COLORADO
Department of Revenue
Taxation Division
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Denver, CO 80217-0087

PLR-17-009

December 29, 2017

XXXXXX
Attn: XXXXXX
XXXXXX
XXXXXX

Re: Treatment of Gain Realized from the Sale of Ownership Interest in an LLC

Dear XXXXXX,

You submitted a request for a private letter ruling on behalf of XXXXXX ("Company A") 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 for whom the ruling is made.

Issues

1. Is the gain realized by Company A from the sale of its interest in the limited liability company considered business income?
2. Should Company A include its distributive share of the limited liability company's gross sales in its Colorado apportionment factor?
3. Should the gain Company A realized from the sale of its interest in the limited liability company be excluded from its Colorado apportionment factor?

Conclusion

1. Based on the facts presented, the gain Company A realized from the sale of its interest in the limited liability company is business income.
2. Based on the facts presented, Company A should include its distributive share of the limited liability company's gross sales in its Colorado apportionment factor.

3. Based on the facts presented, Company A should exclude the gain it received from the sale of its interest in the limited liability company from its Colorado apportionment factor.

Background

According to the facts presented, XXXXXX operates two separate and distinct manufacturing divisions: one division in Colorado ("Colorado Division") and another division in Illinois ("Illinois Division"). Both divisions function independently, with separate executive management, accounting, engineering, purchasing, marketing, manufacturing, distribution, and human resource operations. The Illinois Division manufactures and sells products in the aerospace industry, while the Colorado Division manufactures and sells products in the energy industry. Company A appears to be commercially domiciled in Colorado as most of its corporate officers are located in Colorado. But, as described above, all of Illinois Division's operational management is in Illinois. For the purpose of this letter, we assume that Company A is commercially domiciled in Colorado.

Company A and an unrelated company ("Company B") entered into a joint venture, whereby the joint venture, either directly or through Company A or Company B, provides varying support for the fuel system requirements on Company B's engines. After the establishment of the joint venture, Company A and the joint venture entered into a supply agreement pursuant to which Company A provides the joint venture with fuel system components at its direct product cost plus an overhead rate.

In August 2015, Company A formed, as the sole member, a new Delaware limited liability company, XXXXXX ("LLC I"), which is treated for tax purposes as a partnership. Immediately thereafter, Company A contributed to LLC I certain contracts between Illinois Division and Company B relating entirely to Illinois Division's business of providing fuel system components for Company B's engines. All of the activities related to these contracts performed by Company A are solely related to the activities of the Illinois Division.

On the same day, after contributing the contracts to LLC I, Company A formed a second new Delaware limited liability company, XXXXXX ("LLC II"), which is treated for tax purposes as a C corporation. Company A then contributed a 10% ownership interest in LLC I to LLC II.

Company B expressed a desire to purchase an interest in LLC I and, in January of 2016, following negotiations led by Illinois Division, Company A sold a 50% interest in LLC I to Company B for cash and contingent consideration in the form of an annual payment for each of the 15 years following closing. LLC I made an election under section 754 of the Internal Revenue Code with respect to such purchase to step up the basis in the partnership property (the contracts contributed to LLC I by Company A) as it relates to the purchased portion. After this transaction, LLC I was owned 40% by Company A, 10% by LLC II and 50% by Company B. All income, losses, and distributions are shared in accordance with these ownership percentages.

LLC I does not have any direct common-law employees, but approximately 10 people from both Illinois Division and Company B are working on behalf of LLC I through a secondment agreement. Among the employees from Illinois Division and Company B working on behalf of LLC I are a Finance Manager and General Manager, both of whom are located in Illinois. Additionally, all other employees working on behalf of LLC I from Illinois Division are also located in Illinois. The other employees from Company B working on behalf of LLC I are located in Ohio. The law firm working on the legal aspects of LLC I is located in California.

All products manufactured by Company A for the fulfillment of the LLC I supply agreement are manufactured in and shipped from Illinois Division. Also located at this location in Illinois are the accounting, financial, payroll, engineering, manufacturing, and distribution departments that account for and manage its business activities. The local management team's titles at this location include President, Vice President of Finance, Sales & Marketing Head, and Manufacturing Head. Other than some limited corporate oversight, all of Illinois Division's business activities are managed, accounted for, and directed by the local management team. Since its inception, LLC I has made sales to customers and has shipped products to destinations in a limited number of states, none of which were in Colorado. In addition, LLC I has foreign sales that also have no relationship to Colorado.

Company A will recognize a gain ("the Gain") for income tax purposes from the sale of the 50% partnership interest in LLC I to Company B. Company A will report the Gain as apportionable business income in all states where it files income tax returns for its fiscal tax year ending September 30, 2016. For state apportionment purposes, Company A expects the net gain or gross receipts, (depending upon the state) to be excluded in most states that it will file in under specific state apportionment rules and/or regulations. For example, in Illinois, Company A will be reporting the Gain as apportionable business income subject to tax, but will exclude the gross receipts from the sales apportionment factor under Illinois Section 100.3380(c)(2) which excludes gross receipts that arise from an occasional sale in the regular course of business.

