INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-101886-04, CC:FIP:B02

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

City A =

Bank =

a =

b =

c =

Year 1 =

Agreements =

Date 1 =

Date 2 =

ISSUES:

1) Are the credit card late fees ("late fees") charged by Bank interest income to Bank under the Internal Revenue Code?

2) If the late fees are interest income to Bank, do they create or increase original issue discount (OID) on Bank's credit card pool?

3) Are the merchant fees paid to Bank under the Agreements interest income to Bank under the Code?

4) If the merchant fees are interest income to Bank, do they create or increase OID on Bank's credit card pool?

5) What is the proper treatment of the merchant fee based on the intercompany transaction regulations under section 1502 of the Code?[1]

CONCLUSIONS:

1) The late fees charged by Bank are interest income to Bank for federal income tax purposes.

2) This issue is returned to the field to be considered under section 7 of Rev. Proc. 2004-33, 2004-22 I.R.B. 989, 990.

3) The merchant fees paid to Bank under the Agreements are for services. Therefore, the merchant fees are not interest income to Bank for federal income tax purposes.

4) Because Bank's merchant fees are not interest income, we do not reach the issue of whether such fees create or increase OID on Bank's pool.

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[1] We have restated the issue statements. See section 12.12 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86, 109.

5) The merchant fee is a corresponding item that is deductible by Taxpayer when properly taken into account under its separate method of accounting. See section 1.1502-13(c)(2)(i) of the Income Tax Regulations. Bank takes the merchant fee into account to reflect the difference for the year between the Taxpayer's corresponding item taken into account and the recomputed corresponding item. See section 1.1502-13(c)(2)(ii). In this case, the recomputed corresponding item is zero. Accordingly, under the facts of this case, Bank is required to take the merchant fee into account as income in a taxable year in an amount that corresponds to the Taxpayer's merchant fee deduction for that taxable year.

FACTS:

Taxpayer owns and operates retail businesses. Bank is a wholly-owned subsidiary of Taxpayer and a member of the Taxpayer consolidated return group. The Taxpayer group's consolidated federal income tax return is filed using a 52/53 week tax year that ends on the Saturday closest to Date 1. Taxpayer and Bank generally use an accrual method of accounting for both book and tax purposes.

Bank issued credit cards to qualifying customers of Taxpayer's retail operations that could be used only in Taxpayer's retail stores. The relationship between Bank and its cardholders was governed by a credit card agreement that was standardized and applicable to the cardholders of the relevant retail operation identified in the cardholder agreement. The cardholder agreements commonly provided that a cardholder must pay a minimum amount each month, calculated based on the greater of a percentage of the cardholder's outstanding balance or a minimum fixed amount.

Under its cardholder agreements, Bank charged cardholders a finance charge (expressed as an annual percentage rate or APR) if the outstanding balance reflected on the statement was not paid in full by the due date for that billing cycle. Finance charges, when imposed, were computed by multiplying the average daily balance during the monthly billing period by the applicable rate. Apart from the stated finance charge, the cardholder agreements provided for a late fee if the minimum monthly payment was not received within a days of the due date for payment.

During Year 1, the late fee charged by Bank to a cardholder was b dollars. Under the cardholder agreements, the late fee was added to a delinquent cardholder's balance, and if the amount due remained unpaid at the next payment due date, an additional late fee was added. This practice continued for each subsequent period until the account was returned to a current condition. Late fees could be waived by Bank on a case-by-case basis.

Taxpayer and Bank entered into the Agreements, which established the terms and conditions under which Bank dealt with Taxpayer's retail stores. The Agreements

provided that Bank would operate and administer a merchant authorization and settlement program whereby, subject to certain conditions, Bank would authorize certain credit card transactions for Taxpayer's retail stores and the retail stores would present Bank with transaction records for payment. The Agreements also provided that Bank would transfer funds to Taxpayer's retail stores for purchases made by a customer with a credit card issued by Bank within the timeframe specified in the Agreements. When a customer at one of Taxpayer's retail stores presented a Bank issued credit card for payment, the retail store was required to obtain authorization from Bank before it could accept the card. If the transaction was approved, Bank was obligated to remit funds to the retail store in an amount equal to the customer's purchase within the time frame provided in the Agreements.

