

Debt Buyer Apportionment Guidelines

Introduction

During the 2018 Session, the Virginia General Assembly enacted House Bill 798 (2018 Acts of Assembly, Chapter 807), which requires multistate debt buyers to apportion their income to Virginia using a special method of apportionment (“Debt Buyer Apportionment”). Under Debt Buyer Apportionment, debt buyers are required to use a single factor method of apportionment based on sales and market-based sourcing methods to source certain sales that consist of money recovered on debt.

These guidelines are published by the Department of Taxation (“the Department”) to provide guidance to taxpayers regarding the apportionment method and market-based sourcing methods that apply to debt buyers, as required by the second enactment clause of House Bill 798. These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner’s general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information will be published and posted on the Department’s website, www.tax.virginia.gov. These guidelines complement the Department’s existing Corporation Income Tax Regulations (23 *Virginia Administrative Code* (“VAC”) 10-120-10, et seq.). To the extent that there is a conflict between the Department’s existing regulations and *Va. Code* §§ 58.1-416 and 58.1-422.3, the provisions of those sections of the *Code of Virginia*, as interpreted by these guidelines, supersede the existing regulations.

These guidelines represent the Department’s interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845. To the extent there is a question regarding the application of these guidelines, taxpayers are encouraged to write to the Department and seek a written response to their question.

Companies Required to Use Debt Buyer Apportionment

For taxable years beginning on or after January 1, 2019, a company that qualifies as a debt buyer is required to use Debt Buyer Apportionment when apportioning income to Virginia. No company may utilize Debt Buyer Apportionment unless it qualifies as a debt buyer.

For purposes of Debt Buyer Apportionment, “debt buyer” is an entity and its affiliated entities that purchase nonperforming loans from unaffiliated commercial entities that are in default for at least 120 days or in bankruptcy proceedings. “Debt buyer” does not include an entity that provides debt collection services for unaffiliated entities. “Affiliated” means the same as the term is defined in *Va. Code* § 58.1-302.

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Example 1:

Taxpayer A provides debt collection services to Bank B, an unaffiliated entity. Taxpayer A assists Bank B in collecting defaulted consumer debt but does not buy such debt from Bank B. Taxpayer A may not use Debt Buyer Apportionment and is not a debt buyer simply because it provides debt collection services.

Example 2:

Taxpayer A purchases nonperforming loans from Taxpayer B and does not purchase nonperforming loans from any other entity. At the time that these loans were purchased, they were in default for at least 120 days. Taxpayer A is a fully-owned subsidiary of Taxpayer B. Taxpayer A may not use Debt Buyer Apportionment because a taxpayer cannot qualify as a debt buyer on the basis of purchasing nonperforming loans from entities with which it is affiliated.

If the corporation's business is composed of both debt buying and business that is not debt buying, separate accounting and the application of Debt Buyer Apportionment only to the debt buying portion of the corporation's business is not permitted. See Commonwealth of Virginia v. Lucky Stores, Inc., 271 Va. 121 (1976). The application of Debt Buyer Apportionment is required to be determined for the corporation as a whole based upon the majority of the corporation's business. The majority of a corporation's business constitutes debt buying when more than 50 percent of the corporation's revenues from the current taxable year are from its debt buying business. Therefore, if debt buying business constitutes a majority of the corporation's business, the corporation is considered a debt buyer that is required to use Debt Buyer Apportionment. If debt buying business does not constitute a majority of the corporation's business, the corporation is not considered a debt buyer and may not use Debt Buyer Apportionment.

Example 3:

During Taxable Year 2019, Taxpayer A earned \$900,000 of revenue by collecting on nonperforming loans that it had purchased from unaffiliated commercial entities. At the time that these loans were purchased, they were in default for at least 120 days. Taxpayer A also earned \$80,000 of revenue from service fees and \$20,000 in interest income. Taxpayer A's total revenues are as follows:

	Revenues	Percentage of Revenues
Collections from eligible nonperforming loans	\$900,000	90%
Service fees	\$80,000	8%
Interest income	\$20,000	2%
Total revenues	\$1,000,000	100%

Because a majority of Taxpayer A's revenues for Taxable Year 2019 come from collecting on eligible nonperforming loans, Taxpayer A's debt buying business is a

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majority of its business. As a result, Taxpayer A is considered a debt buyer that is required to use Debt Buyer Apportionment for Taxable Year 2019.

