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*U.S. SUPREME COURT UPDATE*

## **U.S. Supreme Court Update**

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### **Solicitor General Invited to File A Brief in *New Hampshire v. Massachusetts* and Two New SALT Petitions.**

On January 25, 2021, the U.S. Supreme Court invited the Solicitor General to file a brief in *New Hampshire v. Commonwealth of Massachusetts* (Docket No. 220154) expressing the views of the United States. In that case, the State of New Hampshire brought an action before the Court against the Commonwealth of Massachusetts seeking to enjoin Massachusetts from enforcing its new telecommuting regulation against New Hampshire residents.

Two new petitions for writ of certiorari were filed with the Court involving state and local tax matters. As we went to press, the Court denied certiorari in *Idaho State Tax Commission v. Noell Industries, Inc.* **1** (Docket No. 46941). In this issue of the Journal, we will review the lower court's holding that stands as a result of the denial of certiorari whereby, the Idaho Supreme Court ruled that an S corporation's gain on the sale of its interests in a limited liability company doing business in Idaho that itself had no business activities in Idaho did not constitute apportionable business income, and therefore was not taxable by Idaho.

This issue also reviews the brief *amicus curiae* filed by the Multistate Tax Commission in support of Petitioner, Idaho State Tax Commission, in this case. The Court is also asked in *Ortiz v. Walsh* (Docket No. 20-1015) to review a decision by the Court of Special Appeals of Maryland involving a Fourteenth Amendment Due Process Clause challenge to a right of redemption by a property owner, against a tax sale purchaser. The Maryland Court of Special Appeals found that "paying taxes is a condition

precedent to overturning a tax sale," and here the Petitioner failed to satisfy this condition precedent.

Finally, we continue to wait the issuance of the Special Master's Reports in the MoneyGram cases: *Delaware v. Pennsylvania*, 220145 and *Arkansas et al. v. Delaware*, 220146. These cases involve a dispute between Delaware and several other states concerning which states have priority rights to claim abandoned, uncashed MoneyGram official checks.

## **Idaho State Tax Commission Challenge to Ruling that Gain on Sale of Pass-Through Entity is Not Apportionable Business Income**

Petitioner, Idaho State Tax Commission, filed a petition for writ of certiorari with the Court (Docket No. 20-947), challenging the Supreme Court of Idaho's decision in *Noell Industries, Inc. v. Idaho State Tax Commission*, [2](#) that the gain resulting from the sale of limited liability company ("LLC") interests, by the LLC's corporate member, did not constitute business income.

### **Background.**

As explained by the Idaho Supreme Court, in 1993, Mike Noell ("Noell" or "Mr. Noell"), a retired U.S. Navy Seal, incorporated Noell Industries, Inc. ("Noell Industries" or "Taxpayer" or "Holding Company"), under Virginia law. Per the court, Noell Industries was created to develop and sell combat and tactical gear, which it did for about a decade. Noell Industries made an election to be treated as an S corporation. In 2003, per the factual background set forth in the majority opinion, Noell Industries transferred its net assets to a Virginia LLC, Blackhawk Industries Products Group Unlimited, LLC ("LLC" or "Blackhawk"), in exchange for 78.54% of the membership interests in Blackhawk. Other third-party investors acquired the remaining membership interests in Blackhawk.

The Idaho Supreme Court further explained that Blackhawk is a Virginia limited liability company that operated throughout the U.S. In addition, it noted that "as a 'high-level executive' Noell did not manage Blackhawk's day-to-day operations, marketing decisions, and other ordinary business and sales decisions" and "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."

In 2007, per the court's opinion, "Blackhawk leased a factory in Boise to serve as its 'operation center' for the West Coast." Moreover, according to the court, 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, the court noted that "Noell Industries never owned any real property in Idaho and its 'activities' 'were limited to owning the 78.34% investment in Blackhawk [LLC]' and another business that leased real property to Blackhawk within Virginia." The court also noted that "Noell Industries did not have any employees between the 2003 reorganization and the 2010 sale," "Noell Industries did not share any

assets or expenses with Blackhawk, nor did it provide financing or other services to Blackhawk."

