INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-102645-04, CC:FIP:B02

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Bank =

Year 1 =

Company A =

Company B =

a =

b =

c =

d =

e =

ISSUES:[1]

1) Are the credit card annual fees ("annual fees") received by Bank interest for federal income tax purposes?

2) Are the credit card late fees ("late fees") received by Bank interest for federal income tax purposes?

3) Are the credit card over-the-limit fees ("OTL fees") received by Bank interest for federal income tax purposes?

4) Are the credit card cash advance fees ("cash advance fees") received by Bank interest for federal income tax purposes?

5) Are the credit card non-sufficient funds fees ("NSF fees") received by Bank interest for federal income tax purposes?

6) Are the interchange fees received by Bank with respect to its cardholders' credit card purchase transactions interest for federal income tax purposes?

7) Do any of the aforementioned fees create or increase original issue discount (OID) on the cardholder loans to which the fees relate?

CONCLUSIONS:

1) The annual fees received by Bank are not interest for federal income tax purposes.

2) The late fees received by Bank are interest for federal income tax purposes.

3) The OTL fees received by Bank are interest for federal income tax purposes.

4) The cash advance fees received by Bank are interest for federal income tax purposes.

[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 NSF fees received by Bank are interest for federal income tax purposes.

6) The interchange fees received by Bank with respect to its cardholders' credit card purchase transactions are not interest for federal income tax purposes.

7) The issue of whether Bank's late fee income creates or increases the amount of OID on the cardholder loans to which the fees relate is returned to the field to be considered under section 7 of Rev. Proc. 2004-33, 2004-22 I.R.B. 989, 990. The cash advance fees, OTL fees, and NSF fees received by Bank create or increase the amount of OID on the cardholder loans to which the fees relate. The annual fees and interchange fees received by Bank do not create or increase OID on Bank's cardholder loans.

FACTS:

Taxpayer's wholly-owned subsidiary, Bank, is a limited-purpose credit card bank and issuer of credit cards. For Year 1, Bank and Taxpayer were members of an affiliated group that joined in the filing of a consolidated federal income tax return.

To effectively market its credit card programs, Bank tests various fee and finance charge revenue combinations to determine their appeal to various segments of consumers. Bank's credit card offerings utilize various combinations of finance charges and fees to reflect the degree of risk, the cost of money, and competitive pricing factors for the given segment of the consumer credit market to which Bank directs a particular card program offering. The terms and conditions governing a cardholder's use of Bank's credit card are set forth in the applicable cardholder agreement for that cardholder.

Each cardholder agreement includes a "finance charge." The finance charge is calculated using a stated daily or monthly periodic rate or combination of rates for any balance not paid as of the payment due date in the manner described in the applicable cardholder agreement. The finance charge is assessed on new transactions made during the monthly billing cycle, as well as on balances that remain outstanding from prior cycles.[2]

In addition to the stated finance charges, Bank could assess a combination of fees under the terms of its cardholder agreements. The fees that Bank charged to cardholders in Year 1 included annual fees, late fees, cash advance fees, OTL fees and NSF fees.[3] If a fee was assessed, it was added to the cardholder's outstanding principal balance, along with the amount of any prior finance charges, new purchases, and cash advances for the billing cycle. A cardholder's minimum monthly payment

[2] Bank's cardholder agreements generally include a grace period provision for purchases.

[3] Interchange fees are not listed in the cardholder agreements.

amount is determined based on the amount outstanding after taking into account any new items, including fees incurred during the billing period.

When an annual fee was imposed in Year 1 by Bank, the cardholder was charged a non-refundable flat annual fee of as much as a dollars. Bank normally deferred the initial billing of the annual fee from b to c months, at which time it charged the fee ratably over a 12-month period. Thereafter, the fee was billed annually if the cardholder continued to meet Bank's criteria. As represented by Taxpayer, Bank often waived the annual fee at the request of a cardholder in order to increase customer satisfaction and retention and because this fee is particularly sensitive to competitive pressures.

