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## **Text**

On your letter dated August 26, 201X, you requested, on behalf of BANK certain rulings in connection with the applicability of the sales and use tax ("SUT"), including the surtax provisions, to the Merchant Discount Fee charged by BANK to its merchants clients for the processing and accepting credit card payments, and crediting such funds to the merchant's account.

### **I. FACTS**

BANK is a corporation organized under Act No. 55 of May 12, 1933, as amended, commonly known as the Banking Law of Puerto Rico, as amended, 7 L.P.R.A. §1 *et seq.* As part of its business operations, BANK enters into agreements with different merchants to provide card payment processing services. In said agreements, which are generally in standard form, BANK acts as an "acquiring bank."

The Merchant Discount Fee is a fee that a bank charges for providing card payment processing ("CPP Services"), which are born from a separate agreement that banks enter with their clients. In order to provide CPP Services, Banks enter into Merchant Services Agreements ("MS Agreement") with their merchant clients. As part of the CPP Services, the merchant authorizes in the MS Agreement for certain debits and credits to be made in the merchant's account with the bank, to facilitate the CPP Services. Only Banks may charge Merchant Discount Fees to clients, since they may only act as acquiring banks in the transaction.

The parties involved in the CPP Services depend on the network used by the card. In the case of the two largest networks -Visa and MasterCard- the transactions typically involve four parties: (1) the issuing bank, which is the financial institution that issues card to the cardholder; (2) the cardholder; (3) the seller or merchant that accepts the card payment made by the cardholder, and (4) the acquiring bank, also known as merchant's bank. An

acquiring bank processes card transactions on behalf of the merchants and executes the settlement process for said merchants within the corresponding card systems.

Acquiring banks supply the means for merchants to accept bank cards, by sending the authorization request through the card network to the issuing financial institution, which authorizes the transaction by checking that the account is valid and that the cardholder has enough credit amount for the sale. In case of merchants accepting cards in their stores, authorization usually occurs automatically via electronic point-of-sale ("POS") terminals that read cards. Acquiring banks clear and settle card purchases by providing payment from the issuing institution to the merchant's account, except for the interchange fees and their own service fees. The process lasts between 24 and 72 hours for the merchant to get the payment, according to industry estimates.

In fact, under the MS Agreement the merchant is provided a line of credit, to effect the processing of the acceptance of the credit card payments. The acquiring bank in a credit card payment transaction, is in fact accepting the risk of the credit card payment for the client. This is because if the acquiring bank client were not to remain solvent, the acquiring bank retains the risk of fund reversals of credit card payments previously deposited to the client. Accordingly, if there were no amounts remaining in the client's account, the acquiring bank may not be able to collect from its client the reversal of funds already deposited in the account, but will still be required to provide the funds to the issuing bank relating to the cardholder reversal, refund, chargeback or dispute. For this reason the acquiring bank is financing the credit card payments deposited in the client's accounts.

In some cases, acquiring banks may execute contracts with third-party entities to provide the data processing services to the acquiring banks, as the banks currently do in support of their services. Nevertheless, as discussed, the services that acquiring bank provides to its client merchants may only be provided by banks, which as discussed includes an intrinsic line of credit.

The majority of the cost related to accepting cards consists of the merchant discount fee paid to the acquiring bank. Generally, in a Visa or MasterCard transaction, a portion of the merchant discount fee is paid by the acquiring bank to the issuing bank. Said portion is known as the interchange fee, which compensates issuing banks "for a portion of the costs they incur in providing card services." The acquiring bank keeps the remaining portion to "cover its costs of providing services." It should be noted that the merchant does not pay the interchange fee directly. Rather, in the case of Visa or MasterCard, the network transfers the interchange fee part of the merchant discount fee from the acquiring bank to the issuing bank.

Prior to accepting any card payment from a customer, the merchant has to establish a demand deposit account at BANK, known as the merchant's account or operating account, to facilitate the CPP Services. The merchant authorizes BANK to debit all of the amounts the merchant owes the Bank from said account.

The merchant must honor all valid cards when correctly presented by a cardholder for the payment of goods or services, subject to certain rules, bylaws, regulations, policies, and guidelines. The merchant must obtain an authorization for all card sales whether electronically or through the designated authorization center. In case the transaction is authorized, the merchant must legibly print the authorization number on the sales draft. The authorization merely provides that the account of the cardholder has sufficient credit available to cover the amount of the current sale. It does not guarantee that the transaction will not be subject to dispute or chargeback and does not warrant the cardholder's identity. Furthermore, the authorization does not release the merchant of liability for chargeback on any transaction in which the merchant does not obtain an imprint or the cardholder's signature.