Under each of the Agreements, Bank charged Taxpayer a fee (the "merchant fee") of c percent of the amount of any cardholder purchases made with a Bank issued credit card. Charge slips reflecting sales to customers and receivables were reconciled between Taxpayer and Bank daily. The merchant fees between Bank and Taxpayer were reconciled monthly. The merchant fee was set between Bank and Taxpayer by reference to fees charged to Taxpayer by third-parties with respect to Taxpayer's acceptance of credit cards not issued by Bank.

Bank's cardholder accounts system was directly linked on-line to Taxpayer's retail facilities. Accounts were generally initiated through in-store solicitation of Taxpayer's customers. Bank established the underwriting standards for new accounts and monitored the accounts on an on-going basis. Upon approval by Bank, an account was immediately created in the Bank system and credit was extended to the customer. For existing accounts, an on-line credit authorization system between Taxpayer and Bank permitted Bank to determine whether it was appropriate for Taxpayer to accept a cardholder's proffered Bank-issued card for a particular transaction.

LAW:

For federal income tax purposes, interest is an amount that is paid in compensation for the use or forbearance of money. Deputy v. DuPont, 308 U.S. 488 (1940), 1940-1 C.B. 118; Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932), 1932-1 C.B. 274. Whether a fee is an interest charge for federal income tax purposes is determined by reference to all of the relevant facts and circumstances. Neither the label used for the fee nor a taxpayer's treatment of the fee for financial or regulatory reporting purposes is determinative of the proper federal income tax characterization of that fee. See Rev. Rul. 72-315, 1972-1 C.B. 49 (as to the label); Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979) (as to financial or regulatory reporting).

Rev. Rul. 74-187, 1974-1 C.B. 48, holds that late fees on utility bills are interest absent evidence that the late payment charge assessed by the public utility is for a

specific service performed in connection with the customer's account. Even if a charge is a one-time charge or is imposed as a flat sum in addition to a stated periodic interest rate, that charge may still be interest for federal income tax purposes. See Rev. Rul. 77-417, 1977-2 C.B. 60 and Rev. Rul. 72-2, 1972-1 C.B. 19.

Rev. Proc. 2004-33, 2004-22 I.R.B. 989, provides conditions under which the Commissioner of Internal Revenue will allow certain taxpayers that issue credit cards to treat their late fees as interest income that creates or increases the amount of OID on a pool of credit card loans to which the late fees relate provided that they comply with the requirements set forth in the revenue procedure. See section 4 of Rev. Proc. 2004-33, 2004-22 I.R.B. at 990. The revenue procedure is effective for taxable years ending on or after December 31, 2003. However, for taxpayers described within the scope of the revenue procedure that currently use a method of accounting that treats their late fees as interest that creates or increases the amount of OID on a pool of credit card loans to which the late fees relate, the revenue procedure provides audit protection in taxable years ending before December 31, 2003, with respect to the issue of whether the taxpayer is properly treating its late fees as OID on a pool of credit card loans. See section 7 of Rev. Proc. 2004-33, 2004-22 I.R.B. at 990. A taxpayer is within the scope of the revenue procedure if the taxpayer issues credit cards allowing cardholders to access a revolving line of credit established by the taxpayer, and none of the cardholders' credit card transactions with the taxpayer is treated by the taxpayer for federal income tax purposes as creating either debt that is given in consideration for the sale or exchange of property (within the meaning of section 1274) or debt that is a deferred payment for property (within the meaning of section 483). See section 3 of Rev. Proc. 2004-33, 2004-22 I.R.B. at 990.

Rev. Rul. 71-365, 1971-2 C.B. 218, addresses whether an accrual method taxpayer bank may prorate certain fee income earned on credit card sales over the life of the receivables created by those sales. The revenue ruling concludes that this fee is charged to merchants in connection with services performed by the taxpayer bank in operating the credit card plan and no part of the merchant fee is a charge for the use of the bank's money. The revenue ruling holds that the bank must accrue the merchant fee in the year in which the bank remits payment to the merchant on a credit card purchase.