When a late fee was imposed in Year 1 by Bank, the cardholder was charged a specified flat charge. Bank imposed a late fee if the stated minimum payment from a cardholder was not received by Bank by the payment due date. Failure to make a timely minimum payment was an event of default under the terms of Bank's cardholder agreements.

When an OTL fee was imposed in Year 1 by Bank, the cardholder was charged a flat fee. Bank imposed an OTL fee on any day (but not more than once in a billing cycle) that a cardholder exceeded the agreed credit limit. Exceeding the credit limit was also an act of default under Bank's cardholder agreements. However, in certain circumstances, Bank permitted a cardholder to exceed the credit limit by a certain margin.

Under Bank's cardholder agreements, permitted cash advance transactions in Year 1 included ATM withdrawals, convenience checks, wire transfers, and bail bonds.[4] Bank did not provide a grace period with respect to cash advance transactions. Additionally, Bank imposed a cash advance fee for every cash advance transaction. The cash advance fee was a small percentage (usually d or e percent) of the cash advance, with a minimum fee amount depending on the terms of the cardholder agreement.

When a NSF fee was imposed in Year 1 by Bank, the cardholder was charged a flat amount. Bank imposed a NSF fee whenever a cardholder's attempted payment was returned unsatisfied. The amount of the charge was determined primarily, if not exclusively, based on what Bank's competitors charged their customers.

[4] In certain ATM cash advance transactions, Bank's cardholders may have incurred a fee (an ATM fee) at the time the cash advance was obtained. Bank's treatment of these cardholder ATM fees is not before us for technical advice. Under the parties' submission, the cash advance fees do not include any ATM fees charged by Bank to its cardholders. Accordingly, the discussion of cash advance fees that follows does not address the federal income tax treatment of ATM fees.

In Year 1, Bank earned interchange fees under the interchange programs operated by the credit card associations, such as Company A and Company B, under which Bank issued its credit cards. According to the information submitted by Taxpayer, an interchange program promotes the broad acceptance of credit cards by facilitating the exchange of a large volume of information and money on a standardized and consistent basis and by ensuring that credit card transactions are properly settled among the numerous parties involved in a credit card program.

There are several parties in an interchange program. First, there are the credit card associations, each of which establishes the rules for its own program. Second, there are the issuing banks, such as Bank, that issue credit cards under an association's program.[5] Third, there are the merchant banks, which enter into agreements with various merchants so that the merchants can accept credit cards under an association's program. Finally, there are the associations' clearinghouses, which maintain records and perform other operating functions that ensure the orderly flow of information and money.

Under the rules of the associations' programs, a merchant bank is charged an interchange fee with respect to a purchase transaction involving the use of a credit card by an issuing bank's cardholder. The majority of the interchange fee is received by the issuing bank and a small portion is received by the applicable association's clearinghouse to cover operating expenses.

Interchange fee rates are set by, and are adjusted regularly by, the associations. The associations' interchange rates may differ (for example, there may be one set of interchange rates for Company A transactions and another set of interchange rates for Company B transactions). Thus, a merchant bank may be charged different interchange fees for different transactions. The associations generally take into account costs to the parties involved in the interchange function when setting and revising their applicable interchange fee rates.[6]

Typically, the amount of an interchange fee charged to a merchant bank in connection with a particular credit card purchase transaction being settled through an association's interchange function is computed by applying the applicable interchange

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[5] In order to issue credit cards under an association's credit card program, Bank entered into a separate contractual relationship with that association and agreed to be bound by the association's rules. Consequently, Bank was contractually bound by the associations' rules with respect to its own participation in the associations' interchange programs.

[6] Taxpayer generally describes an association's pricing strategy for interchange fees as, largely, an incentive to increase the issuance and acceptance of the association's branded credit cards, taking into account overall lending costs, competition, appropriate issuer and merchant incentives, and the business environment, among other factors, to maximize the value of the association's brand for the benefit of all participants.

rate to the face amount[7] of credit card purchases and adding a flat amount for each transaction. Interchange fees are not normally remitted to issuing banks, including Bank, on a transaction-by-transaction basis.

