

Cite as Det. No. 15-0030, 39 WTD 103 (2020)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 15-0030
)	
...)	Registration No. . . .
)	

ETA 3204.2017; WAC 458-20-111; RCW 82.04.080: INTERCHANGE FEES – CREDIT CARD PROCESSORS – GROSS INCOME OF THE BUSINESS – ADVANCE OR REIMBURSEMENT. The interchange fee is an amount that a credit card processor is contractually entitled to receive and is contractually obligated to pay to the bank that issued the purchaser’s credit card. Interchange fees are therefore rightfully included in a credit card processor’s gross receipts and are subject to B&O taxation.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Weaver, A.L.J. – A company that processes credit and debit transactions for merchants and banks protests the assessment of service and other activities business and occupation (B&O) tax on interchange fees paid to card-issuing banks for each credit card transaction. We hold that the company is responsible for paying the interchange fees, that the interchange fees are includable in its merchant discount revenues, and that the interchange fees are therefore part of its taxable gross income. Taxpayer’s petition is denied.¹

ISSUES

1. Whether interchange fees are part of the “gross income of the business” of a credit card processing company when they are nondeductible costs of doing business as a bank card processor and the processor assumes financial responsibility for the interchange fees as a condition for providing merchant processing services through the Visa or MasterCard payment systems.
2. Whether the interchange fees the card-issuing bank retains from the settlement proceeds arising from a bankcard transaction qualify as advances or reimbursements under WAC 458-20-111, which may be excluded from the gross income reported by a credit card processor.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

. . . (Taxpayer) is a corporation with principal offices in . . . , California, that is engaged in marketing credit card processing services. Taxpayer acts in the capacity of an Independent Sales Organization (ISO) and, on June 1, 2008, Taxpayer and . . . (Merchant Bank) entered into a “Merchant ISO Agreement” in which Taxpayer agreed to act as the Merchant Bank’s agent to market the Merchant Bank’s credit card processing services and provide customer support with respect to those services. Taxpayer serves over . . . merchants and processes over \$. . . in credit card sales volume throughout the United States.

Taxpayer solicits relationships with merchants and enters into a three-party “Merchant Processing Agreement” with the Merchant Bank and the enrolling merchants. Merchant Bank receives payments from merchants for providing credit-card processing services. Taxpayer is likewise entitled to payment for servicing the merchant credit-card processing accounts. In the event that a merchant transaction is “charged back” and the merchant subsequently defaults on payments due to Merchant Bank, Taxpayer acts as a guarantor. It is necessary for Taxpayer to use Merchant Bank, in order to access the Credit Card Associations’ services, because the Taxpayer is neither a bank nor a credit union and, therefore, does not possess the requisite capacity to provide credit card processing services directly to merchants by itself or on its own behalf.

The three-party Merchant Processing Agreement lists the contractual terms and conditions for all three parties, Taxpayer, Merchant Bank, and the enrolling merchant, and contains the following provision:

5.05 Fees and Charges. Merchant shall pay to [Merchant Bank] the fees and charges set forth in Schedule A (Rates and Fees) including any additional charges applied to Transactions that fail to meet Card Association requirements for the lowest interchange levels. Merchant’s Account will be debited through ACH or withheld from daily payments to Merchant for such amounts and for any other fees, charges or adjustments incurred by Merchant and associated with processing services. [Merchant Bank] and [Taxpayer] shall have the right to charge fees, including adding fees for additional services utilized by Merchant, upon thirty (30) days written notice.

Merchant Processing Agreement, ¶ 5.05. While we were not provided with Schedule A, it is our understanding that the rates and fees in Schedule A include the “merchant discount” which, itself, includes the “interchange fee.”

