The Harmful Impacts of **Removing** Sales Tax from Interchange Calculations

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Executive Summary

Sales tax is a crucial component of revenue in 45 states. For merchants, collecting sales taxes on goods and services is as much a part of doing business as paying for utilities or employee wages. Yet over the past 17 years, state legislative proposals to require financial service providers to exclude payment processing fees from the sales tax portion of a card payment have been introduced and repeatedly rejected.

Seven states and one territory currently have legislative proposals in place that seek to exclude state and local sales tax from the calculation of interchange fees when consumers pay with debit, credit or prepaid cards. The proposals look to remove interchange fees for each card payment transaction within the daily settlement process or an after-the-fact rebate.

While it might appear that these proposals would benefit retailers and other merchants, nothing is farther from the truth—the bills pose an enormous threat to the payment system and will result in higher (not lower) costs to all but the largest merchants. Removing sales tax from interchange calculations will:

- Introduce complexity, cost and risk to a global, interoperable payment system
- Create significant operational burden to merchants with small businesses seeing little to no benefit
- Require a system of accountability to ensure that the sales tax charged on every card transaction is accurate

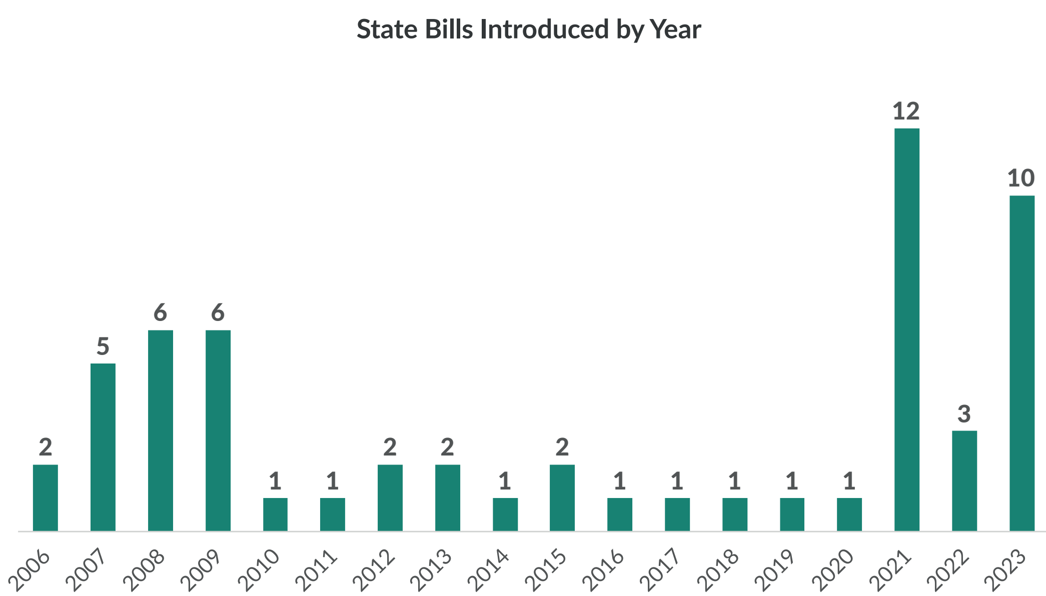
The conclusion is clear: Policymakers must consider alternative methods outside of interchange rebates to assist merchants. Large-scale changes to card payments require a full understanding of the risks the changes will bring and the costs that merchants, consumers, state governments and financial institutions will incur.

This report provides a review of the sales tax process, merchants' concerns, the complexity of sales tax calculations and the challenges of implementing proposals to change how state tax calculations impact interchange fees.

Proposed State Legislation

In the past 17 years, 29 states have introduced a total of 58 bills seeking to remove interchange fees from the state and local sales tax portion of debit and credit card purchases. None of these bills have been approved (Figure 1).

Figure 1: History of State Bills by Year to Exclude Interchange on Sales Tax



Source: Cornerstone Advisors

The last few years have seen an increase in interest to remove interchange fee calculation from the sales tax portion of a card payment. A few examples:

- **Florida:** Prohibits issuers, payment card networks, acquirer banks and processors from receiving or charging merchants interchange fees on the tax amounts of electronic payment transactions if the merchant provides certain information in a specified manner. A credit is required within a certain timeframe.[1]

- **Georgia:** No payment card network shall apply an interchange fee to a retailer based on an amount greater than the goods and services consumer purchase price. A payment card network shall either exclude the amount of any taxes from the calculation of interchange fees specific to each payment card transaction or refund an amount of interchange fee proportionate to the amount attributable to the taxes at the time of settlement with the retailer. If not at time of settlement, merchant may submit sales data to payment card network for proof of tax/fee collected on sales.[2]

- **Texas:** Excludes state and local tax from interchange fee calculation and requires a deduction or rebate to occur at time of settlement. If not at time of settlement, merchant may submit sales data to payment card network for proof of tax/fee collected on sales.[3]

These state level bills seek to regulate a worldwide payment system and are often very brief on details, leading to confusion to both merchants and financial institutions. Additionally, these proposals would create a disjointed set of standards whereas today credit and debit card networks are interoperable at a global level, ensuring common standards regardless of location. These common standards allow a merchant to operate in multiple states with the processes and protocols to provide a reliable payment experience for all customers.