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. 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), 1979-1 C.B. 167, 174-75 (as to financial or regulatory reporting).

In Rev. Rul. 2004-52, 2004-22 I.R.B. 973, the Internal Revenue Service considered the issue of whether credit card annual fees are interest for federal income tax purposes. The revenue ruling holds that because cardholders pay annual fees to credit card issuers in return for all of the benefits and services available under the applicable credit card agreement, annual fees are not compensation for the use or forbearance of money. Accordingly, an issuer's annual fee income is not interest income for federal tax purposes.

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 to treat their credit card 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 credit card 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

[7] As used in this document, the face amount of a cardholder's credit card purchase transaction refers to the amount charged the cardholder by the merchant for that purchased good or service as reflected on the sales receipt. Thus, if a cardholder used a Bank credit card to purchase an item selling for $100, the face amount of that credit card purchase transaction would be $100.

taxable years ending before December 31, 2003, with respect to the issue of whether the taxpayer is properly treating its credit card 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 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.

Under section 1273(a)(1), OID is the excess of the stated redemption price at maturity (SRPM) of a debt instrument over the issue price of that instrument. Under section 1.1273-1(b) of the Income Tax Regulations, the SRPM is the sum of all payments provided by the debt instrument other than qualified stated interest ("QSI"). Under section 1.1273-1(c), QSI is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) or that will be constructively received under section 451 at least annually at a single fixed rate. See sections 1273 and 1274, and the regulations thereunder, for rules with respect to determining the issue price of a debt instrument.

Although the total amount of OID on a debt instrument may not be determinable on issuance, the interest payable (other than QSI) on the instrument may still be OID. Section 1.1273-1(a) indicates that the total amount of OID for a debt instrument may be indeterminate. Under section 1.1273-1(a), a debt instrument does not fail to have OID merely because the total OID on the instrument cannot be determined on issuance. Generally, under the OID regulations, there are special rules for determining SPRM when payments on a debt instrument are subject to contingencies. Thus, an interest amount is not precluded from creating or increasing OID on a debt instrument merely because the contingent nature of the interest amount results in an uncertainty in the total amount of OID on the instrument on issuance. See, for example, Rev. Proc. 2004-33.

The treatment of cash payments made incident to private lending transactions (including seller financing) are addressed in section 1.1273-2(g). Payments from the borrower to the lender in lending transactions to which section 1273(b)(2) applies are addressed in section 1.1273-2(g)(2). That provision provides that a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) will reduce the issue price of the debt instrument evidencing the loan. In general, the tax consequences to both the lender and the borrower are governed by this rule.

Section 1.1273-2(g)(4) provides rules for determining the treatment of cash payments made incident to a lending transaction when the cash payment is between the lender and a third party (that is, between the lender and a person other than the

borrower). That section provides that if, as part of a lending transaction, a party other than the borrower (the third party) makes a payment to the lender, that payment is treated in appropriate circumstances as made from the third party to the borrower followed by a payment in the same amount from the borrower to the lender and governed by the provisions of paragraph (g)(2). Thus, in appropriate circumstances, a cash payment made incident to a lending transaction by a third party to a lender is treated as if made by the borrower and, if that amount does not compensate the lender for services or property provided by the lender, it will reduce the issue price of the debt instrument evidencing the loan and create or increase the amount of discount on that loan.

ANALYSIS:

A. Annual Fees

The Taxpayer has not presented any facts that distinguish the annual fees charged by Bank to its cardholders from the facts of Rev. Rul. 2004-52. The annual fees charged cardholders by Bank bear no relationship to the use of the line of credit. Neither Bank's delayed billing of the fee, nor Bank's ratable billing of the fee thereafter, establishes that these annual fees are for the use or forbearance of money. Accordingly, we conclude that the annual fees charged by Bank to cardholders, like the annual fees addressed in Rev. Rul. 2004-52, are not interest for federal income tax purposes.

