."[2] Both parties recognized that the primary issue presented on review was "whether Idaho has authority to tax the gain on Noell Industries' sale of its interest in Blackhawk LLC." The complaint framed the issues for which review were sought as "whether the Tax Commission erred in affirming the deficiency determinations and assessing additional tax and interest in the Decision, related to the gain on the sale of the Blackhawk interests," which is inconsistent with Idaho Code section 63-3027 and a violation of the Due Process and Commerce Clauses of the U.S. Constitution. Pursuant to section 63-3049(b) of the Idaho Code, and prior to filing its complaint, Noell Industries paid the requisite 20% deposit ($300,000) as a condition of appealing the Commission's decision. The Commission requested a de novo review pursuant to Idaho Code section 63-3049. After reviewing cross-motions for summary judgment, the

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[2] To be clear, there is no "Rule 84(d)(5)" in the applicable version of the Idaho Rules of Civil Procedure. Likewise, the Court notes that Rule 84 does not allow for the filing of a "complaint"; rather, it requires that judicial review be commenced "only by the filing of a *petition* for judicial review." I.R.C.P.84(b)(1) (emphasis added). However, Idaho Code section 63-3049 directs an aggrieved taxpayer to file a "complaint" with the district court. While such inconsistency in terminology between court rules and statutes is not unique, it is noted to avoid confusion.

district court found that the gain was not "business income" under section 63-3027 and, therefore, not subject to apportionment to Idaho. The Tax Commission timely appealed.

II. STANDARD OF REVIEW

Questions of law, including the interpretation of relevant statutes and constitutional provisions, receive de novo review by this Court. *Nye v. Katsilometes*, 165 Idaho 455, ___, 447 P.3d 903, 906 (2019). When such questions are considered in the context of a summary judgment order, we review the record *de novo*, applying the familiar standards set forth in I.R.C.P. 56:

> "[T]he standard of review for this Court is the same standard used by the district court in ruling on the motion. The court must grant summary judgment if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law. Summary judgment is appropriate if the pleadings, affidavits, and discovery documents on file with the court, read in a light most favorable to the nonmoving party, demonstrate no material issue of fact such that the moving party is entitled to a judgment as a matter of law. If the evidence reveals no genuine issue as to any material fact, then all that remains is a question of law over which this Court exercises free review."

Lee v. Willow Creek Ranch Estates No. 2 Subdivision Homeowners' Ass'n, Inc., 164 Idaho 396, 399, 431 P.3d 4, 7 (2018).

III. ANALYSIS

A. The district court did not base its decision on an unpleaded issue.

The Commission first argues on appeal that the district court erred by deciding this case on an unpleaded issue, the unitary business test, which was first raised in Noell Industries' motion for summary judgment. It further argues that the unitary business issue is a "discrete" question and test arising from the "business income" question. Noell Industries contends that this argument is a "straw man" procedural technicality because the question at issue—one that was pleaded in the complaint—is whether the gain from selling Blackhawk is "business income." We agree with Noell Industries.

Idaho Code section 63-3049(a) permits a taxpayer to appeal the Tax Commission's decision by filing a complaint in district court. Under the Idaho Rules of Civil Procedure for pleadings, "[e]ach allegation must be simple, concise, and direct. No technical form is required." I.R.C.P. 8(d)(1). These rules comport with Idaho's notice-pleading requirement, which requires a pleading to put the adverse party "on notice of the claims brought against it." *Hodge for & on behalf of Welch v. Waggoner*, 164 Idaho 89, 96, 425 P.3d 1232, 1239 (2018) (citation omitted). Accordingly, notice

pleading requires the complaint to provide "some indication" of the basis for relief, but not always an exact statutory basis or formal cause of action. *Brown v. City of Pocatello*, 148 Idaho 802, 807, 229 P.3d 1164, 1169 (2010)).

We conclude that Noell Industries sufficiently pleaded this issue below. The pertinent provisions of Noell Industries' complaint read as follows:

> 7. This case involves the question of whether Plaintiff is subject to tax, as a non-resident of Idaho, on gain from the sale of an intangible asset with a situs in Virginia. That asset is Plaintiff's ownership of interests in a Virginia limited liability company named [Blackhawk].
>
> 8. Pursuant to Rule 84(d)(5) of the Idaho Rules of Civil Procedure, Plaintiff states that the issues on appeal are whether the Tax Commission erred in affirming the deficiency determinations and assessing additional tax and interest in the Decision, related to the gain on the sale of the Blackhawk LLC interests, for reasons that include the following in paragraphs 9-12 of this Complaint.
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> 9. The Tax Commission's assessment of tax on the gain on the sale of the Blackhawk LLC interests is inconsistent with Idaho law, in that it does not represent business income of Plaintiff subject to apportionment under Idaho Code § 63-3027. Instead, it represent [sic] an investment by Plaintiff, an intangible

> asset the gain from which should be allocated to Virginia, the state of Plaintiff's residence.
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> 10. Plaintiff did in fact report the gain on the sale to the State of Virginia, and paid the tax on that sale to that state.
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> 11. Alternatively, the Tax Commission's assessment of tax on the gain on the sale of the Blackhawk LLC interests violates the Due Process and Commerce Clauses of the United States Constitution and the comparable provisions of the Idaho Constitution. The state of Idaho has insufficient contacts with plaintiff to justify taxation of this income of this income in Idaho.
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> 12. Alternatively, even if the gain on the sale of the Blackhawk LLC interests was taxable in Idaho, the Tax Commission erred in determining the amount of that gain. . . .

Within these paragraphs are references to the overarching issue—whether the Commission erred in finding that the gain was "business income"—as well as arguments relating to Idaho Code section 63-3027 and the Due Process and the Commerce Clauses of the U.S. Constitution. Therefore, this issue turns on whether the "unitary test" falls under the "business income" analysis under either Idaho Code section 63-3027, or the cited constitutional provisions. The short answer is that it falls under both because the unitary business test is part and parcel of the "business income" question.

First, the unitary-business principle was developed by the U.S. Supreme Court under the Commerce and Due Process Clauses of the U.S. Constitution to deal with mounting constitutional inquiries concerning what and how much a state could tax multi-state businesses. *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 24 (2008). Generally, determining whether a business is unitary arises in courts under claims that a state violated the Due Process and Commerce Clauses by imposing an income-based tax on gains earned outside the state's borders. *See e.g. MeadWestvaco Corp. ex rel. Mead Corp.*, 553 U.S. at 24; *Hercules Inc. v. Comm'r*, 575 N.W.2d 111, 116 (Minn. 1998); *Luhr Bros. v. Dir. of Revenue, State of Mo.*, 780 S.W.2d 55, 57 (Mo. 1989). This Court has previously stated that establishing whether two businesses constitute a "unitary business" is "fundamental" to the determination of whether Idaho can apportion the income of a foreign, wholly-owned subsidiary as if it was the income of the parent corporation:

> [W]hether 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. This qualification, though not directly stated by the statute's literal language, is required by the theory underlying apportionment statutes, i.e., that the business income of a unitary

> business operating in several states cannot be precisely identified with particular states, and by the constitutional requirement that there must be some minimal connection between the interstate business activities generating the income and the state seeking to tax that income.

Albertson's, Inc., 106 Idaho 810, 811, 815 n.4, 683 P.2d 846, 847, 851 n.4 (1984) (internal citations and quotation marks omitted) (quoting *Am. Smelting & Ref. Co. v. Idaho State Tax Comm'n*, 99 Idaho 924, 931, 592 P.2d 39, 46 (1979), *vacated sub nom. Asarco Inc. v. Idaho State Tax Comm'n.*, 445 U.S. 939 (1980) (overruling the Idaho Supreme Court's constitutional analysis but not the statutory interpretation of the Idaho Code)).

Second, while the unitary-business test typically arises in the constitutional context, Idaho Tax Administrative Rules have incorporated the unitary test as one method to determine "business income" under Idaho Code section 63-3027(a)(1):

> Application of the functional test is generally unaffected by the form of the property (for example, tangible or intangible property, real or personal property). Income arising from an intangible interest, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations. Thus, while apportionment of income derived

> from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

IDAPA 35.01.01.333.08. Under this rule, "business income" can be established by either the unitary-business test or by finding that the intangible interest serves an operational function—rather than a passive investment—as "an integral, functional, or operative component to the taxpayer's trade or business operations." *Id.*

The U.S. Supreme Court, however, has rejected the application of the operational-function test and the unitary-business test as distinct and separate principles. *MeadWestvaco Corp. ex rel. Mead Corp.*, 553 U.S. at 29. In *MeadWestvaco*, Mead, an Ohio corporation and wholly owned subsidiary of MeadWestvaco Corp., originally purchased an Illinois-based company that specialized in inkjet printing technology for $6 million. 553 U.S. 16, 19–20 (2008). Mead renamed the inkjet company Lexis. *Id.* at 20–21. Over the next 26 years, Mead developed Lexis into an electronic research service. *Id.* at 20. Then, in 1994, Mead sold Lexis to a third

party for $1.5 billion, collecting a gain of just over $1 billion. *Id.* Mead did not report the gain as business income in Illinois. *Id.* Instead, Mead argued that the gain was "nonbusiness income that should be allocated to Mead's domiciliary State, Ohio, under Illinois' Income Tax Act." *Id.* The State of Illinois argued that the gain was business income subject to apportionment. *Id.* at 20-21. The trial court agreed with Illinois, holding that the two companies were not a unitary business but that Mead's gain was still business income under Illinois tax laws. *Id.* at 23. The appellate court affirmed on the basis of the state's operational-function test. *Id.* However, the U.S. Supreme Court reversed, explaining that it was error to only consider the operational-function test and remanded the case for a determination on the unitary-business test. *Id.* at 32. The Court explained:

> [O]ur references to 'operational function' in *Container Corp.* and *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'

MeadWestvaco Corp. ex rel. Mead Corp., 553 U.S. at 29.

Therefore, the "unitary business" question the district court addressed here was fundamental to both the constitutional and statutory issues raised by Noell Industries. As required by the Idaho Rules of Civil

Procedure, the complaint provided ample citations to statutory authority to lay the foundation for Noell Industries' requested relief, and the pleading put the Commission on notice of the claims brought against it. Indeed, the unitary-business principle is "the linchpin of apportionability in the field of state income taxation." *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 439 (1980). The Commission should reasonably have been aware of the argument's inevitable assertion under the broader business-income analysis, as well as the constitutional inquiry into Idaho's ability to tax Noell Industries, a Virginia corporation.

B. The district court did not err in finding that Noell Industries' gain from the sale of Blackhawk was nonbusiness income.

The Commission next contends that Noell Industries' gain from the sale of Blackhawk qualifies as business income because the "acquisition and management of Blackhawk, LLC constituted a necessary part of its business operations." The district court concluded that the gain was not apportionable after analyzing both the transactional and functional tests as laid out in case law, the Idaho Code, and Idaho's Income Tax Administrative Rules. The district court's analysis is correct.

Section 63-3027 of the Idaho Code "contains rules for determining the portion of a corporation's total income from a multistate business which is attributable to this state and therefore subject to Idaho's income

tax." *Albertson's, Inc.*, 106 Idaho at 811, 683 P.2d at 847. This portion of the Idaho Code is Idaho's version of the Uniform Division of Income for Tax Purposes Act (UDITPA). *Id.* The statute divides a multistate corporation's income into two categories: business income and non-business income. *Id. See also* I.C. § 63-3027(a)(4); IDAPA 35.01.01.330. Business income is apportioned to Idaho under specific statutory formulas based on payroll, sales, and property, I.C. § 63-3027(i), while non-business income is allocated to the taxpayer's commercial domicile. I.C. § 63-3027(d)–(h). *See also Albertson's, Inc.*, 106 Idaho at 811, 683 P.2d at 847.

