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VIA FEDEX AND EMAIL

Internal Revenue Service
Office of Prefiling and Technical Services
Large and Mid-Size Business Division LM: PFT
Mint Building 3rd Floor M3-420
111 Constitution Avenue NW
Washington DC, 20224

Re: Proper Tax Accounting Method to be Used by the Charged-Off Debt Purchasing Industry

To Whom it May Concern:

This correspondence is a submission under the Industry Issue Resolution ("IIR") Program pursuant to Revenue Procedure 2003-36. The undersigned is outside tax counsel to Portfolio Recovery Associates, Inc. ("PRA"), a publicly-traded company, and Atlantic Credit & Finance, Inc. ("Atlantic Credit"), each engaged in the business of purchasing charged-off debt. PRA and Atlantic Credit are joined in this submission by Encore Capital Group, Inc. ("Encore"), a publicly-traded company also engaged in the business of purchasing charged-off debt, and by Asset Acceptance Capital Corp. ("Asset Acceptance") which was recently acquired by Encore (collectively with PRA and Atlantic Credit, the "Companies"). The Companies reflect a representative sample of the participants in the charged-off debt purchasing industry and additional industry participants are currently being solicited to join in this IIR.

It is important to note at the outset that the issue discussed herein is at the heart of a case currently docketed with the United States Tax Court. *See Portfolio Recovery Associates, Inc. v. Commissioner*, Docket No. 25240-11. At issue in *Portfolio Recovery Associates,* is whether

PRA's tax method of accounting for reporting collections on purchased charged-off debt was proper in light of existing published guidance. Specifically, for the years at issue in the litigation, PRA used the cost recovery method of tax accounting with respect to amounts collected on purchased charged-off debt. For several years prior to the filing of the Tax Court petition by PRA, both PRA and the IRS discussed the merits and continued usefulness of the cost recovery method of tax reporting for the charged-off debt industry. At the time the IRS issued a notice of proposed assessment to PRA, the IRS asserted that PRA should have used the GAAP method to report for tax purposes. After the filing of the action in Tax Court, the IRS presented its alternative – and preferred – tax reporting method for the charged-off debt industry. The IRS has referred to this new tax reporting method, discussed in further detail herein, as the "cost-over-estimated collections" or "CEC" method.

The Companies, as representatives of the charged-off debt industry, respectfully request that the IRS accept this IIR submission and provide much-needed guidance with respect to an issue that has caused unneeded friction between the IRS and multiple taxpayers over the last several years.

Industry Background

The role played by the debt purchasing industry is vitally important to the U.S. economy. In a recent notice of proposed rulemaking from the Bureau of Consumer Financial Protection, it was stated:

> "[C]onsumer debt collection is critical to the functioning of the consumer credit market and has a significant impact on consumers. By collecting delinquent debt, collectors reduce creditors' losses from non-repayment and thereby help to keep consumer credit available and potentially more affordable to consumers. Available and affordable credit is vital to millions of consumers because it makes it possible for them to purchase goods and services that they could not afford if they had to pay the entire cost at the time of purchase. Further, debt collection is a large, multi-billion dollar industry that directly affects a large number of consumers. In 2011, approximately 30 million individuals, or 14 percent of American adults had debt that was subject to the collections process (averaging approximately $1,400). Although these figures include not only consumer debt covered by the Act and the Proposed Rule, but also other types of debt such as medical debt, they indicate the importance and central role of consumer debt collection as a market for consumer financial products or services."

See 12 CFR Part 1090 (Docket No. CFPB-2012-0005).

The charged-off debt industry provides a solution for financial institutions to rid themselves of arguably the most toxic of all financial assets. The assets bought and sold by the Companies include not only financial accounts that have been charged off, but those that have been worked previously by one or more collection agencies post charge off, or even accounts that are in bankruptcy. The amounts at issue are significant – by one account, charged off debt purchases exceeded $55 billion in 2012. In short, the industry deals with one of the most speculative of all financial assets.

