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Tax Gap: Administration Proposal to Require Information Reporting on Merchant Payment Card Reimbursements

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Tax Gap: Administration Proposal to Require Information Reporting on Merchant Payment Card Reimbursements

Summary

The high current and forecast budget deficits as well as pay-as-you-go (PAYGO) procedures have resulted in congressional and executive branch interest in raising additional revenue through proposals for improved tax compliance. The Bush Administration's FY2009 budget includes a proposal (the proposal) to require each payment card processor to inform the IRS on the net dollar amount paid to reimburse each merchant (i.e., seller) for his payment card receipts in a calendar year. Payment cards consist of both credit cards and debit cards. The card processor is responsible for delivering the payment card transaction to the appropriate card issuer in order that the customer is billed and the merchant receives funds for the purchase. The proposal would allow the IRS to compare the aggregate net payment card amounts reported by processors with the payment card amounts reported by merchants. The proposal would be effective for payment transactions made on or after January 1, 2010. The Bush Administration maintains that this third-party reporting would significantly increase compliance.

The payment card industry has several possible configurations. A configuration may consist of four parties, three parties, or two parties. A four-party system would include a payment card association, a card issuer, a merchant acquirer, and a processor. Regardless of the number of parties in the configuration, the processing function is the point where the proposed reporting requirement would apply.

The Treasury argues that the proposal would yield substantial revenue because of third-party reporting, which has been shown to significantly increase compliance. Proponents maintain that the proposal would improve the allocation of productive resources. They also claim that private sector compliance costs would be reasonable. And, they argue that the IRS has the ability to process additional information returns.

The proposal is not without its critics. Some question the accuracy of the U.S. Treasury estimates of the revenue yield. The U.S. Treasury estimates that the proposal would yield $5.735 billion for FY2009-FY2013 and $18.730 billion for FY2009-FY2018. Opponents also are concerned about the possible reduction in privacy from the proposal. In addition, they maintain that private compliance costs would be substantial. Finally, some argue that numerous potential administrative difficulties have not been addressed. These administrative issues include definitions of terms, reporting of transactions, timing of transactions, and administrative procedures. The Government Accountability Office has indicated some policy options to mitigate some potential problems.

Congress may want to weigh the costs of requiring information reporting on merchant payment card reimbursements against the benefits.

This report will be updated as issues develop and any new legislation is introduced.

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The high current and forecast budget deficits as well as pay-as-you-go (PAYGO) procedures have resulted in congressional and executive branch interest in raising additional revenue through proposals for improved tax compliance.[1] The Bush Administration's FY2009 budget includes a proposal (the proposal) to require each payment card processor to inform the IRS on the net dollar amount paid to reimburse each merchant (i.e., seller) for his payment card receipts in a calendar year. Payment cards consist of both credit cards and debit cards. This report examines the proposal by describing current law, presenting the proposal contained in the FY2009 budget, describing the structure of the payment card industry, analyzing the justifications for the proposal, explaining the criticisms of the proposal, and offering concluding observations.

Current Law

Under current law, a taxpayer making payments to a noncorporate recipient, which total $600 or more for services or determinable gains in the course of a trade or business in a calendar year, is required to send an information return to the IRS.[2] This information return (generally on Form 1099) indicates the payment amount, and the name and address of the recipient.[3] This requirement is far from universal. Information reporting is not required on many other types of transactions including payments not in the course of a trade or business and payments for purchases other than services.[4]

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[1] For an analysis of current PAYGO procedures in the Senate and House of Representatives, see CRS Report RL34300, *Pay-As-You-Go Procedures for Budget Enforcement*, by Robert Keith.

[2] U.S. Treasury, *General Explanations of the Administrations's Fiscal Year 2009 Revenue Proposals*, Feb. 2008, p. 65. Available at [http://www.treas.gov/offices/tax-policy/library/bluebk08.pdf], visited Apr.16, 2008.

[3] Ibid.

[4] Ibid.

