

Cite as Det. No. 17-0211, 37 WTD 165 (2018)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| 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. 17-0211 |
|) | |
| ...) | Registration No. . . . |
|) | |

[1] ETA 3204.2017; RCW 82.04.290; RCW 82.04.080: B&O TAX – GROSS INCOME – VALUE PROCEEDING OR ACCRUING – CREDIT CARD PROCESSOR – INTERCHANGE FEES. A credit card processor that is contractually obligated to assume the financial obligation to pay interchange fees under a sponsorship agreement with a merchant bank cannot deduct the interchange fees from its gross income.

[2] WAC 458-20-111; RCW 82.04.080: B&O TAX – GROSS INCOME – ADVANCEMENTS OR REIMBURSEMENTS – CREDIT CARD PROCESSOR – INTERCHANGE FEES. When a credit card processor has a contractual agreement with a merchant bank that the credit card processor is liable for the payment of interchange fees, the credit card processor cannot exclude interchange fees from its gross income under WAC 458-20-111 unless it can establish an agency relationship with the merchant bank.

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, T.R.O. – A credit card processor protests business and occupation tax imposed on interchange fees paid to its sponsoring bank on the grounds that it never actually receives the interchange fees and that the interchange fees are excludible from gross income as an advance or reimbursement under WAC 458-20-111. The petition is denied.¹

ISSUES

1. Whether, under RCW 82.04.290 and ETA 3204.2017, interchange fees are includible in the gross income of a credit card processor’s business.
2. Whether, under WAC 458-20-111, interchange fees are excludible from the gross income of a credit card processor’s business as an advance or reimbursement.

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

FINDINGS OF FACT

. . . (Taxpayer) is a domestic payment processing facilitator. Taxpayer and its sponsor bank enter into agreements with merchants and automated teller machine (ATM) owners to process credit and debit card transactions and ATM withdrawals. Under these agreements, Taxpayer and its sponsor bank (also referred to herein as “Acquiring Bank”) facilitate the flow of funds from the cardholder’s bank to the merchant (or in the case of ATM transactions, to the cardholder and ATM owner). The services Taxpayer provides include authorization, electronic draft capture, submission of transactions to payment networks, and additional related services.

Under a separate sponsorship agreement, Taxpayer contracts with its Acquiring Bank. The Acquiring Bank is a party to all merchant and ATM agreements. The Acquiring Bank maintains an account to receive the transaction funds, while Taxpayer manages, accounts for, and oversees the funding transfers during the merchant and ATM transaction settlement process. All of Taxpayer’s merchant and ATM agreements are three-party contracts between Taxpayer, the merchant or ATM owner, and the Acquiring Bank. Under these agreements, Taxpayer delivers funding files and data to all of the parties involved in the actual cash flow activity. Taxpayer records the full amount of all transactions in its books and records. Taxpayer claims that, for financial statement purposes, it only reports the fees that it earns from its processing activities and does not include the interchange fees as gross income in its financial statements.

A typical credit card transaction involves the following parties: (i) the cardholder or consumer (Cardholder) who purchases goods or services; (ii) the issuing bank (Issuing Bank) that issues the card and provides credit to Cardholder; (iii) the merchant (Merchant) from whom Cardholder purchases goods or services; (iv) the Acquiring Bank that purchases Merchants’ credit card receivables; (v) . . . credit card networks (Card Associations); and (vi) the transaction processors (Taxpayer, in this case).

Taxpayer provided a copy of the three-party Customer Processing Agreement between it, its Acquiring Bank, and its merchant customers. That Agreement defines “Processing Charges” as:

the interchange, assessment and all other fees charged by the Card Associations and the processing and other fees charged by [Acquiring Bank] and [Issuing Bank] to [Merchant] as set forth in the accompanying Fee Schedule²

The processing charges are Taxpayer’s compensation for the processing services it provides. The Acquiring Bank also receives compensation for sponsoring the processor (Taxpayer) with the Card Associations. Interchange fee amounts are set by the Card Associations.

