COLORADO
Department of Revenue
Taxation Division
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PLR-16-006

April 12, 2016

XXXXXXXXXXXXXX
Attn: XXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX

Re: Credit for Taxes Paid to Another State

Dear XXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXXX ("Taxpayers") a request for a private letter ruling to the Colorado Department of Revenue ("Department") pursuant to Department Rule 24-35-103.5. 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. Are Taxpayers entitled to a credit for taxes paid to another state?
2. How is the credit for taxes paid to another state computed and what is the amount of the credit under the assumptions given?
3. In what tax year do Taxpayers claim the credit on the Colorado income tax return?

Conclusions

1. Taxpayers are entitled to a credit for taxes paid to Ohio on income that Colorado sources to Ohio. Taxpayers determine the amount of income sourced to Ohio by using an average of the limited liability company's apportionment ratios using Colorado's apportionment methodology set forth in 39-22-303.5, C.R.S. for the three tax years immediately preceding the tax year in which the husband's interest in the limited liability company was sold. That apportionment will determine whether husband has income derived from sources in Ohio. Income from the sale of the wife's interest does not generate a credit because such income was not subject to Ohio income tax. However, because Taxpayers filed a joint 2011 Colorado income tax return, then the credit, if any, will be applied to the net income tax liability of both husband and wife.
2. The credit for taxes paid to another state is the lesser of (1) the amount computed by multiplying the husband's capital gain by the limited liability company's average sales factor for the prior three years, dividing it by Taxpayers'[1] total modified federal adjusted

[1] The husband and the wife.

gross income derived from sources inside and outside Colorado multiplied by the tentative Colorado tax or (2) the tax paid to Ohio.

3. The credit is claimed by filing an amended 2011 Colorado individual income tax return.

Background

Taxpayers provided a lengthy description of the facts. For purposes of this ruling, the following is a summary of those facts. Taxpayers formed and were initially the sole members of a limited liability company which provided services both inside and outside Colorado. The percentage of their membership interests varied over time. They also transferred their membership interests to other pass-through entities, and created and owned by them, in whole or in part, at different times. Taxpayers eventually sold their direct and indirect interests in the limited liability company and realized substantial gain. Ohio assessed the husband income tax liability on gain from the sale of his interest in the limited liability company. Because of certain ownership threshold requirements in Ohio law, Ohio did not assess the wife Ohio tax on the gain from the sale of her interest in the limited liability company. Ohio calculated the tax based on a three year average of the limited liability company's apportionment ratio.[2] Ohio's apportionment ratio is computed based on a weighted average of the payroll, property and sales factors. In this case, the limited liability company's sales apportionment factor is the highest of the three factors.

For purposes of illustrating our ruling, we make the following assumptions: The Colorado taxable income is $34,800,000 and the Colorado tax amount is $1,600,000. The average of the Colorado sales factor for 2009 through 2011 is 18.5 percent and the average of the Ohio Weighted Apportionment Factor for 2009 through 2011 is 15 percent. The total capital gain generated by the husband's sale of his limited liability company interests is $28,700,000. The total capital gain sourced to Ohio under O.R.C. § 5747.212(B) is $4,300,000.

Structure of Analysis

To determine whether Taxpayers are entitled to a credit for taxes paid to another state, the Department will examine the following questions:

1. Do Taxpayers derive income from sources within the other state?
    a. If so, how do Taxpayers apportion such income?
2. How is the credit for tax paid to another state calculated?
3. In which tax year is the credit applied?

Discussion

1. Determination of Source of Income.

Colorado allows residents to claim a credit for tax paid to another state "on income derived from sources within the other state."[3] Colorado statutes do not directly define when the

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[2] We do not rule here whether Ohio correctly imposed or calculated the Ohio income tax on Taxpayers. To reach the question posed in the ruling request, we assume Ohio correctly imposed and calculated the tax.

[3] § 39-22-108, C.R.S. Taxpayers represent that the limited liability company elected to be treated as a S-corporation. § 39-22-329, C.R.S. addresses when a tax credit is paid by a S-corporation and the tax is not measured by the income of the shareholder, which is not the case here because company did not pay Ohio income tax - the husband paid the tax. In the absence of

income of an individual is derived from sources within another state.[4] To resolve this issue, the Department traditionally looks to § 39-22-109, C.R.S., which sets forth rules for determining whether a nonresident has income derived from sources within Colorado. Although section 109 addresses the income of nonresidents, the sourcing rules do provide legislative guidance for determining the source of income for residents claiming the credit for taxes paid another state. For example, § 39-22-109(2)(a)(II), C.R.S. states that income derived from a trade or business carried on in Colorado by a nonresident is Colorado-source income. Applying this principle to the converse case, a resident derives income from another state if he or she carries on a trade or business in that state.