When the merchant presents the sales drafts for collection and payment to BANK, said merchant assigns and transfers all of its rights, title and interest in each sales draft completed in conformity with BANK acceptance procedures. BANK accepts from the merchant all sales drafts deposited by merchant pursuant to the agreement and submits the same to the appropriate issuing banks for collection against cardholder accounts. To that effect, the merchant must transmit the sales drafts and credit vouchers to BANK or its processing vendor on the same or next business day immediately following the day of origination of said sales drafts and credit vouchers. Each and every one presentment and assignment of the sales drafts, collection and reassignment or rejection are subject to the terms of the agreement and regulations of the Card Association. BANK conditionally credits the value of collected sales drafts to the operating account of the merchant. The Bank reserves the right to adjust amounts collected to reflect fees, chargebacks, penalties, and items for which Bank did not receive final payment, among others.

Generally, in the reconciliation process, the transactions are cleared on a daily basis. The Bank must deliver payment to the merchant as soon as practicable by crediting merchant's account in an amount equal to the reconciled summary of the transactions since the prior credit. The credit is reduced, if necessary, by: (1) cardholder charges denied or refused; (2) refunds processed during the time period; (3) fees and charges, including but not limited to chargebacks; (4) penalties, charges and other items incurred by the Bank that are reimbursable according to the agreement and (5) all applicable rates, fees and charges explained in the application.

In addition, BANK must provide a statement to the merchant at least once per month. The merchant may object the information included in such statement by written notice within thirty (30) days from the statement date. Amounts credited to merchant's account may be subject to reversal by BANK until the transaction is final and no longer subject to a chargeback by the issuing bank or cardholder.

The Bank may receive payment of any sales draft submitted by the merchant and paid by BANK, except and until there is a chargeback. Unless specifically authorized in writing by the Bank, the merchant cannot collect or attempt to collect any sales draft, including chargebacks, and will hold in trust for BANK and promptly deliver in kind to the Bank any payment received by the merchant, in whole or in part, of the amount of any accepted

transaction, including the cardholder's name and account number and any correspondence accompanying payment.

The merchant must accept a chargeback for any sale involving the following, among others: (1) the cardholder challenges the validity of the sale in conformity with the existing Card Association rules; (2) an issuing bank concludes that the merchant has failed to comply with Card Association rules or the bank's procedures in accepting a card and presenting the corresponding sales draft to the bank for purchase; (3) no specific prior authorization for the transaction was obtained; (4) the authorization approval number is not shown on the electronic transmittal that is maintained by the Bank; (5) the transaction was submitted to the bank thirty (30) days or more after the date on which the goods and/or services to which the transaction relates were purchased or leased by the relevant cardholder; (6) the card giving rise to the transaction was cancelled; (7) the card expired prior to the transaction date; and (8) the transaction date preceded the card validation date. In any of the above mentioned circumstances, the Bank is not required to accept a transaction for credit to the merchant operating account. If the Bank has already credited merchant operating account or reserve account for such transaction, BANK may give back the transaction to the merchant, who must pay the transaction amount and the published fees for each chargeback to the Bank.

BANK monitors merchant's processing activity, business condition, financial condition, and daily deposit activity to detect improper trends and tendencies in chargeback and negative cardholder inquiries. The Bank may upon rational grounds halt disbursement of merchant's funds for any reasonable period of time needed to investigate irregular or unusual deposit activity. BANK will make good faith efforts to notify merchant promptly following suspension.

For each transaction, the acquirer banks generally charges to the merchant one or more of the following: (1) an amount equal to a specified percentage of the total cash price of each sales transaction ("Merchant Discount Fee"); (2) a specified amount per transaction; and (3) a stipulated amount per authorization. The Merchant Discount Fee is based on sales, not net sales. Different merchant discount rates apply to qualified, mid-qualified and non-qualified transactions.

BANK takes into consideration the following factors to determine the Merchant Discount Fee: (1) cost of crediting and/or advancing funds to the merchant; (2) interchange fees; (3) cost of data processing of the sales drafts; (4) fraud risk; (5) management of fraud credit risk related to the transactions; (6) counterchange services; (7) financial data management; (8) volume of transactions; and (9) transaction risk.

BANK charges the Merchant Discount Fee to cover the rendering of the following services: (1) processing and handling card payment request authorizations; (2) crediting and/or advancing funds to the merchant; (3) risk management; (4) fraud monitoring; and (5) other miscellaneous related services provided by the Bank. BANK deducts the Merchant Discount Fee from the merchant's account.

The Bank may hire a third party for data processing services, e.g. processing sales drafts, but not for financial related services such as crediting and/or advancing the funds to the merchant. In case there is a third party data processor, BANK pays the agreed compensation, including any applicable SUT, to said third party.

