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INSIGHT: Persistence Pays Off in Sale of Idaho Pass-Through Entity

BY STEVEN N.J. WLODYCHAK AND BRUCE P. ELY

Retired Navy SEALs apparently have a persistence that other taxpayers may not have. Case in point (literally)—*Noell Industries, Inc. v. Idaho State Tax Commission*, decided on May 22, 2020, by the Idaho Supreme Court.

Upholding a decision of the district court, the majority of the Idaho Supreme Court ruled that $120 million of gain on the sale of the membership interest in a limited liability company doing business in the state by an S corporation-member that itself had no business activities in the state does not constitute apportionable business income and was erroneously taxed by Idaho. The Idaho State Tax Commission had held to the contrary and was therefore overruled.

The *Noell Industries* case is another in a series of recent cases around the country focusing on which state or states can tax gains on a sale of either ownership interests in, or the underlying assets of, a business operating as a pass-through entity (PTE). As the court's ruling suggests, the critical question is whether income is ''business income'' or ''nonbusiness income'' (or, in the parlance of the new model apportionment regulations of the Multistate Tax Commission (MTC), ''apportionable income'' or ''allocable income,'' respectively) in order to properly source income to the ''right'' state for income tax purposes.

The court properly (in our opinion) pointed out that the analysis requires consideration of principles on the limits of state taxation under the Due Process and Commerce Clauses of the U.S. Constitution and the state statutes developed in response to those concerns. Under unitary business principles laid down by the U.S. Supreme Court, business income is income that is subject to income tax in any state in which the activity occurs subject to apportionment, while nonbusiness income is allocable to a specific state and only subject to tax there. In the context of the sale of equity interests in a PTE, that decision is crucial in determining which state or states can tax the gain. The court's thoughtful ruling and discussion of this issue could be useful to taxpayers in other states.

First, some important background. Mike Noell was a retired Navy SEAL who, from his experience in battle fronts throughout the world, thought he could develop better protective tactical gear for the military, law enforcement, and ultimately, outdoors enthusiasts. He founded Noell Industries, Inc. in his garage in Virginia in 1993. Noell Industries elected from inception to be treated as an S corporation. In 2003, Noell Industries transferred its net assets to a Virginia limited liability company Mr. Noell created named Blackhawk Industrial Products Group Unlimited, LLC (Blackhawk), in exchange for 78.54% of the membership interests of Blackhawk. The remaining interests in Blackhawk were subscribed by other investors. Blackhawk operated in multiple states.

In 2004, Blackhawk opened a facility in Idaho and in 2007 leased a factory in Boise that operated as its ''West Coast operations center,'' but ultimately expanded to become one of four U.S. factories producing duty gear, body armor, holsters, and other outdoor hunting products. By 2010, Blackhawk operated in substantially all states and the court found that it owned approximately $20 million of real and personal property in Idaho. In contrast, the court also found that Noell Industries, the corporate member of Blackhawk, never owned any real property located in Idaho. Instead, the court found that other than owning the majority interest in Blackhawk, Noell Industries simply leased real property located in Virginia to Blackhawk. Almost all of Noell Industries' income came directly from Blackhawk. As an owner of Blackhawk, Noell Industries annually filed returns with and paid tax to Idaho on its apportioned share of Blackhawk's income. Noell Industries had no employees following the formation of Blackhawk.

Mike Noell served as Blackhawk's President and CEO and was part of a six-member management team. But he did not manage Blackhawk's day-to-day operations, marketing decisions, or other ordinary business and sales decisions.

In 2010, Noell Industries sold its 78.54% membership interest in Blackhawk to an unrelated third party for a net gain of $120 million and reported it on its 2010 Idaho corporate tax return. It did not, however, apportion any of the gain on the sale to Idaho, treating it as ''goodwill''—all of which was subject to tax in Virginia, Noell Industries' headquarters/domiciliary state.

Idaho state tax auditors concluded otherwise and treated the gain as business income, issuing an assessment of $4.48 million. The commission affirmed the decision to treat the income as business income but reduced the assessment to $1.42 million by finding, without explanation, that the use of the standard apportionment factor did ''not fairly reflect [Noell Industries'] business activity in Idaho,'' and eliminating the penalty. A copy of the commission's heavily redacted ruling, which appears to recite essentially the same facts as those cited by the court and, therefore, must be the commission ruling from which the appeal was based, is available on the Internet as Docket No. 0-976-965-632. A comparison of the commission's ruling with the court's decision indicates that the facts weren't in dispute, simply the application of the law.

