OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
AUG 3, 2001

Number: **200145013**
Release Date: 11/9/2001
CC:FIP:2
TL-N-1990-01
UILC: 61.15-00
1272.06-02

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB), ATLANTA
ATTENTION: CLINTON M. FRIED, SENIOR ATTORNEY (LMSB)
CC:LM:RFP:ATL

FROM: Acting Associate Chief Counsel (Financial Institutions and Products) CC:FIP

SUBJECT: Certain Credit Card Fees

This Chief Counsel Advice responds to your memorandum dated April 2, 2001. In accordance with ' 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corporation 1
Corporation 2
Sub 1
Sub 2
Year 1
Year 2
$a
$b
c%
d%
Card A

ISSUES

1. Whether certain credit card fee income received by an Issuer may be treated as interest income?

2. Whether an Issuer making a change in method of accounting with respect to pools of credit card receivables under section 12.02 of the Appendix to Rev. Proc. 98-60 may include more than grace period interest?

CONCLUSIONS

1. As discussed below, in appropriate circumstances certain credit card fee income received by an Issuer may be susceptible to interest treatment. The proper characterization of such fee income, however, is a factual determination.

2. As discussed below, an Issuer may include items in addition to grace period interest with respect to its pools of credit card receivables in making the change in method of accounting under section 12.02 of the Appendix to Rev. Proc. 98-60.

FACTS

Prior to Year 2, both Corporation 1 and Corporation 2 were separate bank holding companies, each owning the stock of a banking subsidiary having credit card operations. Sub 1 was part of the group of affiliated corporations that filed a consolidated federal income tax return with Corporation 1 as parent prior to Year 1. Sub 2 was part of the group of affiliated corporations that filed a consolidated federal income tax return with Corporation 2 as parent prior to Year 1. Corporation 1 and Corporation 2 merged in Year 1 with Corporation 1 surviving. Sub 2 joined in the filing of consolidated federal income tax returns with Corporation 1 as parent, commencing with Year 2.[1]

Sub 1 and Sub 2 are banks that issue credit cards to customers in the ordinary course of business. Neither Sub 1 nor Sub 2 is an acquirer of merchants under the bank credit card programs in which it participates. Both Sub 1 and Sub 2 earn income from grace period interest and from certain fees charged to card holders with respect to their accounts (including the AOver-the-limit@ fees, ALate charge@ fees, and ACash advance@ fees which are at issue here).

Forms 3115 for Sub 1 and Sub 2 were filed pursuant to section 12.02 of the Appendix to Rev. Proc. 98-60, 1998-2 C.B. 761, modified and superseded by Rev. Proc. 99-49, 1999-2 C.B. 725.[2] These Forms 3115 were attached to the respective consolidated federal

[1] We understand that the merger occurred as of the close of the last business day in Year 1 and that Sub 2 continued as an active subsidiary of Corporation 1.

[2] Section 12.02 of the Appendix to Rev. Proc. 98-60 (the AAppendix@) is the

corporate income tax returns (Forms 1120) for Corporation 1 and Corporation 2 for Year 1. Both Sub 1 and Sub 2 included fee income in their respective accounting method changes.

The examining agent questions, as a preliminary matter, whether fee income received by a lender with respect to credit card debt can ever qualify for interest treatment. Although the facts are not yet fully developed, we assume for purposes of our discussion that the practices of both Sub 1 and Sub 2 were substantially similar and as described below.

A. Description of the fees at issue

(1) Over-the-limit fees

Over-the-limit fees are charged by an Issuer of a credit card when a cardholder=s credit limit is exceeded. In general, an Over-the-limit fee is billed directly against a cardholder=s account and, once posted, is included in the outstanding account balance to which interest is charged at the stated rate. On the facts provided, it appears that an Over-the-limit fee in a fixed amount of $a (as opposed to a variable percentage) was imposed on cardholders for instances in which such a fee was charged in Year 1. This charge appears on the cardholder=s next account billing statement.

(2) Late charge fees

Late charge fees are charged by an Issuer of a credit card when a cardholder fails to make a payment otherwise due. In general, a Late charge fee is billed directly against a cardholder=s account and, once posted, is included in the outstanding account balance to which interest is charged at the stated rate. On the facts provided, it appears that a Late charge fee in a fixed amount of $b (as opposed to a percentage of the delinquency) was imposed on cardholders for instances in which such a fee was charged in Year 1. This charge appears on the cardholder=s next account billing statement.