## **II. RULINGS REQUESTED**

1. BANK is a financial institution, as defined in Section 1033.17(f)(4) of the Code.
2. The Merchant Discount Fee should be considered economically equivalent to interest for purposes of SUT, including the surtax provisions.
3. Pursuant to Sections 4010.01(nn)(3)(A) and (E), and 4010.01(bbb)(1) and (5) of the Code, the Merchant Discount Fee constitutes either interest, a charge for the use of money, or a charge for services provided by financial institutions as defined in Section 1033.17(f)(4) of the Code, and is not one of the specified bank charges subject to SUT.
4. Pursuant to Section 4010.01(nn)(3)(A) and (E), and 4010.01(bbb)(1) and (5) of the Code, the Merchant Discount Fee is not considered “taxable services” nor “services rendered to other merchants”, not being subject to SUT, including the surtax provisions.

## **III. LAW AND ANALYSIS**

Section 1033.17(f)(4) of the Code defines a financial institution as any person doing business in Puerto Rico who is: (A) a commercial bank or trust company; (B) a private bank; (C) a savings and loan association or a building and loan association; (D) an insured institution as defined in section 401 of the National Housing Act; (E) a savings bank, industrial bank or other institution of savings or economy; (F) a brokerage or securities house; (G) institutions involved in mortgage loans, commonly known as Mortgage Banks or Mortgage Brokers; (H) any other entity organized or authorized to operate under the banking or financing laws of the Government of Puerto Rico, of the United States of America, of any State of the Union or of a foreign country. BANK is a commercial bank and, therefore, qualifies as a financial institution pursuant to Section 1033.17(f)(4)(A) of the Code.

Section 4020.01(a) of the Code imposes a tax upon every sale transaction of a taxable item in Puerto Rico. Section 4210.01(a) of the Code imposes an additional tax on every sales transaction of a taxable item in Puerto Rico carried out after June 30, 2015. Paragraph (d) of Section 4210.01 of the Code states specifically that for purposes of such section, there shall be used the definitions established in Subtitle D of the Code. The applicable SUT rate is composed of a base rate of 6% and a surtax rate of 4.5%, for a combined rate of 10.5%, pursuant to Sections 4020.01(b) and 4210.01(b) of the

Code. The application of the tax shall be subject to the exemptions granted in Chapter 3 of Subtitle D of the Code. This tax is known as the SUT.

Section 4210.01(c) of the Code imposes a tax on services rendered to other merchants and designated professional services, as defined in Subtitle D of the Code, carried out after September 30, 2015, at the rate of four (4) percent. Furthermore, paragraph (d) of Section 4210.01 of the Code states specifically that for purposes of such section, there shall be used the definitions established in Subtitle D of the Code.

A “taxable item”, which sale is subject to SUT, is defined under Section 4010.01(aa) of the Code as tangible personal property, taxable services, admission rights and bundled transactions. Section 4010.01(nn)(1) defines the term “taxable service” as any service rendered to any person. However, subsection (nn)(3)(A) and (E) states that taxable services shall not include after September 30, 2015, services rendered to other merchants; and interest and other charges for the use of the money and the charges for services provided by financial institutions as defined in section 1033.17(f)(4) of the Code, excluding bank charges subject to the provisions of Section 4010.01(nn)(2)(A)(i) of the Code. Similar provision applies before October 1, 2015, pursuant to Section 4010.01(nn)(2) of the Code.

Section 4010.01(bbb)(5) of the Code provides that the term “services rendered to other merchants” means services rendered to a person engaged in a trade or business or for the production of income, including services rendered by a nonresident person to a person located in Puerto Rico, regardless of the place where the service was rendered, provided that said service is directly or indirectly related with the operations or activities carried out in Puerto Rico by such person; except interests and other charges for the use of the money and the charges for services provided by financial institutions as defined in section 1033.17(f)(4), excluding bank charges subject to the provisions of Section 4010.01(nn)(2)(A)(i) of the Code.

Neither the Code nor the regulations provide a definition of the term “interest” for SUT purposes. However, generally, interest has been defined, for income tax purposes, as the “compensation for the use or forbearance of money. See *Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, 560 (1932); *Fall River Elec. Light Co. v. C.I.R.*, 23 B.T.A. 168, 171 (1931); and Genovevo Meléndez Carrucini, *Ingreso Tributable – Inclusiones y Doctrinas*, ¶10.02 (1st ed. 1991).