Section 63-3027(a)(1) of the Idaho Code provides two separate definitions for "business income." The first definition is the transactional test—"income arising from transactions and activity in the regular course of the taxpayer's trade or business." The second definition is the functional test—"income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations." *Union Pac. Corp. v. Idaho State Tax Comm'n*, 136 Idaho 34, 38–39, 28 P.3d 375, 379–80 (2001) (quoting I.C. § 63-3027(a)(1)). *See also* IDAPA 35.02.02.332 through 333. Here, the Idaho Tax Commission is trying to apportion the income from a foreign holding company's sale of its wholly-owned subsidiary that conducted a portion of its business in Idaho. Accordingly, we must determine whether the gain qualifies as "business income" as defined in Idaho Code section 63-3027(a)(1)

under either the (1) transactional test or (2) the functional test.

1. Transactional Test

The transactional test provides that business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." I.C. § 63-3027(a)(1); IDAPA 35.01.01.332.01. The transaction or activity, however, "need not be one that frequently occurs in the trade or business." IDAPA 35.01.01.332.03. It is reasonable to conclude that transactions are done "in the regular course of a trade or business" where they "are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does." *Id.* In addition, "[i]ncome may be business income even though the actual transaction or activity that gives rise to the income does not occur in Idaho." IDAPA 35.01.01.332.02.

The district court examined two cases from the Midwest in reaching its decision wherein the respective appellate courts concluded that the gain arising from a holding company's sale of a subsidiary can qualify as business income if the holding company regularly engages in the buying and selling of subsidiaries; however, a one-time sale does not qualify. *Compare E.I. DuPont De Nemours & Co. v. Indiana Dep't of State Revenue*, 79 N.E.3d 1016, 1023 (Ind. T.C. 2017), *with PPG Indus., Inc. v. Dep't of Revenue*, 765 N.E.2d 34, 45 (Ill. App. 2002). Importantly, the Illinois and Indiana

statutes at issue in these cases utilize similar language to UDITPA and Idaho to define business income, including the term "regular" to describe the trade and business operations that qualify as "business income" under the transactional test. I.C. § 63-3027(a)(1); *E.I. DuPont De Nemours & Co.*, 79 N.E.3d at 1022 (quoting Indiana Code § 6-3-1-20 (2001)); *PPG Indus., Inc.*, 765 N.E.2d at 42 (quoting 35 ILL. COMP. STAT. 5/1501(a)(1) (1994)).

On appeal, Noell Industries argues that it "does not have a trade or business," yet its tax returns list "investment" as its business activity, as well as its "product or service." Because of this entry, the district court concluded that Noell Industries is an "investment" company for the purposes of its transactional-test analysis. The district court also found that Noell Industries "was essentially a holding company or parent company to Blackhawk." Under either business operation, Noell Industries does not appear to have regularly engaged in the trade or business of buying and selling subsidiary companies. Noell Industries only held interests in two companies: Blackhawk and another entity that leased real property to Blackhawk within Virginia. It did not purchase or sell interests over that seven year period except in the original purchase and sale of Blackhawk. Thus, Noell Industries' primary function was holding its interests in the two business entities over several years, relying primarily on Blackhawk for its income. While the business operations "need not be one that frequently occurs in the trade or business," IDAPA 35.01.01.332.03, a one-time

sale over a seven-year span does not constitute a "regular" trade or business.

2. Functional Test

The Commission argues that Noell Industries satisfies the functional test in two ways: first, its income from the sale of Blackhawk "was income that arose from property acquired as a necessary part of its business." Second, the income from the gain of the sale "was income that arose from property managed as a necessary part of its business." We disagree.

The functional test provides that business income is "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." I.C. § 63-3027(a)(1). Rule 333.08 of Idaho's Income Tax Administrative Rules provides two methods for meeting the functional test: "business income" can be established either by (a) finding that the intangible interest serves an operational function—rather than a passive investment—as "an integral, functional, or operative component to the taxpayer's trade or business operations," or (b) by meeting the unitary-business test. IDAPA 35.01.01.333.08. Even though these methods would appear to be independent of each other, the U.S. Supreme Court has rejected the notion that the operational-function test and unitary-business test are separate principles. *MeadWestvaco*

Corp. ex rel. Mead Corp. v. Illinois Dep't of Rev., 553 U.S. 16, 29-32 (2008). Therefore, we must apply both tests.

a. Operational or Passive Investment Test

Income from intangible property qualifies as "business income when the intangible property serves an operational function as opposed to solely an investment function." IDAPA 35.01.01.333.05. The court's inquiry "focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and taxpayer's activities." *Id.* However, the "functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general." *Id.*

In *American Smelting and Refining Co.*, this Court addressed how to define business income where the Idaho Tax Commission sought alleged tax deficiencies against American Smelting and Refining Company (ASARCO). *Am. Smelting & Ref. Co.*, 99 Idaho at 927-30, 592 P.2d at 42-45. ASARCO was a multistate and multinational corporation engaged in mining, smelting, and refining activities. *Id.* at 927, 592 P.2d at 42. After an auditor "unitized" six corporations with ASARCO—each a wholly owned subsidiary of ASARCO—their incomes were combined for Idaho tax

purposes and the State assessed against ASARCO three years' worth of tax deficiencies, plus interest. *Id.* at 927–30, 592 P.2d at 42–45.

On appeal, the Court explained that the "'integral or necessary parts of the taxpayers' trade or business operations' refers to property which, though not absolutely essential to the conduct of the taxpayer's business, contributes to and is identifiable with the taxpayer's trade or business operations." *Id.* at 932, 592 P.2d at 47. Nevertheless,

> in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. 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 business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

Id. at 933, 592 P.2d at 48. Importantly, the Court recognized that a broad interpretation of this definition of "business income" could render "all corporate investments . . . as property the acquisition, management or disposition of which constitutes an integral or

necessary part of its trade or business operations." *Id.* Yet "such an approach would include virtually all income as business income and would in effect emasculate the provisions of UDITPA which provide for the allocation of income from specified tangible and intangible property." *Id.* at 932, 592 P.2d at 47. The Court then proceeded to examine the apportionability of ASARCO's dividends, interest income, and capital gains from the sale of stocks. *Id.* at 936–37, 592 P.2d at 51–52.

Here, the district court found that Noell Industries was merely a holding company. It held interests in only two business entities: Blackhawk and a Virginia company that leased real property to Blackhawk. Once Noell Industries transferred its net assets to Blackhawk in exchange for a majority interest, Noell Industries ceased most—if not all—of its business activity, notwithstanding its representation as an "investment" company on its tax returns. The 2010 sale of its interests in Blackhawk was a passive investment because the sale was not "an integral, functional, or operative component to the taxpayer's trade or business operations." IDAPA 35.01.01.333.08. Indeed, by selling Blackhawk, Noell Industries lost its primary source of income in exchange for the financial betterment of $120 million. This sale was not conducted "in furtherance of the taxpayer's trade or business," which was holding interests, but to discontinue it—*i.e.* discontinuing its interest in Blackhawk. As stated in the Income Tax Administrative Rules: "The functional test is not satisfied where the holding of the property is limited

to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general." 35.01.01.333.05.

b. Unitary Business Test

Generally, "a State may not tax value earned outside its borders." *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). However, a State may "tax an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a unitary business." *MeadWestvaco Corp. ex rel. Mead Corp.*, 553 U.S. at 19 (internal quotation marks omitted). This unitary-business principle is a constitutional creation under both the Commerce and Due Process Clauses. The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax, as well as a rational relationship between the tax and the values connected with the taxing State." *Id.* at 24. The Commerce Clause "forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation." *Id.* (internal citations and quotation marks omitted). Together, these clauses impose "distinct but parallel limitations on a State's power to tax out-of-state activities." *Id.*

Determining whether a business is a single, unitary, or several separate businesses for tax purposes is

required "by the theory underlying apportionment statutes, I. e., [*sic*] that the business income of a unitary business operating in several states cannot be precisely identified with particular states, and by the constitutional requirement that there must be some minimal connection between the interstate business activities generating the income and the state seeking to tax that income." *Am. Smelting & Ref. Co.*, 99 Idaho at 931, 592 P.2d at 46. Idaho's Income Tax Administrative Rules have incorporated the unitary test into the business income analysis as a method of meeting the functional test, IDAPA 35.01.01.333.08, as well as defining "trade or business" to mean "the unitary business of the taxpayer, part of which is conducted in Idaho." IDAPA 35.01.01.331.02.

Originally, the unitary-business test required "unity of ownership, unity of operation, and unity of use." *Albertson's, Inc.*, 106 Idaho at 815, 683 P.2d at 851. More recently, the U.S. Supreme Court described the " 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." *MeadWestvaco Corp. ex rel. Mead Corp.*, 553 U.S. at 30. *See also* IDAPA 35.01.01.341.02. The U.S. Supreme Court also reiterated that "capital transactions can serve either an investment function or an operational function." *Id.* at 29 (quoting *Container Corp. of Am.*, 463 U.S. at 180 n.19).

Idaho's Income Tax Administrative Rules further define a "unitary business" as "a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group

of business entities that 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 among them and a significant flow of value to the separate parts." IDAPA 35.01.01.340.01. The Idaho rules also utilize the same "hallmarks" from U.S. Supreme Court case law to determine the existence of a unitary business: functional integration, centralization of management, and economies of scale, which "provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence." IDAPA 35.01.01.341.02.

In *Alberston's*, the Skaggs-Albertson's partnership formed two separate corporations in Texas, each of which was a holding company "for their respective 50% interests in the Skaggs-Albertson's operation." 106 Idaho at 812, 683 P.2d at 848. After examining the U.S. Supreme Court case *Container, Corp., of America v. Franchise Tax Board*, 463 U.S. 159 (1983), this Court determined that Albertson's and its Texas subsidiary were a unitary business because of the close operational business relationship that existed between them. *Id.* at 816–17, 683 P.2d at 852-53. The Idaho Supreme Court based this decision on several key facts concerning the business operations:

> In almost every respect Albertson's operational relationship with Texas-Albertson's was as close as or greatly exceeded that which existed between Container Corp. and its subsidiaries. . . . Every Texas-Albertson's director

> and officer was an Albertson's employee or officer. Every decision made by Texas-Albertson's was actually made by Albertson's employees. In addition Albertson's employees performed other activities including keeping books, tax return preparation, payment of officers and directors, and preparation of corporate meeting documents. The parent in *Container* held or guaranteed half of the subsidiaries' long term debt, and Albertson's furnished all of Texas-Albertson's initial operating capital with no written agreements providing for repayment of capital or interest to Albertson's.

Id. Effectively, it was a unitary business because the parent company—Albertson's—controlled most, if not all, of the subsidiary's operations. The subsidiary was only a shell, a holding company, created in order to receive tax and liability benefits under Texas law. *Id.* at 812, 683 P.2d at 848.

