COLORADO
Department of Revenue
Taxation Division

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PLR-16-015

September 30, 2016

XXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXX
XXXXXXXXXXXXXXX
XXXXXXXXXXXXXXX

Re: Acquisition and restructuring transaction

Dear XXXXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXXXX ("Company") a request for a private letter ruling to the Colorado Department of Revenue ("Department") pursuant to Department Rule 24-35-103.5. This letter is the Department's private letter ruling. This ruling is binding on the Department to the extent set forth in Department Rule 24-35-103.5. It cannot be relied upon by any taxpayer other than the taxpayer to whom the ruling is made.

## Issues

1. Is the gain realized by the corporate partner from the sale of its interest in the partnership considered business income?
2. Should a corporate partner include in its apportionment factor its distributive share of the partnership's gross sales?
3. Should the gain the corporate partner realized from the sale of its interest in the partnership be excluded from its Colorado apportionment factor?

## Conclusion

1. The gain from the sale of its interest in the partnership is business income for the corporate partner.
2. To the extent that the partnership income a corporate partner receives is business income, the corporate partner should include in its apportionment factor its distributive share of the partnership's gross sales.
3. Because the sale was directed by the corporate partner's new ownership outside of Colorado, because the gain from the sale was fully subjected to state taxation by the states in which the partnerships operate, and because inclusion of the gain in Colorado's apportionment factor would not fairly represent the corporate partner's

business activity in Colorado, the corporate partner should exclude from its apportionment factor the gain it realized from the sale of its interest in the partnership.

## Background

Company requests guidance regarding the tax treatment of a gain that XXXXXXXXXXXX ("Affiliate") realized from the sale of part of Affiliate's interest in a partnership as part of a series of related transactions. See Appendix A at the end of this ruling for an illustration of ownership structure both before and after the transactions discussed herein.

Prior to the series of transactions that included the sale under consideration here, Affiliate was one of six blocker corporations that, along with other unrelated entities, held ownership interests in XXXXXXXXXXXXXX, a Delaware limited liability company ("XYZ"). The six blocker corporations were each controlled by separate investment entities. Affiliate was controlled by a private equity fund located in Colorado. However, Company represents that Affiliate had no other business activity in or connection to Colorado beyond the private equity fund that controlled it.

Affiliate is a holding company that exists for the sole purpose of investing in XYZ. Affiliate's only business activity is investing in XYZ and eventually selling its investment in XYZ. This activity comprises the entirety of Affiliate's economic enterprise.

XYZ holds a majority interest in XXXXXXXXXX, another Delaware limited liability company ("Operating LLC"). Both XYZ and Operating LLC were treated as partnerships for federal and state income tax purposes. Both XYZ and Operating LLC operate and are subject to taxation exclusively in six states (Alabama, Florida, Illinois, Kentucky, Louisiana, and Mississippi).

The focus of this ruling is a series of related transaction, described below, involving Affiliate, XYZ, Company, and Company's subsidiaries. Company is a private equity fund located outside of Colorado. Company is the managing member of two LLCs, XXXXXXXXX and XXXXXXXXXXXX ("ABC" and "DEF", respectively), each of which is treated as a partnership for state and federal income tax purposes. Company, ABC, and DEF are all commercially domiciled outside of Colorado.

In 2015, Company, ABC, and DEF engaged in three related transactions involving Affiliate. Company represents that the three transactions occurred at about the same time and were treated as an integrated transaction for federal tax purposes. First, DEF acquired ownership shares of XYZ from the six blocker corporations, including Affiliate, resulting in a gain for each of the blocker corporations. Affiliate's sale of shares in XYZ to DEF ("Sale") and the gain resulting therefrom are the subject of this ruling. ABC then fully acquired all 6 blocker corporations. Finally, the five other blocker corporations were then merged into Affiliate. Company managed and directed all three of these transactions. Following these transactions Affiliate and DEF, along with other unrelated entities, held ownership interests in XYZ, and Affiliate was owned entirely by ABC.