B. Late Fees

Nothing in the facts indicates that the late fees at issue were charged to cardholders to compensate Bank for services or property provided by Bank. Based 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 rate finance 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 that portion of issue 7 dealing with late fees (that is, we are returning the issue of 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.

C. OTL Fees

Nothing in the facts indicates that the OTL fees at issue were charged to cardholders to compensate Bank for services or property provided by Bank. Based on the facts and representations in this case, we conclude that the OTL 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 OTL fees at issue were not denominated as a finance charge and were imposed as a flat sum in addition to the stated periodic rate finance charge. See Rev. Ruls. 72-315, 74-187, and 77-417.

D. Cash Advance Fees

Nothing in the facts indicates that the cash advance fees here were charged to cardholders to compensate Bank for services or property provided by Bank. Based on the facts and representations in this case, we conclude that the cash advance fees were charged by Bank to cardholders for the use or forbearance of money and, thus, are interest. This is so even though these cash advance fees at issue were not denominated as a finance charge and were imposed in addition to the stated periodic rate finance charge. See Rev. Rul. 77-417; see also Rev. Ruls. 72-315, 74-187.

E. NSF Fees

Nothing in the facts indicates that the NSF fees at issue were charged to cardholders to compensate Bank for services or property provided by Bank. Based on the facts and representations in this case, we conclude that the NSF 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 NSF fees at issue were not denominated as a finance charge and were imposed as a flat sum in addition to the stated periodic rate finance charge. See Rev. Ruls. 72-315, 74-187, and 77-417.

F. Interchange Fees

Section 1273 defines OID and generally applies to payments between the lender and the borrower. Section 1.1273-2(g), however, treats certain payments between a lender and third parties as also creating or increasing the amount of OID on a loan. Generally, for a third party's payment to a lender to result in OID, three requirements must be satisfied: (1) under section 1.1273-2(g), the third party's payment to the lender must be made incident to, and part of, a lending transaction between the lender and the borrower; (2) under section 1.1273-2(g)(4), the circumstances must be appropriate for imputing that payment to the borrower; and (3) when considered under section 1.1273-2(g)(2), that payment is not for property or services. Although interchange fees are paid to the lender (Bank) by third parties (merchant banks), Taxpayer has not established that Bank's receipt of the interchange fees satisfies any of these requirements.

Taxpayer has established neither that the fees were received by Bank incident to, and part of, a lending transaction, nor that the fees were paid under circumstances that

would cause them to result in OID. Taxpayer argues that credit card purchase transactions are lending transactions, and absent the credit card purchase transactions, interchange fees would not be paid. Also, Taxpayer argues that the amount of the fee is based primarily on the amount of funds loaned and, under the associations' rules, is intended to compensate Bank for providing a grace period to its cardholders. These factors alone, however, do not make the payment of those fees incident to, and part of, a lending transaction between Bank and a cardholder.

Several factors suggest that these interchange fees are not earned by Bank incident to, and part of, Bank's lending transactions with its cardholders. First, the interchange fee rates charged to the merchant banks are set by the associations, who are not parties to the lending transactions, and those rates are determined for each merchant transaction or class of merchant transactions. Second, unlike seller-paid points, the interchange fee is paid by a merchant bank under the associations' rules on its own behalf, rather than on behalf of the cardholder.[8] Third, a portion of each interchange fee is paid under the associations' rules to the clearinghouses, who are also not parties to the lending transaction. Fourth, interchange programs were developed by the associations to promote the broad acceptance of credit cards by facilitating the consistent exchange of information and money and by ensuring proper settlement. These factors suggest that the interchange fees earned by Bank are too attenuated from Bank's discrete cardholder lending transactions to be considered incident to, and part of, those lending transactions. Because Taxpayer has not clearly established that these interchange fees were earned by Bank incident to, and part of, its cardholder lending transactions, we conclude that the interchange fees received by Bank in Year 1 are outside the scope of section 1.1273-2(g)(2). Therefore, these interchange fees do not result in OID on Bank's cardholder loans.