The Commission cites to the Supreme Court of Tennessee's decision in *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59 (Tenn. 2011) to explain why Noell Industries is a unitary business with Blackhawk. Blue Bell is a Delaware limited partnership and Texas-based ice cream company that produces, sells, and distributes ice cream across multiple states. *Id.* at 62. After Blue Bell gained capital from a one-time stock transaction with its holding company, Tennessee's Department of Revenue assessed taxes on the capital gain because the stock transaction was "one part of a reorganization of the business entities that own [Blue

Bell Creameries, LP] and profit from the Blue Bell ice cream business." *Id.* The Supreme Court of Tennessee held that the stock transaction served an operational function because the taxpayer "acquired and sold the 1,131 shares of stock solely as part of the reorganization of the entities profiting from the business." *Id.* at 70–71. The stock transaction did not diversify the business or "reduce[] risks associated with the ice cream business." *Id.* Rather, the reorganization and sale of the stock "served to increase net gain from the ice cream business." *Id.* Thus, the Tennessee court concluded, Blue Bell's income from the stock was unitary with its ice cream business. *Id.*

In contrast to these cases, Arizona's Board of Tax Appeals decided a case similar to the situation here, where a foreign corporation acquired an interest in an Arizona-based partnership. *Western Phoenix, N.V. v. Arizona Dept. of Revenue*, 1994 WL 143279, at *1 (Ariz. Bd. Tax. App. 1994). The foreign corporation held no offices or employees in the U.S. and was not involved in the partnership's management. *Id.* The corporation "had no activity other than owning the partnership interest." *Id.* Yet when the corporation sold its interests to another company, and allocated the gain of the sale to Texas—where the acquisition's sale and negotiations occurred—Arizona audited the foreign corporation and concluded income from the sale was allocable business income. *Id.* Like here, the state taxing authority argued that the unitary-business test was inapplicable because the partnership business and foreign corporation "[were] one and the same." *Id.* at *2. The

Arizona Board of Tax Appeals disagreed, holding that the gain from the sale was not apportionable business income because there was "no integration or interdependence of the basic operations" between the two businesses. *Id.* at *3. Indeed, the foreign corporation held "no real 'operation' "—"its sole business was its investment in the partnership." *Id.* at *3.

As the dissent points out, the 78.54% membership interest held by Noell Industries in Blackhawk conclusively determines that they are part of a commonly controlled group. IDAPA 35.01.01.344.02. Nevertheless, the situation is different from *Blue Bell* and the reverse of what occurred in *Albertson's.* Rather than dealing with a parent company with full control of the subsidiary holding company, Noell Industries is a parent holding company with no shared control or operations over Blackhawk. Noell Industries shared no centralized management, oversight, or headquarters with Blackhawk. Indeed, Noell Industries held no employees, payroll, or offices at all. While the companies utilized the services of the same accounting and legal firms, they did not share resources or employees. The only transactions between the companies consisted of the 2003 transfer of assets to Blackhawk, regular income from Blackhawk for the held interests, and the 2010 sale of those interests. This high-level separation of the companies—combined with Noell Industries' only role as a shell holding company—showcases substantial independence rather than the level interdependence required to manifest unity.

The primary common denominator between the two companies was their foundation by Mike Noell, but his presence at both companies alone does not suggest the level of oversight that the unitary principle requires for functional integration, centralized management, and economies of scale. As Blackhawk's President and CEO—indeed, as the founder of both companies—Mike Noell certainly provided experience and oversight, as the dissent reminds this Court. Yet the record still showcases that Mike Noell was one voice of a six-member management team, and a "high level executive" who did not manage Blackhawk's day-to-day operations. Daily business operations were handled in an Executive Director of Operations and Vice President of Blackhawk. Sales decisions were handled by an appointed team. Marketing Decisions fell to the purview of the Vice President of Marketing, and so on. Blackhawk's wide range of officers and employees "had no involvement with Noell Industries." Thus, there was no centralized management.

In addition, while Noell Industries occupied the same role and business functions as Blackhawk prior to the 2003 reorganization, Blackhawk's creation relieved Noell Industries of those responsibilities. In the 2003 reorganization, Noell Industries effectively handed over the reins to Blackhawk to make, sell, and distribute tactical and combat gear. Noell Industries could have retained control, and oversight over Blackhawk, but it did not. Control and management of Blackhawk products passed from Noell's wholly-owned corporation to the multi-manager managed limited

liability company—Blackhawk. Like in *Western Phoenix, N.V.*, Noell Industries' sole business between 2003 and 2010 was holding its investment in Blackhawk.

Because this type of gain does not meet the definition of "business income" under either the transactional test or functional test (including the unitary business test), we affirm the district court's conclusion that the gain from selling Blackhawk was nonbusiness income under Idaho Code section 63-3027. The Commission argues that this decision will open a tax loophole to companies, permitting them to dodge taxes through the creation of sham shell entities. We disagree. Our decision rests on a fact-intensive inquiry based on the extensive—and largely undisputed—findings of the district court. Moreover, this is not a case of a corporation dodging its tax obligations. Noell Industries reported the income from the sale to both Idaho and Virginia, but it only paid taxes on the gain as "business income" to Virginia because that was its commercial domicile. There has been no fraud or subterfuge shown in the record. This case clearly concerns a passive investment, the taxation of which is not apportionable to Idaho.

IV. CONCLUSION

For the reasons set forth above, we affirm the judgment of the district court. Costs are awarded to Noell Industries as the prevailing party.

Justices BRODY and BEVAN CONCUR.

STEGNER, J., dissenting.

I respectfully dissent. I agree with the majority's conclusion that "[t]his case concerns a straightforward issue of tax law: whether the gain from the sale of an ownership interest in a legal entity constituted 'business income' under Idaho Code section 63-3027." However, I diverge from the majority's conclusion that the sale by Noell Industries, Inc. (Noell Industries), of its interest in Blackhawk Industries Products Group Unlimited, LLC (Blackhawk LLC), did not constitute business income attributable to Noell Industries.

This case was decided on cross motions for summary judgment. Summary judgment is appropriate if the movant shows "that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." I.R.C.P 56(a). Here, based on the undisputed facts, Noell Industries was not entitled to summary judgment as a matter of law. Rather, the undisputed facts show that Noell Industries and Blackhawk LLC constituted a unitary business. Further, the sale of Blackhawk LLC constituted business income under the functional test. Accordingly, summary judgment should not have been granted to Noell Industries. Instead, it should have been granted in favor of the Tax Commission. I would reverse the grant of summary judgment, and remand the case for a determination of Noell Industries' tax liability.

A. Background of Noell Industries and Blackhawk LLC.

In 1993, Mike Noell incorporated Blackhawk Industries, Inc., in Virginia to develop and sell combat and tactical gear. (Blackhawk Industries, Inc., was renamed Noell Industries, Inc., in 2010. In order to avoid confusing Blackhawk Industries, Inc., with the similarly named Blackhawk LLC, Noell Industries will be used to refer to both Blackhawk Industries, Inc., and its successor Noell Industries.) The company was inspired by Noell's service as a U.S. Navy SEAL. In 2003, Mike Noell transferred the net assets of Noell Industries to a new company of his creation, Blackhawk LLC, in exchange for a 78.54% ownership interest in Blackhawk LLC. The remaining ownership (21.46%) was transferred to persons other than Noell Industries. Mike Noell at the time and throughout these proceedings was President and Chief Executive Officer (CEO) of Blackhawk LLC. He was also part of a six-member management team. While Noell Industries bears Mike Noell's name, Blackhawk LLC was his brainchild.

Blackhawk LLC is a Virginia limited liability company which operated in multiple states, including Idaho. In 2004, Blackhawk LLC established a physical presence in Idaho when it purchased and developed real property, commenced sales of its products, and hired employees here. Then, in 2007, Blackhawk LLC leased a factory in Boise to serve as its "operation center" for the West Coast. The Boise factory was one of four U.S. factories that produced duty gear, body armor, holsters, and other outdoor and hunting products. By

2010, Blackhawk LLC "operated in substantially all of the states" and held approximately $20 million worth of real and personal property in Idaho.

Blackhawk LLC was the company that manufactured and sold the combat and tactical gear designed as a result of the vision and oversight of Mike Noell.[3] At the same time, Noell Industries, which was solely owned by Mike Noell, held a super-majority interest in Blackhawk LLC. Virtually all of Noell Industries' income came directly from Blackhawk LLC. For example, in 2009, Blackhawk LLC "generated $10,496,500 in income for Noell Industries." The annual income generated by Blackhawk LLC was recognized as business income as opposed to passive income.

In 2010, Noell Industries sold its 78.54% interest in Blackhawk LLC for a net gain of $120 million. Noell Industries reported the gain from the sale on its 2010 Idaho tax return, but did not apportion any of the gain to Idaho and reported "nearly all of the gain to goodwill." Idaho's state tax auditors, however, concluded that the gain was "business income" pursuant to Idaho Code section 63-3027, and the Idaho Tax Commission affirmed this decision. In its initial Notice of Deficiency Determination ("NODD"), the Tax Commission's Income Tax Audit staff calculated the total tax owed to be $4,481,875. The Tax Commission later reduced that

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[3] According to the Business Activity Questionnaire prepared by Noell Industries' tax advisors, Mike Noell, as CEO and President of Blackhawk, was "responsible for directing the vision of Blackhawk Products and overseeing all aspects of Blackhawk Products, with a particular focus on product development."

amount to $1,423,520 after removing the penalty assessments in its final decision of November 8, 2017.

B. Noell Industries and Blackhawk LLC constitute a unitary business because the two companies were part of a common control group and had functional integration and centralized management.

It is evident that Noell Industries and Blackhawk LLC constitute a unitary business. There is a constitutional doctrine that a state may not tax a corporation's income unless there is "some definite link" or "some minimum connection" between the state and the corporation it seeks to tax. *Miller Bros. v. Maryland*, 347 U.S. 340, 344–45 (1954). Without these minimum contacts, the state cannot tax the corporation's income. *See id.* The unitary business principle is a doctrine which allows states to determine whether there are sufficient contacts with the state in order to have business income apportioned to that state. Generally,

> if a taxpayer is carrying on a single "unitary" business within and without the state, the state has the requisite connection to the out-of-state activities of the business to justify inclusion in the taxpayer's apportionable tax base of all of the income generated by the combined effect of the out-of-state and in-state activities.

Walter Hellerstein, *State Taxation of Corporate Income from Intangibles:* Allied-Signal *and Beyond*, 48 Tax L. Rev. 739, 746 (1993). Accordingly, in order for business

income to be apportioned to Idaho, it must first be ascertained whether Noell Industries and Blackhawk LLC constitute a unitary business to satisfy this due process demand. *See* IDAPA 35.01.01.340.

> Pursuant to Idaho's regulations, a unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that 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 among them and a significant flow of value to the separate parts.

Id.

1. Noell Industries and Blackhawk LLC are part of a commonly controlled group.

First, "separate corporations can be part of a unitary business only if they are members of a commonly controlled group." IDAPA 35.01.01.344. A "commonly controlled group" includes:

> A parent corporation and any one (1) or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if:
>
> > i. The parent owns stock possessing more than fifty percent (50%) of the voting power of a[t] least one (1) corporation[.]

IDAPA 35.01.01.344.02.

There can be little doubt that Noell Industries and Blackhawk LLC were both "commonly controlled" as that term is defined in the regulations governing this matter. It is undisputed that Noell Industries, the parent company, owned 78.54% of Blackhawk LLC. Consequently, based on the applicable regulations, Noell Industries and Blackhawk LLC are part of a commonly controlled group.

2. Noell Industries and Blackhawk LLC are functionally integrated and have a centralized management.

The Idaho Tax Commission's regulations provide additional principles for determining the existence of a unitary business. *See* IDAPA 35.01.01.342. Here, Noell Industries and Blackhawk LLC are functionally integrated and have centralized management.

First, Noell Industries and Blackhawk LLC are functionally integrated. An example of functional integration includes:

> Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, *know-how*, research, or development, provide evidence of functional integration when the matter transferred is significant to the business' operations.

IDAPA 35.01.01.342.01.c (italics added). There is no question that Mike Noell, the creator of both these

enterprises, provided the "know-how" for their mutual success.

Second, Noell Industries and Blackhawk LLC have centralized management.

