Statement for the Record

of the

AMERICAN BANKERS ASSOCIATION

Committee on Small Business

U.S. House of Representatives

For the hearing

Electronic Payments Tax Reporting: Another Tax Burden for Small Businesses

June 12, 2008
The American Bankers Association (ABA) appreciates the opportunity to submit comments to the House Small Business Committee for the written record of its hearing on the merchant card information reporting proposal currently being considered by Congress. ABA is strongly opposed to this provision and appreciates the Committee’s continued interest in this subject.

The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation’s banking industry and strengthen America’s economy and communities. Its members— the majority of which are banks with less than $125 million in assets— represent over 95 percent of the industry’s $12.7 trillion in assets and employ more than 2 million men and women.

Since 2006, the Treasury Department, IRS, and Congress have been considering a proposal that would require banks to collect and report payment card transaction data on their business customers to the IRS annually. The President’s FY2007 “Blue Book” Budget Proposal included a vague proposal that would have required “card issuers” to report the payment card receipts of their small business customers to the IRS annually (“the proposal”). Since that time, the proposal has taken on greater shape in the FY2008 and FY2009 proposed budgets, as well as in draft proposals that are currently being considered by the House Ways and Means and Senate Finance Committees. Regardless of the format, ABA continues to have serious concerns and continues to oppose the proposal.

The structure of the card system does not make complying with the proposal feasible. Payment card information systems do not contain merchant tax identification numbers (TINs) and other information that the proposal would require to be reported. If implemented, the proposal would require the industry to spend hundreds of millions of dollars to redesign their information systems to comply with the new information reporting regime. In addition to the direct costs of this provision, banks would be forced to move key information technology personnel away from innovative and profit-driven products—beneficial to our customers—to build the system changes
that will be required to comply with the law. Additionally, there would be ongoing costs for banks to store, secure, and send information to the IRS. In other words, the quality of card services, now and going forward, would be compromised.

It is also important to recognize that this new information reporting regime would result in new constraints, confusion, costs, and potential cash flow challenges for all businesses that accept payment cards.

The payment systems industry is also concerned that its relationship with the merchant community could be greatly damaged by adding one more major surveillance program on our customers. To many customers, the banking relationship appears increasingly like a government reporting regime rather than a business service. The proposal could operate counter to the enormous efforts by banks and regulators to bring more people into the financial mainstream and out of the hands of shadowy financial services providers.

A final point to consider regarding this proposal is whether or not it is appropriate to impose huge new costs and burdens on the banking industry and its merchant customers during a time of looming uncertainty in our economy. This problematic provision would heap new expenses and additional uncertainties on the industry, adding new strains to the current economic situation.

Included below are additional concerns that banks have with the proposal. Also included in an appendix is very important background information on the “systems operations” of the card industry. This information is intended to show the inherent complexity of the card payment systems, which illustrates that complying with the proposal will be very difficult (costly and time-consuming) and, in some cases, impossible.

Although this statement represents the major concerns that ABA has with this proposal, this statement does not provide an exhaustive list of our concerns and suggestions.

Additionally, it is important to point out that while ABA opposes this provision, the industry is engaged in an ongoing dialogue with the House Ways and Means and Senate Finance Committees.
on this issue. ABA deeply appreciates their willingness to have continuing discussions with ABA and our members regarding this proposal.

**Industry Issues of Concern Regarding the Proposal**

- **Terms/Definitions Unclear**

Although there have been several attempts to refine and sculpt the proposal to make it workable, the payment card industry still has many concerns about ambiguities in the terms and definitions laid out by the proposal. These ambiguities range from exactly which entities would be required to provide reporting, to the specific entities for which reports would be required, and exactly what information would be required to be reported to the IRS.

- **Information to be Reported**

The transaction information that currently flows through a typical payment card system is very limited. In most cases, a typical transaction record includes the date of the transaction, transaction amount, payment card number, merchant name, and merchant customer number. It does not include any indication of the size of the merchant (e.g., large or small business), taxes paid, or whether the merchant is incorporated or unincorporated. So if the proposal is intended to target merchants by any of these factors, those distinctions cannot be made based on the information in payment card processing systems.