Discussion

<u>1. Is the Gain Company A realized considered business income?</u>

The tax treatment of corporate income is determined, in part, by whether the income is business income or nonbusiness income. Colorado law defines both "business income" and "nonbusiness income" for corporate income tax purposes.[1]

[1] §§ 39-22-303.5(1)(a) & (c), C.R.S

These definitions contain a clear presumption, in absence of compelling evidence to the contrary, that a corporation's income 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"[3] and will, in general, include "all transactions and activities of the taxpayer that are dependent upon or contribute to the operation of the taxpayer's economic enterprise as a whole."[4] More specific to the facts of this case, Colorado regulation states:

> *"Gain or loss from the sale...of...intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business."5*

Company A's ownership interest in LLC I is intangible personal property. Company A manufactures and sells products in the aerospace industry. Company A formed LLC I in furtherance of this purpose and contributed to LLC I contracts created in the regular course of Company A's business. Therefore, the Gain Company A realized from the sale is business income.

Additionally, under Colorado law a corporation may elect to treat all of its income as business income.[6] Consequently, even if the Gain was not properly classifiable as business income, Company A may elect to treat the Gain as such, along with the rest of its income.

2. Should Company A include in its apportionment factor its distributive share of the limited liability company's gross sales?[7]

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.[8] Gross sales that flow up from LLC I to Company A, as a partner, are treated for federal tax purposes as if the gross sales from such work was paid directly to Company A[9]. This approach is consistent with the tax treatment of a partner's gross income for federal purposes.[10] Thus, where Company A's pass-through income from LLC I is business income for Colorado tax purposes, Company A's distributive share of LLC I's gross sales are Company

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[2] § 39-22-303.5(1)(a), C.R.S.
[3] Ibid.
[4] Dept. Reg. 1 CCR 201-2, 39-22-303.5.1(A)(2)
[5] Dept. Reg. 1 CCR 201-2, 39-22-303.5.1(A)(3)(b)(i)
[6] § 39-22-303.5(6), C.R.S.
[7] This section of this ruling concerns not the Gain Company A realized, but the pass-through income it received through its ownership, directly and indirectly, in LLC I.
[8] § 39-22-303.5(4), C.R.S.
[9] A "partner is generally deemed to be conducting the partnership business directly."Hellerstein & Hellerstein, State Taxation, ¶ 9.12[1]. See also Hellerstein & Hellerstein, State Taxation, ¶ 20.08[2][b].
[10] 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."

A’s own gross sales. To the extent that the pass-through income that Company A receives through LLC I is business income, Company A should include its distributive share of LLC I’s gross sales in its Colorado apportionment factor.

3. Should the Gain be excluded from its Colorado apportionment factor?

Statute and regulation prescribe apportionment on the basis of total gross receipts[11] and the sourcing of gains from sales of intangible property to the taxpayer’s commercial domicile.[12] However, the statute allows for an alternative apportionment if:

> *“The apportionment and allocation provisions of this section do not fairly represent the extent of the taxpayer's activities in Colorado, the taxpayer may petition for, or the executive director may require, with respect to all or any part of the taxpayer's business activities, if reasonable…[t]he employment of any other method to effectuate an equitable apportionment or allocation of the taxpayer's income, fairly calculated to determine the net income derived from or attributable to sources in Colorado.”*[13]

Regulation further allows departure from prescribed apportionment methodology “only in limited and specific cases” that are “unique and nonrecurring” and for which application of the normal apportionment rules would “produce incongruous results.”[14] In order to achieve more equitable and appropriate apportionment, “[i]n some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business.”[15]

Under the standard apportionment rules, “gain from the sale of intangible property” is assigned to Colorado and included in the numerator of the apportionment ratio “if the taxpayer’s commercial domicile is in Colorado.”[16] As discussed above, for the purpose of this letter, we assume that Company A is commercially domiciled in Colorado.

Under the facts presented, sourcing the entire Gain to Colorado on the basis of commercial domicile would not fairly represent the extent of the taxpayer’s activities in Colorado. All the accounting, financial, payroll, engineering, manufacturing, and distribution departments that account for and manage Company A’s business activities that relate to the Gain are performed in Illinois. Based on these facts, sourcing the entire Gain to Colorado on the basis of

[11] §§ 39-22-303.5(4) and (1)(d), C.R.S.and Dept. Reg. 1 CCR 201-2, 39-22-303.5.4(A)
[12] § 39-22-303.5(4)(c)(V), C.R.S. and Dept. Reg. 1 CCR 201-2, 39-22-303.5.4(C)(5)
[13] § 39-22-303.5(7)(b)(III), C.R.S.
[14] Dept. Reg. 1 CCR 201-2, 39-22-303.5.7(B)(a)
[15] Dept. Reg. 1 CCR 201-2, 39-22-303.5.4(A)(2)
[16] § 39-22-303.5(4)(c)(V), C.R.S.

commercial domicile would not effectuate an equitable apportionment or allocation of the taxpayer's income. Instead, apportionment of the Gain on the basis of the taxpayer's other sales, which presumably represent more accurately the taxpayer's business activities in the state, appears to most fairly represent the extent of the taxpayer's business activities in Colorado.

As a result of these considerations we find that sourcing the Gain based upon commercial domicile would produce incongruous results and not fairly represent the taxpayer's activity in Colorado. In order to effectuate equitable apportionment, we find it necessary to disregard the Gain in determining the sales factor for Company A. Consequently, the Gain should be excluded from Company A's 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 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.