Example 4:

During Taxable Year 2019, Taxpayer A earned \$450,000 of revenue by collecting on nonperforming loans that it had purchased from unaffiliated commercial entities. At the time that these loans were purchased, they were in default for at least 120 days. Taxpayer A also earned \$550,000 of revenue by providing debt collection services to unaffiliated entities. Taxpayer A's total revenues are as follows:

	Revenues	Percentage of Revenues
Collections from eligible nonperforming loans	\$450,000	45%
Debt collection service fees	\$550,000	55%
Total revenues	\$1,000,000	100%

Because a majority of Taxpayer A's revenues for Taxable Year 2019 do not come from collecting on eligible nonperforming loans, Taxpayer A's debt buying business is not a majority of its business. As a result, Taxpayer A is not considered a debt buyer and may not use the Debt Buyer Apportionment for Taxable Year 2019.

If a debt buyer is part of an affiliated group consisting of non-debt buyer corporations and files a Virginia consolidated return, then the affiliated group must follow the mixed apportionment factors method under 23 VAC 10-120-326.

Virginia Code § 58.1-418 requires that a financial corporation use a single factor method of apportionment based on the percentage of its total business that is in Virginia. Because of how the term "financial corporation" is defined by Virginia law, a debt buyer will not generally be considered a financial corporation. See, e.g., Public Document ("P.D.") 04-167. However, to the extent that a debt buyer is also considered a financial corporation, the Debt Buyer Apportionment provisions of *Va. Code* §§ 58.1-416 and 58.1-422.3, as interpreted by these guidelines, will apply rather than *Va. Code* § 58.1-418.

Overview of Debt Buyer Apportionment

Debt buyers are required to use a single sales factor method of apportionment and market-based sourcing methods for assigning certain sales under such method of apportionment.

Single Sales Factor Method of Apportionment for Debt Buyers

The Virginia taxable income of a multistate corporation, other than dividends, is apportioned to Virginia by multiplying such income by an apportionment percentage. Under Virginia's standard apportionment method, the apportionment percentage is generally calculated by adding together a property factor plus a payroll factor, plus twice

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a sales factor, and then dividing such sum by four. In addition to its standard apportionment method, Virginia has specialized apportionment methods for calculating the apportionment percentage of multistate manufacturing companies, retail companies, companies with enterprise data center operations, motor carriers, railway companies, financial corporations, and construction companies.

A corporation subject to Debt Buyer Apportionment is required to use a single factor method of apportionment based on sales. Therefore, a debt buyer is required to apportion its Virginia taxable income to Virginia by multiplying such income by its sales factor only. Dividends will continue to be allocated pursuant to *Va. Code* § 58.1-407 and 23 VAC 10-120-140.

Market-Based Sourcing Methods for Sourcing Certain Sales of Debt Buyers

For apportionment purposes, the sales factor consists of a fraction, the numerator of which is the total sales of the corporation in Virginia during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. To be included in the sales factor, the sales must be used to produce Virginia taxable income and be effectively connected with the conduct of a trade or business within the United States, where the income from such conduct is includable in federal taxable income.

According to *Va. Code* § 58.1-416(A), sales of tangible personal property are generally deemed in Virginia and must be included in the sales factor numerator if the tangible personal property is delivered to a location in Virginia. In contrast, sales other than sales of tangible personal property are generally deemed in Virginia and must be included in the sales factor numerator if:

- The income-producing activity is performed in Virginia; or
- The income-producing activity is performed both in and outside of Virginia and a greater proportion of the income-producing activity is performed in Virginia than in any other state, based on costs of performance.

Debt Buyer Apportionment provides a limited exception to these rules by requiring a debt buyer to source sales that consist of money recovered on debt (“debt receipts”) using market-based sourcing. Pursuant to *Va. Code* § 58.1-416(B), debt receipts will be deemed in Virginia and will be required to be included in the sales factor numerator if they are collected from a person who is a resident of Virginia or an entity that has its commercial domicile in Virginia

Virginia Code § 58.1-414 and 23 VAC 10-120-210 continue to apply to a debt buyer’s sales, including the determination of whether its debt receipts are to be included on a gross or net basis. In addition, the rules set forth in *Va. Code* § 58.1-415, *Va. Code* § 58.1-416(A), 23 VAC 10-120-220, and 23 VAC 10-120-230 continue to apply to a debt buyer’s sales that do not consist of debt receipts.