Merchants and Sales Tax

Running a business, regardless of size, comes with a set of compliance standards set forth by the state(s) where a business sells goods and services to consumers. One of these requirements is to register with the appropriate state agency to collect sales tax on products and services sold to consumers. To illustrate, in Florida before a business begins sales to customers, it must register to collect sales tax. It is a simple fact of doing business that all firms, including some nonprofits, must abide by these laws. The merchant must serve as a collector of tax on the goods and services it sells.

Thanks to electronic point of sale (POS) systems and integrated accounting software, sales tax calculations are largely managed by technology. While there have been many advances in software and money movement capabilities, the collection and reporting process has essentially been unchanged for nearly a century.

Yet simplicity and sales tax collection are not terms often used together. Tax rates and which goods and services are taxed vary greatly among states and localities. While there are five states with no statewide sales tax, sales tax can be charged by localities despite the presence of a statewide sales tax exemption and may vary based upon specific items or services purchased.[4]

In fact, some states have sales tax rates that differ depending on products and services purchased. The complexity of sales tax variations is evident in the varying sales tax policies tied to groceries based on data from the Tax Foundation in 2020:[5]

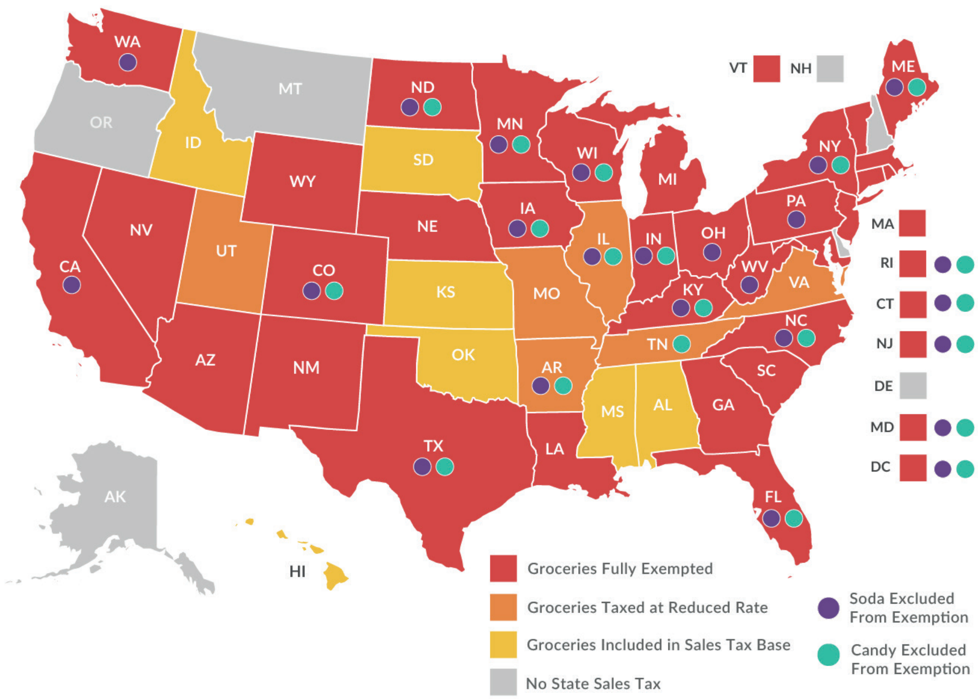
- 32 states and the District of Columbia do not charge sales tax on groceries
- 6 states tax groceries at a lower rate than the state's prescribed sales tax
- 24 states and the District of Columbia tax candy or soda differently than groceries

Plus, many states charge excise taxes on tobacco, alcohol and motor fuel (Figure 2).

Figure 2: Variance in Sales Tax Rates for Consumable Products

How Are Groceries, Candy and Soda Taxed in Your State?

Sales Tax Treatment of Groceries, Candy and Soda as of January 1, 2020



Source: Tax Foundation

Merchant Concerns with Sales Tax Collection

Advocates for merchants cite that merchants are involuntary tax collectors. Merchants are required by law to collect tax, hold the funds, and prepare and file returns to the appropriate revenue agency. Additionally, there are many rules that merchants must adhere to and penalties for noncompliance with regards to the collection of tax on behalf of any jurisdiction. According to Dean E. Sheaffer, founder and CEO of Team PayTech, an industry leader in payments and merchants, there are longstanding concerns for merchants related to collecting sales tax and costs associated with these obligations:[6]

- The full cost of collecting and managing sales tax is considerable given the tight margins for retailers.
- The complexity related to various tax rates and exemptions is a burden for many merchants.
- Merchants can be audited for sales tax compliance, and in states with complex tax rules, it is an additional burden to manage.

These merchant concerns can be traced back to 2006 and generally seek to remove sales tax from interchange fee calculations. None of these bills have been successfully enacted by any state legislature.