The “interchange fee” is the part of the merchant discount that is paid to the Issuing Bank (i.e., the bank that issued the customer’s card used in the transaction). Interchange fees are an expense the Taxpayer factors into its determination of the amount merchants are contractually obligated to pay for Taxpayer’s credit card processing services. The crux of Taxpayer’s case is its claim that it should not be taxed on interchange fees, because Taxpayer never actually receives the interchange fees. Rather, the Issuing Bank and Credit Card Associations retain the fees they are due before transmitting the settlement proceeds, less interchange (and other) fees, to the Merchant Bank for eventual remittance to the merchant. Taxpayer does not dispute that it owes business and occupation (B&O) tax on the funds that flow through to its bank account, because it “actually

receives” them. Taxpayer does dispute that the interchange fees paid to the Issuing Banks and the Credit Card Associations are part of its taxable gross income.

In general, bank interchange fees, debit card network fees, association assessments and other association fees are collected directly from merchant proceeds by the banks who issue consumer credit and debit cards (Issuing Banks) and by third party credit and debit card associations such as Visa and MasterCard (Credit Card Associations). Generally, these fees are set by the Credit Card Associations for all merchants processing transactions on the Credit Card Association networks and do not vary by credit card processing service provider.

Visa has issued a document entitled “Visa U.S.A. Interchange Reimbursement Fees.”² This document can be found on the internet. The document states in its Introduction:

Visa uses interchange fees as transfer fees between financial institutions to balance and grow the payment system for the benefit of all participants. Merchants do not pay interchange reimbursement fees; merchants pay “merchant discount” to their financial institution. This is an important distinction; because merchants buy a variety of processing services from financial institutions; all these services may be included in their merchant discount rate, which is typically a percentage rate per transaction.

In short, Visa itself explains that merchants pay the merchant discount, but do not pay interchange fees to Issuing Banks or to Credit Card Associations (like Visa). Therefore, according to Visa, the merchant is not liable to Visa or Issuing Banks for payment of the interchange fees. Rather, the interchange fee is the obligation of the Merchant Bank and/or the third party that provides merchant processing services under the sponsorship of the Merchant Bank.

With respect to the issue of who bears the risk of loss (as between the Merchant Bank and the credit card processor) from merchant default, paragraph 4.12 of the Merchant ISO Agreement,³ provides:

[Taxpayer] will pay all costs it incurs in connection with the performance of its obligations under this Agreement, including, without limitation, all Association registration and renewal fees, interchange fees, assessments, authorization fees, settlement fees, ACH fees, transaction fees, chargeback fees, report fees, statement fees, statement message fees, merchant enrollment fees, telephone authorization fees, monitoring fees, imaging costs, and postage, courier and other fees and Association fines and penalties. In addition [Taxpayer] will pay any and all fees, charges, and costs imposed by any Association, Third Party Service provider or other third party providing any service or product in connection with this Agreement or [Merchant Bank’s] or [Taxpayer’s] performance of the Services or its obligations under this Agreement.

² See <<http://usa.visa.com/download/merchants/Visa-USA-Interchange-Reimbursement-Fees-2014-Oct-18.pdf>> (last visited, November 14, 2014).

³ The Merchant ISO Agreement is the two-party contract between Taxpayer and the Merchant Bank. It is to be distinguished from the Merchant Processing Agreement, which is a three-party agreement among Taxpayer, the Merchant Bank, and the merchant that contracts to receive credit card processing services.

Merchant ISO Agreement, ¶ 4.12, at p. 5 (emphasis added). Similarly, paragraph 7.1 provides:

[Taxpayer] will indemnify and hold [Merchant Bank] harmless from and against any and all claims, damages or losses suffered or incurred by [Merchant Bank] (including attorney's fees and costs) in connection with any (i) Merchant, including, without limitation, losses associated with purchases that are charged back to, and not paid by, a Merchant, fines, fees, assessments, penalties, expenses or any other charges assessed by any Association relating to any Merchant, and losses arising out of any breach of a Merchant Agreement by a Merchant, or (ii) fines, fees, assessments, penalties, or expenses and any other charge assessed by any Association relating to [Taxpayer], except where any such losses are due to [Merchant Bank's] gross negligence or willful misconduct.

