

Excise Tax Advisory

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ETA 3204.2017

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Credit Card Processors

Purpose

This Excise Tax Advisory (ETA) describes how a credit card processor (“Processor”) should measure, for B&O tax purposes, its gross income from processing credit card transactions.

Definitions

For purposes of this ETA, the following definitions apply:

A “**Merchant Bank**” is a bank that contracts with a merchant, enabling the merchant to accept a Card Association-branded credit card and receive cash proceeds from the sale.

An “**Issuing Bank**” is a bank that issues Card Association-branded credit cards to consumers.

A “**Processor**” generally provides credit card processing services to a merchant, pursuant to contracts with the Merchant Bank and the merchant.

“**Card Association**” means an association that manages the rules and practices involved in processing credit card transactions.

“**Merchant Discount**” means the total fee a merchant must pay for the processing of credit card transactions. For example, a merchant might agree to pay under a Merchant Agreement a flat 3% Merchant Discount fee. In this scenario, the merchant will receive \$97 on a credit card sale of a \$100 product. The \$3 the merchant does not receive is the Merchant Discount.

“**Interchange Fee**” is a fee the Issuing Bank is entitled to retain as compensation for its role in issuing credit to a cardholder and advancing proceeds to settle a credit card transaction.

“**Merchant Agreement**” means the documents that govern the services provided by a Processor/Merchant Bank to a merchant and the related fees.

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“**Sponsorship Agreement**” is a contract that governs the rights and obligations of the Processor and the Merchant Bank with respect to the Merchant Bank’s sponsorship of the Processor’s use of the Card Associations’ networks and the processing services provided to merchants.

**Overview of
Credit Card
Processing
System**

A merchant seeking to accept a Card Association-branded credit card as payment for goods or services must contract with a Merchant Bank, and often a Processor, to participate in the Card Association’s payment system network. Because a Processor typically cannot participate in a Card Association network on its own, it enters into the Merchant Agreement jointly with the Merchant Bank. The Merchant Bank and the Processor also execute a separate Sponsorship Agreement that governs their relationship.

Other parties involved in processing a credit card transaction are not part of the Merchant Agreement. They also earn fees on each completed transaction. The Interchange Fee is the largest of these fees. The Card Associations set the Interchange Fees and periodically revise the rates based on a number of factors that influence the supply and demand for the credit card products marketed by its financial institution members.

Merchant Banks and sponsored Processors are free to independently negotiate the Merchant Discount they charge merchants for credit card processing services. Most commonly, the merchant is charged a fixed Merchant Discount rate for every card transaction, or for specified categories of card transactions. Alternatively, the Merchant Discount may be charged on a “cost plus” basis. Under a cost plus arrangement, the amount a merchant is charged equals the total of Interchange Fees determined on each card transaction and other incidental fees or charges, plus a specified mark-up.

The Card Associations’ operating rules, which are binding on the participating banks and their sponsored Processors, specify that the Interchange Fee is a liability of the Merchant Bank to the Issuing Bank. The Merchant Bank is free to require a Processor to assume liability for Interchange Fees as a condition of the Sponsorship Agreement. Although the Processor charges the merchant the Merchant Discount on the front end, fees charged by other parties involved in processing the credit card transaction are netted out of funds distributed to the Processor.

Under a less common business model, the Merchant Bank (or, alternatively, another entity that markets credit card processing services to merchants) simply pays the Processor for services the Processor performs solely as an agent of the Merchant Bank (or the other entity).

**Gross Income
of Processors**

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.**

Note, in the limited situations where both the practices of the parties and the contractual documents establish that a Merchant Bank (or, alternatively, another entity that markets processing services to merchants) pays the Processor fees for services the Processor performs solely as an agent of the Merchant Bank (or the other entity), the fees are the measure of the Processor's gross income for B&O tax purposes. Under this arrangement, the Merchant Discount is gross income to the Merchant Bank (or the other entity). The Department will presume a Processor is not performing services solely as an agent unless both the contractual documents and the parties' practices indicate otherwise.

Examples

The following examples identify a number of facts and then state conclusions. These examples should only be used as a general guide. The tax results of other situations must be determined after a review of all the facts and circumstances.

Example 1

Merchant X enters into a Merchant Agreement with Processor Y and Merchant Bank Z. The arrangement enables Merchant X to make certain credit card sales to customers and receive cash from the transactions. The Merchant Agreement charges Merchant X a Merchant Discount equal to 3% of the amount of each transaction. The difference between the purchase price and Merchant Discount on each transaction is deposited into an account designated by Merchant X.

On a sale of a \$100 product, Merchant X receives \$97 from the transaction. Pursuant to their Sponsorship Agreement, Merchant Bank Z and Processor Y receive \$0.10 and \$0.70, respectively, from the same transaction after deductions of \$2.20 in other fees, such as Interchange and Card Association fees. The Department will presume Processor Y's gross income from the transaction is \$3, the amount of the Merchant Discount.

Example 2

Under a Merchant Agreement between Merchant Bank A and Merchant C, Merchant Bank A agrees to process Merchant C's credit card transactions in exchange for a Merchant Discount equal to 3% of the amount of each transaction. Under a separate services agreement between Merchant Bank A and Processor B, Processor B will process Merchant C's credit card transactions. In exchange for the processing services, the services agreement entitles Processor B to a fee from Merchant Bank A. As provided in the services agreement, Processor B performs the services solely as an agent of Merchant Bank A without undertaking any liability of Merchant Bank A to either Merchant C or any other party.

Because the terms of the contracts and the practices of the parties indicate Processor B is acting solely as an agent of Merchant Bank A, Processor B's gross income from these services is the fees it earns from Merchant Bank A under their services/agency agreement. Merchant Bank A's gross income from its processing services is the 3% Merchant Discount required by its Merchant Agreement with Merchant C.