Section 1.1502-13 of the Income Tax Regulations provides special rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. In relevant part, section 1.1502-13[2] provides:

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[2] All references to Treas. Reg. section 1.1502-13 are to the consolidated return regulations in effect for transactions occurring in years beginning on or after July 12, 1995. Taxpayer has urged that the treatment of the merchant fees be determined by reference to proposed regulation section 1.1502-13(c)(7)(ii), Example 13(c), (d), and (e) (REG-131264-04, 69 F.R. 50112). The proposed regulations, however, do not address the facts of this case and therefore, are inapplicable.

(a) In general -- (1) Purpose. * * * The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

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(3) Timing rules as a method of accounting -- (i) In general. The timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member's other methods of accounting. See § 1.1502-17. * * * S's or B's application of the timing rules of this section to an intercompany transaction clearly reflects income only if the effect of that transaction as a whole * * * on consolidated taxable income is clearly reflected.

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(b) Definitions. For purposes of this section –

(1) Intercompany transactions --- (i) In general. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. * * * *

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(2) Intercompany items -- (i) In general. S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items.

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(3) Corresponding items -- (i) In general. B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items.

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(4) Recomputed corresponding items. The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions.

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(c) Matching rule. For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

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(2) Timing -- (i) B's items. B takes its corresponding items into account under its accounting method, * * *

(ii) S's items. S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

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ANALYSIS:

Late Fees

Nothing in the facts indicates that the late fees at issue were charged to cardholders to compensate Bank for services or property. On the facts and representations in this case, we conclude that the late fees at issue were charged by Bank to cardholders for the use or forbearance of money and, thus, are interest. This is so even though the late fees at issue were not denominated as a finance charge and were imposed as a flat sum in addition to the stated periodic interest charge. See Rev. Ruls. 72-315, 74-187, and 77-417.

Subsequent to the submission of this matter for technical advice, the Service issued Rev. Proc. 2004-33. In view of Rev. Proc. 2004-33, we are returning issue 2 (whether Bank's late fees create or increase the amount of OID on Bank's credit card pool) to the field so that the field can consider whether Bank is described within the scope of Rev. Proc. 2004-33 and, therefore, entitled to audit protection on this issue in accordance with section 7 of that revenue procedure.

Merchant Fees

Based on the facts and representations in this case, we conclude that under the Agreements all of the merchant fees here are paid by Taxpayer in connection with services rendered to Taxpayer by Bank in authorizing and settling credit card transactions of customers using Bank issued credit cards to purchase goods and services at Taxpayer's retail stores. See Rev. Rul. 71-365. Because Taxpayer and Bank have failed to establish that any portion of these fees are properly allocable to Bank's cardholder loans, we do not need to consider whether there are any circumstances under which these merchant fees may create or increase the amount of OID on Bank's credit card pool.

Based on the facts and representations in this case, we conclude that because these merchant fees are compensation for services rendered by Bank to Taxpayer, they are intercompany transactions within the meaning of section 1.1502-13(b)(1)(i). Further, we conclude that under Taxpayer's separate method of accounting, the merchant fees are deductible expenses under section 162(a).

Under the intercompany transaction regulations, Taxpayer takes its otherwise deductible expense (the corresponding item) into account under its separate method of accounting. See section 1.1502-13(c)(2)(i). Bank takes its intercompany item into account to reflect the difference for the year between Taxpayer's corresponding item taken into account and the recomputed corresponding item. See section 1.1502-13(c)(2)(ii). In this case, the recomputed corresponding item is zero. If Taxpayer and Bank were treated as divisions of a single corporation, Taxpayer would not take into account any deduction for the merchant fees. Accordingly, Bank's intercompany item inclusion for the merchant fees is computed as follows under section 1.1502-13(c)(2)(ii):

> Taxpayer's merchant fee deduction (corresponding item) minus zero (recomputed corresponding item) equals Bank's merchant fee income inclusion (intercompany item).

Consequently, we conclude that Bank is required to take the merchant fees into account as income in an amount that corresponds to Taxpayer's deduction for those fees.

CAVEATS:

No opinion is expressed as to the proper timing of the accrual of any OID attributable to the late fees.

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the memorandum. See section 15.04 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86, 112 (or any successor). However, a technical advice memorandum that modifies or revokes a letter ruling or another

technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in section 15.06 of Rev. Proc. 2005-2, are satisfied.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.