XYZ and Operating LLC generated income from six states (Alabama, Florida, Illinois, Kentucky, Louisiana, and Mississippi) and have no business activity in or income from any other states. Affiliate, XYZ, and Operating LLC filed or will file 2015 income tax returns in each of these six states. On each of the six state returns Affiliate files for these states, the entire gain for Sale is 1) included in apportionable income and 2) excluded when computing the sales factor.

## Structure of Analysis

1) Is the gain Affiliate realizes from Sale "business income" under §§§39-22-303.5(1)(a), (4)(a), and (6), C.R.S.?
2) Under § 39-22-303.5(4), C.R.S. should Affiliate include in its apportionment factor its distributive share of Operating LLC's gross sales?
3) Should the gain from Sale be excluded under § 39-22-303.5(7), C.R.S. and Dept. Rules 1 CCR 201-2, 39-22-303.5.4(A)(2) and 303.5.7(4)(c) from Affiliate's Colorado apportionment factor?
    a) How was Affiliate's commercial domicile, as defined in §39-22-303.5(1)(b), C.R.S., affected by the series of transactions that included Sale?
    b) For the purpose of applying § 39-22-303.5(7), C.R.S and Dept. Rule 1 CCR 201-2, 39-22-303.5.4(A)(2), what was Affiliate's business activity in Colorado during the tax year?
    c) For the purpose of equitable apportionment under §39-22-303.5(7), C.R.S., to what extent was the gain from Sale taxed as source income by other states?

## Discussion

*1.Is the gain Affiliate realized from Sale business income?*

The tax treatment of corporate income is determined in part by whether the income is business income or nonbusiness income. Both "business income" and "nonbusiness income" are defined by law for Colorado corporate income tax purposes.[1] Within these definitions there is a clear presumption, in absence of compelling evidence to the contrary, that the income of a corporation is business income ("the income of the taxpayer is business income unless clearly classifiable as nonbusiness income").[2] Furthermore, business income is defined as income derived through the "regular course of a taxpayer's trade or business" and includes "income from...intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[3] Affiliate is a holding company whose business activity consists exclusively of acquiring, holding, and selling investments. Therefore, the gain Affiliate realized from Sale (a sale of intangible property) is business income.

Additionally, under Colorado law a corporation may elect to treat all of its income as business income.[4] Consequently, Affiliate's may elect to treat all of its income, including the gain from Sale, as business income for Colorado tax purposes.

*2. Should Affiliate include in its apportionment factor its distributive share of Operating LLC's gross sales?*[5]

[1] §§ 39-22-303.5(1)(a) & (c), C.R.S
[2] § 39-22-303.5(1)(a), C.R.S.
[3] Id.
[4] § 39-22-303.5(6), C.R.S.

For corporations, Colorado statute prescribes the apportionment of business income in the ratio of the taxpayer's total sales in Colorado to the taxpayer's total sales everywhere.[6] With respect to state taxation, a "partner is generally deemed to be conducting the partnership business directly."[7] This approach is consistent with the tax treatment of a partner's gross income for federal purposes.[8] Thus, where's Affiliate's partnership income from Operating LLC is business income for Colorado tax purposes, Affiliate's distributive share of Operating LLC's gross sales are Affiliate's own gross sales. To the extent that the partnership income that Affiliate receives through Operating LLC is business income, Affiliate should include in its apportionment factor its distributive share of Operating LLC's gross sales.