Merchant Options to Recoup Costs

In 29 states, merchants have the option to obtain a rebate when submitting sales tax. These rebates, otherwise known as sales tax reporting discounts, carry considerable variability in the conditions and the amount of the discount available to the merchant. A few examples:

- **Florida:** 2.5% of the first $1,200 due; maximum of $30 per report; only available to taxpayers who file and pay electronically
- **Georgia:** 3% on the first $3,000, 0.5% on the remainder
- **Pennsylvania:** The lesser of $25 or 1% of the tax collected for monthly filers; the lesser of $75 or 1% for quarterly filers; the lesser of $150 or 1% for semiannual filers

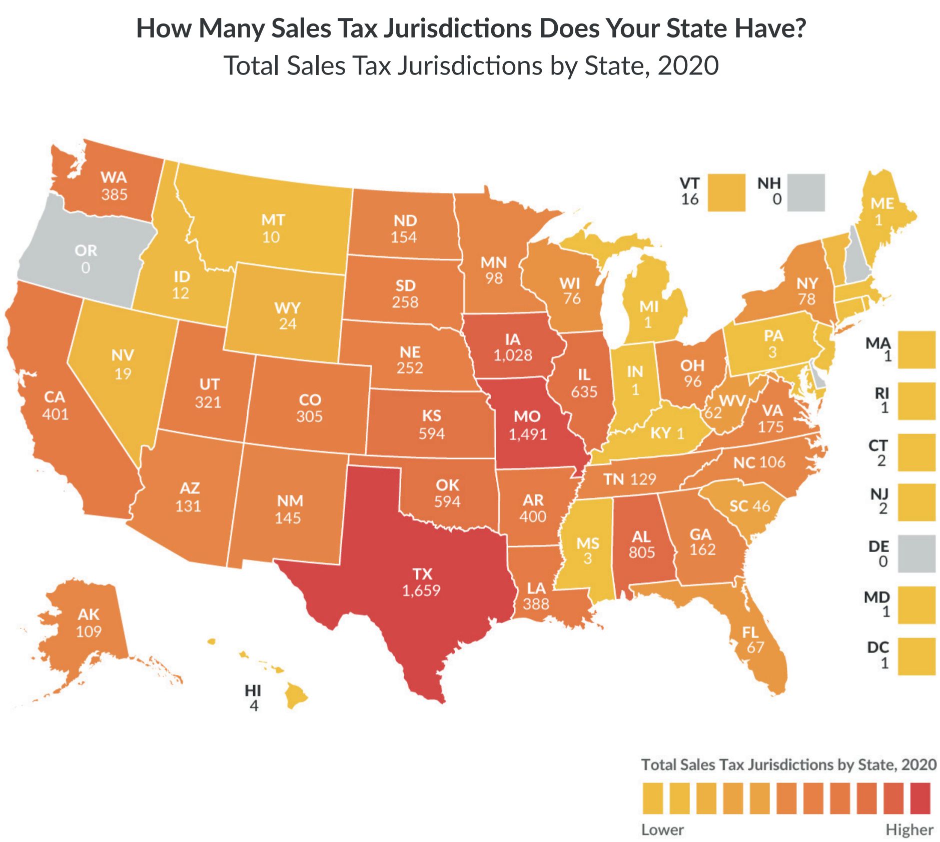
The state bills currently being proposed do not offer a rebate or an increased rebate to offset costs tied to card payments and sales tax. States likely do not want reduced revenues from sales tax collection. Yet the federal government allows a merchant to deduct the cost of card processing as a business expense on federal taxes.[7]

These state proposals are a one-size-fits-all approach. The state rules for rebates and federal tax deductions do not contain language that distinguishes between merchants based on their size. Small businesses do not have the benefit of economies of scale when it comes to tax collection costs and negotiating card payment processing fees. If states are concerned about the cost of sales tax collection, merchant size should be considered to account for the various factors that impact small businesses compared to large, national retailers.

Intricacies of Sales Tax

Sales tax rates vary greatly with over 11,000 different sales and use tax jurisdictions in the United States where merchants of all types from "mom and pop" retailers, "big box" retailers and online sellers are required to collect tax on the products and services they sell. Tax rates can vary by product or could be fully exempt in some jurisdictions. Regardless of payment method, the merchant is required to apply sales tax to applicable goods and services and remit the sales tax to a state department of revenue and possibly a local jurisdiction that administers their own local sales and use tax (Figure 3).

Figure 3: Sales Tax Jurisdictions



Source: Tax Foundation

The scale and complexity of state and local sales taxes is enormous. Keeping up with the changes is a burden to merchants and point-of-sale system providers. According to Avalara, a provider of tax automation software, there were 131,000+ tax holiday rule updates in 2021 and numerous new categories where taxes were exempted or applied.[8]