Colorado's rules for determining the source of an individual's income are typically the same or similar as other states' sourcing rules and, therefore, there is consistency in the application of credit for tax paid another state. However, there are instances, such as in the case described in this ruling request, when the sourcing rules of another state are different from Colorado's sourcing rules. Both Colorado's and Ohio's law treat, in principle, the gain or loss from the sale of a member's active[5] interest in a pass-through entity that engages in a trade or business in the other state as income derived from sources within that other state. In particular, § 39-22-109(2)(a)(V), C.R.S. states that the gain from the sale of an intangible is Colorado-source income to the extent the intangible was used in the trade or business conducted in Colorado. A member's interest in a pass-through entity is an intangible property interest, and that interest is used in the conduct of a business in the state where such business operates if the member is actively engaged in the pass-through entity's income generating activities.[6] Thus, Colorado income tax applies to the sale of a nonresident member's interest in a pass-through entity that conducts business in Colorado if the member actively participates in the income-generating activities of the pass-through entity. Conversely, Colorado sources, for purposes of determining the credit, the gain from the sale of a resident's membership interest to a state where the pass-through entity conducted business if the member actively participated in the pass-through entity's business.[7]

Colorado statutes do not provide guidance on how to apportion the gain on the sale of a member's interest between or among states in which the pass-through entity operates. The Department has recently adopted revisions to Department Rule 1 CCR 201-2, 39-22-109 that provides the guidance needed to resolve this issue. Specifically, the rule uses a three year average apportionment ratio rule, which is very similar to Ohio's rule. The Department uses a three year average apportionment ratio, as opposed to, for example, using only the current tax year apportionment ratio, because, unlike income generated in the regular conduct of a business (which is apportioned on only the current tax year apportionment ratio), the sale of a member's interest is an issue of valuation. The valuation

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any express provision in subpart 3 (S corporations), we look to the more general provision of 39-22-108, C.R.S. for guidance on how to compute the tax credit.

4 This is in large part because determining the source of income of a resident individual is not an issue: all income of the resident individual is subject to Colorado tax. § 39-22-104, C.R.S.

5 In 1 CCR 201-2, Department Rule 39-22-109(3)(e)(ii), adopted in December of 2015, the Department distinguishes between active and passive interests in pass-through entities; the interests of a passive ownership interest is treated as an intangible which has not acquired a business situs in the state in which the income-generating activity occurs.

6 Ibid. See, e.g., *Arizona Tractor Co. v. Arizona State Tax Com'n.*, 566 P.2d 1348, 1350 (Ariz. App. 1997)

7 See discussion supra regarding 1 CCR 201-2, Rule 39-22-109.

is a reflection not only of the amount of income that the interest will generate but also the sources from which the income will be generated. For example, the pass-through may have had an usually successful year in making sales in Colorado. If only that year is used to determine the appropriate ratio of Colorado income attributable to the sale of the interest, then the apportionment ratio will be skewed toward Colorado. Therefore, the Department believes a three year average will, in general, better reflect the sources of income giving rise to the value of the member's interest. Ohio, as we noted above, uses the same approach.

The difference between Colorado's sourcing rule and Ohio's sourcing rule is found in the methodology for determining how much of the gain (or loss) is attributable to each state. Ohio's sourcing rule states that the amount of gain or loss from the sale of the member's interest attributable to Ohio is determined using an apportionment formula that considers a variety of factors. Colorado also has a similar rule but Colorado uses a single sales factor apportionment formula that is not used in Ohio. These may produce different results.[8] In cases of conflicting sourcing rules, 1 CCR 201-2, Department Rule 39-22-108 states that Colorado's sourcing rules govern.[9]

Therefore, the husband must use Colorado sourcing rules to determine the amount of gain from the sale of the husband's membership interest in the limited liability company that is attributable to Ohio. The husband must use a three year average of the limited liability company's apportionment ratios using Colorado's single sales factor apportionment methodology for the three tax years immediately preceding the tax year in which the interest was sold (*i.e.* 2009-2011). Because the limited liability company's sales factor is the highest of the three apportionment factors Ohio considers, the total gain sourced to Ohio, under Colorado's sourcing rules, is greater than the total gain sourced to Ohio under Ohio's sourcing rules. This larger total gain sourced by Colorado to Ohio is used to apply the limits set forth in § 39-22-108(2), C.R.S. Income from the sale of the wife's interest does not generate a credit because such income was not subject to Ohio tax.[10] However, because the Taxpayers filed a joint Colorado income tax return for tax year 2011, the credit generated from the Ohio tax on the husband's income from the sale of his interest is applied to the Taxpayers' net income tax liability.