Additionally, the transaction files in existing payment systems are currently maintained for a very short period of time – between 45 days and 18 months. The payment industry is made up of a large number of players and most participants would be forced to make substantial system changes to comply with the law. Also, lengthy retention of such information increases its vulnerability to data breaches.
• Backup Withholding

All versions of this proposal would require banks to collect and verify merchant TINs or Social Security numbers (SSNs). Payment card systems are currently not set up to identify merchants by their tax identification numbers. Rather, merchants are identified by randomly assigned merchant identification numbers. These merchant ID numbers are used for data security purposes and for a number of other reasons.

The proposal provides that backup withholding will apply unless the reporting entity has validated the “TIN of the payee.” This would require building an entirely new business function and administering it on an ongoing basis. Some companies process payments for more than a million merchant locations. Therefore, obtaining and validating TINs for millions of entities and building the processes and systems to maintain such a function on an ongoing basis would be a tremendously time consuming and expensive task.

Backup withholding would be impractical and extremely difficult for credit card transactions with cash backs, charge backs, gift cards, and other complex transactions flows. Payment card transactions are settled through a complex and fluid series of interconnected systems that involve numerous parties. While data regarding what settlement amounts are due to each merchant are available, settlement funds may actually be transferred in multiple stages during the settlement process or may be made in lump sum amounts that do not match the amounts reflected in the settlement data. Backup withholding will be next to impossible under the proposal, due to the complexities in card systems operations. Additionally, the fact that merchants may be subject to reporting by more than one reporting entity would make the application of any backup withholding rule a nightmare for “participating merchants.”

Most importantly, subjecting payments reportable under the proposal to backup withholding could have a draconian effect on many small businesses that rely on the use of electronic payment mechanisms in their trade or business. In many cases, it appears that the imposition of backup withholding would occur when no additional tax would be due and may be imposed in situations
where there is little risk of tax avoidance or evasion. Thus, electronic payments made to such businesses could result in 28 percent of the aggregate amount of such payments being withheld (28 percent is the typical backup withholding rate), which could prove catastrophic to some businesses. The fact that such businesses could eventually be refunded any amounts withheld could be of little assistance when a 28 percent reduction in available funds could make the difference between a business remaining solvent or going out of business. Cash flows for many businesses (large and small) are actually financed either by loans or other forms of very short-term credit; businesses cannot afford the financial carrying costs of significant, non-earning loans to the government or anyone else.

Backup withholding has not been contemplated in the development and operation of existing payment card systems. The development of data processing capabilities to comply with backup withholding will be extremely costly and require long lead times. It is also important to recognize that the cost of developing such data processing capabilities will also include the opportunity costs from re-directing scarce data processing specialists to such projects. The banking industry’s data processing specialists are a finite resource that would otherwise be employed on projects that help to keep the business competitive in a highly competitive field and support systems to fend off cyber crime assaults and other threats to IT system security, a daily challenge for the industry.

- Duplicative Information Reporting

Under current law (IRC sections 6041(a) and 6041A(a)), a purchaser that makes payments of $600 or more to non-employee or non-corporate service providers is required to report such payments to the IRS on Form 1099-MISC. (Federal agency purchasers also must report payments to corporate service providers.) In addition, most government agencies will be required to report and withhold three percent of all service and merchandise transactions beginning in 2011 under IRC section 3402(t)(3). If the proposal is adopted, and these two requirements are not repealed – at least to the extent they relate to payment card transactions – there will be unnecessary and duplicative reporting requirements. For example, if a merchant acquirer is reporting a merchant’s payment card transactions to the IRS, why should a taxpayer be required to report those same payment card transactions under 6041(a) and 6041A(a), and possibly be expected to engage in backup
withholding? If a merchant’s payment card transactions are already being reported, why must purchases made with a government payment card be subject to reporting by the government entity and to the three percent backup withholding requirement? These duplicative requirements would result in distortion of income and place unnecessary compliance burdens on a variety of public and private sector entities with little or no corresponding tax compliance benefit.\(^1\) In addition, there would be confusion for merchants, who may also be exposed to the risk and cost of unnecessary tax audits.

- **Effective Date**

Under current drafts of this proposal, it would take effect only one year after enactment. ABA believes that if the proposal is ever enacted, it must have a delayed effective date of at least three years to five years. It will take at least this much time to perform the required research, make all the necessary system changes, build and test new systems, re-negotiate contracts, employ and educate additional staff to implement the rules, gather the information required to comply with the rules, and develop internal policies and procedures for the new processes. During this time, reporting entities will also engage in TIN solicitation (which will take a huge amount of time, effort, and resources) and study the IRS TIN matching program, after which they will begin to “validate” the millions of merchant TINs within their databases.

