STATE OF COLORADO

DEPARTMENT OF REVENUE
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PLR-12-008

December 31, 2012

XXXXXXXXXXXXXXXXXXXXX
ATTN: XXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXXX

Re: Private Letter Ruling

Dear XXXXXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXX ("Taxpayer") a request for a private letter ruling to the Colorado Department of Revenue ("Department") pursuant to Regulation 24-35-103.5. This letter is the Department's private letter ruling.

Issue

Can Taxpayer and its members amend their 2008-2010 individual Colorado income returns to exclude the net capital gain resulting from the sale of the Taxpayer's business assets?

Conclusion

Taxpayer and its members cannot amend their 2008-2010 individual returns to exclude the net capital gain resulting from the sale of the Taxpayer's business assets.

Background

Taxpayer is a LLC formed to develop, own, and operate a private laboratory located in Colorado. Taxpayer did not own any property or other assets outside of Colorado. In 2008, Taxpayer sold its assets to an unrelated company ("Buyer"), which has continued this Colorado business under the same name, at the same location, and has invested substantial funds in the business to expand and update the laboratory, equipment, and to employ additional personnel.

To effectuate the sale, Taxpayer entered into an Asset Purchase Agreement. Taxpayer transferred all rights, title, and interest and all assets of every kind or type, tangible or intangible, real or personal that were necessary or desirable to operate Taxpayer's

business. Taxpayer retained ownership of certain corporate and financial records, cash in excess of $500,000, and incidental assets of a personal nature to Taxpayer or its members and not used in the business. Taxpayer received installment payments for the Asset Purchase Agreement in 2008, 2009, and 2010.

Taxpayer represents that this sale meets all the holding period and other requirements of the Colorado Source Capital Gain Subtraction ("Subtraction"). Taxpayer states there is limited published guidance from the Department as to how the Subtraction is to apply to a business sale of substantially all the assets of the business compared to a sale of the ownership interests in the business. Given the lack of guidance, the Subtraction was not claimed on the 2008, 2009, and 2010 Colorado income tax returns filed by Taxpayer and its members. However, Taxpayer and its members now desire to amend their returns to claim and report the Subtraction.

Discussion

Colorado taxpayers can reduce their Colorado taxable income that is treated at the federal level as capital gains derived from (1) the sale of real or tangible personal property located in Colorado, or (2) the sale of stock or an "ownership interest" in a Colorado company. Specifically, §39-22-518, C.R.S. provides, in pertinent part:

> (1) [A qualified taxpayer is allowed] a reduction of income taxable by the state of Colorado...for the amount of income attributable to qualifying gains receiving capital treatment earned by the qualified taxpayer during the taxable year and included in federal taxable income.
>
> (2) ...
>
> (b)(I)"qualifying gains receiving capital treatment" means the amount of net capital gains, defined in section 1222(11) of the internal revenue code, included in any qualified taxpayer's federal taxable income and:
>
> (A) Earned by the qualified taxpayer on <u>real</u> or <u>tangible personal property</u> located within Colorado...; or
>
> (B) Earned on the sale of stock or on the sale of an <u>ownership interest</u> in a Colorado company, <u>limited liability company</u>, or partnership where the stock or ownership interest was acquired on or after May 9, 1994, and that has been held by the qualified taxpayer for a holding period of at least five years prior to the date from which the capital gains arise ... (emphasis added)

In 2008, Taxpayer sold all of its assets to Buyer and ceased its management, control, and ownership of its enterprise. Taxpayer continued as a partnership after 2008, but only for the purpose of collecting installment payments paid in 2009 and 2010. The principal asset sold by Taxpayer was its goodwill, which was approximately ninety-four percent of the purchase price. Income from this sale of the goodwill qualified for capital gain treatment under 26 USC §1222(11).[1] We agree with Taxpayer that this capital

[1] Taxpayer represents that the income from the sale of goodwill is properly treated as capital gains pursuant to 26 USC §1222(11). Income from the sale of goodwill can qualify capital gains under §1222(11) and Taxpayer appears to have held the property for the requisite period for purposes of the

gain does not qualify under subsection (A) because goodwill is neither real property nor tangible personal property. However, Taxpayer requests the Department treat the sale of its assets as a sale of an "ownership interest" under subsection (B).

We begin with a review of the statutory language, both in terms of the language used and the organization of the statutory provisions. The legislature defined two large categories (subsections A and B) of capital gains that qualify for the Subtraction. The first is comprised of two of the three most familiar forms of property: real property and tangible personal property. Notably absent in subsection (A) is the third of the most common forms of property: intangible property. This obvious omission suggests the legislature intended the Subtraction to not extend to a variety of intangibles, such as goodwill. Intangible property is traditionally defined as conceptual in nature and includes such things as patents, copyrights, tradenames, trademarks, franchise rights, licenses, contract rights, claims of action, stocks, ownership interests, and goodwill, among many others. Goodwill is universally recognized as an intangible property right.