Proposal

> The proposal would require the institution that makes the payment to the merchant (i.e., the seller) for a card transaction (for example, the merchant acquiring bank) to make an annual information report to the IRS.
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> Generally, the reporting institution would be the bank or central organization to which the merchant sends payment card transactions for actual payment. The report would state the net total amount paid to the merchant during a calendar year. The report would reflect appropriate adjustments for amounts that represent cash advances made by the merchant via the payment card or other amounts not included in the merchant's gross income. Where an electronic payment facilitator or other third party processes payments between a merchant acquiring bank and a merchant, the third party would be subject to the information reporting requirement. Similarly, if payment card transactions of several merchants are aggregated, the intermediary acting on behalf of the merchants and actually making the payment to the merchants also would have to report. In that case, the bank (or central organization) would report only as to the intermediary.[5]

The U. S. Treasury estimates that the proposal would yield $5.735 billion from FY2009-FY2013 and $18.730 billion from FY2009-FY2018.[6] The proposal would be effective for payment transactions made on or after January 1, 2010.

Structure of the Payment Card Industry

The proposal would require credit- and debit-card processors to inform the IRS annually about all aggregate reimbursement payments made to merchants. To fully understand the proposal, an understanding of the structure of the payment card industry is helpful.

The payment card industry has several possible configurations. A configuration may consist of four parties, three parties, or two parties. A four-party system would include a payment card association, a card issuer, a merchant acquirer, and a processor. The primary payment card associations are Visa and MasterCard, and U.S. consumers held 795.5 million of their cards in 2004.[7] "MasterCard and Visa provide the networks through which financial institutions interact to complete payment transactions pursuant to their respective rules and regulations."[8] A card issuer is simply a nonfinancial or financial institution (usually a bank) that issues

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[5] Ibid.

[6] Ibid., p. 66.

[7] Ramon P. DeGennaro, "Merchant Acquirers and Payment Card Processors: A Look Inside the Black Box," *Federal Reserve Bank of Atlanta Economic Review*, First Quarter, 2006, p. 28. Available at [http://www.frbatlanta.org/filelegacydocs/erq106_degennaro.pdf], visited Apr. 1, 2008.

[8] American Bankers Association, *White Paper on the Administration's Proposal to Require Information Reporting on Merchant Payment Card Reimbursements*, June 8, 2007, p. 2.

payment cards. A merchant acquirer is "a card association member that initiates and maintains relationships with merchants that accept payment cards."[9] A processor is "an organization that is connected to a payment card association and provides authorization, clearing and settlement services on behalf of a member."[10] "The processor is responsible for delivering the transaction to the appropriate card issuer so that the customer is billed and the merchant receives funds for the purchase."[11]

In a three-party system, the roles of card issuer and acquirer are combined in one institution.[12] Examples of the three-party systems are American Express and Discover Card.[13] For a two-party system, "payment cards are issued by a merchant to its retail customers for use only at the issuing merchant's locations."[14] An example of a two-party system is a department store that issues its own payment cards.

Regardless of the number of parties in the configuration, the processing function is the point where the proposed reporting requirement would apply. The proposal states, "Generally, the reporting institution would be the bank or central organization to which the merchant sends payment card transactions for actual payment."[15] The Treasury's description of the proposal gives an example of the processor as "the merchant acquiring bank." The processor would inform the IRS of the net dollar amount paid to reimburse each merchant for his payment card receipts in a calendar year. This reported amount by the processor can be compared with the amount reported by the merchant to the IRS.

Justifications for the Proposal

The Treasury maintains that the proposal would raise substantial revenue at a relatively low cost. The Treasury further asserts that "some merchants are underreporting gross income derived from payment card transactions."[16] Justifications for the proposal are high revenue yield, improved economic efficiency, reasonable private sector compliance costs, and the ability of the IRS to process additional information returns.

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[9] Indiana University, Office of the Treasurer, "Glossary of Payment Card Terms," p. 1. Available at [http://www.indiana.edu/~iutreas/pmtcrdtrm.html], visited Apr. 1, 2008.

[10] Ibid., p. 5.