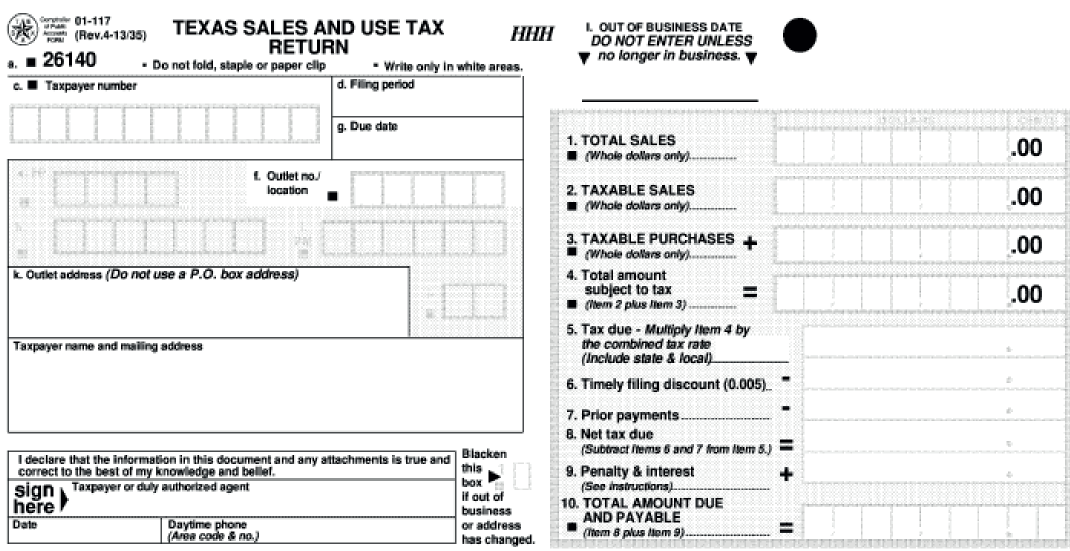
Reporting Sales Tax

Sales taxes are reported by the business in a single payment for a location and typically in quarterly payments. In contrast to merchant card processing, payments are tracked by terminal ID (TID), card type used and the specific date of the payment.

Missing in the state sales tax reports are sales by payment method such as credit or debit card and dates associated with these transactions. These state proposals are short on details, and a glaring omission is a provision to ensure the sales tax reported to a merchant's payment processor is reconciled with a merchant's reported sales tax to the state.

Sales tax is reported by the merchant only for total sales at a single location for a period of time, often quarterly or monthly. In Texas, sales are reported in aggregate and for a specific filing period (Figure 4).

Figure 4: Sample State Sales Tax Reporting


01-117 (Rev.4-13/35)
TEXAS SALES AND USE TAX RETURN
a. 26140 • Do not fold, staple or paper clip • Write only in white areas.
HHH
l. OUT OF BUSINESS DATE
DO NOT ENTER UNLESS no longer in business.
c. Taxpayer number
d. Filing period
g. Due date
f. Outlet no./location
k. Outlet address (Do not use a P.O. box address)
Taxpayer name and mailing address
I declare that the information in this document and any attachments is true and correct to the best of my knowledge and belief.
sign here Taxpayer or duly authorized agent
Date
Daytime phone (Area code & no.)
Blacken this box if out of business or address has changed.
1. TOTAL SALES (Whole dollars only) .00
2. TAXABLE SALES (Whole dollars only) .00
3. TAXABLE PURCHASES (Whole dollars only) + .00
4. Total amount subject to tax (Item 2 plus Item 3) = .00
5. Tax due - Multiply Item 4 by the combined tax rate (Include state & local)
6. Timely filing discount (0.005) -
7. Prior payments -
8. Net tax due (Subtract Items 6 and 7 from Item 5.) =
9. Penalty & interest (See instructions) +
10. TOTAL AMOUNT DUE AND PAYABLE (Item 8 plus Item 9) =

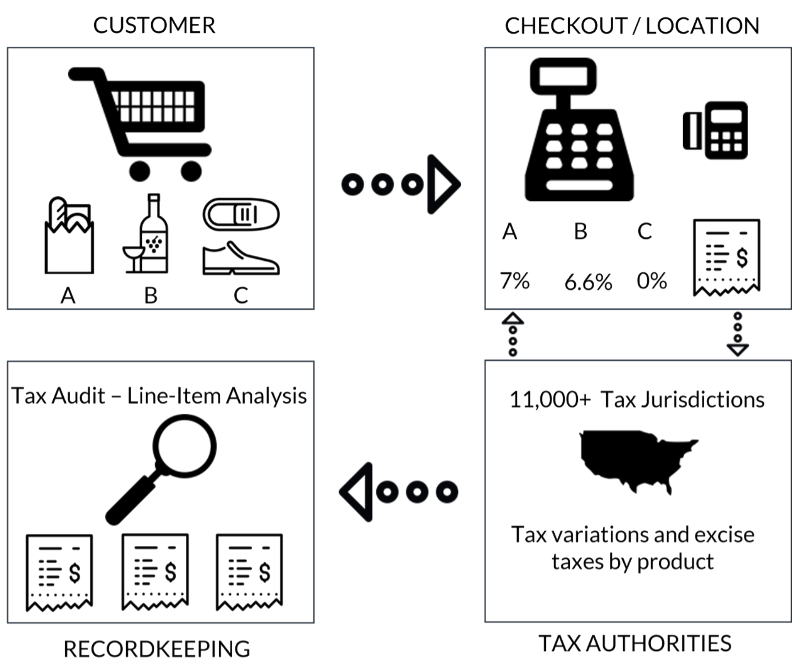
Source: Texas Department of Revenue

In contrast to the methods used to report sales revenue to the state, merchant processing systems use TIDs to organize card payments into daily batches. Missing from sales tax reporting are sales by payment method (e.g., debit or credit card or cash) and payments made each day or ideally per payment batch sent to the card processor. Reconciling card payments to reported sales tax is impossible with today's processes.

Additionally, these proposed bills will complicate e-commerce card payments. An online merchant often operates a single TID for payments, and the ability to identify payments eligible for sales tax interchange exclusions and tax jurisdiction is foreign to how online payments are managed.

Merchants already must be accountable to a department of revenue and can be audited to ensure the accuracy of sales taxes reported. These proposals would now require more reporting and a dual accountability to the state and a merchant acquirer to provide accurate sales tax figures to ensure a trustworthy and accountable system (Figure 5).