2. Computation of the Credit for Taxes Paid to Another State

After applying the sourcing rules to determine the amount of the gain that will generate a credit for taxes paid to another state, the amount of the credit for taxes paid to another state is computed under § 39-22-108(2), C.R.S. Applying the limits set forth in § 39-22-108(2), C.R.S., because the total gain sourced by Colorado to Ohio exceeds the total gain sourced by Ohio to Ohio, the numerator of the fraction determined under 1 CCR 201-2, Rule 39-22-108(3)(a)(i) is the amount determined under 1 CCR 201-2, Rule 39-22-109(3)(e)(ii), rather than the amount apportioned to Ohio under Ohio law. Thus, for illustrative purposes, based on the assumptions presented above, the credit for taxes paid

[8] In fact, in this case, the two sourcing rules product different apportionment factors of 18.5 percent versus 15 percent.

[9] 1 CCR 201-2, Department Rule 39-22-108 states that Colorado will apply its sourcing rules to determine the source of income.

[10] Again, we do not rule that the wife does or does not owe tax in Ohio; we accept Taxpayers' representation for purposes of addressing the issue set forth in the ruling request. The source of the wife's income has no bearing on the credit calculation because such income was not subject to Ohio tax.

to another state is computed as follows:

(1) Colorado tax	1,600,000
(2) Modified Colorado Adjusted Gross Income Sourced to Ohio[11]	5,300,000
(3) Total modified Colorado adjusted gross income	34,800,000
(4) Line (2) divided by line (3)	.152
(5) Line (1) multiplied by line (4)	243,000
(6) Ohio tax liability	240,000
(7) Allowable credit (smaller of line (5) and line (6))	240,000

3. Credit Claimed in the Tax Year the Other State's Tax Accrued.
The credit allowed for tax paid another state must be taken in the tax year that the other state's tax accrues, regardless of the accounting method used by the taxpayer.[12] In addition, Taxpayers must have already paid the tax to the other state in order to claim the credit.[13] In general, a tax accrues when it becomes due and payable rather than when the liability is actually paid.[14] Taxpayers represent that Ohio's tax accrued in 2011. Therefore, the credit must be claimed by filing an amended 2011 Colorado income tax return. The Taxpayers filed a joint federal income return for 2011. As a result, the credit will be applied to the combined income tax liability of husband and wife on the amended 2011 Colorado income tax return. If the husband filed a separate federal income tax return in 2011, then only the husband may claim the credit on an individual state income tax return.

This ruling addresses only the narrow issue of the methodology for determining amount of gain, if any, that was derived from sources in Ohio for purposes of claiming the Colorado credit for tax paid to Ohio. This ruling does not address, among other things, whether Taxpayer correctly applied the apportionment formula described in §39-22-303.5, C.R.S., whether Taxpayer correctly calculated the credit; and whether both taxpayers correctly reported their Colorado income tax liability for tax year 2011 or any other tax year.

Miscellaneous

This ruling is premised on the assumption that Taxpayers have completely and accurately disclosed all material facts. The Department reserves the right, among others, to independently evaluate Taxpayers' 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 or revocation in accordance to Department Rule 24-35-103.5.

[11] Husband's total capital gain of $28,700,000 multiplied by average Ohio sales factor for 2009-2011 of .185.

[12] §39-22-108(4), C.R.S.

[13] If Taxpayers have not yet paid the tax, Taxpayers may file a Protective Refund Claim in the form of a Protective Amended 2011 Return. This will hold the statute of limitations open until Taxpayers finally pay this tax.

[14] See, e.g., IRS Publication 538 (accrual method).

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 (husband) identified in this ruling.

Enclosed is a redacted version of this ruling. Pursuant to statute and rule, 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,

Neil L. Tillquist
Colorado Department of Revenue
Office of Tax Policy Analysis

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