Merchants are charged interchange fees for the convenience of providing customers with the ability to pay with a credit or debit card. Merchants are contractually bound to obey the regulations and pay the fees asserted by Card Associations, including interchange fees. Taxpayer provided a Sponsorship Agreement between Taxpayer and its Acquiring Bank that describes “Interchange Fees” as:

² Customer Processing Agreement, “Section 1. Definitions.”

fees paid to the Card-issuing bank [Issuing Bank] and the Payment Networks [Card Associations] in connection with Interchange Settlements and in accordance with Applicable Law and the Rules . . .³

A portion of the interchange fee represents Issuing Bank's compensation for the credit risk it undertakes in the event of Cardholder's default. In a document entitled "[Card Association] Interchange Reimbursement Fees," [Card Association] describes interchange fees as follows:

[Card Association] uses interchange reimbursement 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 of these services may be included in their merchant discount rate, which is typically a percentage rate per transaction.⁴

Taxpayer emphasizes that it never actually receives the interchange fees from Merchants. [However, we find that Taxpayer is contractually responsible, under the Sponsorship Agreement, for paying the interchange fee portion of the "merchant discount" to its Acquiring Bank for the eventual benefit of the Issuing Bank.]

Taxpayer also acts as a processor of ATM transactions. While the structure of a typical ATM transaction slightly differs from that of Taxpayer's credit card processing transactions, the end result is the same. In the case of an ATM transaction, the Acquiring Bank receives settlement funds, as well as the interchange and surcharge fees. However, that full amount is immediately remitted to the ATM owner. Under the rules associated with debit card transactions, the ATM owner is entitled to reimbursement of the cash disbursed, the surcharge charged to the customer by the ATM owner, and the interchange fee paid by the Issuing bank. The Card Associations forward these amounts to the Acquiring Bank that consequently forwards these amounts to the ATM owner's account.

Taxpayer was audited by the Audit Division of the Department of Revenue for the period of June 1, 2010, through June 30, 2013. During this period, Taxpayer reported processing fees as gross receipts under the service and other activities business and occupation (B&O) tax classification. The amounts Taxpayer reported did not include interchange fees or surcharges. Taxpayer maintains that its financial statement reporting is consistent with its reporting to the Department. The Audit Division calculated Taxpayer's total gross receipts based on all revenue accounts listed on Taxpayer's trial balance, including interchange fees and surcharges.

On October 24, 2014, the Audit Division issued Assessment No. . . . , in the amount of \$. . . , which consisted of \$. . . in service and other activities B&O tax, interest of \$. . . , an interest reconciliation of \$. . . , a 5% assessment penalty of \$. . . , less a payment of \$

³ Sponsorship Agreement, "Article I, Definitions," p. 4

⁴ . . .

ANALYSIS

1. Gross Income of the Business

Taxpayer argues that the interchange fees paid to the Acquiring Bank are not “gross income of the business” to Taxpayer because Taxpayer never actually receives them. The business and occupation (“B&O”) tax is calculated based on the “gross income of the business.” RCW 82.04.290. “Gross income of the business” is broadly defined and means:

[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) (emphasis added). The phrase “value proceeding or accruing” is defined as “the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued.” RCW 82.04.090. “Business” includes “all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly.” RCW 82.04.140. Under this broad definition, a service provider may not deduct any of its costs of doing business from its gross income. *See Pilcher v. Dep’t of Revenue*, 112 Wn. App. 428, 49 P.3d 947 (2002) (citing *Rho Co. Inc. v. Dep’t of Revenue*, 113 Wn.2d 561, 570, 782 P.2d 986 (1989)). Thus, unless a specific exemption, deduction, or exclusion applies, a taxpayer’s gross income is subject to B&O tax without any deduction for overhead or other expenses.

On June 26, 2017, the Department issued Excise Tax Advisory (ETA) 3204.2017, on the taxability of credit card processors. ETA 3204.2017 describes how a credit card processor (Processor) should measure its gross income, for B&O tax purposes, from processing credit card transactions. It reads, in pertinent part, as follows:

For business and occupation (B&O) tax purposes, the transaction/relationship between a merchant and the Merchant Bank and Processor creates tax consequences separate from the transactions/relationships that generate Interchange Fees and other fees resulting from the processing of a credit card transaction. While the activities of the parties processing a credit card transaction are related, the activities and responsibilities of the Processor differ from those of the other parties, including the Issuing Banks. Accordingly, each party must be taxed based on the gross income of its respective business.