(3) Cash advance fees

Cash advance fees are charged by an Issuer of a credit card when a cardholder uses that card to obtain cash drawn (or deemed to be drawn) against the line of credit on the card. A minimum or maximum fee may be imposed in some situations. In general, a Cash advance fee is billed directly against the cardholder=s account and, once posted, is included in the outstanding account balance to which interest is charged at the stated rate. On the facts provided, it appears that a transaction fee (from c% to d% of the amount advanced depending on applicable state law) was imposed on cardholders whenever a cardholder

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operative provision here.

used its credit card to obtain cash in Year 1.[3] This charge appears on the cardholder=s next account billing statement following the Cash advance (presumably, this is the same billing statement that also reflects the cardholder=s underlying Cash advance transaction).[4]

B. The Forms 3115

(1) Sub 1's Form 3115 under Rev. Proc. 98-60

Sub 1 filed a Form 3115 (AForm 3115 #1") under section 12.02 of the Appendix and described the item affected by the change as Athe taxpayer=s treatment of original issue discount (AOID@) on any pool of debt instruments the yield on which may be affected by reason of prepayments.@ Form 3115 #1, Statement #4. The applicable year of change for this accounting method change is Year 1.

(2) Sub 1's Form 3115 under Rev. Proc. 97-27

Sub 1 also filed a Form 3115 (AForm 3115 #2") under Rev. Proc. 97-27, 1997-1 C.B. 680, with respect to the fees charged for Cash advances that would, if granted, allow Sub 1 to treat such fees as creating or increasing the amount of OID on such debt instruments. See Form 3115 #1, Statement #12; Form 3115 #2, Statement #4. The requested year of change for this accounting method change is Year 1.[5]

(3) Sub 2's Form 3115 under Rev. Proc. 98-60

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[3] It is not clear whether a separately stated ATM fee is also charged when a cardholder uses a credit card at an ATM to obtain the Cash advance. Further, it is not clear whether a Cash advance fee is charged for other types of transactions that are treated under the applicable cardholder agreements as Cash advances (for example, if a cardholder uses an account draft/check drawn on the credit card=s line of credit to pay for goods or services or to transfer balances from a different loan account to the credit card account).

[4] Based on the information provided, we understand that certain terms and conditions (including the amount of the Cash advance fee charged to any given cardholder) may depend on which credit card program is involved as well as the cardholder=s state of residence. We also understand that, as a general matter, no grace period is provided with respect to Cash advances under the bank credit card programs at issue here.

[5] Sub 1's treatment of Cash advance fees will be addressed in the Service=s consideration of Form 3115 #2 and not in this memorandum.

Sub 2 filed a Form 3115 (AForm 3115 #3") under section 12.02 of the Appendix and described the item affected by the change as Sub 2's Atreatment of [OID] on any pool of debt instruments the yield on which may be affected by reason of prepayments.@ See Form 3115 #3, Statement #2. The year of change for this accounting method change is Year 1.[6]

LAW AND ANALYSIS

Part I: Background

In addition to credit cards, banks may issue a number of different other types of cards in the ordinary course of their business.[7] However, in this memorandum we address only certain fee income earned by banks that issue credit cards (AIssuers@) bearing a national card association=s logo (for example, Card A).[8] By way of an introduction to the specific issues before us, we offer (A) a brief description of the relevant segment of the credit card industry involved and (B) a sample credit card purchase transaction.

A. The Relevant Credit Card Industry Segment

By the latter half of the twentieth century, the use of bank-issued credit cards for the payment of good and services (in place of cash or checks) became a fairly commonplace occurrence. Bank-issued credit cards are used by cardholders to acquire goods or services currently while deferring for a period of time the cardholders= actual outlay of cash in payment for such goods or services. Even when a cardholder pays the balance in full immediately upon being billed, that cardholder has enjoyed (with respect to the cardholder=s own funds) the time value of some deferral for the interim period between the purchase transaction and payment.