Subsection B addresses intangibles eligible for the Subtraction. Of the many types of intangible property we list above, the legislature identified only two that qualify for the Subtraction: stock in corporations and ownership interests in partnerships and limited liability companies.[2]

We note, however, that the exclusion of intangibles (other than stock and ownership interests) from the Subtraction is not as absolute as would first appear. The value of a stock or an ownership interest likely reflects the value of intangibles owned by a company (e.g., patents, goodwill). Thus, a Colorado taxpayer does receive, albeit indirectly, a subtraction for goodwill when the taxpayer sells stock or an ownership interest. However, this untidiness in excluding intangibles may not be so much a reflection of legislative intent to include intangibles, such as goodwill, as it is a reflection of the difficulty, if not impossibility, of drafting legislation that in all respects perfectly effectuates legislative intent.[3]

We next consider Taxpayer's specific argument that the sale of all a company's assets is, as a matter of economic reality, the same as a sale of an "ownership interest." This is a close question. We believe that there are four substantial arguments in favor of Taxpayer's argument. First, Taxpayer has, as both an economic and operational matter, sold a business enterprise to Buyer. Taxpayer itself no longer has an active business enterprise: its sole function appeared to be to collect the final installment

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Subtraction. The Department presumes Taxpayer's representation is correct for purposes of addressing the issue raised in this ruling request, but the department does not determine here whether the representation is correct.

[2] Subsection (B) of 39-22-518(2)(b)(I), C.R.S.

[3] Indeed, this sloppiness in line-drawing also works in the other direction. For example, the value of stock of a Colorado company may reflect the value of a company's recent acquisition of a copyright, which, because the copyright was recently acquired, may not itself qualify for capital gains treatment. Nevertheless, the sale of the stock, including the value of the copyright, will qualify for the deduction if the sale of stock qualifies for capital gain treatment.

payments due under the purchase agreement. Thus, as Taxpayer argues, the business enterprise has been effectively sold.

Although not an argument advanced by Taxpayer, the second argument relates to what may have been one of the principal goals of this Subtraction. The legislative declaration for the Subtraction does not explain why some intangibles are included and some are not. One explanation may relate to the legislature's apparent interest in limiting the subtraction to those assets that are physically located in Colorado. And, unlike the situs of real and personal property or the commercial operations of corporations and other entities, the situs of intangible personal property is more a matter of policy than it is of fact. If the legislature intended the Subtraction to be limited to those that arise in Colorado,[4] then the legislature may have excluded intangibles to ensure that only those gains that can be readily traceable to Colorado sources are included in the Subtraction. For this reason, the legislature may have permitted stock and ownership interests to be included in the subtraction if the company itself is located in Colorado. Allowing a deduction for the sale of goodwill in this case seems consistent with the apparent legislative intent to limit the capital gain deduction to those assets located in Colorado. Taxpayer is located in Colorado and its goodwill cannot be said to have a situs other than in Colorado.

Thirdly, Taxpayer observes that the IRS has gone to some length to remove differences in the tax treatment of the sale of a business enterprise through a stock sale versus a sale of its assets.[5] Pursuant to 26 USC §338, a taxpayer whose commercial enterprise is sold via a stock sale will be treated, for tax purposes, as if the company sold its assets. However, it is important, we think, to note here that this was accomplished only by the specific enactment of §338, and that this treatment is only available in limited circumstances and upon the specific election of the taxpayer. In the absence of such a provision and election, the tax outcome at the federal level for an asset sale is quite different from the sale of stock. Taxpayer did not conduct its sale pursuant to §338 and, as discussed below, the tax treatment at the federal level will govern the treatment at the state level.

It is also important to note that, although the two types of transactions may be economically similar, there are important differences between these two transactions (asset sale v. stock sale). In the former case, only assets of the company are sold; in the later case, ownership of the entity itself is sold, not its assets. In the latter case, the buyer is, among other things, purchasing liabilities of the company, including contract and tort liabilities, contractual obligations, regulatory compliance issues, among many

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[4] In order to qualify for the Subtraction, the real or personal property must be "located in Colorado" and the stock or ownership interest must be of a "Colorado company, "which is a company that has at least fifty percent of its payroll and property assigned to Colorado." §39-22-518(b)(I)(A), (B) and (b)(II)(A), C.R.S.

[5] See, generally, §338, I.R.C. which allows the company acquired by stock to have a stepped-up basis in its assets. A similar approach is arguably used for single member limited liability companies. The sale of goodwill of a single member limited liability company will not qualify for the Subtraction because the single member LLC will be disregarded for federal tax purposes when, as here, its members are individuals and be treated as a sole proprietorship. IRS Proc.& Admin.Regs. § 301.7701-3

others. As noted below, treating the sale of the Company as a sale of ownership interest rather than a sale of assets is inconsistent with the realties of the transaction.

Finally, we also acknowledge that, where possible, we interpret statutes governing income tax in such a fashion as to recognize the economic realities of transactions. *General Motors Corporatio v. Franchise Tax Board*, 139 P3d 1183 , 47 Cal.Rptr.3d 233 (2006). These arguments are compelling arguments and may reflect sound policy. However, we conclude that in order to reach such a result we must expand the interpretation of "ownership interest" beyond how this term is generally understood.