Merchant ISO Agreement, ¶ 7.1, at p. 12. In addition, paragraph 7.7(d) discusses merchant chargebacks. It provides in part:

[Merchant Bank] may withdraw from the ISO Reserve Account from time to time amounts equal to any losses suffered or incurred by [Merchant Bank], or reasonably expected by [Merchant Bank] to be suffered or incurred, in connection with (i) Merchant chargebacks, other Merchant acts, omissions, activity or fines, charges or other assessments made by an Association based upon any Merchant Activity.

Merchant ISO Agreement, ¶ 7.7(d), at p. 13. Finally, with respect to payments between the Taxpayer and the Merchant Bank, paragraphs 8.1 and 8.2 provide:

8.1 For the services rendered by [Taxpayer] pursuant to the terms of this Agreement and pursuant to the terms of any Merchant Agreement, [Merchant Bank] will calculate and pay [Taxpayer] a monthly payment amount ("MPA") as set forth in Schedule L attached . . .

8.2 The minimum payment due [Merchant Bank] from [Taxpayer] under the terms of this Agreement and surviving termination of this Agreement guaranteed for the Initial term and any Renewal term is set forth in Schedule L. [Merchant Bank] may deduct from any MPA otherwise payable to [Taxpayer] under this Agreement any amount owed by [Taxpayer] to [Merchant Bank] under this Agreement or otherwise

Merchant ISO Agreement, ¶¶ 8.1, 8.2, at p. 15 (emphasis added). While we were not provided with Schedule L, it is our understanding that the interchange fees that Taxpayer owes to the Issuing Banks are deducted from the MPA prior to Taxpayer receiving those funds.

Taxpayer's books and records were examined by the Audit Division of the Department of Revenue ("Department") for the period January 1, 2009 through December 31, 2012. The Department's Audit Division cites the above-quoted contract provisions of the Merchant ISO Agreement as support for its conclusion that Taxpayer bears the risk of merchant defaults. *See Auditor's Detail of Differences and Instructions to Taxpayer*, p. 6. In the course of its audit, the Audit Division also discovered that Taxpayer reported interchange fees as income on its federal income tax returns. On August 12, 2013, the Audit Division issued Taxpayer an assessment totaling \$. . . , which consisted of \$. . . in service and other activities B&O tax, \$. . . in interest, and a 5% assessment penalty of \$

Taxpayer filed a timely appeal.

ANALYSIS

Taxpayer contends that the interchange fees are not value proceeding or accruing to it, which means they are not part of its gross income and are therefore not subject to B&O tax. Taxpayer argues that it never receives the interchange fees because the Issuing Bank retains the interchange fees and Credit Card Association assessments from the proceeds transferred to the Merchant Bank in settlement of a bankcard transaction.

B&O tax is levied for the act or privilege of engaging in business activities. RCW 82.04.220. The term “business” includes “all activities engaged in with the object of gain benefit, or advantage to Taxpayer or to another person or class, directly or indirectly.” RCW 82.04.140. Activities not otherwise classified fall under the service and other business activities B&O tax classification and are taxed based on “gross income of the business.” RCW 82.04.290. “Gross income of the business” is broadly defined as:

[T]he value proceeding *or accruing* by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.080(1) (*italics added*). “Value proceeding or accruing” means the “consideration, whether money, credits, rights, or other property expressed in terms of money, actually received *or accrued*.” RCW 82.04.090 (*italics added*).

With respect to the interchange fees,⁴ Visa has issued a document entitled “Visa U.S.A. Interchange Reimbursement Fees” that applies to persons, banks, and companies (such as Taxpayer and its Merchant Bank). That document declares that merchants pay the merchant discount, but do not pay interchange fees to card-issuing banks, like Issuing Bank, or to Credit Card Associations. According to this document, merchants are therefore not liable to Credit Card Associations or Issuing Banks for payment of the interchange fees. The Merchant Bank refers the merchant account to Taxpayer and in return receives a referral fee from Taxpayer. The Merchant Bank does not own the merchant account. Rather, Taxpayer is the party that owns the merchant account, processes the card transactions for which it receives the merchant discount, and is liable for the transaction in case of merchant default.