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[6] We assume that Sub 2 separately continued its credit card operations after being acquired by Corporation 1 and that ' 381 is not implicated in connection with Form 3115 #3.

[7] For example, banks may also issue debit cards which permit cardholders to access their own funds as opposed to a line of credit.

[8] In addition to not addressing other types of fee income earned by Issuers with respect to the credit card transactions of their cardholders, we also do not address the characterization for purposes of subpart F of the Code ('' 951-964) of any credit card fee income received by an Issuer or consider any collateral issues (such as the appropriate treatment of any foreign tax credits pertaining thereto, etc.) that may flow from any cross-border aspects of such payments.

One characteristic of these bank-issued credit cards (hereafter, Acredit cards@) is that they provide for a line of credit which may be withdrawn in cash by the cardholder. Another characteristic is that these credit cards are generally accepted by a wide number of unrelated providers of goods and services (Amerchants@). A bank that issues a credit card to a customer (Acardholder@) is referred to throughout this memorandum as an AIssuer.@

With respect to a credit card, the Issuer and cardholder enter into an agreement (the Acardholder agreement@) that commonly contains all of the applicable terms and conditions for the cardholder=s use of the credit card. The Issuer sets the amount of the credit line available to the cardholder, the amount of stated interest to be charged on the credit card, and any other applicable charges or costs to be borne by the cardholder. A bank that contracts with merchants and service-providers to participate in a particular credit card program, however, is known in the credit card business as an AAcquirer.@

For each such card program in which it participates, an Issuer is a party to an interlocking contractual arrangement with the holder of the card brand (the AAssociation@) whose logo appears on the credit card (for example, Card A). An Acquirer participating in that same card program is also a party to an interlocking contractual arrangement with the same Association. However, Issuers and Acquirers do not appear to be directly in contractual privity with each other. Rather, each of the Issuers and Acquirers participating in the Association=s card program appears to be a third-party beneficiary of all the other participants= contracts with the Association. One common condition of each such contract appears to be that the participant agrees to be bound by the operating rules and conditions set forth by the Association.

The process by which credit card transactions are authorized and settled is historically referred to as interchange.[9] That is, the receivable is routed either electronically or

[9] Interchange refers to that function managed by the credit card association to exchange information, transactions, money, and other items on a standardized and consistent basis. See, e.g., The Bank Credit Card Business (2d ed.) (1996) (an American Bankers Association publication). Fees are generally charged as part of the clearing and settlement process and Issuers may derive interchange fee income in connection with certain types of cardholder transactions. The difference between the face amount of the receivable and the amount paid in settlement of that receivable by the Issuer is generally referred to as the Ainterchange fee.@ The amount of the interchange fee is generally determined under the operating rules established by Association and imposed by the automated clearinghouses that perform Interchange. We understand that the amount of the interchange fee may vary depending upon certain factors, including the nature of the transaction, the applicable rate indicator, the applicable geographic regions, the particular card program and merchant category involved, and the manner of authorization and clearance of the transaction. However, the proper tax treatment of interchange fee income by an Issuer is outside the scope of this memorandum.

physically through the payment/settlement processing system for that credit card until it is ultimately presented for settlement to the Issuer of the cardholder=s credit card which was used in the underlying transaction.[10]

B. Sample Purchase Transaction

For purposes of discussion only, assume the following facts:

> Card Program (ACP@) contracts separately with a bank (AIB@) to issue credit cards bearing the CP logo, and with another bank (AMB@) to authorize participating merchants to accept credit cards bearing the CP logo in payment for purchase transactions.
>
> Merchant (AM@) agrees, through contractual arrangement with MB, to accept credit cards bearing the CP logo in payment of goods and services. Cardholder (AC@), having been extended a line of credit and issued a credit card bearing the CP logo by IB, subsequently uses that CP card to make a purchase of goods from M. The goods have a stated purchase price of $100.
>
> In accordance with the terms of its contract with MB, M provides C=s $100 purchase transaction record to MB and receives $98 in return. In turn, MB presents C=s $100 purchase transaction record for settlement through CP=s clearinghouse. C=s $100 purchase transaction record is presented to IB by CP=s clearinghouse. In settlement, MB receives $99 for C=s $100 purchase transaction receivable.[11]

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[10] We understand that transactions are settled by an Association=s clearinghouse on a net basis, generally daily. We also understand that a nominal service charge is usually imposed to cover the clearinghouse=s costs associated with interchange.