"Ownership interest" is not explicitly defined in the tax statutes. However, a similar term is used in the Colorado statutes governing limited liability companies.[6] There, a "membership interest" means a member's share of the profits and losses of a limited liability company and the right to receive distributions of such company's assets. A membership interest is, itself, personal property and is distinct from the limited liability company's ownership interest in the assets.[7]

We think "ownership interest" is a slightly broader term that encompasses not only membership interests in a limited liability company but also partnership interests in a partnership. As in the case of a membership interest in a limited liability company, a partnership interest in a partnership is personal property, is saleable, and must, itself, qualify for capital gains treatment regardless of how the real and tangible assets, whose value is reflected in these interests, qualify for capital gains treatment. Moreover, title to assets of a partnership or limited liability company is held in the name of the company, not in the name of its partners or members. Thus, when a partner or member sells its membership interest, title to the assets does not pass from seller to buyer. In the present case, members did not sell their membership interests to Buyer; rather, members sold title to the assets passed from Taxpayer to Buyer.

More importantly, construing the sale of a business enterprise by means of its assets as a sale of an ownership interest is inconsistent with the way the transaction is viewed at the federal level and how the parties treated the sale. Although the IRS has, as noted above, eliminated disparate tax treatment of asset and stock sales under 26 USC §338, the sale at issue was not made pursuant to 26 USC §338 because a 26 USC §338 election is not even available to entities that are not taxed as corporations. How the transaction is handled at the federal level is important because it controls how the transaction is treated for Colorado's income tax purposes. For example, in the sale of assets, the buyer receives a stepped-up basis in the assets and the seller receives capital gains treatment of the income. The buyer does not receive a stepped-up basis if it purchases the membership interests.

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[6] Title 7, article 80, C.R.S.

[7] 7-80-702(1), C.R.S. "(1) The interest of each member in a limited liability company constitutes the personal property of the member and may be assigned or transferred. Unless the assignee or transferee is admitted as a member, the assignee or transferee shall only be entitled to receive the share of profits or other compensation by way of income and the return of contributions to which that member would otherwise be entitled and shall have no right to participate in the management of the business and activities of the limited liability company or to become a member."

In addition, it is not clear to us that the Taxpayer's approach reflects the realities of the transaction. There are substantial practical and commercial differences between the sale of assets and the sale of an ownership interest in a company. For example, an asset sale by-passes dissident members who object to a sale and allows the buyer to avoid the assumption of contractual, tort, and regulatory liabilities of the company. In the present case, Taxpayer opted to sell its assets rather than have individual members sell their membership interests.

As with all transactions, the avenue selected by the seller and buyer will have advantages and disadvantages depending on the form chosen. We think it inconsistent with both federal tax treatment and the intentions of the parties to treat the sale of assets as a sale of an ownership interest at the federal level, and then construe the sale as a sale of member's membership interest at the state level.

Taxpayer's argument also leads to results that are unusual. The thrust of Taxpayer's argument is that the sale in this case is a sale of an ownership interest because all assets are sold. However, subsection (B) does not require all ownership interest to be sold in order to qualify for the Subtraction. This subsection applies even if only some ownership interest is sold. It is unclear why, under this rationale, the Subtraction would not be available to, for example, a publishing company that sells an important copyright through which it engages in a substantial enterprise. It is difficult to see why a corporation's sale of the copyright does not qualify as a sale of an "ownership interest" in that line of business. Such an approach essentially undoes any distinction between subsections (A) and (B) - a result that we believe is not permitted.

Finally, we note that our conclusion here is consistent with prior advice on a related transaction. In FYI Income 15 (Colorado Capital Gain Subtraction), the Department states that it will disallow the subtraction for the sale of goodwill by a sole proprietorship. A sole proprietor does not have an ownership interest in a company, limited liability company, or partnership separate and apart from its ownership interest in the assets. As noted above, the sale of a company, limited liability company, or partnership's ownership interest in assets is not the same transaction as the sale of a company, limited liability company or partnership's ownership interest. In other words, the sale of all the assets of a sole proprietorship does not constitute the sale of an "ownership interest" in a company, limited liability company, or partnership.

In sum, we conclude that "ownership interest" must be interpreted to mean the sale of member's interest in the limited liability company, and does not include the sale by the limited liability company of its assets.

Miscellaneous

This ruling applies only to sales and use taxes administered by the Department. Please note that the Department administers state and state-collected city and county sales taxes and special district sales and use taxes, but does not administer sales and use taxes for self-collected home rule cities and counties. You may wish to consult with

local governments which administer their own sales or use taxes about the applicability of those taxes. Visit our web site at www.colorado.gov/revenue/tax for more information about state and local sales taxes.

This ruling is premised on the assumption that Company has completely and accurately disclosed all material facts. The Department reserves the right, among others, to independently evaluate Company's representations. This ruling is null and void if any such representation is incorrect and has a material bearing on the conclusions reached in this ruling. This ruling is subject to modification or revocation in accordance to Department Regulation 24-35-103.5.

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,

Neil L. Tillquist
Colorado Department of Revenue
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