[11] DeGennaro, p. 31.

[12] American Bankers Association, *White Paper on the Administration's Proposal to Require Information Reporting on Merchant Payment Card Reimbursements*, p. 2.

[13] Ibid.

[14] Ibid.

[15] U.S. Treasury, *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals*, p. 65.

[16] Ibid.

Revenue Yield Due to Third-Party Reporting

The Treasury argues that the proposal would yield substantial revenue because of third-party reporting, which has been shown to significantly increase compliance.[17] The Internal Revenue Service has estimated individual income tax underreporting by "visibility" categories for 2001. For income subject to little or no information reporting, the net misreporting percentage was 53.9%.[18] For income subject to some information reporting, the net misreporting percentage was 8.6%.[19] These data suggest that the proposal would substantially reduce noncompliance.

In addition, payment card reimbursement information for a business could be used to determine if revenue from cash payments to the business has been understated. Former IRS Commissioner Mark Everson gave the following example:

> What this would do is if you had a dry cleaning business, for example, and let's assume that the typical breakdown of that revenue is 50 percent credit and 50 percent cash, and if you were reporting to us $1 million in revenues, and then we got a notice from a series of credit card issuers that there was actually $1 million of credit card revenues from that business, that would raise a real red flag and might prompt an audit. It would certainly prompt a communication.[20]

Improved Economic Efficiency

Proponents argue that the proposal would improve the allocation of productive resources. Better tax compliance due to greater enforcement causes some resources to shift to away from sectors of the economy where they were attracted by the ease of tax evasion. These resources will shift to other sectors where they will now earn a higher after-tax rate of return.

Reasonable Private Sector Compliance Costs

Proponents argue that private sector compliance costs would be reasonable as indicated by current reporting practices of payment card processors and compliance costs of existing information reporting.

Current Reporting Practices of Payment Card Processors. The payment card processors (usually banks that have issued payment cards) already report summaries of payment card transactions to both customers who have

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[17] Ibid.

[18] U.S. Treasury, Internal Revenue Service, Feb. 2007, *Tax Gap Data for 2001*, p. 2. Available at [http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf], visited Apr. 1, 2008.

[19] Ibid.

[20] U.S. Congress, House Committee on the Budget, *Hearing on IRS and the Tax Gap*, Testimony of Mark Everson, Commissioner, Internal Revenue Service, Feb. 16, 2007, Washington, U.S. Govt. Print. Off., p. 20. Available at [http://budget.house.gov/hearings/2007/02.16eversontestimony.pdf], visited Apr.18, 2008.

purchased goods and services and merchants who have been reimbursed for selling these goods and services.[21] Thus, former IRS Commissioner Mark Everson argued that the proposal merely required that available information be sent to the IRS.[22]

Compliance Costs of Existing Information Reporting. The Government Accountability Office (GAO) conducted a study concerning two information reporting proposals: merchant payment card reimbursements and payments to corporations. One of the purposes of this study was to identify the compliance costs of existing information reporting using case studies.[23] A finding of low existing compliance costs would suggest that compliance costs of additional reporting requirements may also be low.

GAO examined nine case studies to determine "the kinds of third-party compliance costs that may result from merchant payment card reimbursements."[24] GAO obtained some of its information through structured interviews. GAO interviewed five companies that it selected "from lists of vendors, IRS approved e-filers, and Information Reporting Program Advisory Committee members...."[25] GAO also interviewed four organizations volunteered through International Accounts Payable Professionals or the National Federation of Independent Business.[26] GAO found the following:

> In our nine case studies, filers of information returns told us that existing information return costs, both in-house and for external payments, were relatively low. In-house compliance costs included the costs of getting taxpayer identification numbers (TIN), buying software, tracking reportable payments, filing returns with IRS, and mailing copies to taxpayers. One small business employing under five people told us of possibly spending three to five hours per year filing Form 1099 information returns manually, using an accounting package to gather the information. An organization with more than 10,000 employees estimated spending less than .005% of its yearly staff time on preparing and filing Forms 1099, including recordkeeping. Two external parties reported prices for preparing and filing Forms 1099 with IRS of about $10 per form for five forms to about $2 per form for 100 forms, with one of them charging about $.80 per form for 100,000 forms. As expected, unit prices for services provided to payers by selected software vendors, service bureaus, and return preparers decreased as the number of forms handled increased.[27]

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[21] Ibid.