Figure 5: Sales Tax Complexities

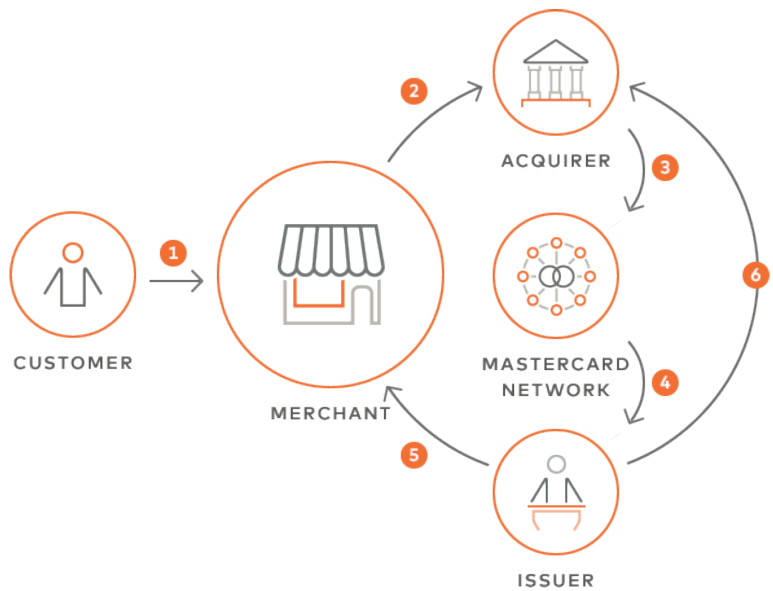


Source: Cornerstone Advisors

How Card Payments Work

When a consumer pays for goods with a debit or credit card, the payment is processed in the blink of an eye with a computerized POS system connected to a payment gateway. That total amount, including sales tax, is transmitted to the merchant's acquiring bank (aka merchant payment processor), the payment network, and finally the cardholder's issuing bank or credit union. The transaction decision (approved or declined) is transmitted back to the POS in milliseconds (Figure 6).

Figure 6: How Card Transactions Work



Source: Mastercard

The next phase is "clearing" the merchant's transaction, which typical occurs at the end of the business day. This is the final step in the settlement process, where the card-issuing bank or credit union and the merchant-processing bank exchange transactional information from the merchant. "Settlement," represented as Step 5 in Figure 6, is where funds from all card issuers for goods and services purchased by customers are transmitted to the merchant and where additional challenges exist with these proposals.

The settlement process deducts the contractual fees, often referred to as the merchant discount rate (MDR), and the funds are then deposited in the merchant's account, typically the next business day. A few state proposals require changes to the settlement and clearing process to deduct the portion of interchange tied to sales tax at this point in the process. The settlement and clearing process was not designed to account for sales tax adjustments and would introduce cost and risks to issuers, merchant processors and merchants to support accurate and reliable calculations.

Policymakers should note that the card payment system is designed for speed and efficiency. Only the necessary data required to authorize a payment transaction is captured. The card issuer, processors and payment networks operate on the limited data sent from the merchant's POS terminal. Currently this limited data includes the following:

- Merchant name
- Merchant category code
- Billing ZIP code
- Total purchase amount
- Purchase date

No details are collected on what is purchased or categories of items that can be taxed differently (i.e., alcoholic beverages or clothing). The data requirements are standard for every merchant regardless of location. It is fast, efficient and reliable. Merchants send the same data in all states, making card payments uniform regardless of where the merchant operates. These proposed state bills would alter a system known for reliability and efficiency.

Paying for Card Payments

Merchants contract with payment processors to authorize card transactions. The MDR, which varies based on the merchant's contractual arrangement, includes three components: acquirer fee, payment network fee and interchange fee from the issuer. Many merchants, especially large retailers, negotiate the rate they pay for elements of the MDR.[9] To understand how the MDR is calculated, consider a $100 purchase in Miami, Fla., with an MDR of 2.5% (Table A).

Table A: Breaking Down Merchant Card Payment Costs

Breakdown of a $100 credit card purchase in Miami, Fla.

	Purchase Amount	Sales Tax Rate	Total MDR (2.5%)
Purchase	$100	-	$2.5
Florida Sales Tax	$6	6%	$0.15
Miami-Dade County Sales Tax	$1	1%	$0.025
Total Tax	$7	7%	$0.175
Total Payment	**$107**	**7%**	**$2.68**

Source: Cornerstone Advisors

Each component of the MDR corresponds to a service that facilitates card payments for the merchant. Issuing banks and credit unions receive the largest percentage of the MDR because they incur servicing expenses such as statements, billing, card issuance, customer service, transaction disputes and fraud expenses. Additionally, they take on the risk related to nonpayment by the cardholder with credit cards and possible overdrafts in the case of debit cards.

