COLORADO
Department of Revenue
Taxation Division
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PLR-15-006

June 8, 2015

XXXXXXXXXXXXXX
Attn: XXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX

Re: Apportionment of Corporate Income Tax

Dear XXXXXXXXXX

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

Issue

How should Company apportion their income when it does not squarely fit into existing apportionment methodologies?

Conclusion

Company should consider itself a service provider and apportion its gross receipts based upon where the cost to perform the service is incurred.

Background

Company has its commercial domicile in Colorado. Its primary business is the acquisition, management, and collection of charged-off consumer and commercial accounts receivable, which are purchased from other financial institutions, finance and leasing companies, and other issuers. Charged-off accounts receivable are defaulted accounts receivable that credit issuers have charged-off as bad debt, but that remain subject to collection. Typically, Company buys entire groups of accounts, or debt portfolios, in order to mitigate risk within its business model. Fresh charged-off credit card and consumer loan receivables are generally 180-210 days past due at the time of purchase and typically have not been subject to previous collection attempts by a third-party collection agency. The act of charging-off an account is an action required by banking regulations and is an accounting action that does not release the obligor on the account from his or her responsibility to pay amounts due on the account.

Because the credit issuer was unable or unwilling to collect the charged-off receivables that Company purchases, Company is able to acquire the debt portfolios at a substantial discount to their face value. Company's primary source of revenue is recognized on the portfolio base of purchased debt assets which are driven primarily by cash proceeds from voluntary, judicial and nonjudicial collections.

Once the charged-off receivables are acquired, the accounts are placed for collection with one of Company's affiliated but independently-owned third-party law firms, to which Company refers as its "branch offices". The branch offices are located across the country and have agreed to work exclusively for Company to collect upon the accounts that are placed with them. Each branch office has an executed detailed agreement that provides the legal structure for the relationship with Company, including its right to use Company's integrated account management system software used to maintain and collect upon accounts. To a much lesser extent, Company also utilizes specialized non-affiliated third-party collection firms throughout the United States. It also employs a small number of collectors focused exclusively on commercial collections. Under the terms of Company's contractual arrangements, the branch offices license Company's proprietary technology and perform recovery work on Company's behalf in accordance with its required policies. Company is under no obligation to provide accounts to any branch office. It pays its branch offices a fee, which varies based upon their performance against Company's return assumptions and is subject to adjustment based upon the performance against its operational standards. Accounts are allocated to branch offices based on the capacity, geographic coverage, their performance against return expectations, and adherence to the aforementioned operational requirements.

Effective January 2, 2013, the Consumer Financial Protection Bureau ("CFPB") has assumed direct regulatory oversight of the debt-purchasing and collection industry including supervisory jurisdiction over large market participants, defined as having over $10 million in annual receipts. The CFPB specifically supervises banks, credit unions, and other financial companies and also enforces federal consumer financial laws. Company is subject to regulatory oversight by the CFPB. In 2013, the CFPB exercised its regulatory authority over Company by conducting and on-site examination at Company's headquarter location.

Company has historically apportioned one hundred percent of its operating revenue to Colorado. Company's filing treatment has been based on the conclusion that while its collection revenues do not fall with any of the enumerated classes of receipts in section 39-22-303.5(4), C.R.S., Company is most akin to either gains from sales of intangible property or interest income. Thus, Company has apportioned its "sales" based on commercial domicile (Colorado), which is the sourcing standard for both classes of revenue. This treatment resulted in the build-up of significant Colorado net operating losses, computed using a near one hundred percent Colorado apportionment factor. Company has reviewed its apportionment methodology and concluded that it is not correct because it operates in many states. Company does not believe the collection of revenue constitutes either interest income or gains from the sale of intangible property, and, thus, does not squarely fall within any of the enumerated categories of receipts under the standard taxpayer apportionment provisions. For these reasons, Company believes the most logical approach to apportioning Company's collection revenue is through the use of the special apportionment regulation applicable to financial institutions.

