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"The Problems and Challenges of Electronic Payments Reporting for Small Business"

Introduction

Good morning Chairwoman Velazquez, Ranking Member Chabot, and distinguished Members of the Committee. My name is Donald Boeding and I am the General Manager of Merchant Services for Fifth Third Processing Solutions, one of five main business lines operated by Fifth Third Bank. Thank you for the opportunity to appear before you today to offer industry perspectives on a proposal to require institutions that make payments to merchants for payment card transactions to file annual information reports with the IRS.

Fifth Third is headquartered in Cincinnati, Ohio with origins dating back to the opening of the Bank of the Ohio Valley in 1858. Today, Fifth Third is a diversified financial services company with $111 billion in assets, nearly 23,000 employees, and retail banking centers in twelve states.

Fifth Third Processing Solutions (FTPS) processes electronic payments at over 157,000 merchant locations for thousands of merchant chains. Our annual volume in payment transactions is over $175 billion, making FTPS the 4th largest Visa/MasterCard acquirer in the U.S., and the largest processor of PIN debit transactions in the country. FTPS has been a premier source of merchant processing services for businesses nationwide for over 30 years. As a pioneer in payment technology, we've partnered with thousands of businesses to increase their sales and profitability by providing state of the art processing services, including:

- **Credit Card Acceptance:** In-house systems and capabilities allowing merchants to choose from a variety of authorization and settlement configurations
- **Debit Card Acceptance:** Featuring speed, security, and the dependability of redundant direct links to every major debit card network
- **Other Key Merchant Services, Including:** Electronic Benefits Transfer, Electronic Check Truncation, Point of Sale Terminal Hardware, and Gift Card Solutions

Brief Description of Payment Systems

The payment card industry is highly complex with many moving parts. The American Bankers Association, in their written statement to the Committee, provides detail on the mechanics of the system, so let me just touch briefly on the characteristics of these systems and transaction paths:

Four-Party Systems

- Often referred to as bankcard systems (such as MasterCard and Visa)
- Feature card issuing financial institutions and merchant acquiring institutions who sign up merchants to accept cards either directly or via third parties
- Often include third party processors who provide transaction processing services for some issuing or acquiring institutions

Three-Party Systems

- Feature a single company that issues payment cards, signs up merchants to accept cards, and performs functions to complete transactions (American Express and Discover are examples)
- Often feature third party processors as with the four-party system

- New growth in complexity through contracting with financial institutions to issue cards for use on third party networks

Two-Party Systems

- Merchants issue cards to customers for use at the merchant's locations only
- Growth in this area through financial institutions issuing cards bearing merchant brand – often referred to as "private label cards"
- The merchant that accepts the card may not be the entity ultimately reimbursed for conducting issuing and acquiring functions

General Thoughts on Increased Information Reporting

In short, we can draw a few initial conclusions about this potentially sweeping proposal, notwithstanding the limited availability of detail as to its specific requirements and implementation parameters.

First, enactment of such an increased information reporting measure would come at a very difficult time in the economy, particularly for the financial services and small business sectors. New and increased risks and reporting requirements will translate into significant IT investment expense and allocation of employee talent by processors to ensure compliance during both a ramp up period and on a go forward basis.

Second, the potential application of backup withholding presents tremendous risks both for processors and merchants. At 28%, backup withholding will have deep impacts on merchants, in some cases representing the difference between success and failure.

Third, the merchant processing industry as developed does not operate in a way to comply with the known parameters of the proposal.

Fourth, the proposal will likely strain the relationship between payment processors and merchant customers, in some cases driving merchants to avoid the convenience and security of electronic payment systems.

Finally, given the vague nature of proposals offered to date, the full impact on all parties will not be known until implementation and compliance has been audited. It is likely that interested parties are not fully aware of the operational impact this will have.

Specific Concerns to Consider

- **Costs of Compliance**

System modifications and contract re-negotiations and the time associated with both, will place significant expense on payment processors. Further, processors will need to store and secure data provided to the IRS.

The expected hard costs associated with ramping up and maintaining a program to facilitate compliant reporting are only a part of the costs that should be expected to arise out of this proposal. It should be expected that the number of hours a processor will ultimately have to devote to troubleshooting alleged errors in the reporting would be significant. For instance if the IRS reporting from a processor does not reconcile with other reporting received by a particular merchant, it will likely result in significant hours spent by the processor's merchant relationship team to work through those issues with that merchant.

This will add a level of complexity to all new product initiatives. Additional analysis and possible extra development may be required each time a new payment product is developed and/or rolled out.

- **Backup Withholding**

As noted, the Merchant Reporting proposal includes the requirement to withhold 28% of payments made to merchants on whom we do not have a valid TIN. Processors would be required to withhold immediately on any payment on which the TIN is missing, or is obviously an incorrect number (for example, all the same digits, or sequential digits).

The impact of this new withholding on merchants, particularly smaller merchants would be substantial, presenting great complication and burden on their cash management procedures. The reduction of cash flow based on transactions that may have no income tax consequence would be a tremendous burden to our merchant clients.