*3. Should the gain from Sale be excluded from Affiliate's Colorado apportionment factor?*

Statute and regulation prescribe apportionment on the basis of total gross receipts, but allow for the departure from prescribed apportionment rules and allow for alternative methods when necessary to "fairly calculate...the net income derived from or attributable to sources in Colorado."[9] Rules further instruct that "gross receipts..be disregarded in determining the sales factor" when necessary to "fairly...apportion to this state the income of the taxpayer's trade or business."[10] More specifically, "[w]here business income from intangible property cannot readily be attributed to any particular income-producing activity of the taxpayer, and such income cannot be assigned to the numerator of the sales factor for any state, such income shall be excluded from the denominator of the sales factor."[11]

For the purpose of apportionment, "gain from the sale of intangible property" is apportioned to Colorado and included in the numerator of the apportionment ratio "if the taxpayer's commercial domicile is in Colorado."[12] A corporation's commercial domicile is "the principal place from which the trade or business of the taxpayer is directed or managed."[13] Prior to the sale that generated the gain, Affiliate was domiciled in Colorado and conceded as much with the filing of 2013 and 2014 Colorado income tax returns. Affiliate's Colorado domicile was assumed because it was controlled by a private equity fund located in Colorado and, as a holding company, Affiliate conducted no active business directed or managed from any location outside of Colorado.

However, Affiliate's commercial domicile in Colorado was terminated by the series of transactions that included Sale. Company, as managing member of ABC and DEF,

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5 This section of this ruling concerns not the gain Affiliate realized from Sale, but the partnership income Affiliate received through its ownership in XYZ and, indirectly, its ownership in Operating LLC.

6 § 39-22-303.5(4), C.R.S.

7 Hellerstein & Hellerstein, State Taxation, ¶ 9.12[1]. See also Hellerstein & Hellerstein, State Taxation, ¶ 20.08[2][b].

8 26 USC § 702. "In any case where it is necessary to determine the gross income for a partner...such amount shall include his distributive share of the gross income of the partnership."

9 § 39-22-303.5(7)(b), C.R.S.

10 Dept. Rule 1 CCR 201-2, 39-22-303.5.4(A)(2)

11 Dept. Rule 1 CCR 201-2, 39-22-303.5.7(B)(4)(c)

12 § 39-22-303.5(4)(c)(V), C.R.S.

13 § 39-22-303.5(1)(b), C.R.S.

directed and managed the series of transactions, including Sale. Following the series of transactions, Affiliate was no longer domiciled in Colorado as its new owner, ABC was not located in Colorado and Affiliate no longer had any connection to the state. As Sale was executed under the management and direction of Affiliate's new ownership that was not located in Colorado, Affiliate's commercial domicile was not Colorado with respect to Sale.[14]

Company further represents that gain from Sale was fully taxed by the six states in which XYZ and Operating LLC were active. With respect to each of these states 1) the gain was *included* in apportionable income and 2) the gain was *excluded* from both the numerator and denominator of the sales factor. As a consequence, the gain Affiliate realized from Sale was apportioned to these six states on the basis of the source of the partnership income Affiliate received from Operating LLC, through XYZ, which was Affiliate's only other income. When two states seek to tax the same income, one on the basis of domicile and one on the basis of source, "the state of domicile ordinarily yields to the state of source to avoid double taxation."[15] Indeed, with respect to individuals, Colorado is just such a state, granting to residents a credit for taxes paid to other state.[16]

Additionally, Affiliate had no business activity in Colorado. Based upon Affiliate's previous commercial domicile, it filed 2013 and 2014 Colorado income tax returns. However, on each of these returns Affiliate reported no Colorado source income, apportioned no income to Colorado, and incurred no Colorado tax. Furthermore, Affiliate derived no income from business activity in Colorado in 2015. Consequently, the inclusion of the gain from the sale in question here in both the numerator and the denominator of Affiliate's apportionment factor would produce inequitable apportionment and a Colorado tax liability where Affiliate had no business activity in Colorado.

Because Sale was directed by Affiliate's new ownership outside of Colorado, because gain from Sale was fully subjected to state taxation by the states in which XYZ and Operating LLC operate, and because inclusion of the gain from Sale in Colorado's apportionment factor would not fairly represent Affiliate's business activity in Colorado, the gain from Sale should be excluded from Affiliate's Colorado apportionment factor.