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Example 5:

The majority of Taxpayer A's business involves purchasing of nonperforming loans from unaffiliated commercial entities and recovering on such loans. At the time that it purchases such loans, they were in default for at least 120 days. As a result, Taxpayer A is a debt buyer. As a small component of its business, Taxpayer A also provides debt collection services to banks. In these arrangements, Taxpayer A assists banks in collecting defaulted consumer debt but does not buy such debt from these banks.

Because Taxpayer A is a debt buyer, Taxpayer A must use market-based sourcing to source all debt receipts from the nonperforming loans that it has purchased. However, Taxpayer A must use the income-producing activity rule to source any receipts from fees that it charges to provide debt collection services to its bank customers. This is so, even if such fees are structured as a percentage of the recoveries that Taxpayer A earns for the banks on their defaulted consumer debt.

Market-Based Sourcing Methods

In determining whether debt receipts are in Virginia under *Va. Code* § 58.1-416(B), various sourcing methods are provided below that apply sequentially in a hierarchy. For each sale consisting of debt receipts, a debt buyer must make a reasonable effort to apply the primary sourcing method before seeking to apply the next sourcing method in the hierarchy. For example, the primary sourcing method requires a taxpayer to determine the state or states of assignment, and if the taxpayer cannot do so, the secondary method requires the taxpayer to reasonably approximate the state or states of assignment. In these cases, the taxpayer must attempt to determine the state or states of assignment (e.g., apply the primary method in the hierarchy) in good faith and with reasonable effort before it may reasonably approximate the state or states.

Primary Sourcing Method. If the necessary information is available to allow the debt buyer to determine the debtor's actual state of residence or actual state of commercial domicile, as applicable, it is required to assign debt receipts received from that debtor to such state or states.

Secondary Sourcing Method. If the necessary information is not available for the debt buyer to determine the debtor's actual state of residence or actual state of commercial domicile, as applicable, the taxpayer may reasonably approximate such state using the debtor's mailing address from which such debts are collected, provided that:

- The estimate has been undertaken in good faith,
- The estimate is a reasonable approximation of the amount of debt receipts attributable to Virginia, and
- In using an estimate the debt buyer did not have as a principal purpose the avoidance of Virginia income tax.

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However, in any instance in which the debt buyer derives more than 5 percent of its debt receipts from a person or entity, the debt buyer is required to identify the person's actual state of residence or the entity's actual commercial domicile and assign the debt receipts to that state.

For purposes of the Secondary Sourcing Method, "mailing address" means the location indicated in the books and records of the debt buyer as the primary mailing address relating to the debtor's account as of the time of the transaction, as kept in good faith, in the normal course of business, and not for tax avoidance purposes.

Related Member Transactions. In the case of debt receipts received from a related member, the debt buyer may not use the Secondary Sourcing Method. For this purpose, "related member" means "related member," as defined in *Va. Code* § 58.1-302.

Example 6:

Debt Buyer A collects money from individual debtors who are residents of Virginia and of other states. Debt Buyer A knows the state of primary residence for some of the debtors from which it collects and, where it does not know this state of primary residence, it knows the debtors' mailing address. Debt Buyer A does not derive more than 5 percent of its debt receipts from any one debtor.

For those debt receipts where Debt Buyer A knows the debtor's state of primary residence, it must assign debt receipts to that state. For those debt receipts where Debt Buyer A does not know the debtor's state of primary residence, but rather knows the debtor's mailing address, it may assign debt receipts to that state.

General Principles of Application; Contemporaneous Records

In order to satisfy the requirements in the "Market-Based Sourcing Methods" section, a debt buyer's assignment of debt receipts must be consistent with the following principles:

Principle 1: A debt buyer must apply the methods set forth in the "Market-Based Sourcing Methods" section based on objective criteria and must consider all sources of information reasonably available to the debt buyer at the time of its tax filing including, without limitation, the debt buyer's books and records kept in the normal course of business. A debt buyer must determine its method of assigning debt receipts in good faith, and apply it consistently with respect to similar transactions and year to year. A debt buyer must retain contemporaneous records that explain the determination and application of its method of assigning its debt receipts, including its underlying assumptions, and must provide those records to the Department upon request.

Principle 2: The "Market-Based Sourcing Methods" section provides various sourcing methods that apply sequentially in a hierarchy. For each debt receipt to which a hierarchical method applies, a debt buyer must make a reasonable effort to apply the

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primary method applicable to the sale before seeking to apply the next method in the hierarchy. For example, the applicable method first requires a debt buyer to determine the actual state or states of assignment, and if the debt buyer cannot do so, the method requires the debt buyer to reasonably approximate the state or states. In these cases, the debt buyer must attempt to determine the actual state or states of assignment (i.e., apply the primary method in the hierarchy) in good faith and with reasonable effort before it may reasonably approximate the state or states.