In 2010, Noell Industries sold its 78.54% interest in Blackhawk for \$120 million (the "Gain"), and per the court's opinion, "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 the gain to goodwill.'" Instead, Mr. Noell reported and paid taxes on the gain on the sale to Virginia. Idaho tax auditors concluded that the Gain was "business income" and the Idaho Tax Commission affirmed its decision but reduced the assessment from approximately \$4.4 million to \$1.4 million. Noell Industries appealed the Idaho Tax Commission's decision with the district court. The district court found in favor of the Taxpayer, that the Gain on the sale was not "business income" under Idaho Code section 63-3049 (as discussed more fully below, this is Idaho's version of the Uniform Division of Income for Tax Purposes Act "UDITPA"), and therefore not subject to Idaho tax.

## **Idaho Supreme Court affirms conclusion that gain from the sale was nonbusiness income.**

The Idaho Supreme Court affirmed the district court's conclusion that Noell Industries' Gain from the sale of its Blackhawk interests was nonbusiness income.

## **Idaho Code section 63-3027 (UDITPA).**

Section 63-3027 of the Idaho Code is Idaho's version of UDITPA, and therefore, "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." <sup>3</sup> As explained by the Idaho Supreme Court, "the statute divides a multistate corporation's income into two categories: business income and non-business income. . . . 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 ."

Under the Idaho Code, there are two distinct definitions of "business income," and therefore tests for determining "business income:" (1) the "transactional test - 'income arising from transactions and activity in the regular course of the taxpayer's trade or business'" and (2) the "functional test - 'income from the acquisition, management or disposition of tangible or intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations.'" The Idaho Supreme Court concluded that it must determine whether the gain qualifies as "business income" under both tests.

## **Transactional test analysis.**

As explained above, under the "transactional test" business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Here, the Idaho Supreme Court noted that "Noell Industries does not appear to have regularly engaged in the trade or business of buying and selling subsidiary companies." The court further found that "Noell Industries' primary function was holding its interests in the two business entities over several years."

Based on these facts, the Idaho Supreme Court determined that "[w]hile the business operations 'need not be one that frequently occurs in the trade or business,' . . . a one-time sale over a seven-year span does not constitute a 'regular' trade or business," and therefore, the Gain does not qualify as "business income" under the transactional test.

## **Functional test analysis.**

Under the functional test, business income is "income from the acquisition, management or disposition of tangible or intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations." Furthermore, under Idaho's Tax Administrative Rules, there are two methods for meeting the functional test: (1) "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 (2) "by meeting the unitary business test." The Idaho Supreme Court also noted that "[e]ven 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." <sup>4</sup> Therefore, the court analyzes both tests.

The Idaho Supreme Court, citing to Idaho's Tax Administrative Rules, explains that 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." Based on the rules, the court concluded that 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." The court also stated, that "[i]ndeed, 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." Therefore, the court ruled that "[a]s 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.'" <sup>5</sup>

Next, the Idaho Supreme Court examined the unitary business principle, which per the court is a "constitutional creation under both the Commerce and Due Process Clauses." Specifically, it explained that initially the test required "unity of ownership, unity of operation, and unity of use." However, the court

stated that "more recently, the U.S. Supreme Court described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." <sup>6</sup> The court, distinguishing the facts from other cases, stated in relevant part, "[r]ather 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."

The court further found that "Noell Industries shared no centralized management, oversight, or headquarters with Blackhawk;" rather, "Noell Industries held no employees, payroll, or offices at all," which meant that it was impossible for it to share "centralized management, oversight, or headquarters." Consequently, the Idaho Supreme Court found that "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 of interdependence required to manifest unity." Therefore, the unitary business test was not met.

## Tax loophole?

Given that the Gain on the sale did not meet the definition of "business income" under either the transactional test or functional test (including the unitary business test), the Supreme Court of Idaho affirmed the district court's ruling in favor of the Taxpayer. The court notes that "[t]he Commission argues that this decision will open a tax loophole to companies, permitting them to dodge taxes through the creation of sham shell entities." The court responds, stating it disagrees, because its "decision rests on a fact-intensive inquiry based on the extensive and largely undisputed-findings of the district court" and that "this is not a case of a corporation dodging its tax obligations," because taxes were paid on the Gain as "business income" to Virginia, the place of commercial domicile of Noell Industries. Therefore, in the court's view "there has been no fraud or subterfuge shown in the records. This case clearly concerns a passive investment, the taxation of which is not apportionable to Idaho."