[22] Ibid.

[23] U.S. Government Accountability Office, *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO-08-266, Nov. 2007, summary page.

[24] Ibid., p. 2.

[25] Ibid.

[26] Ibid.

[27] Ibid., p. 3.

GAO notes that the case study results are intended to provide examples and are not generalized to the entire population.[28] The sample is not random and is too small to yield statistically significant results.

IRS's Ability to Process Additional Information Returns

GAO found that the IRS could process additional information returns. For FY2008, IRS budgeted $8.0 million for programming and start-up costs for the payment card proposal. The IRS estimated administrative implementation costs after FY2008 would be $12.7 million.[29]

Criticisms of the Proposal

Criticisms of the proposal concern the accuracy of the revenue estimates, privacy concerns, third-party compliance costs, and administrative issues.

Accuracy of Revenue Estimates

Some opponents of the proposal question the accuracy of the estimated revenue yield.

> In the FY2007 report, the Treasury estimated that the reporting requirement would help generate $9 million in 2007, $92 million during the years 2007-2011, and $225 million during the years 2007-2016. In contrast, the FY2008 report stated that the reporting requirement would help generate $113 million in 2008, $3.3 billion during the years 2008-2012, and $10.8 billion during the years 2008-2017. Both the FY2007 and FY2008 report are based on data gathered from the 2001 tax year, and there is no explanation for how the proposed revenue estimate jumped astronomically from 2007 to 2008.[30]

Furthermore, as previously indicated, the U.S. Treasury estimates that the proposal would yield $5.735 billion from FY2009-FY2013 and $18.730 billion from FY2009-FY2018. The proposals are the same in the FY2008 and FY2009 budgets, but the U.S. Treasury offers no explanation for the substantial rise in its estimated revenue yield.

In addition, the effect on revenues of a possible behavior response are unknown. Some merchants may require or encourage their customers to pay them in cash rather than by payment card, in order to prevent the IRS from obtaining full information about their payment card sales.

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[28] Ibid., p. 2.

[29] Ibid., p. 65.

[30] Carla Balakgie, Executive Director of Electronic Transactions Association, Statement before the House Committee on Ways and Means, Subcommittee on Oversight, *Hearing on Internal Revenue Service Operations and the Tax Gap*, Apr. 3, 2007, p. 3. Available at [http://waysandmeans.house.gov/hearings.asp?formmode=printfriendly&id=5919], visited Apr.1, 2008.

Privacy Concerns

Some opponents are concerned about possible reductions in privacy from the proposal. For example, a spokesperson for the NSBA (National Small Business Association) stated that "NSBA fully supports efforts to collect legally owed tax revenues, but not at the undue expense of the privacy and integrity of honest, hard-working entrepreneurs."[31]

High Private Compliance Costs

GAO found that new information-reporting requirements for payment card reimbursements would impose new compliance costs such as "(1) merging separately stored taxpayer and merchant identification numbers, especially in the case of multiple locations or franchises; and (2) more generally, new systems and added customer service requirements."[32] But some of these compliance costs could be mitigated. For example current systems and procedures that generate and report related data could be extended.[33]

Administrative Issues

Some opponents argue that before the proposal can be formulated into legislation, numerous potential administrative issues need to be addressed such as definitions of terms, reporting of transactions, timing of transactions, and administrative procedures.[34] The actual settlement process for payment cards can be complicated.