Principle 3: A debt buyer's method of assigning its debt receipts, including the use of a method of approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of debt receipts consistent with the standards set forth in the "Market-Based Sourcing Methods" section, rather than an attempt to lower the debt buyer's tax liability. A method of assignment that is reasonable for one debt buyer may not necessarily be reasonable for another debt buyer, depending upon the applicable facts.

Applying the Method of Reasonable Approximation

In general, the "Market-Based Sourcing Methods" section establishes uniform methods for determining whether and to what extent debt receipts are in Virginia. The section also sets forth a method of reasonable approximation, which applies if the actual state or states of assignment cannot be determined.

Approximation Based Upon Known Debt Receipts: In an instance where, applying the applicable methods set forth in the "Market-Based Sourcing Methods" section, a debt buyer can ascertain the state or states of assignment of a substantial portion of its debt receipts from substantially similar transactions with debtors, but not all of those debt receipts, and the debt buyer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of debt receipts generally tracks that of the assigned debt receipts, it must include debt receipts which it believes tracks the geographic distribution of the assigned debt receipts in its sales factor in the same proportion as its assigned debt receipts.

Related Member Debt Receipts and Information Imputed from Debtor to Taxpayer: Where a debt buyer receives debt receipts from a related member debtor, information that the debtor has that is relevant to the sourcing of debt receipts is imputed to the debt buyer. For this purpose, "related member" means "related member," as defined in Va. Code § 58.1-302.

Exclusion of Sales from the Sales Factor: In a case in which a debt buyer cannot ascertain the state or states to which a debt receipt is to be assigned pursuant to the applicable methods set forth in the "Market-Based Sourcing Methods" section (including through the use of a method of reasonable approximation, where relevant) using a reasonable amount of effort undertaken in good faith, the Department will require that such sale be excluded from both the numerator and denominator of the debt buyer's sales

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factor pursuant to its authority under *Va. Code* § 58.1-416(D) to adopt remedies and corrective procedures.

Changes in Methodology; Department's Review

General Methods Applicable to Original Returns

In any case in which a taxpayer files an original return for a taxable year in which it properly uses the single sales factor method of apportionment and properly assigns its debt receipts using market-based sourcing methods, including a method of reasonable approximation, in accordance with the methods stated in the "Market-Based Sourcing Methods" section, the application of such method of apportionment and sourcing will be deemed to be a correct determination by the debt buyer. In those cases, neither the Department nor the taxpayer may modify the debt buyer's methodology as applied for apportioning income and for sourcing debt receipts for the taxable year. However, the Department and the taxpayer may each subsequently correct factual errors or calculation errors with respect to the taxpayer's application of its filing methodology.

Authority to Adjust a Taxpayer's Return

The Department's ability to review and adjust a taxpayer's return (1) for the use of, or failure to use, the single sales factor method of apportionment includes, but is not limited to, its authority under *Va. Code* § 58.1-446, and (2) for the assignment of debt receipts to more accurately assign debt receipts consistently with the methods or standards of the "Market-Based Sourcing Methods" section, includes, but is not limited to, the following:

- In a case in which a taxpayer fails to properly assign debt receipts in accordance with the methods set forth in the "Market-Based Sourcing Methods" section, including the failure to properly apply a hierarchy of methods, the Department may adjust the assignment of debt sales in accordance with the "Market-Based Sourcing Methods" section.
- In a case in which a taxpayer uses a method of approximation to assign its debt receipts and the Department determines that the method of approximation employed by the taxpayer is not reasonable, the Department may substitute a method of approximation that the Department determines is appropriate or may exclude the debt receipts from the taxpayer's numerator and denominator, as appropriate.
- In a case in which the Department determines that a taxpayer's method of approximation is reasonable, but has not been applied in a consistent manner with respect to similar transactions or year to year, the Department may require that the taxpayer apply its method of approximation in a consistent manner.
- In a case in which a taxpayer excludes debt receipts from the denominator of its sales factor on the theory that the assignment of the debt receipts cannot be reasonably approximated, the Department may determine that the exclusion of those receipts is

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not appropriate, and may instead substitute a method of approximation that the Department determines is appropriate.