## Question presented.

"Previously, this Court considered whether a unitary-business relationship could be determined from the superficial aspects of a corporation. <sup>7</sup> This Court answered that superficial attributes were not determinative of unity. <sup>8</sup> Instead, this Court ruled that a unitary relationship is presumed unless the corporation proved by affirmative evidence that it was a discrete business enterprise." <sup>9</sup>

Today, State courts are wrestling with nearly the same question: should superficial aspects of a pass-through-entity's business determine unity? Courts in Idaho, New Jersey, and Tennessee have wrestled with this question. <sup>10</sup> These decisions have produced a split among the states: the Tennessee court extended the *Mobil* ruling to pass-through entities while the Idaho and New Jersey courts have not. This split in state court cases prompts the question of this case, which is:

"Does this Court's ruling in *Mobil* apply to pass-through entities?"

## **Brief *amicus curiae* of the Multistate Tax Commission**

The Multistate Tax Commission submitted a brief as *amicus curiae* in support of Petitioner, Idaho State Tax Commission on February 12, 2021, arguing the Idaho Supreme Court's "highly formalistic" recitation of the U.S. Supreme Court's prior decisions, results in a misapplication of the Due Process Clause which "potentially signals to taxpayers that they can easily employ a strategy to avoid certain state tax obligations." The Multistate Tax Commission asserts that the case concerns a "now commonplace situation in which a holding company—a company whose sole purpose is to hold assets and not engage in income-producing operations—sells a controlling interest in a multistate business." In its brief, the Multistate Tax Commission urges the Court to grant the petition, in order to "correct the Idaho Supreme Court's decision, resolve an emerging conflict among state courts and administrative tribunals, and provide needed guidance on how to apply the unitary business principle when a holding company sells a controlling interest in a multistate business."

According to the Multistate Tax Commission, the Idaho Supreme Court "missed the mark" and the "U.S. Supreme Court never intended the result reached by the Idaho Supreme Court." In its brief, the Multistate Tax Commission argues that applying the unitary business principle in the way proposed by the Idaho Supreme Court, "ignores its fundamental purpose, which is to determine whether a state has the requisite connection under the Due Process Clause to the interstate activities giving rise to the income it seeks to tax." The brief maintains that Idaho may tax the gain in this case because the state had a sufficient connection to the business activity that gave rise to that gain, and this connection was not affected by the formal structure of the business enterprise that recognized the gain.

## **Due Process Challenge to Maryland Judgment Foreclosing Right of Redemption**

In *Ortiz v. Walsh*, [11](#) the Court of Special Appeals in Maryland upheld the Judgment Foreclosing Right of Redemption issued by the Circuit Court for Prince George's County (the "Judgment"), and found that the Circuit Court properly denied Petitioner's motion to vacate the Judgment; thereby, awarding fee simple title to the property to the tax sale purchaser. On January 28, 2021, Petitioner filed a petition for writ of certiorari with the Court, in *Ortiz v. Walsh* (Docket No. 20-1015).

### **Background.**

Defendant, Mr. Walsh, purchased a tax sale certificate for property located in Maryland at a public tax sale and waited the necessary period before filing a "Complaint to Foreclose the Equity of Redemption for Non-Payment of Taxes." Mr. Walsh also filed an Affidavit of Compliance with the Circuit Court stating

that he complied with the law's notice requirements inasmuch as he mailed notice of the sale to the Petitioner property owner, Mr. Ortiz, and attempted to serve notice on Mr. Ortiz, including asking the Sheriff to post a copy of the notice on the property.