> Centralization of management exists when directors, officers, or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist where the centralization is effected from a parent entity to a subsidiary entity to a parent entity, from (1) subsidiary entity to another, from (1) division within a single business entity . . . even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

IDAPA 35.01.01.342.02. An example of evidence that can establish centralized management includes evidence that "common officers participate in the decisions relating to the business operations of the different segments." *Id.* Additionally, centralized management exists "when management shares or applies knowledge and expertise among the parts of the business." *Id.*

Mike Noell was the sole owner of Noell Industries, and the CEO and President of Blackhawk LLC. According to Noell Industries' tax advisors, Mike Noell was "responsible for directing the vision of Blackhawk [LLC] and overseeing all aspects of Blackhawk [LLC], with a particular focus on product development." In other words, Mike Noell's participation in the performance of Blackhawk LLC was anything but passive. He was intimately involved in the decision-making of both Noell Industries and Blackhawk LLC. As a practical matter and as a legal matter, no one individual exercised more control than Mike Noell over these two entities. As a result, there was a "centralization of management" as that phrase is used in the applicable regulations. Consequently, given the regulations that govern whether an entity is a unitary business, the fact that Mike Noell occupied these two critical executive positions strongly supports the conclusion that a unitary business existed between Noell Industries and Blackhawk LLC.

The district court concluded that Noell Industries and Blackhawk LLC lacked unity. The district court concluded that the two businesses were not functionally integrated and did not have any centralized management. However, based on the undisputed facts noted above, the district court's conclusions were clearly erroneous. The two companies were functionally integrated due to shared know-how and oversight from Mike Noell. Blackhawk LLC is a necessary part of Noell Industries. Further, the two companies shared centralized management, particularly Mike Noell. The

conclusion that Noell Industries and Blackhawk LLC constitute a unitary business is inescapable. The next question which must be answered is whether the sale of its interest in Blackhawk LLC constituted business income attributable to Noell Industries.

C. The sale of the interest in Blackhawk LLC constituted business income through the functional test supplied by statute.

I begin with the district court's correct articulation of the presumption and burden of proof as they relate to the application of the functional test, which is critical to this analysis. As noted by the district court

> [u]nder the functional test, "business income" includes income from "the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." I.C. § 63-3027(a)(1). Importantly, "gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitutes an integral part of the taxpayer's trade or business. I.C. § 63-3027(a)(1). This presumption may only be overcome by "clear and convincing evidence to the contrary." *Id.* Thus the court must presume the gain realized by Noell Industries on its sale of its interest in Blackhawk LLC

> satisfies the functional test unless Noell Industries presents clear and convincing evidence that it does not.

While the district court (and on appeal, the majority) are obligated to presume the gain recognized by Noell Industries satisfied the functional test (and as a result that the gain would be taxable by Idaho) it is important to remember this case was decided on summary judgment. This means that in order to decide the case in favor of Noell Industries, the district court was required not only to determine that there were no genuine questions of material fact, but to do so applying an increased burden of proof, "clear and convincing evidence."[4] *See* I.R.C.P. 56(a). This is an extraordinary showing at summary judgment.[5] Given the clear and convincing burden of proof Noell Industries bore, it would require a substantial showing for Noell Industries to be granted summary judgment. For the reasons outlined in this opinion, not only was this showing not

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[4] This heightened burden is only applicable when the moving party is the party that has the burden of proof at trial. In contrast, when the nonmoving party carries the burden of proof at trial, our case law makes clear that on a motion for summary judgment we do not consider whether a party has produced *clear and convincing evidence*, but only "whether the evidence is sufficient to create a triable issue of fact." *Country Cove Dev., Inc. v. May*, 143 Idaho 595, 599, 150 P.3d 288, 292 (2006) (citation omitted). However, for the party who carries the burden of proof at trial to be entitled to judgment as a matter of law, the sufficiency of the evidence would logically have to satisfy the burden of proof. *See* I.R.C.P. 56(a).

[5] The clear and convincing evidence standard only applies to the functional test, not the unitary business test.

made or supported by the record, the evidence in the record supports the conclusion that the sale of Blackhawk LLC constituted business income under the functional test. Accordingly, the Tax Commission's motion for summary judgment should have been granted, and Noell Industries' motion for summary judgment should have been denied.

Idaho Code section 63-3027 provides two separate definitions for business income. The relevant definition here is known as the functional test. This includes "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations." *Union Pac. Corp. v. Idaho State Tax Comm'n*, 136 Idaho 34, 38, 28 P.3d 375, 379 (2001) (quoting I.C. § 63-3027(a)(1)).

The applicable regulations provide guidance on the application of the functional test to determine whether certain commercial activity is business income.

> Application of the functional test is generally unaffected by the form of the property (for example, tangible or intangible property, real or personal property). Income arising from an intangible interest, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to

> the taxpayer's trade or business operations. Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

IDAPA 35.01.01.333.08. Notably, the conclusion that Noell Industries and Blackhawk LLC constitute a unitary business helps support the conclusion that this sale was business income. *See id.* ("[A]pportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business[.]"). However, evidence of a unitary business alone is generally insufficient evidence. *See id.* There must be more. Another method of satisfying the functional test is a finding that "the holding of the intangible interest served an operational rather than an investment function of mere financial betterment." *Id.*

The regulations provide guidance on the treatment of operational functions and investment functions.

> Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holder of the property is limited to mere financial betterment of the taxpayer in general.

IDAPA 35.01.01.333.05. Passive income, or investment income, generally mean "income derived from a business, rental, or other income-producing activity that the earner does not directly participate in or has no immediate control over." *Passive income*, BLACK'S LAW DICTIONARY (11th ed. 2019). Business income, as used in this context, means income from any activity that meets the "transactional test" or the "functional tests," as defined by the Tax Commission's regulations. *See* IDAPA 25.01.01.331.01. Neither the transactional test nor the functional test are satisfied by mere passive investment.

Noell Industries argues that it was merely a passive investor in Blackhawk LLC. Notably, in all the years leading up to Noell Industries' sale of Blackhawk LLC, Noell Industries recognized the gain from Blackhawk LLC's activities as "business income." However, Mike Noell was not a passive investor in Blackhawk LLC. He was the acting President and CEO of Blackhawk LLC. Additionally, he was responsible for oversight of product development for Blackhawk LLC. The income realized by Blackhawk LLC was, in a very real way, dependent on Mike Noell's contribution to that entity as its spiritual father and its CEO and President.[6] Were Mike Noell not the CEO and President of Blackhawk LLC, the investment by Noell Industries in

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[6] In order to reach its decision, the district court substantially minimized Mike Noell's significant management responsibility at Blackhawk LLC. As noted, Mike Noell was both the CEO and President of Blackhawk LLC. While it is true that other managers played significant managerial roles in Blackhawk LLC, to reach the result the district court reached, it had to *ignore* the fact that Mike Noell was both the President and CEO of Blackhawk LLC.

> Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within Idaho.

IDAPA 35.01.01.333.03. It is not possible to conceive of Blackhawk LLC achieving the success it did without Mike Noell at its helm. Yet that is precisely what the district court did.

Blackhawk LLC might have been correctly characterized as a "passive investment." However, with Mike Noell occupying those two roles, it's impossible to conclude the income was passive.

Applying the functional test to these facts yields the conclusion that the sale of Blackhawk LLC constituted business income to Noell Industries. In order for Noell Industries to avoid its apportionable Idaho income tax, it would be necessary to find that the functional test does not apply. If Mike Noell had sold his interest to an entity other than one *controlled by him*, I might be persuaded that the apportionable income realized by Noell Industries is not due. However, given the structure of the entities, the presumption that the functional test is satisfied, and the obligation of Noell Industries to prove by clear and convincing evidence that the functional test does not apply, I cannot concur in the majority's analysis.[7]

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[7] One of the ways in which to analyze whether Noell Industries owes tax on the gain it realized on the sale of Blackhawk LLC, is to consider whether the gain would be taxable if Noell Industries did not exist. In other words, assume the 78.54% interest in Blackhawk LLC was owned by Mike Noell in his individual capacity. There can be little doubt under these facts that Mike Noell would owe Idaho income tax. The gain would be attributable to him because he was the CEO and President of Blackhawk LLC. The gain would be the result of his work as CEO and President and the creative genius behind product development. If Mike Noell were somehow unconnected with Blackhawk LLC, and its success was in no way connected to him, he would not owe Idaho income tax. (In other words, it's instructive to view Noell Industries as a "straw man." Without this "straw man" existing between Mike Noell and Blackhawk LLC, there would be no

D. Conclusion.

To recap, Noell Industries was granted summary judgment even though it had the burden to prove that the sale of Blackhawk LLC did not satisfy the functional test by clear and convincing evidence. I think the district court erred in granting summary judgment to Noell Industries, not only because of the heightened burden of proof Noell Industries bore to prove that the functional test was not satisfied, but also because the existing statutes and regulations governing this transaction lead to a conclusion contrary to that drawn by the district court. I would reverse, and grant summary judgment in favor of the Tax Commission because the undisputed facts demonstrate that the gain realized by Noell Industries qualifies as business income that can be apportioned to Idaho. However, a question of fact

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question regarding the taxability of the income. Yet, the district court (and the majority) concludes that because there is now an intermediary entity between Mike Noell and Blackhawk LLC, somehow the gain that would otherwise be taxable is magically not taxable.) This is not how the tax code operates. There is symmetry to the tax code preventing a taxpayer from creating a straw man which would enable the avoidance of tax. The investment Noell Industries made in Blackhawk LLC, while characterized solely as an investment, is not merely a passive investment because of Mike Noell's active management of Blackhawk LLC. Noell Industries' gain is not passive income any more than it was *before* the sale of Blackhawk LLC. Rather, it is business income *because of* Mike Noell's contribution to Blackhawk LLC's success. However, Noell Industries seeks to avoid imposition of Idaho state income tax because it maintains that Noell Industries only held ownership in Blackhawk LLC as a passive investor. Noell Industries' argument only makes sense if Mike Noell's significant contribution to Blackhawk LLC as its CEO and President is disregarded.

remains as to Noell Industries' tax liability. Accordingly, I would remand the case for a determination of that liability. For these reasons, I respectfully dissent.

Chief Justice BURDICK concurs in the dissent.

IN THE DISTRICT COURT OF
FORTH JUDICIAL DISTRICT OF THE STATE OF
IDAHO, IN AND FOR THE COUNTY OF ADA

NOELL INDUSTRIES, INC., a Virginia corporation, Plaintiff, -vs- IDAHO STATE TAX COMMISSION, Defendant.	Case No. CV01-18-02355 MEMORANDUM DECISION AND ORDER ON PARTIES' CROSS-MOTIONS FOR SUMMARY JUDGMENT (Filed Feb. 15, 2019)

I. INTRODUCTION

Noell Industries, Inc. is a Virginia corporation. In 2010, Noell Industries sold its 78.54% interest in Blackhawk Industries Products Group Unlimited, LLC ("Blackhawk LLC"), a Virginia limited liability company that operated throughout the U.S., including in Idaho. Noell Industries reported its gain from the sale on its 2010 Idaho tax return. However, reasoning that the gain did not qualify as "business income" under the allocation and apportionment provisions of I.C. § 63-3027, Noell Industries did not apportion any part of the gain to Idaho. The Tax Audit staff of the Idaho State Tax Commission ("Commission") concluded that the gain was "business income" for which Noell Industries owed taxes for the 2010 tax year. The Commission affirmed. Using an alternative method of income apportionment that it believed fairly represented Noell

Industries' business activities in Idaho, the Commission calculated the tax owing to be $1,140,489, exclusive of penalties. It is from this Commission decision Noell Industries now appeals.

The parties submitted cross-motions for summary judgment on the issue of whether Idaho has authority to tax the gain on Noell Industries' sale of its interest in Blackhawk LLC. In addition, the Commission seeks summary judgment on the issue of whether its alternative method of apportionment was reasonable. Relying on the declaration of its expert, David Chase, Noell Industries contends there is a question of fact as to the reasonableness of the alternative method because it fails to properly account for the goodwill aspect of Blackhawk LLC's sales price. The Commission seeks to strike Mr. Chase's declaration on grounds that Mr. Chase was not previously disclosed by Noell Industries as an expert.

