COLORADO
Department of Revenue
Taxation Division

Office of Tax Policy
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GIL-14-017

June 24, 2014

XXXXXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXX

Re: Alternative Apportionment

Dear XXXXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXXXX ("Company") a request for special apportionment of Colorado income tax. Company seeks the Department's permission to use separate accounting to determine what, if any, taxable income should be apportioned to Colorado. Company asserts that the single sales factor apportionment methodology distorts the income apportioned to Colorado and that separate accounting more fairly reflects the economic reality of Company's income derived from Colorado sources. The Department has reviewed this request and, for the reasons set forth below, the Department does not grant Company permission to use separate accounting.

We begin by noting that Colorado, as most other states, long ago abandoned separate accounting as a viable method for allocating income between and among states because of the many difficulties associated with that methodology. Moreover, all apportionment methodologies are approximations of the economic realities and, as such, some measure of distortion is to be expected. We also note that separate accounting is, at some level, inconsistent with the apportionment principles adopted by the Colorado General Assembly. Colorado for a number of years used a two and three factor apportionment methodology that apportioned income based, in large part, on where costs were incurred to generate that revenue. In 2010, Colorado adopted the single sales factor apportionment methodology that places a greater emphasis, particularly with respect to the sales of goods, on apportioning income where the sales are derived rather than where the costs are incurred. In contrast, the separate accounting method places greater emphasis on assigning costs to the jurisdiction where the sale was made. Thus, separate accounting strikes us as at odds with the underlying principles adopted by the legislature. Finally, states moved away from separate accounting and adopted standardized apportionment methodologies because it is administratively overwhelming to engage in a full review of the separate accounting for companies. For these reasons, alternative apportionment based on separate accounting is sparingly used. Nevertheless, the Department is authorized to approve separate accounting under appropriate circumstances.[1]

[1] §39-22-303.5(7)(b)(I), C.R.S.

In our letter of April 10, 2014, we indicated that Company's request to use separate accounting lacked the level of detailed information necessary for the Department to evaluate the request. Indeed, the letter simply stated, in conclusory fashion, that the single sales factor apportionment formula distorts income and that separate accounting more accurately reflects income derived in Colorado. More specifically, we stated that the request was insufficient because such a review requires "detailed" information regarding a whole host of issues, including the nature and extent of the Company's business activities inside and outside Colorado and of its revenues and costs within and outside Colorado. The letter lacked details of the accounting that would allow the Department to independently determine whether separate accounting fairly apportions revenues and costs to Company's activities in Colorado and in other states.

Company submitted additional information by letter dated May 13, 2014. Again, the information provided lacks the detail that would allow us to independently evaluate whether separate accounting is proper. For example, in response to our request for a detailed description of its business activities within and outside Colorado, Company simply states that it is,

> "in the business of supplying machinery to the corrugated board industry."

This does not constitute a detailed description of its business activities inside and outside Colorado. A detailed description includes, among other things: how sales are solicited and consummated; what company's ongoing relations with entities or persons in Colorado are and in the other states; where are a company's operations; etc.

Company also does not provide any meaningful information with respect to revenues and costs inside and outside Colorado or explanations of how and why cost components and revenues were apportioned or allocated. Company provided a statement setting forth the sales price and a few minor revenue components of its Colorado revenues and, notably, a conclusory statement that the costs of the Colorado sale (excluding sales, general and administrative expenses) equaled the sales price. There is no detailed breakdown of what costs are included and no detailed discussion of how and why each cost component is apportioned to Colorado rather than to other states.[2] There is also no detailed discussion of the nature of revenues generated in other states which would allow us to determine whether and to what extent costs should be assigned to those revenues. The simplified chart of revenues and costs is aggregated information that lacks the detail needed to make an independent determination and contains numerous headers that are left unexplained.

Company represents that separate accounting will show that it had a loss in Colorado. Company apparently does business in other states. Most states use some variation of the one, two, or three factor apportionment methodology rather than separate accounting. When Company prepares its income tax returns for other states, it will likely apportion a substantial portion of its taxable income to Colorado. However, Company will not report any taxable income on its Colorado income tax return if it allowed to use separate accounting. Under these circumstances, a substantial portion of Company's income may not be taxed by any state. In general, the Department requires a company that is using an apportionment methodology different than those prescribed by Colorado statute or rule

[2] Even a cursory review of the little information provided suggests areas of inquiry that are precluded by the lack of detailed information. For example, one would reasonably expect the ratio of costs of sale to revenues in 2013 (the year of the Colorado sale) to be larger than in other years if, as seems implicit in Company's representations, costs for the 2013 sale in Colorado were larger than what Company typically incurs in a sale. However, the ratio of costs of sales to gross sales was actually smaller in 2013 than in the prior year (XXr% in 2012 and XX% in 2013). There may be an explanation for this, but we are not given the information needed to independently evaluate Company's separate accounting.

to use the same alternative apportionment methodology in every other state for which it files an income tax return. See, e.g., Department Rule 39-22-303.5.4(a)(6)(c). If Company will file in all states using the same separate accounting methodology if it is granted in Colorado, please affirm that you will do so.

Company has a substantial burden to fully set forth the factual basis on which the Department can independently assess the merits of the petition. We find that Company has not met its burden of proof and persuasion that an alternative apportionment methodology is appropriate and, therefore, the request is denied.

Pursuant to Colorado law, the enclosed redacted response to the petition for alternative apportionment will be published on the Department's website.[3] The purpose of the redaction is to remove confidential information relating to Company. Company has sixty days from the date of this response to submit in writing changes or objections to the proposed redaction.

Sincerely,

Office of Tax Policy
Colorado Department of Revenue

[3] §§39-22-303.5(7)(d) and 24-35-103.5, C.R.S.