

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

Notice

CC-2010-018

September 27, 2010

	Change in Litigating Position on the Treatment of Interchange Fee	Effective until further
Subject:	Income by Issuers of Credit Cards	Cancel Date: notice

UIL: 1273.00-00

Purpose

This Notice provides guidance concerning a change in litigating position to be followed for interchange fee income earned by issuers of credit cards as a result of the Tax Court's decision in Capital One Financial Corporation and Subsidiaries v. Commissioner, 133 T.C. No. 8 (September 21, 2009).

Background

In Capital One, the taxpayer's subsidiaries, issuers of Visa and MasterCard credit cards, earned an interchange fee in connection with each cardholder's credit card purchase transaction that was submitted for approval and settled through the interchange system of the Visa or MasterCard credit card association. The amount of the interchange fee was usually calculated as a percentage of the total purchase price plus, in some instances, a small fixed amount. The Visa and MasterCard systems employ net settlement procedures, whereby Visa and MasterCard withdraw from the accounts of the taxpayer's subsidiaries an amount equal to the stated purchase price of the goods or services net of the interchange fee. This net amount is paid to the merchant bank, which in turn pays the merchant this amount net of its own fee.

Prior to 1998, the taxpayer's subsidiaries recognized interchange fees as current fee income at the time that the credit card transactions were settled through the credit card association. However, for 1998 and 1999, the subsidiaries began treating interchange fees as creating or increasing original issue discount (OID) on a pool of loans to which the fees related and recognizing the interchange fee income over time under §1272(a)(6)(C)(iii). The Internal Revenue Service (Service) challenged the treatment of interchange fees as creating or increasing OID. The Service argued that interchange fees are paid by the merchant, and not by the credit card holder (borrower), that interchange fees fund a system providing many benefits and services to the merchant, and that interchange does not resemble interest or OID in either form or substance. The Service also argued that the issue price of a credit card loan is the purchase

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price of the goods or services financed by the credit card loan and is not reduced by the interchange fee.

The Tax Court held that an interchange fee is not a fee for any service other than lending money to a cardholder, income from which generally is treated as interest. The court also held that the issue price of a credit card loan is the price paid for the loan, which is the amount authorized to be withdrawn from the subsidiary's account and deposited with the merchant bank. Therefore, the court concluded that the interchange fee, which is the difference between the purchase price of the goods or services financed by the credit card loan (that is, the amount owed by the cardholder) and the issue price of the loan, is properly treated as OID.

Change in Litigating Position

The Service will no longer challenge or litigate the issue of whether interchange fee income earned in connection with a credit card transaction by an issuer of credit cards creates or increases OID on a pool of credit card loans. This Notice, however, does not address any of the other issues litigated and decided by the Tax Court in Capital One, including the proper calculation of the accruals of OID on a pool of credit card loans for purposes of §1272(a)(6).

Questions about this Notice should be directed to Jonathan Silver, CC:FIP:2 at (202) 622-3930.

/s/

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