Additional insight as to the very difficult and speculative nature of this asset class is evidenced by the impressive list of companies that have failed or withdrawn from the industry in recent years. This list includes companies that were once large, stable and, in many cases, dominant participants with significant market share prior to their bankruptcy, failure or withdrawal from this industry. Below is a partial list of such companies.[1]

Arrow – Purchased by Sallie Mae (FAILED)
Credit Store – (FAILED)
Conti Financial – (FAILED)
First Select – Debt buying arm of Providian (FAILED)
Great Lakes – Purchased by GE (FAILED)
Homecomings – Affiliate of GMAC (FAILED)
Oxford Capital – (FAILED)
Triage – (FAILED)
Capital One – operated a debt buying affiliate (WITHDREW)
NCO – Publicly traded as NCOG and NCPM (WITHDREW)
West Teleservices – (WITHDREW)
Camco – (SEIZED BY REGULATORS)
CFS – Had 4,000 collectors at peak (BANKRUPT)
Credit Trust – Publicly traded as CRDT (BANKRUPT)
Exterra – (BANKRUPT)
Hudson and Keyse – (BANKRUPT)

<u>Initial Participant Information</u>

As mentioned above, the matter addressed in this IIR request impacts virtually all of the participants in the charged-off debt purchasing industry. While efforts are ongoing to broaden the list of participants for this IIR, the initial participants are as follows:

[1] The list does not include a listing of hedge funds that were purportedly in the market in a significant way during the 2006-2008 timeframe.

Portfolio Recovery Associates, Inc.

PRA is a purchaser, manager and collector of defaulted consumer receivables, most of which are credit card accounts. These accounts are purchased and serviced by PRA. PRA has not resold any accounts since its IPO in 2002, nor have they ever sold any meaningful amounts of accounts prior to that. Nor has it ever outsourced any meaningful volume of accounts to contingent fee, third party, collection agencies. PRA collects on the accounts that it owns with its own collection staff located in call centers throughout the United States. If PRA finds a customer who they believe has the ability to pay, but who refuses to pay, then PRA uses either a third party collection attorney, or its own attorneys located throughout the United States, to seek legal judgments, which could result in property liens, wage garnishments, bank levies and other post-judgment remedies.

Since 1996, PRA has purchased over 1,290 portfolios at a total cost of approximately $3.0 billion comprising nearly $76 billion of face value of defaulted consumer receivables.

Atlantic Credit & Finance, Inc.

Atlantic Credit is a purchaser, manager and collector of defaulted consumer receivables, most of which are credit card accounts. These accounts are purchased and serviced by Atlantic Credit. Atlantic Credit collects on the accounts that it owns with its own collection staff located in Virginia as well as contingent fee, third party, collection agencies. Under certain circumstances Atlantic Credit also sells accounts. If Atlantic Credit finds a customer who they believe has the ability to pay, but who refuses to pay, then Atlantic Credit uses third party collection attorneys located throughout the United States to seek legal judgments, which could result in property liens, wage garnishments, bank levies and other post-judgment remedies.

Since 2000, Atlantic Credit has purchased over 800 portfolios at a total cost of approximately $800 million comprising nearly $10 billion of face value of defaulted consumer receivables.

Encore Capital Group, Inc.

Encore is a purchaser, manager and collector of defaulted or charged-off accounts receivable portfolios purchased from credit originators at a significant discount to face value of the debt. Encore collects on the debt from the original debtor. Encore has been purchasing and collecting defaulted or charged-off receivable portfolios since its formation and has never sold any meaningful amounts of these accounts. Encore utilizes a quantitative and qualitative analysis of the portfolios to appropriately price the debt. Encore collects the accounts it owns through its call centers located in the United States and other countries. If warranted, these accounts are moved to outside third party collection agencies or are handled through the company's internal legal network.

Since the beginning of 2001 through the end of 2012, Encore has purchased over 1,300 portfolios at a total cost of approximately $2.6 billion, with a face value of approximately $79.6 billion.

Asset Acceptance Capital Corp.

Asset Acceptance purchases and collects defaulted or charged-off accounts receivable portfolios from credit originators at a significant discount to the face value of the debt and collects on the debt from the original debtor. Asset Acceptance is now a wholly owned and operating subsidiary of Encore Capital Group.

