Capital One Fin. Corp. v. Comm'r, 133 T. C. 136 (2009) (United States Tax Court, 2009)

In a landmark decision, the U. S. Tax Court ruled that Capital One's interchange fees from credit card transactions should be treated as Original Issue Discount (OID) on the pool of credit card loans, allowing for deferred income recognition over time. This ruling clarifies the tax treatment of interchange income and sets a precedent for credit card issuers, impacting how they account for revenue from card transactions and potentially affecting their tax liabilities.

Parties

Capital One Financial Corporation and its subsidiaries, Capital One Bank (COB) and Capital One, F. S. B. (FSB), were the petitioners. The Commissioner of Internal Revenue was the respondent. The case was heard at the trial level and on appeal before the United States Tax Court.

Facts

Capital One, through COB and FSB, issued Visa and MasterCard credit cards and earned interchange fees when cardholders used their cards for purchases. Interchange fees are a percentage of the transaction amount, paid by the merchant's bank to the issuing bank. Capital One treated interchange fees and overlimit fees as creating or increasing OID under section 1272(a)(6)(C)(iii) of the Internal Revenue Code for tax years 1998 and 1999. COB submitted Form 3115 to change its accounting method for OID, while FSB did not. Capital One also offered a Milesone reward program where cardholders earned miles for purchases, which could be redeemed for airline tickets.

Procedural History

Capital One filed a petition with the U. S. Tax Court after the IRS determined deficiencies in its Federal income taxes for tax years 1995-1999. The court previously addressed the parties' cross-motions for partial summary judgment on the change in accounting method for late fees, holding that COB and FSB could not retroactively change their methods without following IRS procedures. The current case focused on the treatment of interchange fees, the calculation of OID, and the deductibility of estimated costs for the Milesone reward program. The standard of review applied was de novo.

Issue(s)

Whether interchange fees earned by Capital One from credit card transactions should be treated as creating or increasing Original Issue Discount (OID) under section 1272(a)(6)(C)(iii) of the Internal Revenue Code?

Whether the KPMG model used by Capital One to calculate OID complies with the

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requirements of section 1272(a)(6) of the Internal Revenue Code?

Whether Capital One may deduct the estimated cost of future redemptions of miles issued under its Milesone reward program under section 1. 451-4 of the Income Tax Regulations?

Rule(s) of Law

Section 1272(a)(6)(C)(iii) of the Internal Revenue Code requires taxpayers to treat certain credit card receivables as creating or increasing OID on the pool of credit card loans to which the receivables relate. OID is the excess of the stated redemption price at maturity (SRPM) over the issue price of the debt instrument.

Section 1. 451-4 of the Income Tax Regulations allows a taxpayer to deduct from sales revenues an estimate of the expenses associated with redeeming coupons issued with sales.

Holding

The court held that interchange fees are not fees for any service other than the lending of money and are properly treated as OID under section 1272(a)(6)(C)(iii). The KPMG model used by Capital One to calculate OID was held to be reasonable in most respects, except for the inclusion of new additions in the beginning issue price and the application of payments to current month's finance charges. FSB could not treat interchange and overlimit fees as OID due to its failure to change its accounting method. The court ruled that Capital One could not deduct the estimated costs of redeeming Milesone miles under section 1. 451-4 because the miles were not issued with sales.

Reasoning

The court reasoned that interchange fees compensate issuing banks for the costs of lending money, including financial carrying costs, credit and fraud risks, and processing costs. The fees were not found to be payments for services provided by the issuing bank to the merchant or the cardholder. The court rejected the respondent's argument that interchange fees were paid by the acquiring bank to the issuing bank, instead treating them as a reduction of the issue price of the credit card loan under section 1. 1273-2(g)(4) of the regulations.

The KPMG model was analyzed under a reasonableness standard, given the lack of specific regulations for calculating OID on a pool of credit card loans. The court found the model's approach of treating the pool of loans as retired and reissued each month to be reasonable, as it was based on the OID regulations for debt instruments modified by contingencies. However, the court found that the inclusion of new additions in the beginning issue price and the application of payments to current month's finance charges did not comply with section 1272(a)(6).

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The court applied the all events test to the Milesone reward program, holding that the miles were not issued with sales because the lending of money by Capital One was not considered a sale of services. Therefore, the estimated costs of redeeming the miles could not be deducted under section 1. 451-4.

Disposition

The court's final decision was to enter judgments under Rule 155, reflecting the court's holdings on the treatment of interchange fees as OID, the adjustments required to the KPMG model, and the disallowance of the deduction for the estimated costs of the Milesone reward program.

Significance/Impact

This case is significant for its clarification of the tax treatment of interchange fees as OID, which may impact the tax planning and reporting of credit card issuers. The court's decision on the KPMG model provides guidance on calculating OID for pools of credit card loans, despite the lack of specific regulations. The ruling on the Milesone reward program reinforces the applicability of the all events test and the limitations of section 1. 451-4. The case has been cited in subsequent tax court decisions and may influence future IRS guidance on OID and credit card receivables.

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