Discussion

If a legal entity has sources of income from both inside and outside Colorado, the entity must allocate and apportion its income among the relevant states. Colorado has adopted the single-sales factor apportionment methodology to apportion business income.[1] This methodology uses general sourcing rules for various types of income.[2] However, Colorado recognizes that these sourcing rules may not be suited for certain types of business[3] and, therefore, the Department adopts by regulation apportionment and allocation rules for certain industries, including financial institutions.[4]

We first consider whether Company is a financial institution. Financial institutions are commonly understood to be institutions that handle financial transactions and provide financial services such as investments, loans, and deposits. Company does not handle financial transactions nor does it provide financial services. Rather, Company purchases charged-off financial services (loans) originated by a financial institution and strives to collect on such purchased loans. The fact that financial institutions can and do collect on loans and credit card receivables does not automatically qualify Company as a financial institution. Company appears not to be a financial institution because it does not handle financial transactions and does not provide financial services to customers.

Moreover, Company is not registered under state or federal law as a bank, saving association or thrift institution; Company is neither organized for the purpose of engaging in international or foreign banking or other international or foreign financial operations nor an agency or branch of a foreign depository; Company is not a production credit association; and Company does not derive more than fifty percent of its total gross income from finance leases; thus, Company does not meet the definition of a financial institution in 1 CCR 201-3 Special Regulation 7A, is not considered to be a financial institution, and is unable to allocate and apportion its income based upon the financial institution sourcing rules.[5]

We next turn to the general sourcing rules. There are three sourcing rules that must be considered, 1) gain or loss from the sale of intangibles, 2) interest income, and 3) revenue from services performed in Colorado. The Department agrees that Company should not apportion its income as gains or losses from the sale of intangible property. Gain from the sale of intangibles arises when the asset is sold to a third party. Although Company bought an intangible (i.e., accounts receivables), the income is not generated from the sale of the intangible property. Instead, the income is generated from the performance by the debtor of its payment obligations.

Moreover, this income is not interest income. Interest income is income paid for the time-value of money. The majority of Company's income is generated from the payment of the principal on debt obligations. Although some of the payments to the Company may reflect

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1 § 39-22-303.5, C.R.S.

2 § 39-22-303.5, C.R.S. and 1 CCR 201-2, 39-22-303.5.4(C).

3 § 39-22-303.5(7)(a), C.R.S.

4 1 CCR 201-3, Special Regulation 1A - 8A

5 Even if Company were to meet the definition of a financial institution, there are no sourcing rules within the financial institutions special regulation that are specifically applicable to Company's income.

interest[6], the majority of income is the repayment of the principal debt. Thus, neither of these two sourcing rules apply to Company.

The third sourcing rule we consider is that relating to services rendered in Colorado. Revenue from services is sourced to the place where the service is performed. Company engages law firms and other similar service-related industries to generate income from delinquent debt. Company also has staff in its headquarters who perform services that generate the income. The Department acknowledges that characterizing Company as a service provider is unusual because a service provider typically generates income by selling its services to a third-party[7] Here, Company is engaging in a service that it consumes. However, the activities engaged by Company are most closely related to a service provider. The service rule reflects Company's gross receipts better than other rules available because it is based on the proportionate cost of performance rather than solely where Company's commercial domicile is located. Finally, although attenuated, there is a service being performed by Company to the sellers of the charged-off debt in the form of creating a market for the underlying debt to be purchased if the debt is charged-off by the seller. For these reasons, we rule that Company should use the rules relating to service providers when apportioning its income.

If Company does not have cost records for previous tax years to substantiate where Company's cost of performance took place, Company may use its current cost of performance results to determine the proportionate Colorado net operating losses. In order to use the current year's cost of performance results, Company must represent that the operating facts of Company's business have not substantially changed from the periods for which Company will revalue the net operating losses.

Miscellaneous

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. 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.

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6 To the extent Company's income does reflect interest income, such income should be sourced under the interest income sourcing rules (commercial domicile); however, the Department assumes that most of Company's income is not from such source.

7 The Department intends to propose a modification to the service provider rule to make clear that the service provider sourcing rule can include entities whose services generate income or create a special regulation for the debt collection industry. If such amendment or new regulation is adopted, Company must prospectively follow the guidance adopted by the Department in regulation for the tax year in which the regulation becomes effective.

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