State Income Tax Traps for Owners of Distressed Debt

BY PARRISH IVY, SENIOR MANAGER, DELOITTE TAX LLP
II. Sourcing Interest Income for a Financial Organization

Assuming for purposes of this discussion that a purchaser of distressed debt has nexus in a jurisdiction, the question then becomes how the related income should be sourced to the state. A threshold question in addressing income sourcing is whether the purchaser may be characterized as a financial organization. Although hedge funds and other non-banking institution investors created to hold distressed debt usually do not fall within the definition of a bank or financial organization under federal regulatory statutes, those entities nevertheless may be classified as financial institutions for state income tax purposes. An entity classified as a financial organization or as a financial institution under state income or franchise tax law may be required to follow an alternative tax regime or apportion its income under special rules, may be precluded from

cable to nonfinancial organization investors holding distressed debt. The absence of guidance for nonfinancial organizations can lead to confusion, inconsistency, and improper reporting of interest income to the states. This article will discuss some of the complexities surrounding the proper state income tax treatment of distressed debt.

We will address some of the questions surrounding the sourcing of interest income, examining how the sourcing rules may be affected by whether the holder of the debt is considered a financial organization.²

²Note that the complexities in this area are not limited to revenue apportionment and may include, for example, how the various states apply their apportionment property factors. That and other related questions are beyond the scope of this article.

using some filing methods, or may be subject to other special rules or exceptions.

**Defining Financial Organizations and Financial Institutions**

More than half the states have special sourcing rules for entities that fall within the applicable definition of a financial organization. Among those states, there is a large variation regarding the degree to which federal law is taken into account in defining a financial organization. Many states follow the federal definition as provided in the Bank Holding Company Act of 1956. For example, Illinois defines a financial organization as:

any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. . . . A “person” will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956.

However, in other states, an entity that does not qualify as a financial organization for federal purposes may still qualify as a financial organization for state purposes, based on the type of income received. Those states typically define a financial organization based on the presence of a specific type of income (for example, interest income) or a defined percentage of a specific type of receipt.

**In some states an entity that does not qualify as a financial organization for federal purposes may still qualify as a financial organization for state purposes.**

For example, in Indiana if a corporation derives more than 50 percent of its gross income from lending activities in substantial competition with financial institutions, it is deemed to be in the “business of a financial institution” and, therefore, subject to the state’s financial institution sourcing method. Virginia is another example of a state defining a financial institution by its level of interest income, except that Virginia uses a 70 percent of gross income threshold.

Thus, investors of distressed debt should carefully review state rules regarding the definition of a financial organization (or, for that matter, a financial institution) in order to ascertain whether they (or their holding companies) may qualify for revenue sourcing rules specific to financial organizations.

**Sourcing a Financial Organization’s Interest Income**

Typically, financial organizations source income to the states based on an approach that is specific to the circumstances of a financial transaction. Also, the rules regarding how to source interest income for financial organizations differ depending on whether the loan is secured by real property.

For example, California and Massachusetts include interest in the numerator of the sales factor if that interest is generated by loans secured by real property located in the state. However, for loans not secured by real property, California and Massachusetts source interest income and other receipts to their respective states if the borrower is located in that state. Usually, that means the location of the borrower that is associated with the loan that generated the interest income.

**III. Sourcing Interest Income for Nonfinancial Organizations**

**Sourcing Interest Income Within Generally Applicable Sourcing Rules**

Depending on the jurisdiction in which the purchaser of distressed debt has nexus, the purchaser may not be considered a financial organization for state purposes. Therefore, an investor holding distressed debt may have to use the generally applicable rules of a state to determine the sourcing of its interest income. States generally follow one of two for sourcing receipts: market-based sourcing or cost-of-performance sourcing.