A hearing on the cross-motions for summary judgment and the motion to strike was held on November 13, 2018. The Court ordered supplemental briefing and took the motions under advisement after the parties submitted their replies to the supplementation. The Court concludes the gain realized by Noell Industries on the sale of interest in Blackhawk LLC is not "business income" under I.C. § 63-3027 and, therefore, not subject to apportionment to Idaho.

II. STANDARD

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 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. *Williams v. Computer Resources, Inc*., 123 Idaho 671, 673 (1993). 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. *Argyle v. Slemaker*, 107 Idaho 668 (Ct. App. 1984); *Loomis v. City of Hailey*, 119 Idaho 434 (1991).

When a taxpayer appeals a determination made by the Commission by filing a complaint against it, "[t]he case is to proceed as a de novo bench trial." *Parker v. Idaho State Tax Commission*, 148 Idaho 842, 845 (2010). In such matters, the "deficiency determination issued by the Commission is presumed to be correct, and the burden is on the taxpayer to show that the Commission's decision is erroneous." *Id.*

III. FACTS

In seeking summary judgment, both parties rely on the facts presented in the Tax Commission's decision giving rise to the instant appeal, to wit:[1]

> Michael M. Noell is Petitioner's founder and president. He is also a former Navy SEAL. It was during his service as a SEAL that he decided to start a business to make tactical and combat gear. The inspiration to start this business came when he was operating inside Northern Iraq. Mr. Noell was carrying a large amount of gear in a pack through an enemy minefield. The pack failed, dumping the gear onto the mine-ridden ground. Mr. Noell remarked to a fellow operator, 'If I get out of this one alive, I will make this stuff the way it needs to be built so none of my buddies have to go through this.' Mr. Noell formed Petitioner to do just this; starting in his garage, Mr. Noell began designing and manufacturing gear and packs that were more robust.
>
> Mr. Noell formed Petitioner in 1993 and used Petitioner from 1993 through 2003 to manufacture and sell tactical and combat gear. Mr. Noell incorporated Petitioner under Virginia law on February 12, 1993, as Blackhawk Industries, Inc. Starting on January 1, 2001, and for all times relevant to this matter, Petitioner has been an S corporation.

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[1] References in the following excerpt to "Petitioner" mean Noell industries. Further, the footnotes added by the Commission citing to supporting documents have been omitted.

> On January 1, 2004, Mr. Noell directed Petitioner to contribute its net assets to Blackhawk LLC, a limited liability company formed on December 1, 2003. In exchange, Petitioner received a controlling, 78.54% membership interest in Blackhawk LLC. Following this transaction, Mr. Noell continued to direct the vision of his business. He served as Blackhawk LLC's President and CEO. Just as with Petitioner, Mr. Noell directed the vision of Blackhawk LLC and oversaw all aspects of Blackhawk LLC with a particular focus on product development.[2]

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[2] References to Mr. Noell's role in Blackhawk LLC were derived from a statement provided to the Commission by Noell Industries' accounting firm stating, in part: "As President & CEO, [Michael Noell] is responsible for directing the vision of [Blackhawk LLC] and overseeing all aspects of Blackhawk LLC, with a particular focus on product development." Aff. Nielson, Exh G (Oct. 16, 2018). In its briefing, the Commission—likely relying on the foregoing statement—described Mr. Noell as "direct[ing] the daily operations" of Blackhawk LLC through Noell Industries. Amend. Memo ISO MSJ, p. 12. Noell Industries responded by submitting the declaration of Mr. Noell, who, as described herein, explained the management structure of Blackhawk LLC, pointing out that he did not direct its daily operations. Second Decl. M. Noell (Oct. 20, 2018). Both parties question whether Mr. Noell's declaration creates a question of fact as to the extent of his role in management and operations of Blackhawk LLC. However, the Court does not find the declaration to be contradictory to the accounting firm's statement at all. That Mr. Noell "directed the vision of Blackhawk LLC and oversaw all aspects of Blackhawk LLC with a particular focus on product development" does not *ipso facto* mean that he directed its daily operations. As CEO, Mr. Noell can direct the vision of Blackhawk LLC and oversee its various aspects without "directing" the daily operations and management. The Court views Mr. Noell's declaration as simply fleshing out a

Starting in 2004, Blackhawk LLC began reporting a physical presence in Idaho. From 2004 through 2006, Blackhawk LLC had property, payroll, and sales in Idaho. This presence expanded in 2007 when Blackhawk LLC leased a "100,000 square foot factory in Boise, Idaho." This factory served as Blackhawk LLC's "West Coast operation center." Blackhawk LLC stated that this facility would "shorten the time-to-market" of its products and would "reduc[e] production lead times." Blackhawk LLC used this Idaho factory for assembling, warehousing, and shipping its products. Blackhawk LLC maintained the Idaho factory through the Petitioner's 2010 sale of Blackhawk LLC.

For taxable years 2004 through 2009, Blackhawk LLC passed through its income to Petitioner who paid Idaho tax on behalf of Mr. Noell. From 2004 through 2009, Petitioner treated the income generated by Blackhawk LLC as Petitioner's business income.

In 2010, Mr. Noell directed Petitioner to sell its interest in Blackhawk LLC for a net gain of nearly $120 million. Of this income, Petitioner attributed nearly all of the gain to goodwill. Despite its history of treating income derived from Blackhawk LLC as business income, Petitioner—when applying the allocation and apportionment provisions found in

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more general statement of his role with Blackhawk LLC. Thus, the Court does not find there to be a question of fact as to Mr. Noell's role in Blackhawk LLC.

> Idaho Code § 63-3027—treated the income it derived from the sale of Blackhawk LLC as nonbusiness income and did not include the income in its calculation of Idaho taxable income. Likewise, Petitioner excluded the receipts related to the sale of Blackhawk LLC from its Idaho apportionment factor calculation.
>
> For taxable year 2010, Audit primarily reviewed Petitioner's treatment of income and receipts from its sale of Blackhawk LLC. Audit also adjusted Petitioner's Idaho sales factor numerator to include the amount of Blackhawk LLC's out-of-state sales that should be "thrown back" to Idaho and treated as Idaho sales. Audit required Petitioner to include a substantial amount of sales Blackhawk LLC made to other states as Idaho sales. On March 27, 2015, Audit issued a Notice of Deficiency Determination (Notice) to Petitioner for the 2010 taxable year. Then, on May 27. 2015, Petitioner filed a timely protest of the Notice.[3]

In addition, the parties provide the following references to the record:

- Upon its formation in 2003, the ownership units of Blackhawk LLC that were not transferred to Petitioner were transferred to other persons.[4]

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[3] Tax Comm. Decision ("Order"), pp. 2-5, attached as Exh A to Decl. Nielson (Oct. 16, 2018).

[4] Decl. David Chase, Jr., ¶ 2 (Oct. 30, 2018).

- From its formation until 2009, Mr. Noell owned 100% of Noell Industries. In 2009, Mr. Noell conveyed about one-third of his interest in Noell Industries to a grantor-retained annuity trust organized by Mr. Noell.[5]

- In the years following the 2004 reorganization, the activities of Noell Industries were limited to owning the Blackhawk LLC interest and owning an interest in a Virginia business which leased real property to Blackhawk LLC in Virginia, but the lease terms were at market. On its 2010 U.S. Income Tax Return, Noell Industries represented that its "business activity" was investment and its "produce or service" was investment. Noell Industries never owned any property in Idaho. Noell Industries did not have any employees from the time of Blackhawk LLC's formation until its sale in 2010, and Noell Industries did not share any assets with Blackhawk LLC, did not provide financing or other services to Blackhawk LLC, and did not share any expenses with Blackhawk LLC. Blackhawk LLC operated in substantially all of the states at the time of its sale by Noell Industries.[6]

- Until Blackhawk LLC was sold in 2010, it was managed by a six member management team, one of whom was Mr. Noell. Mr. Noell did not direct the day-to-day operations of Blackhawk LLC's business. Responsibility for directing daily business

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[5] Noell Industries' responses to Commission's Request for Admissions, attached as Exh I to Decl. Nielson (Oct. 16, 2018).

[6] Decl. M. Noell, ¶¶ 3-6 (Aug. 27, 2018); Aff. Nielson, Exh D (Oct. 16, 2018).

operations was vested in the Executive Director of Operations and the Vice President/CFO. Executive/management meeting were held on a weekly basis. Mr. Noell participated in these meeting with the executive/management team. Ordinary business and sales decisions concerning operations were made by Steven Matulewicz (Vice President of Sales and Executive Director of Operations), and his team. Ordinary marketing decisions were under the purview of Terry Naughton (Vice President of Marketing). Ordinary manufacturing decisions were made by Clifton Cook (Vice President of Manufacturing and Research and Development). In addition, Blackhawk LLC had a full human resource department.[7]

- On its tax return for taxable year 2009, Noell Industries reported that Blackhawk LLC generated $10,496,500 in income for Noell Industries. The other entity in which Noell Industries held an interest produced a loss of $396,394. Noell Industries' only other source of income for 2009 was $18,948 in interest. The, the vast majority of Noell Industries' reported income for 2009 derived from its interest in Blackhawk, LLC.[8]

IV. ANALYSIS

In 1965, Idaho rewrote I.C. § 63-3027 for purposes of codifying the majority of the Uniform Division of Income for Tax Purposes Act (UDITPA) provisions.[9]

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[7] Decl. M. Noell, ¶¶ 1-3 (Oct. 30, 2018).

[8] Aff. Nielson, Exh. L (Oct. 30, 2018).

[9] 1965 Session Laws ch. 254, § 1. p. 639.

Section 63-3027 contains rules for determining the taxable portion of a corporation's total income from a multistate business transacting business within and without of Idaho. In general, I.C. § 63-3027 divides a multistate corporation's income into two groups: business income and non-business income. Income is either apportioned or allocated. If a taxpayer earns "business income" derived in some part in Idaho, such income will be apportioned according to a three factor formula based on sales, property and payroll. If the income is non-business income, it will be allocated to the state of the taxpayer's commercial domicile. I.C. § 63-3027(d)-(h). Specifically, capital gains from the sale of intangible personal property are allocable to Idaho if the taxpayer's commercial domicile is in Idaho, unless such gains qualify as "business income." I.C. § 63-3027(f)(3).

Noell Industries' commercial domicile is in Virginia, not in Idaho. Therefore, to determine whether its gain from the sale of its interest in Blackhawk LLC—intangible property—is subject to apportionment by Idaho, the gain must qualify as "business income" under I.C. § 63-3027(a)(1). Accordingly, the parties' cross-motions for summary judgment present three questions: 1) whether Noell Industries' gain from the sale of its interest in Blackhawk LLC qualifies as business income under Idaho law; 2) if so, whether allowing Idaho to tax the gain is constitutional, and; 3) if constitutional, whether the alternative method of apportionment that the Commission utilized was reasonable.

In relevant part, I.C. § 63-3027(a)(1) defines business income for multistate or unitary corporations

transacting business within and outside Idaho as follows:

> 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations.[10]

As observed by the Idaho Supreme Court, this statute sets forth "two separate and independent definitions of business income." *Union Pac. Corp. v. Idaho State Tax Comm'n*, 136 Idaho 34, 38-39, 28 P.3d 375, 379-80 (2001). The first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." The second definition is "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or

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[10] This definition is adapted from the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which provides: "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the properly constitute integral parts of the taxpayer's regular trade or business operations." Unif. Div. of Income for Tax Purposes Act § 1. UDITPA has been adopted, in whole and in part, by 34 states. M. Bernadette Welch, *Construction and Application of Uniform Division of Income for Tax Purposes Act (UDITPA)—Determination of Business Income*, 74 A.L.R. 6th 1, § 2 (2012).

disposition constitute integral or necessary parts of the taxpayer's trade or business operations." *Id*. These two definitions are commonly referred to as the "transactional test" and the "functional test," respectively. *Id*.