In closing, the ABA has numerous and significant concerns with this proposal and continues to oppose its use in any legislation being considered by the 110\(^{th}\) Congress.

The ABA is grateful to Chairwoman Nydia Velázquez for holding a hearing on this important issue, and we look forward to working with the Committee on this subject going forward.

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\(^1\) The IRS has noted that a key driver of tax compliance is the reporting of information to the IRS. If the proposal is adopted, all payment card receipts will be reported to the IRS, suggesting little need for duplicative or additional measures to encourage tax compliance by merchants.
APPENDIX

Background

In general, payment card systems in the U.S. operate in several different ways, including “four-party systems,” “three-party systems,” or “two-party systems.” Given the highly competitive nature of the payment card industry, new networks and payment processing systems are continuously emerging, and they work in different ways. The following briefly describes the three major types of payment card systems and the transaction flows that occur within these systems.

Four-Party Systems

Four-party systems (sometimes referred to as bankcard systems) involve thousands of participating financial institutions around the globe. MasterCard and Visa are examples. The financial institutions that issue the cards are commonly referred to as “card issuers,” while the financial institutions that sign up merchants – directly or through third parties – to accept the cards are generally referred to as “acquirers.” MasterCard and Visa provide the networks through which financial institutions interact to complete payment transactions pursuant to their respective rules and regulations. Neither MasterCard nor Visa issue payment cards to cardholders, nor do they contract with merchants for payment card acceptance. Card issuers and acquirers frequently use third-party service providers (called “processors”) to provide transaction processing services.

Three-Party Systems

In a three-party system, a single company is responsible for issuing the payment cards, entering into contracts with merchants to accept the cards, and performing the functions necessary to complete the transactions (American Express and Discover Card are examples). In this case, the roles of card issuer and acquirer are undertaken by the same institution. Like participants in four-party systems, three-party systems frequently make use of service providers to fulfill various functions. Three-party systems also are becoming more complex by contracting with financial institutions to issue cards on the three-party system’s network.
Two-Party Systems

In the traditional two-party system, payment cards are issued by a merchant to its retail customers for use only at the issuing merchant’s locations. A traditional two-party system is fundamentally a relationship between the customer and the merchant. Many of these programs have evolved into modified three-party systems, in which a bank (or other financial company), rather than the merchant, issues the card bearing the merchant’s brand, extends the credit, and provides the processing apparatus. Gasoline credit cards, big-box retail charge cards, and department store charge cards are typical examples of a two-party system. These modified two-party systems, sometimes referred to as “private-label” cards, are different from the other systems because the merchant that accepts the card at the point of sale is not necessarily the entity that is reimbursed by the bank performing the issuing and acquiring functions.

Other Systems

The payments industry is highly competitive and innovative, with new types of networks and payments emerging on a regular basis. For example, some debit networks enable cardholders to make purchases at merchant locations by presenting a card and entering a personal identification number (PIN) at the point of sale. Other types of electronic payment systems include Automated Clearing House transactions (ACH) and electronic check transactions. Some companies are attempting to develop their own electronic payment methodologies, including those using wireless phones.

Typical Transaction Flow Summary

The typical flow of a payment card transaction can vary depending upon the type of system and is a complicated process that is the work of years of development and refinement. For example, the typical four-party system uses what is commonly referred to as a two-message transaction scheme for the “authorization” and “clearing and settlement” processes for credit and signature debit transactions. A sales clerk swipes the card at the point of sale (beginning the authorization process). A message containing relevant information is then transmitted to the merchant’s acquirer or its processor, and the message is then relayed to the appropriate network (e.g., MasterCard or Visa). The network then sends a message to the bank that issued the card (or the bank’s processor). The card-issuing bank (or its
processor) checks for sufficient funds/credit. The card issuer’s decision to approve or decline authorization for the transaction is then routed back to the merchant in reverse sequence to the authorization request. A second message, the “clearing and settlement message,” is sent, typically later in the day, to confirm that the transaction has been completed. This message follows the same route and is used by the card-issuing bank as a record to post the transaction to the cardholder’s account, and it is based on that clearing record that the card-issuer pays the acquirer for the transaction.

The process of moving funds from issuers to acquirers is known as the “settlement process” and typically takes place on a net basis with issuers paying acquirers, through clearing banks, the net amount that the issuers owe to the acquirers.