

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
Subject: Income by Issuers of Credit Cards
Effective until further
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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