Taxpayer assumes liability for payment of the interchange fees as a condition of its sponsorship agreement with the Bank. The interchange fee is a cost of doing business that Taxpayer takes into account in negotiating the bankcard transaction fees it charges merchants. Indeed, Taxpayer’s

⁴ [On June 26, 2017, after this determination was decided, the Department issued ETA 3204.2017 entitled “Credit Card Processors” which states the Department’s position on the taxability of gross income from processing credit card transactions.]

federal income tax returns show that Taxpayer reports its gross receipts inclusive of interchange fees, and deducts those fees as ordinary business expenses. The fact that Taxpayer deals with the Credit Card Associations and Issuing Banks through its Merchant Bank does not relieve Taxpayer of its liability for interchange fees. Taxpayer contractually assumed liability for those fees in its agreement with the Merchant Bank. Moreover, the fact that Taxpayer does not possess the interchange fees does not mean that Taxpayer is not legally entitled to the interchange fees. *See* WAC 458-20-197(2)(a) (value accrues to a taxpayer at the time it becomes legally entitled to receive the consideration.).

Taxpayer cites *Weyerhaeuser Co. v. Dep't of Revenue*, 106 Wn.2d 557, 723 P.2d 1141 (1986), in support for its position that it cannot be taxed on the interchange fees, because it did not actually “receive” them. We disagree with Taxpayer’s reading of *Weyerhaeuser*. Taxpayer contends the Audit Division is imputing the interchange fee income and that there is actually no gross income of the business upon which to impose the tax. In *Weyerhaeuser*, the Court found that the Department’s assessment was contrary to the terms of the installment contracts at issue in that case, because the installment contracts charged no interest. *Weyerhaeuser*, 106 Wn.2d at 566, 723 P.2d at 1146. *Weyerhaeuser* reported the entire contract price as gross proceeds taxable under the wholesaling B&O tax rate, which was lower than the service rate applied to interest income. *Id.* at 564. The Department did not impute receipts; rather it reclassified *Weyerhaeuser*’s receipts from wholesaling to service, thus “imputing interest.” *Id.* at 565. The *Weyerhaeuser* decision concluded that interest income, which was taxable at a higher rate, could not be imputed from amounts received for the interstate installment sale of *Weyerhaeuser*’s logs.

The Court did not find that *Weyerhaeuser* did not receive the money. *Id.* Rather, the Court found that a wholesale installment sales contract, which did not provide for interest, was not subject to an imputation of interest for Washington business and occupation excise tax purposes even though the wholesaler might have computed an interest component of the sale for its internal bookkeeping purposes. *Id.* at 566. Thus, *Weyerhaeuser* does not preclude the Department from taxing income, as represented by accounting entries. In this case, Taxpayer was contractually entitled to claim the gross amount of the merchant discount from its merchant clients, including the portion intended to cover the Taxpayer’s interchange fee expenses. The interchange fees were part of Taxpayer’s costs of doing business as an ISO, which may not be deducted from the measure of the B&O tax. *See* RCW 82.04.080(1) (“gross income of the business” includes the “value proceeding or accruing” from a business transaction without deduction on account of the costs of doing business). There is no imputation of income in this case. The Department is taxing receipts that the Taxpayer was contractually entitled to receive and contractually obligated to pay.

As stated previously, according to Taxpayer’s own federal tax returns, Taxpayer reports the gross merchant discount as its own income, and reports the interchange fees as ordinary and necessary business expenses.⁵ This is consistent with the fact that the merchant contracted directly with the Taxpayer for credit card processing, and the Taxpayer entered into an independent contractual relationship with the Bank whereby it assumed liability for the interchange fees arising from the transactions it submitted for processing. The interchange fee is required by Credit Card Associations and Issuing Banks to process a transaction. As such, it is a cost of doing business for

⁵ [The fact that a Taxpayer reports Interchange Fees as income on their federal income tax returns is not a determinative fact whether the Interchange Fees are subject to Washington state B&O taxation.]