A. Transaction of Business in Idaho

As recognized by the Income Tax Administrative Rules, both the transactional and functional tests require that the income have some connection to the unitary business of the taxpayer, part of which is transacted in Idaho. IDAPA 35.01.01.331.02.a. This is because due process requires "some minimum connection between the interstate business activities generating the income and the state seeking to tax that income. *American Smelting and Refining Co. v. Idaho State Tax Commission*, 99 Idaho 924, 931, 592 P.2d 39, 46 (1979),[11] citing *Moorman Mfg Co. v. Blair*, 437 U.S. 267 (1978). Idaho law reflects this due process requirement through I.C. § 63-3023, which provides:

> Subject only to the limitations of the constitutions of the United States and of the state of Idaho, the term 'transacting business' shall

[11] This opinion was vacated and remanded by the United States Supreme Court in *Asarco Inc. v. Idaho State Tax Commission*, 445 U.S. 939 (1980). The reason for remand was for further consideration in light of new case law. On remand, the Idaho Supreme Court reinstated its opinion, finding it consistent with the new case law, *American Smelting v. Idaho State Tax Co*., 102 Idaho 38, 624 P.2d 946 (1981). The reinstated opinion was then reversed by the U.S. Supreme Court in *ASARCO Inc. v. Idaho State Tax Com'n*, 458 U.S. 307 (1982) on the constitutional issue, but not on the statutory interpretation issue.

> include owning or leasing, whether as lessor or lessee, of any property, including real and personal property, located in this state, or engaging in or the transacting of any activity in this state, for the purpose of or resulting in economic or pecuniary gain or profit.

I.C. § 63-3023.

Personal property encompasses intangible property.[12] Thus, holding an interest in a company located in Idaho for the purpose of or resulting in economic or pecuniary gain or profit qualifies as "transacting business" in Idaho under I.C. § 63-3023. Further, Rule 620 of Idaho's Income Tax Administrative Rules provides that a corporation is "transacting business" simply by being a partner in a partnership that is transacting business in Idaho, even if the corporation has no other contact with Idaho. IDAPA 35.01.01.620.02. The use of the word "partnership" in Rule 620 includes any organization—including a limited liability company—treated as a partnership under the Internal Revenue Code. I.C. § 63-3006a. Thus, a corporation with an ownership interest in an LLC treated as a partnership is transacting business in Idaho if that LLC is transacting business in Idaho and, as such, is required to file an Idaho income tax return.

This rule is common to most states and under federal law. Jerome R. Hellerstein and Walter Hellerstein,

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[12] Black's Law Dictionary defines "personal property" as: "Any movable or intangible thing that is subject to ownership and not classified as real property." *Personal Property*, Black's Law Dictionary (10th ed. 2014).

State Taxation, ¶ 6.12 (3d ed. 2000); 26 U.S.C. § 875(1).[13] The rule is recognizes that a partnership (or LLC) is a "pass-through" entity for income tax purposes; gains and losses of the partnership are passed directly onto the partners. Hellerstein. et al., *supra* at ¶ 6.12. Under this "aggregate theory," a partnership is treated as an aggregation of individuals, each of whom owns an undivided interest in the partnership assets. *Id*. Each general partner is treated as conducting the partnership business directly and owning a share of the partnership's assets. *Id*. Thus, if the partnership derives income from activity in Idaho and that income is passed onto the partners, the partners must pay income tax to Idaho, even if the partner has no other connection to Idaho. Such taxation rules are widely held to satisfy due process requirements.[14] By contrast, the

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[13] 26 U.S.C.A. § 875(1) provides: a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged[.]

[14] *See, e.g., International Harvester Co. v. Wisconsin Dept. of Tax'n*, 322 U.S. 435 (1944) (upholding validity, for due process purposes, of tax on distributions to nonresident shareholders of income derived from within a state by corporation in which taxpayers owned shares); *Allied-Signal Inc. v. Comm'r of Fin*., 79 N.Y.2d 73, 83. 588 N.E.2d 731, 737 (1991) ("Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's [state] earnings as is distributed to them."); *Borden Chemicals & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 79 (Ill. App. 2000) (finding due process satisfied where a non-resident partner's connection to Illinois was its partnership interest in the entity that availed itself of the laws of Illinois, its receipt of distributable income earned in Illinois, and Illinois' assertion of

"entity theory" views a partnership as an entity distinct from the partners themselves, with the partners holding an interest in the partnership itself but with no direct interest in the partnership assets. J. William Callison & Maureen A. Sullivan, Partnership Law & Practice § 3:1 (2018 update).[15]

By owning an interest in Blackhawk LLC—which does transact business in Idaho—Noell Industries also transacts business in Idaho under the plain language of I.C. § 63-3023 and Rule 620 for purposes of income tax filing requirements. Indeed, Noell Industries does not dispute that Rule 620 requires it to report and pay taxes on income loss or gain from the operation of Blackhawk LLC—it has been doing so for years. Noell Industries disputes, however, that I.C. § 63-3023 and Rule 620 apply to determine the taxpayer's trade or business for purposes of determining whether it earned "business income" under I.C. § 63-3027(1)(a). According to Noell Industries, this approach would disregard the entity theory of partnerships in favor of an aggregate theory.

To this end, Noell Industries relies on the *TTX Co. v. Idaho State Tax Com'n*, where the Idaho Supreme Court determined that a foreign corporation could not be taxed on its business income by Idaho because it did

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jurisdiction over the partner for the sole purpose of taxing this distributable income.)

[15] Idaho has adopted the Revised Uniform Partnership Act which incorporates the entity theory. Under Idaho law, a limited liability company is an entity distinct from its member or members. I.C. § 30-25-108.

not transact business in Idaho. 128 Idaho 483, 915 P.2d 713 (1996). The Court finds *TTX* distinguishable. In *TTX*, a Delaware corporation, TTX Company ("TTX"), leased railroad cars to various railroads operating in Idaho and paid Idaho property tax on the cars while they were in Idaho. *Id*. at 484, 915 P.2d at 714. The Idaho Tax Commission sought to tax TTX's income realized from the presence of its cars in the state. To determine whether TTX's income was taxable by Idaho, the Court first looked to I.C. § 63-3027 which, at that time, applied to "any corporation with a business situs in [Idaho]." *Id*. at 485, 915 P.2d at 715, citing I.C. § 63-3027 (1993). The Court then turned to I.C. § 63-3023(a) which, at that time, stated that "business situs" included "the owning or operating of . . . property . . . within the state of Idaho." *Id*., citing I.C. § 63-3023(a) (1988). Based on the unambiguous language of the statutes, the Court found that TTX had a business situs in Idaho. *Id*. However, the Court noted that the definition of business income under I.C. § 63-3027(a)—which was the same as it is today—and authorities interpreting the definition required that some portion of the taxpayer's income "arise from transactions and activities conducted in this state" to be taxable by Idaho. *Id*. at 785-86, 915 P.3d at 715-16, citing *American Smelting*, 99 Idaho at 931, 592 P.2d at 46. Notably, both parties agreed that *TTX* did not transact business in Idaho nor was it authorized to transact business in Idaho. *Id*. Further, TTX submitted an affidavit from a corporate officer stating that TTX undertook no business transactions in Idaho. Because the Tax Commission failed to produce evidence in opposition, the Court

concluded that the corporation derived no "business income" from the presence of its railroad cars in Idaho because it did not transact business in Idaho. *Id*. at 486, 915 P.2d at 716.

The Court decided *TTX* by applying the plain language of I.C. §§ 63-3023 and 63-3027. However, since *TTX* was decided, both statutes were amended to remove references to "business situs." Rather than stating that a "business situs" in Idaho could be developed by, among other things, the owning of property in Idaho, I.C. § 63-3023 was amended to state that such activity constituted "transacting business." 1995 Idaho Laws Ch. 111 (H.B. 132). Likewise, amendments were made to I.C. § 63-3027 so that it no longer applies to a corporation "with a business situs in Idaho" but instead applies to a "multistate or unitary corporation transacting business both within and without [Idaho.]" *Compare*, I.C. § 63-3027 (1993) with I.C. § 63-3027 (2014). If the Court were to analyze *TTX* based on the plain language of the statutes as amended, it would necessarily conclude that TTX transacted business in Idaho by virtue of owning property in Idaho. Rule 620 and I.C. § 63-3023 are unambiguous in this regard—by virtue of owning an interest (personal property) in a partnership transacting business in Idaho, Noell Industries is also transacting business in Idaho. Thus, whether Noell Industries' income is taxable by Idaho is governed by the definition of "business income."

B. Transactional Test

Under the transactional test, income arising from transactions and activity in the regular course of the taxpayer's trade or business qualifies as business income. I.C. § 63-3027. Pursuant to Rule 332 of Idaho's Income Tax Administrative Rules, the transaction or activity need not be one that frequently occurs in the trade or business. Instead, a transaction or activity is in the regular course of a trade or business "if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does." IDAPA 35.01.01.332. If the transaction or activity is for the taxpayer's mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. *Id*.

Noell Industries contends that the gain it realized on the sale of its interest in Blackhawk LLC does not qualify as business income under the transactional test because the gains did not arise from Noell Industries' regular trade or business, which is limited almost entirely to holding an interest in Blackhawk LLC. The Commission contends that the transactional test is satisfied because Noell Industries represented itself to be an investment company and the sale of an investment is a customary transaction for an investment company.

The first issue to determine is Noell Industries' trade or business. Noell Industries represented itself

on its federal income tax returns in 2010 as being engaged in the business activity of "investment." However, the record demonstrates that Noell Industries was not an investment company in the typical sense of the word. It was not in the business of buying and selling interests in other companies or issuing securities. From 2004 to 2010, Noell Industries' trade or business was limited to owning a membership interest in Blackhawk LLC and in a separate company in Virginia that leases real property to Blackhawk, LLC. Its activity consisted of owning two assets, with its membership interest in Blackhawk LLC being its primary asset. It was essentially a holding company or parent company to Blackhawk LLC.

The following two cases illustrate the application of the transactional test when the gain arises from the taxpayer's sale of a subsidiary. In *E.I. DuPont De Nemours & Co. v. Indiana Dep't of State Revenue*, the taxpayer's regular business was in industrial, agricultural and chemical manufacturing. 79 N.E.3d 1016, 1018 (Ind. T.C. 2017). It sold its 50% interest in a pharmaceutical subsidiary after three years of ownership, resulting in a $4 billion gain. *Id*. The tax court found that the gain did not qualify as business income under the transactional test because the taxpayer's business was not the buying and selling of it subsidiaries. *Id*. at 1023. Conversely, in *PPG Indus., Inc. v. Dep't of Revenue*, the Illinois Court of Appeals determined that gain from the sale of the taxpayer's subsidiary did qualify as business income under the transactional test where the taxpayer's annual report indicated that it acquired

and sold several businesses in the tax year at issue as part of its strategic and performance objectives. 765 N.E.2d 34, 45 (Ill. App. 2002).

The record here demonstrates that, as a holding company or parent company, Noell Industries did not engage in the business of buying and selling other companies, nor is it reasonably customary for companies similarly situated to Noell Industries to do so. Holding companies are designed to hold an interest in another company, not dispose of it.[16] The same is true for parent companies.[17] As such, the Court finds that Noell Industries' gain from the sale of its interest Blackhawk LLC does not qualify as business income under the transactional test.

C. Functional Test

Under the functional test, "business income" includes income from "the acquisition, management. or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's

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[16] Black's Law Dictionary defines "holding company" as "a company formed to control other companies, usu. confining its role to owning stock and supervising management. It does not participate in making day-to-day business decisions in those companies." COMPANY, Black's Law Dictionary (10th ed. 2014).