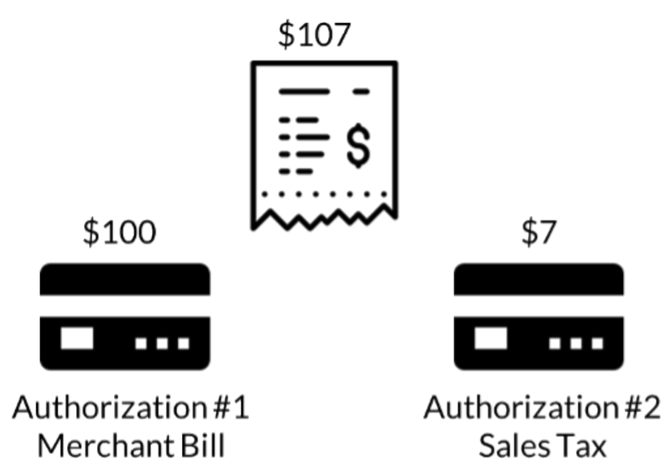
Methods for Excluding Interchange on Sales Tax

To support the legislative proposals, significant changes would be required for both merchant systems and the payments infrastructure that supports credit and debit cards. Merchant acquirers, the payment networks and card issuers would all require technology changes while being forced to accept reduced interchange revenue imposed by these bills. Possible solutions to these challenges include: 1) separate transactions, 2) Level 2 transactions, 3) settlement rebates, 4) surcharging and 5) state-issued rebates.

Separate Transactions

When a consumer makes a purchase, two separate payment authorizations would be conducted. Consider a $100 purchase with $7 in sales tax for a total of $107. Necessary changes to POS systems, payment terminals and payment processing systems would be required to allow two separate transactions to occur on every credit or debit card sale where sales tax is present. The consumer would now see two payment authorizations on their statement instead of one (Figure 7).

Figure 7: Dual Authorization Approach



Source: Cornerstone Advisors

If such an approach were implemented, merchants would experience delays at the checkout and challenges when a customer has one of the transactions approved and a second declined. Returns would be far more complicated, and customer confusion would be likely. Additionally, the payments system would require changes to distinguish between a sales tax authorization and a base sales authorization.

Level 2 Transactions

Currently, the established method to transmit sales tax data is referred to as Level 2 card data. It is only available on specific credit cards such as corporate cards and is not available on debit card payments. The objective of Level 2 transactions on corporate cards is for the business card holder to obtain additional information on purchases for their accounting processes.

Level 2 card processing requires a merchant to have POS systems and payment terminals that support Level 2 standards. Visa and Mastercard support Level 1 to 3 data, American Express supports Level 1 and 2, and Discover supports only Level 1 data. Additionally, a merchant must meet certain requirements to transmit level 2 data today such as being a B2B or a commercially focused merchant. B2C firms do not meet today's standards for Level 2 or Level 3 data (Figure 8).

Figure 8: Levels of Credit Card Data

Level 1	Level 2	Level 3	
	Level 1	Level 1	Level 2
	+	+	
Merchant name	Sales tax amount	Ship-from ZIP/postal code	Item description
Merchant category code (MCC)	Customer reference number/code	Ship-to/destination ZIP code	Item quantity
Billing ZIP code	Merchant ZIP/postal code	Invoice number	Item unit of measure
Total purchase amount	Tax ID	Order number	Item extended amount
Purchase date	Merchant minority code	Item product code	Freight amount
	Merchant state code	Item commodity code	Duty amount

Source: Cornerstone Advisors

Level 2 transactions provide no controls to ensure the tax amount entered is for one item or an entire purchase. The Level 2 approach could also introduce overreporting of sales tax by a merchant. Rolling out Level 2 processing for all card payments would require enormous changes and lengthy deployments for the payment processing and merchant POS systems.

The rollout of EMV provides us with a glimpse of how retailers may react. The EMV rollout to support chip-based cards in the United States—known as the fraud liability shift—had an October 2015 deadline. This was a massive change to card payments, and change did not come quickly or cheaply for merchants. The long tail of merchant adoption in payments is best illustrated by fuel merchants.

Fuel retailers requested and obtained changes to the EMV deadlines multiple times, but many did not make the final April 2021 deadline—more than five years from the original deadline. One study estimated that 52% of fuel merchants did not meet the April 2021 EMV deadline.[10]

Making significant changes to the payment system as these sales tax proposals are suggesting could mirror how merchants behaved with the EMV rollout and lead to a long and costly process for merchants. Many merchants, especially small businesses, could choose to forgo the effort or wait many years to implement the necessary changes.

Rebates Applied to Historical Transactions

Some of the proposed bills suggest that an after-the-fact rebate would be conducted based on merchant-provided details for the sales tax portion of debit and credit card transactions, thus creating a rebate to the settled funds during a specified period. This approach would require merchant processors to create costly new systems and processes.

Many merchants optimize their payment processing fees by contractually agreeing to pay a rate for each type of card processed. Interchange rates vary by the card type. For example, an airline rewards card will have a rate different than a purchasing card used by a business. A blended rate is a single rate charged for all card types, which is a common pricing model used with small businesses and payment providers such as Square.

Unless a merchant is on a single blended rate for payments, there would be a burden on merchants to break out sales tax associated with debit or credit card transactions based on card type and then transmit this data to their merchant acquirer. To ensure a system is auditable and trustworthy, additional checks and balances would be required by the merchant to report sales tax by payment method to ensure the requested rebate amount is indeed the value of sales tax to be remitted to the state.

Interchange Recovery via Surcharging

Merchants in Connecticut, Maine, Massachusetts, Oklahoma and Puerto Rico have surcharge prohibitions for merchants on debit and credit cards. As of April 15, 2023, merchants that choose to accept Visa cards are not permitted to surcharge more than 3%, yet many continue to surcharge as high as 4%, far exceeding the cost of payment processing.[11] These existing procedures allow a merchant to surcharge its customers to recover the interchange portion of sales tax.