[11] In this example, the $2 difference between the $100 face amount of C=s credit card purchase transaction record and the $98 received by M from MB is the merchant discount and the $1 difference between the $100 face amount of C=s credit card purchase transaction record and the $99 received by MB from IB in settlement is the interchange fee. (For purposes of this example, we have assumed that CP is separately compensated for its services and that there are no other parties that may be entitled to compensation for services in connection with the authorization, clearance, and settlement of C=s $100 purchase transaction. However, we understand that CP generally receives compensation for its services directly in the course of interchange and that one or more of the parties may have retained a third-party as agent to perform some or all of its credit card operations. The compensation arrangements for such third-parties is often tied to the number and/or face amount of the credit card transactions involved and may provide for direct sharing of income received with respect to those credit card operations.)

Subsequently, IB provides C with a credit card billing statement requesting payment of $100 from C with respect to C=s $100 purchase transaction from M. As a general matter, the credit card agreement between C and IB provides for a grace period with respect to interest.[12]

Part II: Relevant legal provisions

For federal income tax purposes, the generally accepted definition of interest is Acompensation for the use or forbearance of money@ as stated in Deputy v. DuPont, 308 U.S. 488, 498 (1940). In determining whether a particular charge is an interest charge, labels are not determinative of federal income tax consequences.[13] See, e.g., Goodwin v. Commissioner, 75 T.C. 424 (1980), aff=d, 691 F.2d 490 (3d Cir. 1982). This is also true with respect to regulatory labels.[14]

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[12] Grace periods are generally defined in the relevant cardholder agreements although they may also appear on the billing statement. Typically, a grace period with respect to new purchase transactions may run from the date C uses the card to make the $100 purchase from M to the due date shown on the billing statement from IB in which that purchase is reflected, provided that C pays the $100 in full by that due date. However, another form of grace period can occur with respect to interest if, under its cardholder agreement with C, IB does not charge C interest on the outstanding account balance for the period between a statement=s billing date and the due date for payment, provided that the outstanding balance shown on that billing statement is paid in full by the specified due date.

[13] As stated in Rev. Rul. 72-315, 1972-1 C.B. 49 at 50, Ait is not necessary for the parties to a transaction to label a payment made for the use of money as interest for it to be so treated.@ Rather, the facts of the transaction (and not the label ascribed) control the character of the income received. Id. So too, an item labeled interest will not be accorded interest treatment for federal income tax purposes if, on the facts, that charge is attributable to specific services performed in connection with a borrower=s account. See Rev. Rul. 69-189, 1969-1 C.B. 55.

[14] For example, federally chartered banks are required to comply with the National Banking Act of 1864 (Bank Act), pursuant to which a national bank may charge the same fees as any state bank chartered in the same state although the national bank is not bound by the labels used in the state. Thus, even if the state bank is required under state law to call that fee a service fee, the proper classification of the fee charged by the national bank is made under the Bank Act. See 12 U.S.C. 85 (' 85 of the Bank Act) (interest includes any kind of charge imposed by a national bank for the use or forbearance of money).

Interest with respect to a debt instrument may be generated in more than one form. For example, a particular debt instrument may bear a stated rate of interest. However, interest may also result on that same debt instrument from OID. See United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (OID is the economic equivalent of interest).

OID is defined as the excess, if any, of a debt instrument=s stated redemption price at maturity (ASRPM@) over its issue price. See ' 1273(a). SRPM is the sum of all payments provided by the debt instrument other than qualified stated interest (AQSI@). See ' 1.1273-1(b) of the Income Tax Regulations.

Under ' 1272, a holder of a debt instrument with OID is required to include the sum of the daily portions of OID in income for each day during the taxable year on which the holder held that instrument. See ' 1272(a)(1). Section 1272(a)(6) provides rules to determine the daily portions of OID for certain debt instruments subject to prepayments. Under these rules, the daily portions of OID are determined, in part, by taking into account an assumption regarding the prepayment of principal on the debt instruments. For taxable years beginning after August 5, 1997, ' 1272(a)(6) applies to any pool of debt instruments, including a pool of credit card receivables, the yield on which may be affected by reason of prepayments. See ' 1272(a)(6)(C)(iii) and H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 522 (1997).