There is no applicable local tax guidance to determine whether Merchant Discount Fees are considered interest. Therefore, we turn to U.S. case law, as a persuasive, not binding, source for our analysis. See *Peña Clos v. Cartagena*, 114 DPR 576, 588 (1983) and *Belaval v. Secretario de Hacienda*, 83 DPR 251 (1961). The United States Tax Court (“USTC”) has analyzed, in the case of *Capital One Financial Corp. v. C.I.R.*, 133 T.C. 136, whether interchange fees constitute interest income. In *Capital*, the USTC concluded that the “interchange is not a fee for any service other than lending money to cardholders, income from which is generally treated as interest.” In other words, it determined that the interchange fee is a charge for lending money. In its relevant part, the USTC faced the

following question: whether the interchange charge is a fee for a service or economically equivalent to interest. The USTC started its analysis by pointing out that fees received by lenders in connection with lending money “are properly treated as interest unless the fee is for a specific service.” It added that, when evaluating the facts and circumstances in order to determine whether an item is service or interest, “the primary inquiry is whether the charge compensates the lender for specifically stated services it provided to and for the benefit of the borrower beyond the lending of money”. The USTC then went on to mention factors considered associated with the costs of lending money, such as credit and fraud risks. It explained that interest covers credit administration, cost of funds and credit risk, as well as “compensates lenders for the time value of their money, the risk that the borrower may not repay principal, and expenses of pursuing delinquent debtors.” Then, the USTC pointed out that the interchange fee bears a resemblance to interest, including the fact that when the amount of the loan increases, the amount of the interchange rises just like in the case of interest. Finally, it noted that whether the interchange fee covers all or part of the costs of a transaction is not dispositive of a determination of whether the interchange fee is economically equivalent to interest.

Although *Capital* analyzed the interchange fee charged by credit card issuers, the Merchant Discount Fee can be considered analogous to the interchange fee. As with the commercial considerations taken into account at the moment of setting an interchange fee, the Merchant Discount Fee is based on the sales amount, and considers the credit risk, the fraud risk, the cost of the data processing of the sales drafts and the cost of crediting and/or advancing funds to the merchant. No other fee imposed by the Bank in relation to card payment transactions takes into consideration the cost of crediting and/or advancing funds to the merchant. According to the taxpayer’s representations once the merchant presents the valid sales drafts, and before receiving the proceeds from the issuer, BANK advances –in other words, lends- the funds to the merchant by provisionally crediting merchant’s operating account or reserve account by the total value reflected on said sales drafts less certain fees, including the Merchant Discount Fee. Although the advanced amount is temporarily credited, the merchant may use such monies without restriction. Accordingly, the Bank is being compensated by the merchant for crediting and/or advancing the funds and use of money. Therefore, the Merchant Discount Fee may be considered economically equivalent to interest or, at least, a charge for the use of money, for SUT purposes, described under Section 4010.01(nn)(3)(E) and (bbb)(5) of the Code.

On the other hand, Section 4010.01(nn)(2)(A)(i) of the Code defines “bank charges” considered “taxable services” as “limited to charges and fees that financial institutions charge their merchant clients for [(1)] the management of demand accounts and other deposit accounts [(2)] to cover specific transactions and [(3)] charges to cover costs for exceeding pre-established limits.” Section 4010.01(nn)(2)(A)(i) of the Code further states that “this definition excludes every type of commission and/or fees related to investment banking transactions such as offerings of debt instruments and financial instruments in public and private capital markets.” Furthermore, Article 4010.01(nn)-2(a) of Regulation No. 8049 identifies “bank charges” subject to the sales and use tax as “taxable services”.

The Merchant Discount Fees are not included among the charges and fees subject to SUT and “bank charges”.

#### **IV. CONCLUSION**

Based on the representations made, the provisions of the Code, the applicable regulations, and the information submitted, this Department hereby rules as follows:

1. BANK is a financial institution, as defined in Section 1033.17(f)(4) of the Code.
2. The Merchant Discount Fee, as described above, may be considered economically equivalent to interest or, at least, a charge for the use of money, for SUT purposes, as described under Section 4010.01(nn)(3)(E) and (bbb)(5) of the Code.
3. Pursuant to Sections 4010.01(nn)(3)(E), and 4010.01(bbb)(5) of the Code, the Merchant Discount Fee, as described above, constitutes interest or a charge for the use of money, and not a “bank charge” subject to SUT.
4. Pursuant to Sections 4010.01(nn)(3)(A) and (E), and 4010.01(bbb)(1) and (5) of the Code, the Merchant Discount Fee, as described above, is not considered “taxable services” nor “services rendered to other merchants” subject to SUT.

No opinion is expressed as to the tax treatment of the above transactions under any other provision of the Code, and the regulations issued thereunder, that may also be applicable thereto, or to the tax treatment of any condition existing at the time of the transactions, or any effect resulting therefrom, that is not specifically covered by this ruling. This ruling is based on the factual representations as described above. Any misrepresentation or hiding of a material fact shall render this ruling null and void. The opinion expressed shall be valid only upon the continued existence of the facts as submitted to our consideration. This letter ruling is directed only to the taxpayer requesting it and may not be used or cited as precedent.

Sincerely,

Elisa Vélez Pérez, CPA, MBA, Esq.  
Assistant Secretary