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## WILL CREDIT CARD CHARGES GROSS-UP GROSS REVENUE?

Percentage rent ties a tenant's rental obligation to its sales at the leased premises. Typically, the percentage rent payable will be determined by multiplying an established percentage by the revenue generated at the leased premises in excess of a particular threshold (referred to in the retail real estate sector as a "breakpoint").

Since the amount payable by the tenant is a function of the revenue generated over the breakpoint, the definition of "gross revenue" can be the subject of heavy negotiation.

Percentage rent leases motivate landlords to maximize the line items included in the calculation of gross revenue. They want the basket to include every transaction that has any type of nexus to the leased premises. Naturally, tenants are motivated to minimize gross revenue for percentage rent purposes.

Sometimes the definition of "gross revenue" is also used for a sales performance test that allows one party or the other to terminate the lease (referred to in the retail real estate sector as a "sales kickout clause", regardless of who holds the right).

Some transactions are readily excluded from "gross revenue", for example: sales discounts, repairs or alterations, the sale of gift certificates (although when redeemed at the premises for merchandise or services, that transaction is counted), layaway or finance charges, delivery charges, gratuities, the sale of trade fixtures, and the proceeds of insurance.

The extent to which Internet sales are included in gross revenue is often hotly negotiated. Many issues concerning the location where the order is placed, paid for, filled and united with the customer come into play in those negotiations. The deduction from gross revenue of refunds

of online purchases returned to the store is also vigorously debated (including whether increased customer traffic benefits the shopping centre more than the deductions erode the bottom line).

A new hot topic pertains to Visa and MasterCard credit card processing fees (aka "interchange fees"). As of October 6, 2022, merchants everywhere in Canada (except for Quebec) are allowed to pass their Visa and MasterCard interchange fees on to their customers, up to a maximum of 2.4%. This has implications for "gross revenue".

Historically, Visa and MasterCard merchants were prohibited from charging their customers for interchange fees, and as a result, since these fees were a direct out-of-pocket cost to earn revenue, many tenants would successfully argue that the cost eroded sales and as such, should be deducted from gross revenue to arrive at the "true" sales on which percentage rent should be calculated. (This argument was made, regardless of whether the merchant used only Visa and MasterCard to process their customers' credit card transactions, because Visa and MasterCard are ubiquitously used.)

Some landlords successfully countered that credit card or bank charges were simply a cost of doing business and no different than the cost of wages or inventory.

A common compromise was to allow the deduction subject to a cap of 2%.

Now that Canadian merchants (outside of Quebec) are able to charge customers for Visa and MasterCard interchange fees associated with credit card transactions, the rationale for deducting interchange fees from "gross revenue" might have lost some of its puff.

Interchange fees from Visa and MasterCard transactions now have the potential to increase gross revenue as a new line item across Canada (outside of Quebec).

Amid high interest rates and the increasing costs of running a business, forecasts are that some merchants will elect to pass the interchange fees on to their customers. These additional charges could show up soon.

It may be time to revisit the definition of “gross revenue”, to consider whether it still makes sense in relation to interchange fees.

Assuming that tenants wish to not only preserve the flexibility to charge or not charge their customers for interchange fees, while continuing to minimize gross revenue for percentage rent purposes, it is plausible that the classic deduction of interchange fees will have to be modified along the following lines:

*Interchange or similar processing fees payable by the Tenant to credit card companies in respect of the Tenant's receipt of payment for goods or services by credit card, may be deducted up to a maximum of [x%] of Gross Revenue, but only if the Tenant does not impose a surcharge on the customer in respect of such*

*fees, or, if the Tenant does impose a surcharge (whereby such fees are paid by the customer), interchange fees may be excluded from Gross Revenue, but shall not be deducted (so as to prevent duplication).*

What can be expected is a few months (or years?) of confusion and debate as the dust settles on this topic. It is likely that the interchange fee payable by the customer will ‘go direct’ to the credit card company, who will pay itself (vs being paid to the merchant to remit to the credit card company). Will the interchange fee even show up on the merchants’ ledger? There are other questions, such as whether the “usual” cap of 2% should be increased to 2.4%? Should the deduction/exclusion depend on whether the transaction involves Visa and MasterCard? Should the deduction/exclusion depend on whether the property is outside of Quebec?

At this time, there are more questions than answers, and the fact is that there are existing leases containing *deductions*, which have the potential to result in duplication (i.e., over-deduction) where interchange fees are paid by customers. It will be interesting (at least to leasing lawyers and administrators!) to see how this plays out.

## ANNOUNCEMENT

Daoust Vukovich LLP is pleased to welcome **KRISTINA BEZPROZVANNYKH** to the firm as an Associate Lawyer. Kristina is joining the firm’s litigation team, advocating for both landlords and tenants in their commercial leasing disputes. She also represents owners, general contractors/subcontractors, construction managers and engineers in construction law matters. Kristina is a graduate of the University of Ottawa and was called to the Ontario Bar in 2017. Kristina can be reached at 416-597-9306 (kbezp@dv-law.com).

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