If a merchant chooses to surcharge its customers for the full payment amount and also receive a rebate on the sales tax portion of interchange as proposed by these state bills, the merchant is effectively double-dipping on cost recovery. This is not addressed in any of the current state bills. If states were to enact bills that allow merchants to obtain a rebate for interchange on the sales tax portion of a payment, additional legal requirements must be required to ensure that if a surcharge is applied to a consumer, it is only applied to the payment owed to the merchant, not the sales tax component of the payment.

State-Issued Rebates

All the previous methods require extensive and costly changes to both merchant and payment systems. However, states could provide financial relief to merchants. Today many states permit a merchant to reduce a portion of its sales tax bill to offset the cost of collection sales taxes. States could extend or establish these rebates for the cost of interchange tied to sales tax. This approach transfers the cost to its rightful owner, the department of revenue for each state. It also removes the costly changes to both merchant POS systems and to the payment processing system.

Challenges to All Stakeholders

Except for the state issuing rebates tied to sales tax and card payments, none of the aforementioned methods are quick, easy or low-cost to implement. There will be extensive costs for both payment providers and merchants to create new capabilities. A review of the major challenges follows.

Auditability and Validation

There is no such thing as “trust me” in financial services. Sales tax information must be accurate to payment providers, and to deliver on the hope of transaction level rebates within the daily settlement process would require line-item level details of customers’ purchases to ensure complete accuracy. This would necessitate a complete overhaul of both POS and payment systems. This level of validation is necessary to ensure a merchant does not overreport sales tax to the payment system. Yes, falsely reporting sales tax would be a dishonest business practice, but without any checks and balances in place, there would be no deterrent to fraudulent behavior by merchants.

Providing line-item level detail opens the door to real-time sales tax collection wherein sales taxes paid through card payments would be transmitted from the merchant acquirer to the appropriate tax authority. Merchants are accustomed to holding sale tax funds and making payments often at quarterly due dates. Merchants benefit from the cashflow and float of all the sales tax receipts until payment is due to the applicable department of revenue. Most merchants would be opposed to these changes, but these are possible outcomes with these state proposals.

Sales Tax Repository

The value of sales tax reported to the state must match the value reported to the merchant acquirer. Without this level of detail, an interchange rebate tied to sales tax is susceptible to fraudulent behavior. To enable the ability to match reported sales tax with sales tax shared with a merchant processor, a secure, online repository accessible by the merchant processor would need to be established to validate and reconcile sales taxes reported by merchants.

Card payments identify transactions using terminal and merchant IDs and are typically accounted for in daily transaction batches. This conflicts with the method in which sales taxes are reported by merchants in a single lump-sum with no detail regarding the date of payments and payment method used. Reporting methods would need to be expanded to account for the required details to support a rebate process.

New systems at the state level would need to be constructed to support a sales tax repository at a cost to state taxpayers. Assuming sales tax reporting continues to be reported in a historical manner, any interchange rebate would have to be conducted at a designated time each year, not at a daily transactional level, to ensure an accurate calculation.

Privacy

Today's payment processing provides a level of privacy where issuers are not privy to the details of what a consumer purchases. Proposed changes where a line-item validation is required would alter privacy protections. Banks and credit unions would have access to what consumers purchased. This level of data could then be depersonalized and sold to data brokers or used for internal marketing programs. This would change the privacy landscape and could necessitate new regulation on how this data is used.

The Upgrade Challenge for Business

A major cost for merchants will be updates to their POS systems and related technology for sales tax management. Distributed POS systems are still widespread compared to centralized cloud systems. These legacy POS systems will require upgrades by the vendors or internal software developers and an extensive testing process. Additional costs will be incurred if payment terminals require updates or replacement. These costs may far exceed any benefit from savings associated with excluding interchange from sales tax. The financial resources to upgrade, test and validate their systems will benefit larger merchants, thus making small businesses less competitive with their larger competitors.

PCI Compliance

Solutions that would support these legislative proposals are likely to require varying data standards by state and local jurisdictions. Payment terminals interface with a retailer's POS system and are governed by security standards known as Payment Card Industry Data Security Standards (PCI DSS). Varying data standards by state will lead to more complex and expensive PCI certifications for merchants.

To support an after-the-fact rebate, merchants will need to tabulate payments and sales tax based on card BIN numbers, which is likely a violation of PCI DSS compliance rules. PCI DSS requires debit and credit card numbers to be unreadable when stored within a merchant's system.[12] Some of the most notorious merchant data breaches were the result of merchants storing readable card details on POS systems that were compromised, resulting in millions of consumers being harmed and card issuers suffering financial losses due to fraud.

The Cost of Transaction Fraud

These proposals will require issuers to reduce their revenue but still provide the same fraud protections and service levels without full compensation for services. Fraud costs are growing faster than payment volume with card-not-present fraud leading the way. According to the Federal Reserve, since 2016, credit card program transactional costs exceeded revenues from interchange, thus putting more financial pressure on card issuers if additional revenue is taken away.[13]

The financial impact will likely result in unintended consequences such as higher fees to process payments for merchants and possibly higher fees for cardholders. As what was seen with debit card interchange regulation from the Durbin Amendment, when revenue is reduced, many issuers will seek to replace lost revenue with an increase in fees elsewhere.