After the Judgment was entered by the Circuit Court, beyond the 30-day appeal window, Mr. Ortiz filed a motion to vacate the Judgment. When Mr. Ortiz filed his motion, "he stated that he was ready to pay the back taxes, but he never paid them." In Petitioner's motion to vacate the Judgment, Petitioner challenged the sale procedure by arguing that Defendant's notice was improper and that he was precluded from remitting the tax due because his rights had been foreclosed. The Court of Special Appeals found against Petitioner on both challenges. First, the Court of Special Appeals explained that "counsel for Petitioner acknowledged at oral argument that Mr. Walsh complied with the notice requirements under the law."

Second, the Court of Special Appeals, relying on precedence from the Maryland Court of Appeals, *Quillens v. Moore* [12](#) and *Canaj, Inc. v. Baker and Division Phase III, LLC* [13](#) , ruled that "paying the taxes is a condition precedent to overturning a tax sale." Because Petitioner "did not satisfy this condition precedent, the [Court of Special Appeals held that the] circuit court properly denied the motion to vacate the Judgment Foreclosing rights of redemption." In this regard, the Court of Special Appeals highlighted the Maryland Court of Appeal's reasoning in *Quillens and Canaj*: "If a delinquent taxpayer can find a way to overturn a tax sale without paying the delinquent taxes, the delinquent taxpayer will never redeem. It is for this reason that the general rule is that in order to challenge a tax sale, the payment of taxes in arrears is a condition precedent." [14](#) Or, stated differently, "[b]y attacking the sale procedure in a post-judgment motion to vacate, instead of paying the taxes and charges which it would have been required to do in order to redeem prior to judgment, the taxpayer appears to be seeking to have the title to the property revert back to the delinquent taxpayer without having to ever redeem by paying the overdue and due taxes."

## Question presented.

Did the State court's reliance on *Quillens v. Moore* (requiring an individual to pay taxes, interest, and tax sale purchaser costs prior to any court review) violate a property owner's Fourteenth Amendment due process rights where the enforcement of the condition precedent without a mechanism for compliance created a de facto bar to review of Petitioner's constitutional claims?

## Denied Petitions

*Barnette v. HBI, LLC et al* (Docket No. 20-321) [15](#) , where the lower court found that the purchaser complied with the statutory notice requirements for obtaining a tax deed and such requirements did not violate the Due Process Clause of the Fourteenth Amendment.

**1** *Idaho State Tax Commission v. Noell Industries, Inc.*, (Docket No. 46941) cert. den. Feb. 22, 2021, *Noell Industries, Inc. v. Idaho State Tax Commission*, 167 Idaho 367 470 P.3d 1176 (2020), reh'g denied (Aug. 14, 2020).

**2** *Id.*

**3** *Albertson's Inc.*, 106 Idaho at 811 683 P.2d at 847 .

**4** *MeadWestvaco Corp. ex. Rel. Mead Corp. v. Illinois Dep't of Rev.*, 553 U.S. 16 29 - 32 128 S.Ct. 1498 170 L.Ed.2d 404 (2008).

**5** 35.01.01333.05.

**6** *MeadWestvaco Corp. ex rel. Mead Corp.*, 533 U.S. at 30 .

**7** *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 439 100 S.Ct. 1223 1232 63 L. Ed. 2d 510 (1980).

**8** *Id.*

**9** *Id.* at 439-442, 100 S. Ct. at 1232 - 1234.

**10** See *Noell Industries, Inc. v. Idaho State Tax Commission*, 167 Idaho 367 470 P.3d 1176 (2020), reh'g denied (Aug. 14, 2020) at App. 1-46; *BIS LP, Inc. v. Dir., Div. of Taxation*, 26 N.J. Tax 489 (Super Ct. App. Div. 2011); *Blue Bell Creameries v. Roberts*, 333 S.W.3d 59 (Tenn. 2011).

**11** *Ortiz v. Walsh*, September Term 2018 07/21/2020.

**12** *Quillens v. Moore*, 399 Md. 97 125 (2007).

**13** *Canaj, Inc. v. Baker and Division Phase III, LLC*, 391 Md. 374 400-01 (2006).

**14** *Canaj*, 391 Md. 385 .

**15** *Barnette v. HBI, LLC et al* (Docket No. 20-321), cert. den. Feb. 22, 2021, ruling at (04/10/2020).