Noell Industries appealed the commission's ruling to the district court, which overturned the commission, finding that the gain was not business income under Idaho Code Section 63-3027 (the state's version of the business income provisions of the Uniform Division of Income for Tax Purposes Act) and therefore, not subject to apportionment to Idaho. The commission appealed to the court.

The ''overarching issue'', as the court described it, was whether the ''unitary test'' falls within the business income analysis, under either the statutory provisions of Idaho law or under the U.S. Constitution. The court pointed out that it falls under both, ''because the unitary business test is part and parcel of the 'business income' question.'' From a constitutional perspective, the unitary business principle was developed by the U.S. Supreme Court under claims that a state was imposing an income-based tax on gains earned outside the state's borders. Establishing whether two businesses constitute a ''unitary business'' is fundamental to determining whether the state can apportion the income of a foreign, wholly-owned subsidiary as if it was the income of the parent corporation. The court recognized the U.S. Supreme Court's landmark holding in *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*—that it's not whether there is an operational test and a separate functional test in determining whether the unitary business test is satisfied, but a single test based on whether the income is derived from a unitary business.

The commission contended that Noell Industries' gain from the sale of its Blackhawk ownership interest qualifies as business income because the acquisition and management constituted a necessary part of its business operations. In a lengthy opinion, the district court disagreed, concluding that the gain was not apportionable, after analyzing both the transactional and functional tests.

The transactional test, as set forth in the Idaho statute, provides that business income is income arising from transactions and activity ''in the regular course of a taxpayer's trade or business.'' Idaho Code Section 63-3027(a)(1). Although the court found that Noell Industries was essentially a holding company to Blackhawk, it also found that it was not regularly engaged in the trade or business of buying and selling subsidiaries. Specifically, the court noted the only sale of ownership interests in a company owned by the taxpayer had been the sale of Blackhawk itself which, citing to a commission regulation (Idaho Admin. Code Section 35.01.01.332.03), as a single transaction over a seven-year span, doesn't constitute a ''regular'' trade or business.

The commission also argued, unsuccessfully, that the sale satisfied the functional test, either because it was income from property acquired as a necessary part of its business or was income from property managed as part of its business. Pointing to the commission's own regulations, the court concluded that Noell Industries was merely a holding company and its ownership of Blackhawk did not serve an operational function. In doing so, it specifically found that the sale of the entire interest in Blackhawk wasn't made in furtherance of its trade or business, but rather to discontinue that business entirely. The court cited again to the commission's own regulation that the functional test is not satisfied where the holding of the subject property is solely an investment function.

Two members of the five-member court joined in a dissenting opinion that would have overturned the district court ruling and found that the income was instead business income because Noell Industries was engaged in a unitary business with Blackhawk since they were commonly-controlled.

The decision in Noell Industries is not the first and certainly not the last in the troubling area of determining whether gain on the sale of the ownership interests in, or assets of, a PTE is subject to apportionment or allocation for state income tax purposes. As the opinion (and dissent) demonstrates, not only is the issue entwined in constitutional dogma under the Commerce Clause and the Due Process Clause, but also under the very state statutes and regulations themselves that could result in different outcomes in different states on the same facts.

In contrast to the Idaho Supreme Court's pro-taxpayer ruling, the New Jersey courts on similar facts recently came to an almost 180 degree, diametrically opposite conclusion. See *Xylem Dewatering Solutions, Inc. v. Director, Div. of Taxation*. John Paz was the founder of and owned directly or indirectly through trusts of which he was a contributor all the shares of Xylem Dewatering Solutions, Inc. (Xylem). Xylem was treated as an S corporation for federal and state income tax purposes. Mr. Paz, a Pennsylvania resident, and the trusts agreed to sell the shares of Xylem to an unrelated third party at a substantial gain. But in contrast to the facts of Noell Industries, the parties here elected to treat the sale of Xylem's stock as a deemed sale of its assets under IR.C Section 338(h)(10).

Like the *Noell Industries* case, most of the gain was attributed to goodwill. Upon the sale of the stock, Mr. Paz as a Pennsylvania resident reported all the gain to

Pennsylvania and then apportioned the gain among all the states, including New Jersey, based upon Xylem's own apportionment factors in the year of the sale, appropriately claiming an "other state tax credit" on his Pennsylvania tax return for the taxes paid to the other states.