Rev. Proc. 98-60 provided procedures by which consent to change a method of accounting described in the Appendix was granted to certain taxpayers. The Appendix provided specific procedures for various changes covered under the automatic consent procedures of Rev. Proc. 98-60. Section 12.02 of the Appendix applied to any taxpayer required to change its Amethod of accounting for a pool of debt instruments to comply with ' 1272(a)(6) (as required by ' 1004 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 911), provided the change is for the first taxable year beginning after August 5, 1997.@ See Appendix, section 12.02(1)(a).

Part III: Issues Presented

> Issue 1: Whether certain credit card fee income received by an Issuer may be treated as interest income?

As previously indicated, we are concerned only with whether, for federal income tax purposes, Over-the-limit fees, Late charge fees, and Cash advance fees received by Issuers with respect to credit card debt incurred by their cardholders may be susceptible to interest characterization. Determining the proper federal income tax treatment of these credit card-related fees is a highly factual inquiry. Relevant facts may include: (a) *who* is paying the fee; (b) *what* is the nature of the fee; (c) *when* (or how) is the amount of the fee determined; (d) *where* does the fee appear in the taxpayer=s books and records; and (e) *why* is the fee accounted for in this manner. In addition, the capacity in which such fee

income is earned by an Issuer, as well as the purpose for which it is earned, are also relevant.

To constitute interest for federal income tax purposes, the fee income must be paid to an Issuer in its capacity as a lender and as compensation for the use or forbearance of money. See Deputy v. DuPont, supra. Whether, and to what extent, fee income is earned by an Issuer as compensation for services or property is determined on the basis of all of the surrounding facts and circumstances.

(A) Over-the-limit fee income

As noted above, an Over-the-limit fee is generally imposed because a cardholder has reached (and exceeded) the available credit line previously authorized by the Issuer for that cardholder. Rather than refusing to honor the cardholder=s credit card transaction(s) giving rise to the credit limit being exceeded, however, the Issuer may provide an extension of additional credit on a one-time basis to cover the cardholder=s credit shortfall.[15] When the Issuer does so, the cardholder agreement provides for the imposition of an Over-the-limit fee. Under these circumstances, the Over-the-limit fee appears to function much like an overdraft advance fee.

As described in Rev. Rul. 77-417, 1977-2 C.B. 60, an overdraft advance fee is available to cardholders having a checking account with the Issuer of the credit card. When a cardholder with overdraft protection on such checking account writes a check on that checking account in an amount that exceeds the available balance in that account, a transfer of funds is made from the credit card account to the checking account to cover the shortfall in the checking account. At the time of such transfer, an overdraft advance fee is also imposed and charged to the cardholder=s credit card.

Rev. Rul. 77-417 holds that the overdraft advance fee (which was a one-time charge calculated by reference to the amount of the overdraft advance but with a set minimum amount) can be treated as interest by the cardholder because no part of the charge is attributable to services performed by the bank in connection with the cardholder=s credit card account.[16] Although Rev. Rul. 77-417 is concerned with the cardholder=s

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[15] While Issuers may make additional isolated extensions of credit in excess of the previously authorized credit limit, we understand that no such extension gives rise to a cardholder=s claim of right to a higher line of credit.

[16] We note that, under the facts of the ruling, the fee was in addition to any stated interest that would otherwise be imposed if the balance were not paid when due. We also note that although the set fee in the ruling was 1% of the amount of the advance, the minimum fee ($1) was 20% of the minimum transfer amount ($5).

consequences under prior law, it provides continuing guidance with respect to the relevant factors to consider in determining when an amount is properly treated as interest. As such, the ruling is also useful when determining a similar characterization of that fee from the Issuer=s perspective. We think, therefore, that if an Over-the-limit fee is imposed by an Issuer on a cardholder with respect to the cardholder=s credit card account, and that fee is not imposed for services rendered by the Issuer for the cardholder=s benefit, an Over-the-limit fee like an overdraft advance fee may be susceptible to characterization as interest.