[17] Black's Law Dictionary defines "parent corporation" as "a corporation that has a controlling interest in another corporation (called a subsidiary corporation), usu. through ownership of more than one-half the voting stock." CORPORATION, Black's Law Dictionary (10th ed. 2014).

trade or business operations." I.C. § 63-3027(a)(1). Importantly, "gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitutes an integral part of the taxpayer's trade or business." I.C. § 63-3027(a)(1). This presumption may only be overcome by "clear and convincing evidence to the contrary." *Id*. Thus, the Court must presume the gain realized by Noell Industries on its sale of its interest in Blackhawk LLC satisfies the functional test unless Noell Industries presents clear and convincing evidence that it does not.

Noell Industries argues that its gain does not qualify as business income under the functional test because its interest in Blackhawk LLC was simply a passive investment. It further argues it did not have a unitary relationship with Blackhawk LLC nor did its interest in Blackhawk LLC serve an operational purpose for Noell Industries because Noell Industries did not have operations. Conversely, the Commission argues that Blackhawk LLC was an integral part of Noell Industries' trade or business because the two companies were one in the same, with Blackhawk LLC simply acting as the operational arm of the business enterprise since 2004. The Commission contends that Michael Noell continued to control both companies and points out that the pass-through income Noell Industries received from Blackhawk LLC's income drove Noell Industries' bottom line. Thus, according to the

Commission, Noell Industries cannot satisfy its burden of proof.

Both the Idaho Supreme Court and Idaho's Income Tax Administrative Rules instruct that the focus of the inquiry under the functional test is on the relationship between the intangible property itself and the taxpayer's trade or business operations. *See*, IDAPA 35.01.01.330 ("Rule 333"); *American Smelting*, 99 Idaho at 937, 592 P.2d at 52. The intangible property need not be "an absolutely indispensable part" of the taxpayer's business; rather, it must "contribute[] to and [be] identifiable with the taxpayer's trade or business operations." *American Smelting*, 99 Idaho at 932, 592 P.2d at 47. This connection is not met where the underlying property is simply a passive investment. As observed by the Idaho Supreme Court:

> In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. 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 business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to

> and connected with the taxpayer's business operations.

Id. at 933, 592 P.2d at 48.

Idaho's Income Tax Rules likewise instruct that the income realized from the disposition of intangible property will not qualify as business income under the functional test if it serves an investment rather than operational purpose. Rule 333 provides in relevant part:

> **03. Integral, Function, or Operative Component of Trade of Business.** Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within Idaho. Depending on the facts and circumstances of each case, property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset and is not subject to the rule of the preceding sentence.

. . .

05. Operational Function Versus Investment Function. Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general. (4-6-05)

06. Property Held in Furtherance of Trade or Business. If the property is or was held in furtherance of the taxpayer's trade or business beyond mere financial betterment, then income from that property may be business income even though the actual transaction or activity involving the property that gives rise to the income does not occur in Idaho. (4-6-05)

. . .

08. Application of the Functional Test. . . . Income arising from an intangible interest . . . is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral,

> functional, or operative component to the taxpayer's trade or business operations. Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment. (4-6-05)

Rule 333.

Pursuant to Rule 333, income realized from a transaction involving intangible property can satisfy the business income definition under the functional test in two situations. First, the test is met if the issuer of the intangible property and the taxpayer are unitary. A "unitary business" is defined under Idaho's income tax rules as "a single economic enterprise that is made up either or separate parts of a single business entity or of a commonly controlled group of business entities that 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 among them and a significant flow of value to their separate parts." IDAPA 35.01.01.365. Second, the test is met if the intangible

interest serves an operational function rather than an investment function.

Rule 333's interpretation of the functional test comports with the analytical framework set forth by the United States Supreme Court for determining the constitutional restraints on state apportionment of income.[18] Under both the Due Process and the Commerce Clauses of the United States Constitution, when imposing an income-based tax, a state may not "tax value earned outside its borders." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983), quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). Rather, there must be "some definite link. some minimum connection, between a state and the person, property or transaction it seeks to tax." *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 777 (1992), quoting *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). For income realized from a nondomiciliary taxpayer's acquisition, management or disposition of an intangible asset, apportionment is constitutional where either there is enterprise unity between the investor and investee or when the capital transaction serves an operational rather than investment function for the taxpayer. *Id.* 772, 787.[19]

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[18] Rule 334 or Idaho's Income lax Administrative Rules states that the transactional and functional tests are intended to comply with the United States Constitution.

[19] The United States Supreme Court has noted that the definitions of 'business income" in UDITPA are "compatible" with the unitary business principle. *Allied-Signal*, 504 U.S. at 786.

Where, however, the underlying asset is an interest in another business, income derived from the sale of the interest is apportionable under the Commerce Clause only if there is a unitary relationship between the taxpayer and the other business. *Meadwestvaco Corp v. Illinois Dept. of Revenue*, 553 U.S. 16, 30 (2008). In other words, whether the other business—typically a subsidiary company—served an operational function is not a ground for apportionment unless it is a unitary part of the taxpayer's business. The "hallmarks" of a unitary relationship are functional integration, centralized management and economics of scale. *Meadwestvaco Corp*., 553 U.S. at 30.[20] These determinations are factual in nature, subject to determination by the factfinder, and the following considerations are relevant: (1) a flow of value between the entities that serves operational (rather than investment) functions is evidence of functional integration; (2) arms-length transactions are evidence of a lack of integration; and (3) "occasional oversight—with respect to capital structure, major debt. and dividends—that any parent gives to an investment in a subsidiary" is evidence of a lack of centralized management. *Container Corp*., 463 U.S. at 180, n, 19.

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[20] Idaho's Income Tax Administrative Rules likewise cite these three factors as suggestive of a unitary business. IDAPA 35.01.01.341.02.

1. Meadwestvaco

The United States Supreme Court's decision in Meadwestvaco—its most current articulation of the constitutional parameters of apportionment—illustrates this distinction. There, the taxpayer—Mead—had its commercial domicile in Ohio and engaged in business in Illinois. *Id*. at 20. Mead's business was producing and selling paper, packaging and school/office supplies. *Id*. Mead subsequently acquired a company that, over the course of many years, Mead developed into the electronic research service, Lexis/Nexis.[21] *Id*. Lexis was subject to Mead's oversight, but Mead did not manage Lexis's day-to-day affairs. *Id*. at 21. The two maintained separate manufacturing, sales and distribution facilities, as well as separate accounting. legal, human resources, credit and collections, purchasing and marketing departments. *Id*. Mead's involvement in Lexis was generally limited to approving Lexis's annual business plan and significant corporate transactions. *Id*. at 22. Mead also managed Lexis's idle cash, which was swept nightly into an account maintained by Mead and reinvested in Lexis's business as Mead deemed appropriate. *Id*. Neither business was required to purchase goods or services from the other; neither received discounts on goods and services purchased from the other; and neither was a significant

[21] The taxpayer initially incorporated Lexis as a separate subsidiary but then merged it as a division of the taxpayer's business.

customer of the other. *Id*. Mead sold Lexis and used the gain to repurchase stock, retire debt and pay taxes. *Id*.

Mead took the position that the gain from its sale of Lexis was not includable in its Illinois apportionable tax base. *Id*. at 23. The trial court held that Mead and Lexis were not engaged in a unitary business because the three "hallmarks" were not present. Nevertheless, the trial court concluded that Lexis served an "operational purpose" in Mead's business and, therefore, held the gain was apportionable. *Id*. The Illinois Court of Appeals affirmed, concluding that Lexis served an operational function in Mead's business because: 1) Mead wholly owned Lexis; 2) Mead exercised control over Lexis in various ways, such a manipulating its corporate form, approving significant capital expenditures, and retaining tax benefits and control over Lexis's free cash, and; 3) Mead described itself in regulatory filings as engaged in electronic publishing and developer of a leading information retrieval service. *Id*.

The issue before the United States Supreme Court was whether Lexis served an operational function in Mead's business or whether it was a passive investment. *Id*. at 24. However, the Court concluded that it was error for the lower courts to even consider whether Lexis served an operational function after concluding Lexis and Mead were not unitary. *Id*. The Court explained the genesis of the unitary business principle, including its prior recognition that an asset or capital transaction could form part of a taxpayer's unitary business if it served an operational rather than investment function in that business. *Id*. at 28-29, citing

Allied-Signal, 504 U.S. at 787 and *Container Corp*., 463 U.S. at 180, n. 19. The Court clarified that the "operational function" was not intended as a separate ground for apportionment absent a unitary business. *Id*. at 29. "The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor' and 'payee.' " *Id*.

By way of example, the Court pointed to its decision in *Corn Products Refining Co. v. Commissioner*, where it held that income derived from the taxpayer from its corn futures contract held to hedge itself against an increase in corn prices was operational, even though the taxpayer was not unitary with the counterparty to the hedge. *Id*. at 29. citing *Corn Products*, 350 U.S. 46 (1955). Likewise, a taxpayer is not unitary with its banker, but the taxpayer's deposits of working capital (i.e., operational assets) are unitary with the taxpayer. *Id*. Thus, where the asset is another business, the question is whether that business is unitary with the taxpayer. *Id*. at 30. This inquiry is not answered by applying the operational function test; rather, the appropriate test is whether the three "hallmarks" exist between the taxpayer and the subsidiary business. *Id*.

2. American Smelting

Long before Meadwestvaco was decided, the Idaho Supreme Court applied a similar approach in American Smelting in addressing whether income from the

sale of intangibles met the functional test of I.C. § 63-3027. There, the taxpayer—ASARCO—was a multi-state corporation engaged in mining, smelting and refining metals and had a commercial domicile in New York, 99 Idaho at 927, 592 P.2d at 42. It owned a controlling or substantial interest in several corporations, most of which were engaged in related operations. *Id.* At issue in the case was the apportionability of ASARCO's receipt of intercorporate dividends, interest income, and capital gains from the sale of such stock. In considering the functional test set forth in I.C. § 63-3027, the Court recognized that there must be a "direct relationship" between the underlying asset and the taxpayer's trade or business such that the asset "contributes to and is identifiable with the taxpayer's trade or business." *Id* at 932-33, 592 P.2d at 48-49. It further endorsed the principle that "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. *Id*. at 931, 592 P.2d at 46.

In determining whether this relationship was met, the Court examined the interconnectivity between ASARCO and the subsidiaries at issue. *Id*. at 935, 592 P.2d at 50. While the Court did not specifically cite to the three hallmarks of a unitary relationship—functional integration, centralized management and economics of scale—it analyzed whether similar connections were present. For most of the subsidiaries,

the Court found the connection satisfied. ASARCO owned a controlling or "very substantial" interest in each, they all engaged in business closely related to ASARCO's, and, with the exception of one subsidiary, ASARCO did a substantial amount of business with them and provided them with a variety of technical services. With other subsidiaries, the connection was not met where the business operations of the subsidiaries was unrelated to that of ASARCO. With the final group of subsidiaries, the Court found no connection where ASARCO's stock ownership was small and their business dealings with ASARCO were limited. *Id*. at 936, 592 P.2d at 51.