Asset Acceptance has been purchasing and collecting defaulted or charged-off accounts receivable portfolios from consumer credit originators since the formation of its predecessor company in 1962. Asset Acceptance utilizes a quantitative and qualitative analysis of the portfolios to appropriately price its debt. This analysis includes use of Asset Acceptance's proprietary pricing and collection probability model and draws upon its extensive experience in the industry. Collection efforts begin in Asset Acceptance's collection department and, if warranted, move to the legal collection area. In some instances, collections are outsourced to a network of third party collection agencies.

Since 1990, Asset Acceptance has purchased 1,886 portfolios at a total cost of approximately $1.5 billion, comprising nearly $56.4 billion of face value of defaulted consumer receivables.

The Issue – The Proper Tax Method for Reporting Collections on Purchased Charged-Off Debt

The Companies specifically, and the industry participants in general, purchase portfolios of troubled consumer receivables at deep discounts from the face amount of the portfolio. Collection is then pursued on the receivables in the portfolios. For financial accounting purposes, revenue is reported under the level yield accretion methodology prescribed in Accounting Standard Codification Index 310-30 ("Loans and Debt Securities Acquired with Deteriorated Credit Quality"). For tax purposes, on the other hand, the Companies generally recover their basis in the purchased portfolios at a rate faster than that reported for financial accounting purposes. PRA, Atlantic Credit and Asset Acceptance, for example, use the cost recovery method. Encore Capital uses a variation of the CEC method. The IRS has examined multiple industry participants and has challenged the tax method of accounting. Without further guidance similar to that requested in this IIR, the common factual situations presented in these examinations will require further and extensive Exam, Appeals and IRS Counsel efforts. Moreover, the positions advanced to date by the IRS do not appear to fully appreciate the industry practices regarding tax reporting. Accordingly, the issue presented for determination in this IIR request is the proper method of accounting for tax with respect to collections made on purchased charged off-debt.

The remainder of this submission provides an overview of the cost recovery and CEC methods as they relate to purchased charged-off debt.

Cost Recovery Tax Reporting Method

The inherent risk of investing in speculative assets by the charged-off debt industry gave rise to the use of the long-accepted cost recovery method of tax accounting. Under this method, a taxpayer is not subject to tax on income until its cost basis has been returned. This method, as applied to the Companies, is supported by the Tax Court's decisions in *Liftin v. Commissioner*, 36 T.C. 909 (1961), *aff'd*, 317 F.2d 234 (4th Cir. 1963) and *Underhill v. Commissioner*, 45 T.C. 489 (1966). Over the last several years, the IRS has questioned the continued validity of the authority represented by *Liftin* and *Underhill*.

In *Liftin,* the taxpayers resided in Arlington, Virginia. Over the course of several years, Mr. Liftin purchased 84 interest-bearing second deed of trust notes. The notes were purchased at discounts ranging up to 45%. Mr. Liftin performed substantial due diligence prior to the purchase of the notes. Such diligence entailed considering the maturity period on the note, the holder's equity in the property, the credit standing of the holder, and the location and condition of the property. During the period under audit, Mr. Liftin disposed of 19 notes – half were paid in full and half were satisfied by foreclosure, acceptance of the deed or acceptance of a payoff less than face value. The IRS challenged Mr. Liftin's use of the cost recovery tax accounting method.

The Tax Court concluded that the rule of law applicable to such cases was dependent on certain factors. Specifically, the court noted that where a taxpayer acquires contractual obligations calling for periodic payments at a discount, where the taxpayer's cost of such obligations is ascertainable, and where there is no doubt that the contracts will be carried out, it is proper to allocate payments to both principal and receipt of discount income. However, if it is shown that the amount of the realized discount gain is uncertain or that there is doubt that the contract will be carried out, the payments received thereon should be considered as a return of costs until the full amount thereof has been recovered.