(B) Late charge fee income

Although presented from the customer=s vantage point, Rev. Rul. 74-187, 1974-1 C.B. 48, holds that a surcharge imposed by a public utility company for delinquent payments is deductible as interest by the customer. The holding specifically states that there is no evidence that the charge is assessed by the utility company for any specific service performed in connection with the customer=s account. The ruling=s rationale provides that interest characterization is not precluded either because the late payment charge is a one-time charge or because the surcharge is not tied to the duration of the outstanding balance (the surcharge at issue in the ruling is a set 5% of the amount of the bill). We believe that, as with Rev. Rul. 77-417, the principles enunciated in Rev. Rul. 74-187 may also be useful in determining the proper characterization of Late charge fee income received by an Issuer.

Not every imposition of a late fee is intended to compensate a lender for the use or forbearance of money. For example, a late fee may be imposed by a lender to recoup the additional expenses associated with processing or collecting a delinquent payment. Further, a late fee may be imposed by a lender for more than one purpose. See, e.g., West v. Commissioner, T.C. Memo. 1991-18, aff=d, 967 F.2d 596 (9th Cir. 1992) (unpublished opinion). In West, the petitioners failed to establish what portion, if any, of the late fees incurred with respect to their delinquent mortgage payments was interest where the late fees were imposed by the lender for more than one purpose and the evidence in the record supported a finding that the fee was imposed by the lender to recoup its processing costs.

As with Over-the-limit fees, we also believe that whether interest characterization by an Issuer is appropriate with respect to a Late charge fee will turn on the facts of each case. Consistent with Rev. Rul. 74-187, however, where a Late charge fee is imposed by an Issuer on a cardholder with respect to the cardholder=s credit card account, and it is not imposed for services rendered by the Issuer for the cardholder=s benefit, that Late charge fee may be susceptible to characterization as interest income.

(C) Cash advance fee income

Where a cardholder obtains a Cash advance, a transaction charge known as a ACash advance fee@ is usually imposed by the Issuer. If the Cash advance is obtained against a

credit card, this charge is in addition to any stated interest charge and any separately stated ATM charge billed to the cardholder.

As with the other fees discussed above, the proper character of Cash advance fee income is a factual determination. Although the Service has not specifically ruled on the proper tax treatment of Cash advance fees by an Issuer, it has published guidance with respect to the treatment of Cash advance fees by cardholders. Provided that the Cash advance fee is not attributable to services performed by the Issuer, Rev. Rul. 77-417 permitted such fees to be deducted as interest by the cardholder.[17] However, the result reached in Rev. Rul. 77-417 is indicative that, from an Issuer=s perspective, Cash advance fees may be imposed to reflect the additional cost of funds in this type of credit card transaction.

(D) Application to Sub 1 and Sub 2

Whether Sub 1 or Sub 2 earned fee income (a) in the capacity as a lender, (b) in connection with a lending transaction, and (c) for other than property or services must be determined by considering all the facts. In connection with the factual development of these issues, relevant information may be found in the applicable cardholder agreements and other documentation giving rise to the taxpayer=s right to such fee income.

Issue 2: Whether an Issuer making a change in method of accounting with respect to pools of credit card receivables under section 12.02 of the Appendix may include more than grace period interest?

The change authorized under section 12.02 of the Appendix was with respect to any pool of debt instruments the yield on which may be affected by reason of prepayments. The purpose of the change, as described in section 12.02(1)(c), was to extend the special rules of ' 1272(a)(6) for determining the daily portions of OID on certain debt instruments subject to prepayments to any pool of debt instruments the yield on which pool may be affected by reason of prepayments. A pool of credit card receivables that are subject to a grace period provision was identified as such a pool.