Per RCW 82.04.080(1), gross income of the business means the value proceeding or accruing to the taxpayer by reason of the transaction of the business engaged in without deduction for any expense whatsoever paid or accrued. Under the Merchant Agreement, the Processor is legally entitled to the Merchant Discount charged to

the merchant. The Merchant Discount is consideration that accrues to the Processor, thus representing gross income, notwithstanding that fees charged by other parties may be netted out before the Processor receives payment. Consequently, the Merchant Discount amount is gross income to the Processor subject to tax under the service and other business activities B&O classification.

ETA 3204.2017 (emphasis in original).

The . . . [interchange fees, which Taxpayer passes on to the merchant through the “merchant discount”] is essentially Taxpayer’s cost of doing business because Taxpayer is contractually obligated to [assume financial responsibility for] such fees . . . under the Sponsorship Agreement. . . . Taxpayer entered into a contractual relationship with Acquiring Bank under which it assumed liability for the interchange fees arising from transactions it processes. Interchange fees are [amounts the Issuing Bank is entitled to retain as compensation for its role in the credit card transaction.] As such, interchange fees are a cost of doing business for Taxpayer. Thus, they are not deductible by Taxpayer.

2. Rule 111

The next issue is whether the interchange fees are excludable from gross income of the business. WAC 458-20-111 (“Rule 111”) permits an exclusion from gross income for certain advances and reimbursements that a taxpayer receives solely in its capacity as an agent. Rule 111 provides, in relevant part:

The words “advance” and “reimbursement” apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.

* * *

The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

Rule 111 (emphasis added.)

Rule 111 requires the existence of a true agency relationship between the client and the taxpayer. *See Washington Imaging Services, LLC v. Dep’t of Revenue*, 171 Wn.2d 548, 562, 252 P.2d 885 (2011). Agency requires a factual determination that both parties consented to the agency relationship and that the principal exercised control over the agent. *Id.*; *see also Nordstrom Credit, Inc. v. Dep’t of Revenue*, 120 Wn.2d 935, 941, 835 P.2d 1331 (1993); Det. No. 05-0206E, 25 WTD 72 (2006); Det. No. 03-0128, 24 WTD 168 (2005); Restatement (Third) of Agency § 1.01 (2006).

The *Washington Imaging* court emphasized that “[t]he proper focus is on the facts and whether they show a true agency relationship that requires payment to a third party on behalf of the recipient (e.g., client or patient) paying for the goods or services.” *Washington Imaging*, 171 Wn.2d at 565.

Once an agency relationship has been established, an inquiry must be made into whether the taxpayer’s liability to pay constituted “solely agent liability.” *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 178, 60 P.3d 79, 83 (2002). The *William Rogers* court explained that if a taxpayer assumes any liability beyond that of an agent, payments made pursuant to such liability are not excludable under Rule 111. *Id.* Therefore, for Rule 111 to apply in this case, Taxpayer must establish that it had an agency relationship with its Merchants and that its liability to pay interchange fees to Acquiring Banks was solely in its capacity as its Merchants’ agent.⁵

Here, although Taxpayer is providing services to Merchants, there is no evidence that an agency relationship exists between them. Moreover, the Sponsorship Agreement and the [Card Association] Interchange Reimbursement Fees document make it clear that the liability to Acquiring Bank for the interchange fees is Taxpayer’s responsibility. As such, Taxpayer is liable in its own right for paying the interchange fees. Because Taxpayer is primarily liable for payment of the interchange fees to Acquiring Bank, it is not required to pay the interchange fees solely as the agent of its Merchants. Thus, Taxpayer’s liability to its Acquiring Bank does not constitute “solely agent liability” and Rule 111 is inapplicable.⁶

DECISION AND DISPOSITION

Taxpayer’s petition is denied.

Dated this 17th day of August 2017.

⁵ [Rule 111 could also apply if a credit card processor could establish that it was acting “solely as an agent” of the Acquiring Bank. *See* ETA 3204.2017 Example 2. In this case, the facts presented do not support a finding that Taxpayer was acting as agent of the Acquiring Bank.]

⁶ Because we have concluded that Taxpayer’s liability was not “solely agent liability,” we need not engage in a factual determination of whether Taxpayer and Merchants had a true agency relationship under the *Washington Imaging* case.