In its report, GAO indicates some policy options to mitigate potential problems. In its description of the proposal, the Treasury does state that

> The proposal would grant regulatory authority to allow exceptions from the requirements where the benefit of improved compliance from information reporting is outweighed by the cost of compliance, and to prevent double reporting of amounts potentially reported under other provisions.[35]

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[31] Paul Hense, Immediate Past Chairman of the National Small Business Association, Statement before the House Small Business Committee, Hearing on Closing the Tax Gap Without Creating Burdens for Small Businesses, Apr. 26, 2007, pp. 5-6.

[32] U.S. Government Accountability Office, *Tax Administration: Costs and Uses of Third-Party Information Returns*, p. 15.

[33] Ibid.

[34] Many of these difficulties were examined by the American Bankers Association (for example, see American Bankers Association, *White Paper on the Administration's Proposal to Require Information Reporting on Merchant Payment Card Reimbursements*, pp. 8-11. Another source for an explanation of administrative difficulties is Martin A. Sullivan, Treasury Expects Billions from Credit Card Reporting Proposal, *Tax Notes*, vol. 115, no. 10, June 4, 2007, pp. 890-892.

[35] U.S. Treasury, *General Explanations of the Administration's Fiscal Year 2009 Revenue*
(continued...)

Two examples of likely administrative difficulties serve to demonstrate the complexities of the proposal. First, "transactions processed on one day may be subsequently reversed when cardholders return merchandise or invoke their rights under the federal Truth in Lending Act, Electronic Fund Transfer Act, or similar state laws."[36] Cardholders may be entitled to credits from their card issuers, which can result in the transaction being reversed or "charged back." The proposal does not discuss this issue.

Second, a gift card may be sold in one time period but used to purchase a product in a latter time period. If the initial sale of the gift card is reported as a transaction then the seller's "gross reimbursements" may be overstated. The proposal does not address the issue of gift card sales.

GAO indicates several possible methods of mitigating charge backs, gift cards, and other items that may cause payment reimbursements not to match merchant receipts. For one of its methods of mitigation, GAO states, "Since IRS is not planning an exact match anyway, it could announce it was developing industry norms of net-to-gross ratios to evaluate information, although norms may not be foolproof or always possible."[37]

Conclusion

In summary, Congress may want to weigh the costs of requiring information reporting on merchant payment card reimbursements against the benefits. Principal arguments for the proposal concern its estimated high revenue yield, improved economic efficiency, reasonable private compliance costs, and the ability of the IRS to process additional information returns. Opponents raise a number of questions, including the accuracy of revenue estimates; raise privacy concerns; claim private compliance costs will be high; and argue that many administrative issues are unresolved.

Nina E. Olson, National Taxpayer Advocate at the IRS, supported a proposal for reporting payment card reimbursements that was similar to a proposal in the FY2008 Budget. In 2007, she recommended legislation should

> Provide the Treasury Department and the IRS with authority to promulgate regulations requiring organizations that process card payments to report the gross payments made to the merchant in a calendar year to the IRS. The regulations

[35] (...continued)
Proposals, p. 65.

[36] American Bankers Association, *White Paper on the Administration's Proposal to Require Information Reporting on Merchant Payment Card Reimbursements*, p. 9.

[37] Government Accountability Office, *Tax Administration: Costs and Uses of Third-Party Information Returns*, p. 42.

> should provide for a sufficiently prospective effective date to allow financial institutions to modify their reporting systems.[38]

Conversely, after examining the proposal, one major opponent, the American Bankers Association concluded the following:

> In order to implement the proposal, the payment card industry will be forced to redesign their transaction processing systems at very significant cost, which would likely be passed on to merchants and eventually on to consumers. The development of new software systems would require significant time and resources for a proposal that is fundamentally flawed and unlikely to yield the level of revenue estimated by the Administration and the Joint Committee on Taxation.[39]

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[38] Internal Revenue Service, *National Taxpayer Advocate's 2007 Annual Report to Congress, vol. 1, sec. 2*, 2007, p. 501. Available at [http://www.irs.gov/pub/irs-utl/arc_2007_vol_1_legislativerec.pdf].

[39] American Bankers Association, *White Paper on the Administration's Proposal to Require Information Reporting on Merchant Payment Card Reimbursements*, p. 11.