- In a case in which a taxpayer fails to retain contemporaneous records that explain the determination and application of its method of assigning its debt receipts, including its underlying assumptions, or fails to provide those records to the Department upon request, the Department may treat the debt buyer's assignment of debt receipts as unsubstantiated, and may adjust the assignment of the debt receipts in a manner consistent with the "Market-Based Sourcing Methods" section.
- In a case in which the Department concludes that a debtor's mailing address was selected by the taxpayer for tax avoidance purposes, the Department may adjust the assignment of debt receipts in a manner consistent with the "Market-Based Sourcing Methods" section.

The Department may adopt other remedies and corrective procedures as well, such as sourcing debt receipts based upon reliance on the location of income-producing activity and direct costs of performance or making adjustments based upon *Va. Code* § 58.1-446, if applicable.

Debt Buyer Authority to Change a Method of Assignment on a Prospective Basis

A debt buyer that seeks to change its method of assigning its debt receipts must disclose, in the original return filed for the year of the change, the fact that it has made the change. If a debt buyer fails to adequately disclose the change, the Department may disregard the debt buyer's change and substitute an assignment method that the Department determines is appropriate.

Authority to Change a Method of Assignment on a Prospective Basis

The Department may direct a debt buyer to change its method of assigning its debt receipts in tax returns that have not yet been filed, including changing the debt buyer's method of approximation, if upon reviewing the debt buyer's filing methodology applied for a prior tax year, the Department determines that the change is appropriate to reflect a more accurate assignment of the debt buyer's debt receipts, and determines that the change can be reasonably adopted by the debt buyer. The Department will provide the debt buyer with a written explanation as to the reason for making the change. In a case in which a debt buyer fails to comply with the Department's direction on subsequently filed returns, the Department may deem the debt buyer's method of assigning its debt sales on those returns to be unreasonable, and may substitute an assignment method that the Department determines is appropriate.

Treatment of Pass-through Entities

Pass-through entities ("PTE") are required to use corporate apportionment to determine the portion of their income that is from Virginia sources for purposes of allocating a share

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of that income to nonresident individuals. This will affect the amount that the nonresident individuals report on their Virginia nonresident income tax return or that the PTE reports on behalf of its nonresident owners, and the amount for which the PTE may be required to withhold from Virginia income. See the PTE Guidelines (P.D. 15-240) for more information.

A corporate owner of a PTE may be required to include its share of the PTE's property, payroll, and sales in the corporation's own apportionment factors. (See P.D. 95-19, 95-263, and 99-76.) If the PTE is a debt buyer, it must use Debt Buyer Apportionment. The corporate owners would include in their factors only their share of the PTE's factors for the applicable taxable year.

Inapplicability of Virginia's Administrative Extension of Public Law 86-272

A taxpayer is not subject to Virginia corporate income tax to the extent that federal or state law exempts the taxpayer from such tax. One federal law, Public Law ("P.L.") 86-272, prohibits a state from imposing a net income tax where the only contacts with the state are a narrowly defined set of activities constituting solicitation of orders for sales of tangible personal property. While P.L. 86-272 itself only relates to sales of tangible personal property, the Department has an administrative policy of generally extending this federal law to sales other than sales of tangible personal property. See P.D. 93-75. Because debt receipts are a type of sales other than sales of tangible personal property, a debt buyer would generally be exempt from Virginia corporate income tax to the extent that its only sales in Virginia were debt sales protected under this administrative policy.

However, *Va. Code* § 58.1-416(C) asserts nexus over debt buyers with debt receipts attributable to Virginia to the maximum extent permitted under the Constitutions of Virginia and the United States and federal law. This provision of Virginia law supersedes the Department's administrative extension of P.L. 86-272. As a result, a debt buyer is not eligible for an exemption from taxation on the basis that its debt receipts would be protected under the Department's administrative policy. Note that *Va. Code* § 58.1-416(C) only supersedes the Department's administrative policy. It does not remove any exemption from taxation afforded to taxpayers, including debt buyers, under P.L. 86-272 itself. To the extent that a debt buyer's only sales in Virginia are sales of tangible personal property protected under P.L. 86-272, the debt buyer will continue to be exempt from Virginia corporate income tax.

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Additional Information

These guidelines are available online on the Virginia Regulatory Town Hall website, located at <https://townhall.virginia.gov>, and on the Guidance Documents section of the Department's website, located at <http://tax.virginia.gov/guidance-documents>. For additional information, please contact the Department at (804) 367-8037.