3. Other jurisdictions

Other jurisdictions also recognize that constitutional norms require a unitary relationship where the income at issue arising from the taxpayer's sale of an interest in another company. For example, in *E.I. DuPont De Nemours & Co.*, the Indiana Tax Court classified the taxpayer's gain on the sale of its 50% interest in a relatively independent subsidiary as nonbusiness income under Indiana's UDITPA definition of 'business income" and under the unitary principle standard articulated by the United States Supreme Court, 79 N.E.3d at 1022-24. Namely, the taxpayer demonstrated that it exercised only "occasional oversight" over the subsidiary, they two business operated independently in different industries, they engaged in arms-length transactions, and they did not share centralized management. *Id*. at 1024. As such, the tax

court found the taxpayer's gain was not apportionable business income. *Id*.[22]

The unitary relationship analysis is likewise applied where the taxpayer's business is limited to holding an interest in another company. For example. in *Western Phoenix, N.V. v. Arizona Department of Revenue*, the taxpayer was a foreign corporation whose sole activity was holding a 25% interest in an Arizona partnership that owned a commercial building in Phoenix. 1994 WL 143279, * 1 (Ariz.Bd. Tax.App. March 8, 1994). The taxpayer sold part of its interest to another corporation and allocated the gain from the sale to Texas, the state from where the taxpayer conducted its activities with relation to the partnership interest. The Arizona Department of Revenue sought to tax part of the gain. Much like the Commission here, the Department argued that the business of the partnership and the business of the taxpayer were one and the same because the taxpayer's only business was owning an interest in the partnership. As such, the Department argued there was no need to apply the unitary test. *Id*. at * 2. The Board of Tax Appeals disagreed, finding that the income could only be apportionable under Arizona's business income statute (also UDITPA) if the companies were unitary. Noting that the taxpayer had no real operation, no employees, no offices, and its sole

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[22] *See also*, *BIS LP, Inc. v. Dir., Div. of Taxation*, 2011 WL 3667622, at *6 (N.J. Super. Ct. App. Div. Aug. 23, 2011); *E. I. Du Pont de Nemours & Co. v. Dep't of Treasury*, 2012 WL 3196087, at *2 (Mich. Ct. App. Aug. 7, 2012): *Gannett Co. v. State Tax Assessor*, 959 A.2d 741, 749-51 (Me. 2008).

business was investment in the partnership, the Board found there was no unitary relationship and, therefore, the gain was not apportionable to Arizona. *Id*. at * 3.[23]

As noted by one prominent authority on the issue of state taxation, a holding company will not always be excluded as part of a unitary business if it is shown to exercise control over the subsidiary to some degree.

> In practice, such holding companies usually exercise control of [its subsidiaries'] budgets, large expenditures, major policies, and the general mode of operation of the subsidiaries. To exclude the owning, controlling, integrating holding company that binds the affiliated group into unity is to play Hamlet without the Prince. . . . Accordingly, we believe that a holding company, which holds a majority or more of the shares of stock of one or more subsidiaries of a unitary business which controls such subsidiaries, should be recognized without more as part of the unitary business. Engaging in basic operating transactions with other members of the group, such a buying and selling goods, or performing internal services, such as providing management, financial, accounting, legal or similar services,

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[23] *See also*, *In the Matter of PBS Building Systems, Inc*., 1994 WL 719050 (Cal. St. Bd. Equalization, Nov. 17, 1994) (applying unitary analysis to determine whether holding company and its subsidiary were required to tile combined return); *First National Bank of Manhattan, Kansas v. Kansas Dept. of Rev*., 779 P.2d 457 (Kan. App. 1989) (analyzing whether bank and its holding company were unitary for purposes of a state privilege tax).

> should be regarded as a sine qua non of being part of the unitary business.

Hellerstein, et. al., supra at ¶ 8.11[3][d]

Hellerstein's comments instruct that, absent a holding company's exercise of control over its subsidiary or any other meaningful interaction, unitariness is lacking.

The Commission contends that the unitary test is not well-suited for determining whether a state may constitutionally apportion gain realized by a holding company because the test requires a comparison of holding company's business operations with the subsidiary's business operations. For holding companies, there will never be a finding of unitariness with the underlying subsidiary because holding companies typically do not have operations. To this end, the Commission cites to two Tennessee cases where the courts made the same observation. In *Blue Bell Creameries v. Roberts*, the Supreme Court of Tennessee addressed the application of the unitary relationship test between a non-operating holding company and an operating business. 333 S.W.3d 59 (Tenn. 2011). Noting that the test was "ill-suited" for assessing the relationship between the two, the court reframed the analysis to require that the taxpayer demonstrate that the holding company was a "discrete business enterprise" rather than demonstrating that the two were not unitary. *Id*. at 71-72. Because the holding company did not

conduct business operations, the court found the taxpayer could not satisfy this burden.[24]

Rather than apply the three-prong unitary test, the Commission urges that the Court apply the same approach utilized in *Blue Bell*. However, the Court is not so inclined. The United States Supreme Court has expressly rejected pleas to jettison the unitary business principle where it proved difficult to apply to two businesses that were entirely unrelated. *Allied-Signal*, 504 U.S. at 784. Although this Court agrees that the test for unitariness can be flexible depending on the circumstances, the Court is not willing to discard it altogether, especially given the *Blue Bell* court's lack of thoughtful analysis and the fact that its approach has not been followed outside of Tennessee.

The Court also finds *Blue Bell* approach inconsistent with the functional test, which favors an entity theory rather than an aggregate theory and recognizes that income from a passive investment is not subject to apportionment. Further, the *Blue Bell* approach assumes that a holding company is inactive and, therefore, per se incapable of providing a flow of value to or from an operating company. However, a holding company can still provide financing or loan guarantees to the operating company or provide other forms of value which can give rise to a finding of unity. *See, e.g.*, *In the Matter of PBS Building Systems, Inc.*, 1994 WL 719050

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[24] The Tennessee Court of Appeals followed this same rationale in *H.J. Heinz Co., L.P. v. Chumley*, 2011 WL 2569755 (Tenn. App. June 28, 2011).

(Cal. St. Bd. Equalization, Nov. 17, 1994) (concluding holding company was unitary with its operating subsidiary where there was a complete overlap of officers and directors, extensive intercompany financing, and where the holding company purchased a covenant not to compete for the benefit of its subsidiary). The Court declines to follow *Blue Bell* on this issue.

4. Application of the unitary tests

While the United States Supreme Court deemed the "hallmarks" of a unitary relationship to be functional integration, centralized management and economics of scale, it also observed that "any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach." *Meadwestvaco Corp*., 553 U.S. at 30; *see also*, *Container Corp*., 463 U.S., 178 at fn. 17 ("there is a wide range of constitutionally acceptable variations on the unitary business theme"). "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of value." *Container Corp*., 463 U.S. at 178 (emphasis in original). Flow of value is often characterized by substantial mutual interdependence. *Id*. at 178-79. No one fact necessarily determines whether unity exists. *Id*. at 179-80. Rather, the totality of the facts are examined and weighed for cumulative effect. *Id*.

Two other tests have been employed to measure this flow of value—the *Butler Brothers* test and the *Edison* test. The *Butler Brothers* test—which is the

earliest of the three tests—focuses on unity of use, operation and management as evidenced by central purchasing, advertising, accounting, and management, and the unity of a centralized executive force and general system of operation. The *Edison* test focuses on "contribution and dependency." *Edison California Stores, Inc. v. McColgan*, 183 P.2d 16, 20 (Cal. 1947). If the operations of the business performed within the taxing state contribute to or are dependent on the operations of the business performed outside the taxing state, the test is met. *Id*. at 21. Idaho's Income Tax Administrative Rules state that unity can be established under any one of these three tests. Rule 341.01.

The facts presented by Noell Industries demonstrate a lack of unity between it and Blackhawk LLC under any of the three articulations of unity. The companies were not functionally integrated. Factors that demonstrate such functional integration is a history of transactions not undertaken at arm's length or the sharing of finances. *Allied-Signal*, 504 U.S. at 789. Here, the only transaction between the two companies—other than Noell Industries' transfer of assets to Blackhawk LLC in 2004 in exchange for an interest therein—is that Blackhawk LLC leases property from another business owned by Noell Industries, but the lease terms are at market. Further, they did not share assets, share expenses or provide financing or other services to each other.

Additionally. there was no centralized management between Noell Industries and Blackhawk LLC. Centralization of management entails substantial

participation and oversight by the management of the parent company in the operational decisions of the subsidiary. *Container Corp*., 463 U.S. at 180, n. 19. The inquiry focuses on "whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy." *Id*. While the Commission places great weight on the fact that Michael Noell was Blackhawk LLC's President and CEO and the primary shareholder in Noell Industries. Inc., this sole overlap is not sufficient to demonstrate centralized management. The evidence demonstrates that Blackhawk LLC was organized as a "manager managed" LLC and overseen and operated by a separate six member management team, only one of whom was Mr. Noell. Further, Mr. Noell did not direct the day-to-day operations. Rather, responsibility for directing daily business operations was vested in the Executive Director of Operations and the Vice President/CFO. Ordinary business and sales decisions concerning operations were made by Vice President of Sales and Executive Director of Operations and his team. Ordinary marketing decisions were under the purview of the Vice President of Marketing. Ordinary manufacturing decisions were made by the Vice President of Manufacturing and Research and Development. These officers had no involvement with Noell Industries.

Further, while Noell Industries—as the majority interest holder—may have had the potential to exert control over Blackhawk LLC, it is well-settled that the mere potential to control is not sufficient to establish

centralization of management. *Allied Signal*, 504 U.S. at 781. Otherwise. every majority-owned business would be deemed unitary even where, as here, the parent takes deliberate steps to relinquish control over the subsidiary and establish independent management.

Economies of scale are present where the companies in question are engaged in the same line of business. *Allied Signal*, 504 U.S. at 789. While, as the Commission points out, Noell Industries was Blackhawk LLC until 2004, it divested itself entirely of the business operations and functioned solely to hold interest in Blackhawk LLC and another company since that time. As recognized by Idaho's Rule 333, a taxpayer can convert an operational asset into an investment or an asset can be converted to nonbusiness use through the passage of a sufficiently lengthy period of time. Conversion occurred under both prongs here. Noell Industries converted its operational asset—tactical gear manufacture and sale—to Blackhawk LLC in exchange for an interest therein and then held the interest for six years. By the time of Noell Industries' sale of Blackhawk, there can be no credible argument that Noell Industries continued to be engaged in the same business as Blackhawk LLC. Depending on the facts and circumstances of each case, or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset and is not subject to the rule of the preceding sentence

Not only does the *Meadwestvaco* test result in a finding of no unity, so do the *Butler Brothers* and *Edison* tests for the same reasons. Noell Industries and Blackhawk LLC do not share central purchasing, advertising, accounting, a centralized executive force and general system of operation. Likewise, their business operations are not dependent on each other. Noell Industries does not have operations; rather, it exists to hold its shareholders' business interests. Due to the lack of unity between Noell Industries and Blackhawk LLC, the Court finds that income realized by Noell Industries from the sale of its interest in Blackhawk LLC does not satisfy the functional test under I.C. § 63-3027(a)(1).

In sum, the Court concludes that the gain realized by Noell Industries does not qualify as business income that can be apportioned to Idaho. Therefore, the Court need not undertake an analysis of whether the Commission's alternative apportionment calculation is reasonable.

V. ORDER

Based on the foregoing, Noell Industries' motion for summary judgment is GRANTED; the Commission's motion for summary judgment is DENIED and

the Commission's motion to strike the declaration of David Chase is DENIED as moot.

Dated this 14th day of February, 2019.

/s/ Steven Hippler
Steven Hippler
District Judge

[Certificate Of Mailing Omitted]

IN THE SUPREME COURT OF THE STATE OF IDAHO

NOELL INDUSTRIES, INC., a Virginia corporation, Plaintiff-Respondent, v. IDAHO STATE TAX COMMISSION, Defendant-Appellant.	**Order Denying Petition for Rehearing** Supreme Court Docket No. 46941-2019 Ada County District Court No. CV01-18-02355

The Appellant filed a Petition for Rehearing on June 10, 2020, and supporting brief on June 24, 2020, of the Court's Published Opinion released May 22, 2020. The Respondent filed a Response to Petition for Rehearing on August 4, 2020. Therefore, after due consideration,

IT IS HEREBY ORDERED that Appellant's Petition for Rehearing be, and hereby is, denied.

Dated August 14, 2020

By Order of the Supreme Court

/s/ Melanie Gagnepain
Melanie Gagnepain
Clerk of the Courts