Furthermore, even assuming that Bank earned these interchange fees incident to, and part of, its cardholder lending transactions within the meaning of section 1.1273-2(g), Taxpayer has also not established that it is appropriate to impute the payment of the fees to Bank's cardholders under section 1.1273-2(g)(4). Generally, if a cardholder's cash payment (including any payment from a third party that is imputed to the cardholder under section 1.1273-2(g)(4)) results in OID, that payment will reduce the issue price of the debt instrument evidencing the cardholder's loan. See section 1.1273-2(g)(2). Thus, if the payment of an interchange fee to Bank results in OID, the face amount of a cardholder's credit card purchase transaction would not be the correct issue price of any loan by Bank to the cardholder with respect to that credit card purchase transaction.[9] Allowing Bank and its cardholder to determine a different issue

[8] Taxpayer analogizes the merchant bank's payment of an interchange fee to seller-paid points. See, generally, section 1.1273-2(g)(5), Example 3.

[9] There is no indication that Bank's cardholders have any knowledge of the interchange fees earned by Bank as a result of their respective specific credit card purchase transactions. It is, therefore, not clear to us how a cardholder would be able to determine the correct issue price under section 1.1273-2(g)(2).

price for the same loan is contrary to the general symmetry between lender and borrower with respect to issue price required under section 1.1273-2(g)(2).[10] Because Taxpayer has not clearly established that the circumstances are appropriate to impute the merchant banks' payment of interchange fees to Bank's cardholders, we conclude that these interchange fees are not properly imputed to Bank's cardholders under section 1.1273-2(g)(4). Therefore, these interchange fees do not result in OID on Bank's cardholder loans.

Moreover, even assuming that Bank earned these fees incident to, and part of, its cardholder lending transactions and that the circumstances were appropriate to impute the payment of these fees to Bank's cardholders, Taxpayer has failed to establish that the interchange fees compensate Bank other than for costs in addition to the general costs incurred in connection with processing its cardholders' credit card purchase transactions. Under section 1.1273-2(g)(2), cash payments that compensate lenders for loan processing costs do not result in OID. Because Taxpayer has failed to establish that any portion of the interchange fees from the merchant banks was received by Bank other than as compensation for those services, no portion of the interchange fees at issue is interest income to Bank for federal income tax purposes. Therefore, these interchange fees do not result in OID on Bank's cardholder loans.

G. Whether these fees create OID

As discussed above, the issue of whether Bank's late fee income creates or increases the amount of OID on the cardholder loans to which the fees relate is returned to the field to be considered under section 7 of Rev. Proc. 2004-33, 2004-22 I.R.B. at 990.

Under section 1273 and the regulations thereunder, the cash advance fees, OTL fees, and NSF fees received by Bank create or increase OID on the cardholder loans to which those fees relate. However, because we conclude above that the annual fees and interchange fees received by Bank are not interest income to Bank for federal income tax purposes, these fees do not create or increase OID on Bank's cardholder loans.[11]

CAVEATS:

No opinion is expressed as to the proper timing of the accrual of any OID attributable to those fees that do create or increase OID on Bank's cardholder loans.

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[10] Because interchange obligations between issuers and merchant banks are netted under the associations' interchange programs and because tracing of interchange fees at the cardholder account level is not feasible for Bank, it is not clear to us, even assuming arguendo such fees resulted in OID, that Bank would be able to determine the correct issue price of every individual loan attributable to a cardholder credit card purchase transaction.

[11] For both issue 1 (annual fees) and issue 6 (interchange fees), based on the facts and representations in this case we concluded above that these fees were not received by Bank incident to its cardholder lending transactions.

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.