The New Jersey Division of Taxation agreed with the taxpayer that the sale should be treated as a deemed sale of the assets of the corporation for New Jersey as well as federal tax purposes, but in determining how the gain should be apportioned or allocated among the various states in which the corporation was doing business, pointed to New Jersey's gross income tax law (the personal income tax law in the state) that income is sitused among the states based upon rules peculiar to New Jersey for each separate class of income. In particular, gain on the sale of goodwill is treated as gain from the sale of an intangible asset, and under New Jersey law allocated entirely to the state where the headquarters of the corporation was located. In this case, that happened to be New Jersey.

The Tax Court and appeals court spent considerable time detailing the legislative, administrative, and judicial history describing how New Jersey's unique statute operated and concluded, under that law, the division was correct in assigning the gain on the sale of goodwill entirely to New Jersey. It's unclear whether Mr. Paz could have claimed a complete OSTC in Pennsylvania for the gain wholly-taxed by New Jersey.

Other recent state cases of this genre include *Corrigan v. Testa*, in which the Ohio Supreme Court in a unanimous opinion found that an Ohio statute requiring gain on the sale of the interests in a PTE by a more than 20% individual owner to automatically be subject to apportionment to the state, based upon the PTE's apportionment to Ohio, violated the Due Process Clause of the U.S. Constitution as applied to Mr. Corrigan. The court acknowledged that had the transaction been structured as a sale of the *assets* of the business, apportionment could have applied, but that was not how the transaction was structured.

Regardless, *Noell Industries* is an instructive decision where the persistence of the taxpayer paid-off—but it's hardly settled law among the states. That may be best (or perhaps most painfully) illustrated by the responses of the state taxing authorities to Bloomberg's newly-published *2020 Survey of State Tax Departments* (2020 Bloomberg Survey). Section VII, Subpart C of the 2020 Bloomberg Survey lists the states' varied responses to eight questions involving whether they will tax the gain recognized by an out-of-state corporate or individual owner on the disposition of various types of ownership interests in PTEs doing business in the taxing state. Suffice to say, the results are mixed and may not actually be consistent with the state's own case law.

Owners of interests in pass-through entities and their tax advisors must carefully consider the structure of the transaction (i.e., asset sale, "deemed" asset sale under an IRC Section 338(h)(10) election, or sale of ownership interest) as well as the laws peculiar to the jurisdictions in which the transaction could be subject to income tax.

Lastly, when this type of double taxation occurs in the international context, tax treaties among most countries call for "competent authority" among the countries where the income is subject to tax to come to some reasonable agreement such that no more than 100% of the taxpayer's income is subject to tax by the various countries involved. States rely upon apportionment and allocation rules to do that but, as the cases above indicate, because of the diversity of approaches and the lack of uniformity in state tax law, sometimes (and perhaps more often than not) double taxation can occur.

Perhaps it's time, in the authors' view, for the states to adopt a "clearinghouse" approach similar to that employed in the international arena so that the problems headlined by these cases can be settled in a manner both fair to the taxpayer and to the taxing states. Readers may recall there is a provision in the Multistate Tax Compact for arbitration or mediation among two or more member-states and the taxpayer caught in the middle but, alas, it is rarely used. But for one mediation success story in which one of us (Bruce Ely) was involved, see Mark Buchi, Bruce Ely, Steve Young, and Stewart Weintraub, "An MTC Mediation Success Story", *Multistate Tax Commission Review*, Vol. XX, No. 4, pg. 4 (Summer 2009) (available on the internet at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Publications/MTC_Review/Summer_09_090109.pdf) in which we approached the Multistate Tax Commission to mediate a dispute between the states of Alabama and Utah over taxing the gain from the sale of oil and gas assets located predominantly in Alabama but secondarily in Utah.

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Author Information

Steven Wlodychak is a retired principal and contractor with Ernst & Young LLP in Washington, D.C. Bruce P. Ely is a partner with the law firm of Bradley Arant Boult Cummings LLP in Birmingham, Ala. The views expressed herein are those of the authors and do not necessarily represent the views of either Ernst & Young LLP or those of the member firms of the global EY organization or of Bradley Arant Boult Cummings LLP.