Taxpayer. Costs of doing business are not deductible from “gross income of the business,” which establishes the measure of the B&O tax. In other words, Taxpayer’s gross income is subject to B&O tax without deducting any expenses paid or accrued. RCW 82.04.080. The interchange fee is an amount the Taxpayer is contractually entitled to receive and is contractually obligated to pay to the Issuing Bank. Therefore, we hold that the interchange fees in this case are rightfully included in Taxpayer’s gross receipts and are subject to B&O taxation.⁶

Although Taxpayer did not directly assert that the interchange fees are non-taxable under the authority of WAC 458-20-111 (Rule 111), Taxpayer does state in its petition that the Audit Division “incorrectly analyzes the B&O taxability of the interchange fee under Rule 111.” Because the Taxpayer alleges error under Rule 111, we will address the issue. As we explained in Det. No. 05-0139, 26 WTD 6 (2007), Rule 111 pertains to advances and reimbursements. *See* 26 WTD 6 (2007) (holding that, in addition to Rule 164, commission payments from a general insurance agent to sub-agents also did not qualify for Rule 111 non-taxable pass-through payments because the general agent was not liable for payment of the commissions solely as an agent of the insurance company). Rule 111 recognizes that a business can receive certain advances or reimbursements solely in the business’s capacity as an agent for the customer or client. The payments meeting the requirements of Rule 111 are not attributed to the business activities of the taxpayer and may be excluded from the measure of the tax. The Washington Supreme Court has identified the following criteria for applying Rule 111:

For the rule to apply, three conditions must be met: “(1) the payments are ‘customary reimbursement for advances made to procure a service for the client’; (2) the payments ‘involve services that the taxpayer did not or could not render’; and (3) the taxpayer ‘is not liable for paying the [third party] except as the *agent* of the client.’”

Washington Imaging Servs., LLC v. Dep’t of Revenue, 171 Wn.2d 548, 561-62, 252 P.3d 885 (2011) (citing *Rho Co. v. Dep’t of Revenue*, 113 Wn.2d 561, 567-68, 782 P.2d 986 (1989) (quoting *Christensen, O’Connor, Garrison & Havelka v. Dep’t of Revenue*, 97 Wn.2d 764, 769, 649 P.2d 839 (1982) (emphasis in original)). With regard to the third element, the Washington Supreme Court has further ruled that the taxpayer must also establish that its use of the funds to pay a third party is *solely* as an agent of the customer or client. *Washington Imaging*, 171 Wn.2d at 563, 252 P.3d at 892 (citing *City of Tacoma v. William Rogers Co.*, 149 Wn.2d 169, 178, 60 P.3d 79 (2002)). In the present matter, the taxpayer does not meet the third element because, as explained above, it is primarily liable for payment of the interchange fees. Taxpayer is not required to make the

⁶ WAC 458-20-19404, which applies to financial institutions, specifically states that interchange fees are not deductible from a taxpayer’s gross receipts from providing credit card processing services to merchants. Rule 19404 reads, in relevant part, as follows:

Receipts from merchant discount. The numerator of the receipts factor includes receipts from merchant discount if the commercial domicile of the merchant is in this state. Such receipts must be computed net of any cardholder charge backs, but must not be reduced by any interchange transaction fees or by any issuer’s reimbursement fees paid to another for changes made by its card holders.

Rule 19404(4)(h). There is no reason to tax receipts from merchant discount fees differently when credit card processing services are provided by an entity other than a financial institution.

interchange fee payments “solely as an agent.” For this reason, we find that the interchange fees are not excludable from the taxpayer’s gross income under Rule 111.

DECISION AND DISPOSITION

Taxpayer’s petition is denied.

Dated this 11th day of February 2015.