In addition, the impact of withholding is potentially significant to processors. For any payments on which withholding is required, but a processor fails to withhold correctly, the processor is liable for the amount that should have been withheld, in addition to penalties and interest on the under-withheld amount. Because of the dollar volume involved in these electronic transactions for large processors, the liability for failure to withhold, penalties, and interest could be a very significant monetary risk.

There is nothing in any of the information published to date on this new initiative addressing if, or how, this proposal relates to payments made to non-resident aliens. The withholding and reporting regulations for payments made to non-residents are more complicated than the rules for domestic recipients. If payments to non-residents are included in the scope of this legislation, the processes required to document, withhold and report payments would be significantly more difficult than those for domestic merchants.

At a minimum, should backup withholding remain a part of any increased merchant-reporting proposal, a period of significant phase in, perhaps two to three years, should be provided before withholding is required. This will allow payers time to obtain the necessary customer information. Additionally, any new compliance regime in this area should include appropriate safe harbors from penalties where 100 percent compliance is not achieved.

- **Tax Identification Number Matching and Maintenance**

TIN validation and maintenance presents significant concern. Merchants are not currently identified by acquiring bank or processor systems by SSN or TIN, but rather they are generally assigned a merchant ID number. It could take years for banks to complete a matching process, at significant time and expense.

Payment processors would be required to obtain and store the Employer Identification Number (EIN) or Social Security Number (SSN) for each merchant on whom we are required to report.

In addition to obtaining a tax identification number (TIN) for each merchant, processors will need to verify the name under which the payment is reported is an exact match to the name under which IRS issued the tax identification number.

Since many businesses use a variation of their full business name or a DBA name, many processor records will need to be updated. This will require using the IRS TIN Matching Service or some other service to identify those accounts on which we do not have a name/TIN match. Merchants for whom we do not have a match will need to be contacted to obtain good information. This process can take multiple requests of the merchant to obtain an exact match to IRS records.

Unlike current 1099-MISC reporting done by payers, which limits reporting to services (goods are excluded), and to non-exempt recipients, (exempt entities such as corporations, government entities, etc. are excluded), this proposal will greatly expand the reach of the reportable universe. Because the type of record keeping and reporting required by IRS is not something that has been required of processors previously, the additional operational and IT support could be significant.

The IRS maintains a TIN Matching System through which a file of up to 100,000 records can be submitted to the IRS to verify the customer name and TIN is a match on IRS records. A suggestion has been made that as a part of the merchant reporting initiative, merchants who verify TIN's through this service may not be required to withhold. It is unclear at this time whether withholding would be required on accounts that are returned by the IRS as a mismatch, or if the processor would be relieved of withholding entirely if using the TIN Matching system.

The specifications for the file layout to submit files to the TIN Matching Service are very stringent, and the file is rejected if any record in the file does not meet the specifications exactly. There is likely very limited, if any, experience within most payment processor companies in working with this IRS system on the large scale basis likely required under this proposal.

- **Impact on Merchant Reporting Entity Relationship**

It's certainly possible that the reporting could create tensions between acquirers/processors and their merchant customers who don't understand how the information is going to be used and/or disagree with the methodology by which processors have created the reporting. This will result in a tremendous amount of concern and confusion among merchant customers. Additionally, fear of audit could make merchants less likely to accept electronic payments.

The potential for merchant concern over privacy issues should also not be overlooked. Recent media reports and analysis from the Center for Democracy & Technology raise questions regarding the wisdom of creating a new private sector database tied to Social Security numbers, which are used by many small businesses as their taxpayer ID number.

- **Reporting Questions**

Operationally, merchant payments would be reported on Form 1099-MISC. A file including all reportable information would need to be prepared from a processor reporting system and transmitted in the required format to the IRS reporting system.

At this point, it is unclear if the aggregate payments or another amount would be reported, and who would have reporting responsibility in cases where another party is a middleman in a transaction. Would the proposal include Debit and ACH? Including these products would pull almost every bank in the U.S. under the proposed reporting regime.

In addition, no definition has been provided for how reporting would be handled for companies with stores or divisions that operate independently or are franchisees of a business. Further, it is largely impossible for the payment industry to report on net receipts, given fees, interchange, gift card, chargeback, cash backs, etc. The only possible number to report on would be gross.

Given the variances in the systems utilized by the numerous processors in the industry, it is likely that the accuracy of reporting from acquirer to acquirer, or processor to processor has the potential to vary greatly.

Conclusion

On a final note, it should be expected that the non-compliant taxpayers this proposal targets will ultimately find and develop schemes to avoid recognition through this type of reporting. Some may simply stop accepting cards altogether thereby making it less likely that the IRS will be able to track taxable income, others may simply work to find loopholes in the reporting mechanisms that are ultimately established. The benefits expected to arise from this initiative may ultimately result in increased costs to the compliant payment card participants (consumers, acquirers, processors, issuers, merchants) with no real benefit to those same participants. I look forward to answering any questions you might have, and thank the Committee for taking valuable time to consider this important issue.