Small vs. Large Merchants

The possible solutions to address these state proposals will come with a cost for all stakeholders. Small businesses are at a disadvantage compared to large, national retailers when it comes to the resources to leverage these possible changes. A financial analysis to illustrate the potential savings from rebating interchange from sales tax is provided below. The assumptions for this financial analysis include:

- Distribution of sales by payment method is 35% for credit cards and 38% for debit cards for in-person payments.[14]
- The sales tax is 8% for Philadelphia (6% state level and 2% local).[15]
- Average credit interchange rate is 2.50% for credit and .30% for debit.
- Target's revenue per square foot in 2022 was $447. The average Pennsylvania Target store has 118,718 square feet generating $53,066,923 per store in Pennsylvania.[16]

This analysis compares a small business with $1 million in annual retail sales with Target stores operating with a Philadelphia address.

Small Business (Philadelphia)			**Target: 8 Philadelphia Store Address Locations**		
Annual Revenue		$1,000,000	Annual Revenue		$424,535,385
Total Sales Tax Collected	8%	$80,000	Total Sales Tax Collected	8%	$33,962,831
Credit Card Sales					
Sales via Credit Cards	35%	$350,000	Sales via Credit Cards	35%	$148,587,385
Sales Tax on Credit Card		$28,000	Sales Tax on Credit Card		$11,886,991
Debit Card Sales					
Sales via Debit Cards	38%	$380,000	Sales via Debit Cards	38%	$161,323,446
Sales Tax on Debit Card		$30,400	Sales Tax on Debit Card		$12,905,876
Sales Tax Portion of Interchange					
Credit Interchange	2.5%	$700.00	Credit Interchange	2.5%	$297,175
Debit Interchange	.30%	$91.20	Debit Interchange	.30%	$38,718
Total Annual Sales Tax Savings (before accounting for exempt items)					
Total for a Small Business		**$791.20**	**Target Philadelphia Stores**		**$335,892**

Pennsylvania exempts sales tax on many items, including food (not ready-to-eat) and clothing. The figures above would be reduced to reflect these exemptions.

This analysis demonstrates how the big box retailers will obtain far larger savings compared to a small business operator. Considering the costs to make the necessary changes, the small business owner could determine the cost is not worth the effort. Expanding the Target example to the entire state of Pennsylvania, which means 78 stores, Target Corp. may see savings of more than $2 million annually in Pennsylvania.

Conclusions

The various state bills that seek to remove interchange fees from the sales tax portion of retails sales are seeking to regulate interchange. These proposals have been introduced in the past 17 years and have been rejected by state legislatures across the country. The governance of payments belongs at a centralized level such as the Federal Reserve Board, not as a disparate model of individual states applying their own policies.

These proposals would come at a great cost for all stakeholders. Financial institutions would see a sizeable reduction to the portion of their revenue that covers the cost of operations, fighting fraud and providing service to account holders. To bridge this significant gap in revenue, card issuers could make checking accounts more expensive and raise annual fees and interest on credit cards, leading to additional financial harm to consumers.

Merchants make an argument that they have an unfair burden to collect sales tax and pay for payment services for funds not tied to their revenue. This is a cost that every business that sells goods to consumers must consider. Managing payments is a cost of doing business along with similar costs for serving customers, including wages for employees or paying for utilities.

The global card payment system works efficiently and is interoperable around the globe. Implementing the requirements suggested in these bills would result in significant and costly changes at all points in the payment process. Merchants will also be faced with costs to upgrade their POS and payment systems inclusive of software upgrades, implementation and testing. These costs would result in an increased burden to small business owners compared to large national retailers that can benefit from economies of scale. For many small businesses, it would make no financial sense to implement these changes. Larger retailers would have another unfair advantage compared to small business operators.

Policymakers need to recognize that any proposal must account for transparency, auditability and a system that does not promote fraudulent behavior. Assuming the changes are minimal and the cost burden is only carried by the financial system is foolish and demonstrates a lack of knowledge about how the card payment system operates. State legislatures must recognize that their actions have far-reaching consequences for a system that processed more than 157 billion transactions and $9.43 trillion in payments in 2021 and is vital to America's economy.[17]

About the Author

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Backed by more than 30 years of leadership experience in data analytics, product management and product development in banking growth strategies and bank regulation, Glenn Grossman produces analytical studies aimed at delivering insights for innovation, growth and sustainable competitive advantage for financial institutions and fintech firms. Before joining Cornerstone, Grossman was a principal consultant and senior thought leader with FICO and the product leader for a start-up fintech payments firm. He started his career in the financial services industry managing product innovation and payment strategy at Bank of America. He also served as an economist with the U.S. Department of Labor–Bureau of Labor Statistics.

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About Cornerstone Advisors

After 20 years in this business, Cornerstone Advisors knows the financial services industry inside and out. We know that when banks and credit unions improve their strategies, technologies and operations, improved financial performance naturally follows. We live by the philosophy that you can't improve what you don't measure, and we help financial institutions use laser-focused measurement to develop more meaningful business strategies, make smarter technology decisions and strategically reengineer critical processes.

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About Credit Union National Association

Credit Union National Association is the most credible financial services trade association and the only national association that advocates on behalf of all of America's credit unions. CUNA works tirelessly to protect credit unions' best interests in Washington, D.C., and all 50 states. We fuel credit unions' professional growth at every level, stand committed to the financial well-being of every member, and champion the credit union story at every turn.

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Endnotes

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Have questions regarding this report?

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