Sub 1 and Sub 2 filed Forms 3115 under section 12.02 for Aany pool of debt instruments the yield on which may be affected by reason of prepayments.@ See Appendix, section 12.02(1)(c)(ii). Their respective pools of credit card receivables that were subject to a grace period are covered by this change. A change triggered by application of ' 1272(a)(6)(C)(iii), however, concerns the computation of the daily accruals of OID on pools of debt instruments the yield on which may be affected by prepayments. The grant of

[17] Rul. 77-417 holds that a cardholder may take a deduction for interest (as permitted at that time) for such fees provided they were not made to compensate the Issuer for services directly chargeable to, or incurred for the benefit of, the cardholder.

consent in section 12.02 was not limited to pools of credit card receivables the OID on which is attributable only to the operation of a grace period provision. For items other than grace period interest included by a taxpayer with respect to a pool of credit card receivables, whether a particular item properly creates or increases OID on that taxpayer's pool of debt instruments is determined on the basis of all of the surrounding facts and circumstances.[18]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

A. Administrative burden considerations

Because fee income may be earned by Sub 1 and Sub 2 for more than one purpose, whether (and to what extent) that fee income can now be said to be earned by an Issuer other than for services or property will turn on all of the facts and circumstances. [redacted]

Where a fee is imposed by reference to the face amount of the payment or debt obligation or to the duration in which funds are outstanding, such fees may look more like a charge for the use of money. Conversely, where a fee is imposed at a fixed amount and without regard to either the amount of funds or duration in which the funds are outstanding, that fee may look more like compensation for services. It may, therefore, be easier for both taxpayers and Exam to differentiate between fee income earned by reference to the face amount of the debt and fee income computed by reference to fixed charges.

[redacted]

[18] Even if the fees discussed in this memorandum are properly characterized as interest for federal income tax purposes, it is unclear at this time whether they will create or increase OID with respect to the credit card receivable pools established by Sub 1 and Sub 2. Once the facts are more fully developed, the examining agents may want to seek additional guidance on the OID issues.

[redacted]

With respect to how an Issuer should determine its prepayment assumption, we can only offer some general insights at this time. Whether a taxpayer=s prepayment assumption is reasonable may turn on factors such as what items of income are affected by the change (for example, only OID due to grace period interest or all OID on that pool) and how the pool is structured (for example, whether it is tied to an individual cardholder account or to the Issuer=s daily outstanding receivable balance may make a difference). Generally, in the absence of specific guidance for determining prepayment assumptions, the use of averages and estimates may be acceptable. However, the lack of specific guidance is not a license for taxpayers to estimate or average their income from credit card operations.

Similarly, with respect to the determination of the life of a pool of credit card receivables, taxpayers may be able to look to averages and estimates. Based on industry averages, the life of an average pool of credit card receivables is fairly short (as short as six months according to one industry source we looked at). Credit card debt is also short-lived for regulatory book purposes as it may be written off more quickly than other debt. However, this does not mean that every taxpayer must use such a short life. No matter how a taxpayer establishes the life of a pool of credit card debt for purposes of applying ' 1272(a)(6), it should be able to demonstrate and verify that determination for Exam. We also think that the underlying factors relied on by a taxpayer should be Afreshened@ so that its prepayment assumption remains fairly current (for example, its statistical sampling may need to be updated no less than once a year to reflect current pool performance).

. Other concerns about accounting method changes

We have not addressed the other specific accounting method issues raised by Exam with respect to Sub 1 and Sub 2 for a number of reasons, including (1) a lack of sufficient facts on which these other issues can be analyzed properly and (2) to the extent that Exam is seeking a determination that will affect the rights of these specific taxpayers, technical advice may be required. [redacted] See section 9.01 of Rev. Proc. 98-60. However, if an agent wants to propose an adjustment that would

(a) result in removing one or more of the items included by Sub 1 or Sub 2 in their respective pools, or

(b) alter the methodology being used by the taxpayer, or

(c) challenge whether the respective changes were proper under the terms of the consent given in Rev. Proc. 98-60,

the agent may be required to seek technical advice (ATAM@) prior to asserting the adjustment. See section 9.02 of Rev. Proc. 98-60. Further, although TAM determinations are generally given retroactive effect (see section 17.02 of Rev. Proc. 2001-2, 2001-1 I.R.B. 79, 104), that may not be the case here with respect to any proposed changes or modifications to the taxpayers= respective methods of accounting. See section 17.06 of Rev. Proc. 2001-2, 2001-1 I.R.B. at 104-105;section 8.02 of Rev. Proc. 98-60, 1998-51 I.R.B. at 25.

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Please call if you have any further questions.

By: WILLIAM E. COPPERSMITH
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions and Products)