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What You Need to Know about Credit Card Surcharges

By Eric Cohen, Founder and CEO Merchant Advocate

Medical practices and other small businesses applying credit card surcharges must be aware of potential tax compliance pitfalls as they continue filing under tax extensions. Many assume implementing a surcharge program is as simple as passing [processing fees](#) onto patients. However, improper surcharging, such as misreporting revenue or failing to apply sales tax correctly, can lead to IRS scrutiny, audits, and costly penalties.

With [credit card processing fees rising](#), surcharges have become a common strategy for offsetting costs. However, not all businesses implement them correctly, and regulatory bodies, including state governments and card networks, are increasing enforcement efforts. For example, [a recent law in New York](#) capped surcharge fees at the actual processing cost and mandated clear disclosure. While Visa and Mastercard monitor compliance and issue penalties, enforcement remains inconsistent.

Recently, the Illinois Interchange Fee Prohibition Act, originally set to take effect July 1, 2025, [may be delayed](#) to July 1, 2026, pending final approval of a bill passed by the state legislature. The law prohibits financial institutions from charging interchange fees on the tax and gratuity portions of [card transactions](#) if merchants report those amounts at the time of authorization or settlement. It also limits data use and bans manipulation of fee calculations. While enforcement is still being litigated, medical practices should begin assessing how to separate tax in transactions, as compliance may still be required in the future.

At the same time, many medical practices overlook the tax implications of surcharging as they continue filing under tax extension. If a practice applies a 3% surcharge to a \$100 transaction, bringing the total to \$103, but doesn't offset the \$3 surcharge as an expense in their books, discrepancies between reported gross sales and 1099-K processor statements can also trigger audits. If it's not addressed properly, even small discrepancies between

what's reported on tax returns and the amounts shown on 1099-K forms from processors can raise red flags. This is especially true when larger amounts or a high volume of transactions start to add up, which is often what triggers IRS scrutiny.

Understanding the tax risks

There are two primary tax concerns that medical practices need to be aware of when it comes to surcharging: *sales tax compliance* and *gross sales reporting discrepancies*.

Sales tax compliance varies widely from state to state, with some states applying taxes to the surcharge amount and others exempting it. If a business fails to properly tax surcharges according to these varying regulations, it can open itself up to financial penalties and compliance issues. It's important to consult with an accountant familiar with laws in your state to ensure compliance before starting a surcharge program.

Companies must also inform their merchant acquirer and relevant card networks about implementing a surcharge program and work with them to prevent gross sales reporting discrepancies. If the money accrued from surcharging isn't reported correctly, there's a good chance it will result in a red flag. The payment processor will report gross sales on 1099-K forms, including the surcharge fees, which never hit the business's books.

For example, if a medical practice generates \$500,000 in annual revenue and applies a 3% surcharge to all transactions, the practice might report \$500,000 in total sales. Their 1099-K from the processor would report \$515,000 (including the surcharge). This discrepancy might be interpreted by the IRS as underreported income, resulting in an audit or additional tax scrutiny. Medical practices can avoid this mishap by offsetting the surcharging "income" as an expense.

State regulations and compliance challenges

Laws regarding credit card surcharging vary widely across states, making compliance even more complicated. While surcharging is legal in most states, some jurisdictions impose strict regulations:

[New Jersey](#): Limits surcharge fees to actual processing costs and requires clear disclosure. Violations can result in fines up to \$10,000.

[Colorado](#): Caps surcharges at 2% regardless of processing costs.

[Connecticut](#), [Massachusetts](#): Surcharging is prohibited.

[New York, Florida](#): Laws initially restricted surcharges, but courts ruled in favor of businesses, allowing them to charge with proper disclosure.

Medical practices must stay updated on state-specific laws to avoid costly penalties and legal issues. Card networks like Visa and Mastercard also have their own rules, including strict disclosure requirements, which, if violated, can result in hefty fines or even suspension of processing privileges.

Best practices for surcharge compliance

To avoid costly mistakes, medical practices should take the following steps:

1. **Confirm state regulations**

Laws vary by state, with some prohibiting or restricting surcharges. Medical practices should regularly review state and card network rules to ensure compliance. Consulting with a legal expert can help navigate these ever-changing regulations.

2. **Ensure accurate tax reporting**

Work with a professional to determine if surcharges need to be taxed and confirm that 1099-K forms align with reported revenue. Proper bookkeeping is crucial to prevent discrepancies that could trigger IRS audits.

3. **Properly configure payment systems**

To avoid errors, standalone credit card terminals must be programmed to apply surcharges compliantly; it's illegal to surcharge a debit card. Staff should also be trained on proper transaction entries to minimize mistakes. If a surcharge is applied, it should be listed as a separate line item on receipts with clear labeling.

4. **Monitor processor fees**

Processing statements are often full of hidden fees, [many of which can be negotiated](#). Lowering rates can reduce costs without relying solely on surcharges.

5. **Disclose surcharges transparently**

Card networks require clear signage, and customers must be notified when surcharging programs are in effect. Failure to do so can result in penalties or the loss of processing privileges. Signage should be displayed at the point of sale, and surcharges must be noted before the transaction is completed.

6. **Confirm insurance provider requirements**

Medical practices must also consider their contracts with insurance providers, which may include clauses regulating how payments are processed, if there are ceilings or set prices for covered services or products, and whether additional fees can be passed on to patients. Violating these contracts could lead to reimbursement issues or even termination of the provider relationship.

Avoiding costly errors

Don't assume the processor is ensuring compliance; it is up to the merchant. Misapplying tax, misreporting revenue, or using non-compliant surcharge programs (like charging debit cards) can lead to penalties that far outweigh any cost savings. Processors offering flat-rate pricing may not ultimately reduce fees for practices that adopt them, meaning the true cost savings of a program should be carefully evaluated.

While surcharging may help offset credit card processing costs, medical practices must take a strategic approach to ensure compliance. By proactively addressing tax reporting, transaction processing, and legal requirements, practices can avoid unnecessary financial and regulatory risks, even under a tax extension.

Take action now

With many medical practices operating under tax extensions this season, now is the ideal time to [review surcharge programs](#) for full compliance.

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Easily schedule a 15-minute call with me here.

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