

## Colorado Enacts Market-Based Sourcing Provisions

### Overview

On June 4, 2018, Colorado Governor John Hickenlooper signed House Bill 1185 (HB 1185),<sup>1</sup> which adopts a market-based sourcing methodology for sales of services and intangible property for Colorado corporate income tax purposes. This will replace Colorado's current proportional costs of performance methodology, effective for tax years beginning on or after January 1, 2019. HB 1185 includes the following modifications to Colorado income tax law to affect this apportionment change:

- Implements market-based sourcing for sales of services and intangible property.<sup>2</sup>
- Provides definitions for "apportionable income" and "receipts."<sup>3</sup>

This tax alert summarizes the law changes and provides some taxpayer considerations.

### Market-based sourcing

As a result of the enactment of HB 1185, C corporations and S corporations will be subject to Colorado's market-based sourcing rules for tax years beginning on or after January 1, 2019. Partnerships are required to source income to their nonresident partners in accordance with Colorado's nonresident individual sourcing statute, but can elect to apportion and allocate income using Colorado's corporate apportionment rules in effect through 2018.<sup>4</sup>

The market-based sourcing provisions of HB 1185 closely follow the model provisions adopted by the Multistate Tax Commission (MTC). Under this new market-based sourcing approach, Colorado will source sales of services and intangibles to Colorado if the taxpayer's market for sales is in Colorado.<sup>5</sup>

Receipts from the sales of services will be sourced to Colorado "if and to the extent the service is delivered to a location" in Colorado.<sup>6</sup> The legislation does not provide explicit guidance regarding how taxpayers or the state should interpret this standard, but it is anticipated that the Department will look to the MTC's model market-based sourcing regulation in this regard.

HB 1185 also includes detailed provisions for sourcing sales of intangibles:

- For the sale of intangibles, the taxpayer's market is in Colorado if and to the extent the property is used in Colorado, provided that a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is used in Colorado if the geographic area includes all or part of Colorado.<sup>7</sup>
- For the rental, lease, or license of intangible personal property, the taxpayer's market is in Colorado if and to the extent the property is used in Colorado, provided that the intangible property is utilized in marketing a good or service to a consumer is used in Colorado if that good or service is purchased by a consumer who is in Colorado.<sup>8</sup>

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<sup>1</sup> 2018 Legislation, 71<sup>st</sup> General Assembly, Second Regular Session (HB 1185; June 4, 2018), available [here](#).

<sup>2</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6.

<sup>3</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(a),(d).

<sup>4</sup> COLO. REV. STAT. § 39-22-203(1)(a). Nonresident individuals are required to source income pursuant to Colorado's nonresident individual sourcing statute and its accompanying regulations. The application of HB 1185 to partnerships and individuals is somewhat unclear and continues to be the subject of analysis.

<sup>5</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6).

<sup>6</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6)(a).

<sup>7</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6)(d)(II)(A).

<sup>8</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6)(d)(I).

Receipts from intangible property sales that are contingent on productivity, use, or disposition of the intangible property must be treated as receipts from the rental, lease, or licensing of such intangible property.<sup>9</sup> All other receipts from sales of intangible property not specifically addressed in the statute are excluded from both the numerator and denominator of the receipts factor.<sup>10</sup> If the state of assignment cannot be determined by applying these rules, then the state of assignment must be reasonably approximated.<sup>11</sup> If the state of assignment cannot be determined or reasonably approximated, such receipts are excluded from the receipts factor.<sup>12</sup>

### Definitional changes: apportionable income & receipts

HB 1185 repeals the current definition of “business income” and replaces the term with “apportionable income.”<sup>13</sup> “Apportionable income” generally is defined to include:

- Any income that is apportionable under the U.S. Constitution and is not allocated under the laws of Colorado,<sup>14</sup> including:
  - income arising from transactions and activity in the regular course of the taxpayer’s trade or business,<sup>15</sup> and
  - income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer’s trade or business.<sup>16</sup>
- Any income that would be allocable to Colorado under the U.S. Constitution but that is apportioned rather than allocated pursuant to the laws of Colorado.<sup>17</sup>

The new law also repeals the definition of “sales” and replaces the term with “receipts.”<sup>18</sup> The definition of “receipts” for receipts factor purposes include those received from transactions and activity in the regular course of the taxpayer’s trade or business, except generally excludes receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan, or other disposition of cash or securities.<sup>19</sup>

These market-based sourcing rules do not apply to taxpayers subject to Colorado’s special industry apportionment rules and regulations applicable to airlines, contractors, publishing, railroads, television and radio broadcasting, trucking, financial institutions, and telecommunications.<sup>20</sup> Colorado’s special industry apportionment rules and regulations remain in effect unless inconsistent with HB 1185.<sup>21</sup>

### Considerations

Colorado’s shift from a proportional costs of performance sourcing regime to a market-based sourcing regime effective for tax years beginning on or after January 1, 2019 may increase the tax obligation on profitable out-of-state companies that sell services and intangible property to Colorado customers, particularly given that Colorado applies sales-based economic nexus standards<sup>22</sup> and utilizes a 100%-weighted sales factor to apportion income.<sup>23</sup>

Taxpayers with a significant market and sales presence in Colorado may wish to consult with their tax advisers regarding the effect of HB 1185 on their tax reporting and compliance obligations. Additionally, taxpayers that have negotiated prior audit closing agreements and alternative apportionment agreements with the Colorado Department of Revenue may want to closely review those agreements and consult with their tax advisers regarding whether they may have been superseded by this law change.

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<sup>9</sup> *Id.*

<sup>10</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6)(d)(III).

<sup>11</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6)(e).

<sup>12</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(6)(f).

<sup>13</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(a).

<sup>14</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(a)(II).

<sup>15</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(a)(II)(A).

<sup>16</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(a)(II)(B).

<sup>17</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(a)(I).

<sup>18</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(d).

<sup>19</sup> *Id.*

<sup>20</sup> HB 1185, COLO. REV. STAT. § 39-22-303.6(11).

<sup>21</sup> *Id.*

<sup>22</sup> COLO. CODE REGS. 39-22-301.1

<sup>23</sup> HB 08-1830

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