## Miscellaneous

This ruling is premised on the assumption that Company has completely and accurately disclosed all material facts and that those material facts will not change or be amended. The Department reserves the right, among others, to independently evaluate Company's representations. The ruling is null and void if any such representation is incorrect and has a material bearing on the conclusions reached in this ruling and is subject to modification

[14] In *Commissioner v. Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707 (1945), the Court effectively reordered a series of transactions for tax purposes in order to more accurately reflect the economic reality of the transactions. Where a corporation was liquidated, transferring its assets to its shareholders who subsequently sold such assets, the Court deemed the assets to have been sold directly by the corporation which had engaged in negotiations with the buyer prior to the liquidation. Here, while Sale may have formally preceded Affiliate's change in ownership (and the resultant change in commercial domicile), it nonetheless was executed at the direction of the new owners.

[15] Hellerstein & Hellerstein, State Taxation, ¶ 6.04

[16] § 39-22-108, C.R.S.

or revocation in accordance to Department Regulation 24-35-103.5.

This ruling is binding on the Department to the extent set forth in Department Regulation 24-35-103.5. It cannot be relied upon by any taxpayer other than the taxpayer to whom the ruling is made.

Enclosed is a redacted version of this ruling. Pursuant to statute and regulation, this redacted version of the ruling will be made public within 60 days of the date of this letter. Please let me know in writing within that 60 day period whether you have any suggestions or concerns about this redacted version of the ruling.

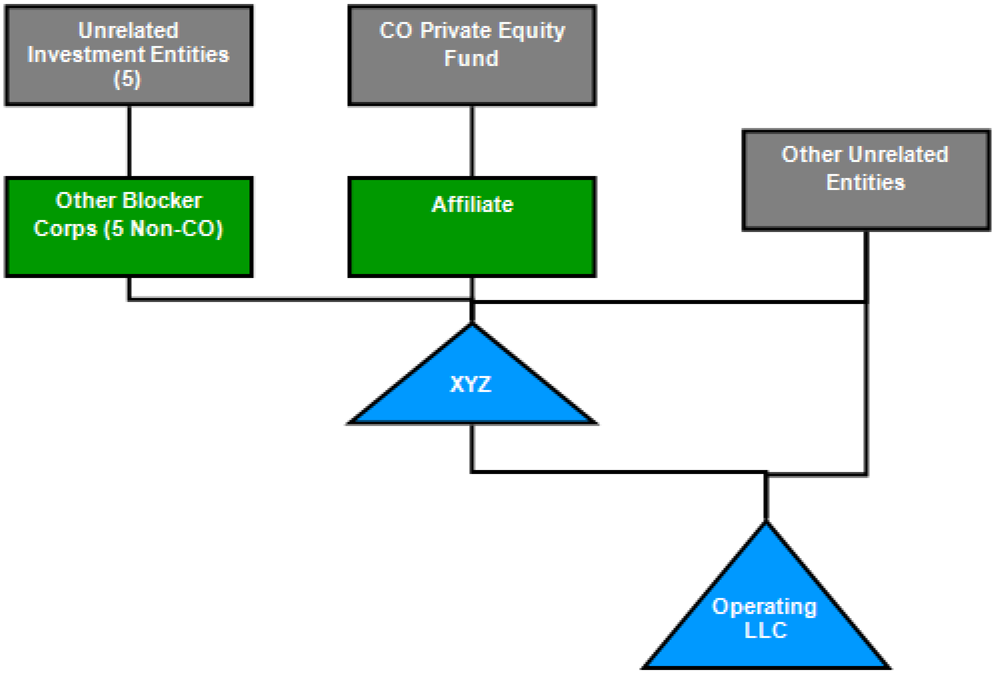
Sincerely,

Ken Schade
Colorado Department of Revenue

**This ruling cannot be relied upon by any other taxpayer other than the taxpayer to whom the ruling is made.**

## Appendix A

### Organizational Structure Prior to Transactions




### Organizational Structure After Transactions