**Market Sourcing**

Under market-based sourcing, receipts are sourced to the state where the “benefit is received.” Although that rule is simply stated, it can present some complexities in application. For example, Georgia has sourcing regulations stating that regarding services:

> 10See generally e.g., Okla. Admin. Code section 710:50-17-71.
all gross receipts from the performance of services are included in the numerator of the apportionment factor if the recipient of the service receives all the benefit of the service in Georgia. If the recipient of the service receives some of the benefit in Georgia, the gross receipts are included in the numerator of the apportionment factor in proportion to the extent the recipient receives the benefit in Georgia.11

Determining the geographic location of where the recipient of the service receives the benefit of that service is not always clear for loan proceeds. Certainly when the borrower is an individual who used the loan proceeds to purchase a house that is security for the loan (for example, a home mortgage), the geographic location of the benefit received is straightforward. However, when the borrower is an entity, such as a corporation, that used the loan proceeds to finance its worldwide business operations, the geographic location of where the benefits of the service are received is more difficult to determine. Furthermore, when the current holder of the debt is not the party that made the original loan, the question becomes whether income on that loan received by the current holder should be sourced based on where the benefit is received for the obligor on the debt instrument or the party that sold the debt instrument to the current holder. Those are just some of the questions that enter into the analysis of determining where income from distressed debt should be sourced for purposes of a state using a market-sourcing method.

Cost-of-Performance Sourcing

Cost-of-performance sourcing rules provide that receipts from sales other than sales of tangible personal property are sourced to the state where the costs of performing the service occur.12 States that apply cost-of-performance sourcing typically use either a greater proportion or a pro rata approach. For a greater proportion state, such as New Hampshire, receipts are attributed to that state if a greater proportion of the income-producing activity is performed there in comparison to any other state, based on costs of performance.13 That results in an all-or-nothing approach to sourcing. For example, 100 percent of the receipts would be sourced to New Hampshire if 40 percent of the overall activity is performed in that state and the activity that occurs in any other state is less than 40 percent. Conversely, the all-or-nothing approach would source zero receipts to a state if, for example, 30 percent of the activity occurred in that state and 45 percent of the activity occurred in another state.

In contrast, pro rata states, such as South Carolina, source receipts based on the percentage of costs in the state.14 For example, if 20 percent of the costs associated with income are attributable to a pro rata state, 20 percent of the income would be sourced to that state even though 30 percent of the related costs may be incurred in another state.

Whether a greater proportion or pro rata approach applies, an investor needs a clear understanding of the potential costs associated with receiving interest income from distressed debt. Those costs may include the cost of acquiring the debt (including negotiation, legal fees, and other costs), the cost of ongoing maintenance and management of the debt, the cost of employees or independent contractors charged with servicing the debt, and general administrative and overhead charges of the investor or holding company. Investors should also be aware that the states do not uniformly determine which costs are included in the cost-of-performance analysis. For example, California’s cost-of-performance regulation includes consideration of transactions and activities performed on behalf of a taxpayer by an independent contractor in determining the state to which receipts from sales, other than sales of tangible personal property, should be assigned.15 In contrast, Missouri does not include the cost of independent contractors in its sales factor determination.16

The above-mentioned cost of independent contractors is of particular relevance because those that invest in distressed debt often use third parties to service the debt. Those third parties may perform activities such as accounting, payment collection, and other tasks related to the maintenance of the debt instruments. When making the determination of where the cost of performance occurred, the question often arises of whether third-party costs are included in the cost-of-performance analysis. As noted above, states differ on whether to include third-party costs, and that goes beyond the disparate approaches of California and Missouri. For example, Florida and Idaho often look to third-party activities when measuring the cost of performance for the sourcing of receipts.17 A number of states,

12Uniform Division of Income for Tax Purposes Act section 17, adopted by various states. See generally e.g., Ala. Code section 40-27-1, Art. IV, 2.
14See generally e.g., S.C. Code Ann. section 12-6-2295(A)(5).
15Cal. Code Regs. tit. 18 section 25136(b).
17Fla. Admin. Code Ann. r. 12C-1.0155(2)(e)/2.a.b.; Id. Reg. Rule 35.01.01.550.06.
including Hawaii and Kansas, exclude third-party costs from the cost-of-performance analysis.\textsuperscript{18}

\textbf{IV. Conclusion}

As purchasers of distressed debt continue to find opportunities in the marketplace, they will encounter a variety of challenges in their state tax compliance. Thus, in evaluating the economics of purchasing portfolios of distressed debt, consideration should be given to the potential state tax ramifications. But as the above discussion indicates, that analysis is not always straightforward because of inconsistent tax treatment among the states and in some instances a lack of clarity regarding how some state income tax regimes approach the taxation of income from distressed debt attributed to nonfinancial investors.

\textsuperscript{18}Hawaii Code R. section 18-235-37-01(b); Kan. Admin. Regs. section 92-12-100(a)