Applying the facts to the law, the Tax Court determined that Mr. Liftin had met the relevant burden of proof and sustained the use of the cost recovery method of accounting. Two key factors influenced the decision of the Tax Court. First, the size of the purchase discount (up to 45%) demonstrated that the notes were highly speculative. In addition, the Tax Court noted that the obligations purchased were subject to second deeds of trust where the makers had small equities in the properties covered by the deeds of trust. Based on these factors, the Tax Court determined that the amount of unrealizable discount income to be derived was uncertain such that the taxpayer was permitted to use the cost recovery method of accounting.

Not long after the *Liftin* decision, the Tax Court decided *Underhill.* The facts of *Underhill* were similar to that in *Liftin.* The taxpayers resided in Washington, D.C. In the years at issue, Mr. Underhill purchased negotiable promissory notes at a substantial discount to face value. The majority of the notes were secured by second deeds of trust, however, certain of the notes were secured by first deeds of trust. The discount on the notes ranged from 27% to 35 ½%. Of the 99 notes Mr. Underhill acquired, he received payment in full on 68 – which is nearly 70% success rate in terms of payment in full. Only one note caused Mr. Underhill to recover less than his cost. Prior to the purchase of notes, Mr. Underhill would research the occupation and place of employment of the borrower, the amount of the down payment, the location of the property, and the amount and terms of the prior liens.

In its opinion, the Tax Court relied heavily on the *Liftin* decision. The Tax Court summarized the factors analyzed in *Liftin* and concluded the appropriate test to be at the time of acquisition, whether the person acquiring the obligation can be reasonably certain to recover their cost *and a substantial portion of the discount.*

Liftin and *Underhill* remain good law. The IRS has relied on *Underhill* in a Field Service Advice and the Tax Court, in *Guaderrama v. Commissioner,* T.C. Memo 2000-104 (2000), cited favorably the test in *Underhill* when it considered a claim that certain obligations at issue in the case were speculative.

The primary argument raised by the IRS with respect to the continuing validity of the rule of law articulated in *Liftin* and *Underhill* relates to advances in technology. Specifically, the IRS maintains that the charged-off debt industry has advanced to the point where it can estimate its return on purchased receivables with a reasonable degree of certainty. The counterargument to this contention is that despite these purported advances in technology the realization rate on purchased receivables by the industry pales in comparison to that achieved by Mr. Liftin and Mr. Underhill almost 50 years ago.

CEC Tax Reporting Method

The specifics of the CEC method have recently been articulated by the IRS pursuant to its examination of certain members of the charged-off debt industry. Under the CEC method, the taxpayer is required to estimate its expected collections on a purchased portfolio of charged-off debt and then allocate, on a pro rata basis, current collections between capital recovery and the receipt of taxable income. The authority advanced by the IRS for the CEC method is that in *Darby Investment Corporation v. Commissioner*, 315 F.2d 551 (6th Cir. 1963). In that case, the appeals court stated that if a taxpayer can be "reasonably certain of recovering his cost, he must report as income each year the proportionate amount of monthly payment which represents income from the discount upon the investment." *Id.* at 553.

One concern with the CEC method as currently described by the IRS is that it does not seem to appreciate the unique nature of the asset class purchased by the charged-off debt industry. Specifically, within a period of time after purchase and after working with the account information, an industry participant will often know with a reasonable degree of certainty which accounts will not produce a single dollar of collections. As understood by the industry, the CEC method will – on a pro rata basis – assign basis to these nonperforming accounts. If, as is the case with PRA, the industry participant does not resell purchased debt, this assigned basis appears to provide no future benefit. Moreover, the CEC method does not seem to provide for variation based on differing types of consumer debt or an appropriate correction mechanism to account for inaccurate initial collection estimates. The industry is hopeful that a full discussion of the CEC method during the IIR process will reveal acceptable variations that work for all parties.

Conclusion

The Companies respectfully request that this important issue be considered for the Industry Issue Resolution Program. We look forward to working together to find an acceptable tax accounting method for reporting collections on purchased charged off debt. Please reach out to the undersigned if you have any questions or if you need additional information.

Sincerely,

Michael J. Bowen

cc: Kevin Stevenson, Portfolio Recovery Associates, Inc. (*via email*)
Mark Warner, Encore Capital Group, Inc. (*via email*)
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