



IRC SECTION 6050W:

FORM 1099-K TAX INFORMATION REPORTING FOR PAYMENTS IN SETTLEMENT OF TRANSACTIONS MADE THROUGH PAYMENT CARDS AND THIRD-PARTY NETWORKS

With new Internal Revenue Code section 6050W, which went into effect at the beginning of 2011, the Form 1099 filing burden for some payers has been eased. Other payers have found themselves responsible for a complex new regime of recordkeeping and 1099 information return filing.

- Many companies will have fewer Forms 1099-MISC to file because the IRS information return requirements for all or nearly all of their card and electronic transactions will be handled by a “merchant-acquiring entity” or a “third-party settlement organization.”
- A smaller number of companies will drop a portion of their Form 1099-MISC burden but replace it with Form 1099-K filing because some of their functions meet the definition of a “third-party settlement organization.”
- Some companies will find themselves to be major Form 1099-K filers, required to track monthly pass-through settlement amounts for their customer base, and report a large number of Forms 1099-K annually to the IRS and customers.
- A third-party settlement organization, which is an organization that has the contractual obligation to carry out the settlement of payments to its participating payees that have agreed to accept payment by having the third-party settlement organization transfer funds through its third-party network to the account of the participating payee.
- Any company or organization that, although it may not have been established for the purpose of being a third-party settlement organization, nevertheless by its actual facts and circumstances fits the definition of a third-party settlement organization.
 - A company whose business is outsourced Accounts Payable or procure-to-pay services could find that it meets this definition of a Form 1099-K filer.
 - A shared Accounts Payable operation serving related business entities would need to carefully examine its operations to determine whether it meets this definition of a Form 1099-K filer, especially if it uses excess capacity to serve unrelated companies.

INTRODUCTION

A new type of Form 1099 tax reporting went into effect on the first of January, 2011: Form 1099-K information reporting of gross amounts paid by a settlement entity to its participating payees. The “participating payees” that will be reported are recipients that accept payment cards as a means of payment, and recipients that accept payment through third-party settlement organizations. The entities that are required to report to the Internal Revenue Service (and to their payees) on the new Form 1099-K, titled Merchant Card and Third-Party Payments, are:

- A merchant acquiring entity, which is the bank or other organization that has the contractual obligation to carry out the settlement of payments to its participating payees that have accepted a payment card as payment for services or goods

Offshore affiliates of a U.S. entity are included in the Form 1099-K reporting requirement. This includes facilities the U.S. entity operates in a foreign country, controlled foreign corporations, and foreign entities that have 50% or more U.S. ownership.

The statutory requirement for this Form 1099-K reporting was created by the addition of Section 6050W to the federal tax code, enacted as part of the Housing Assistance Tax Act of 2008. Sec. 6050W was established as a “revenue offset” to the cost of programs created by the Act. The sense of Congress was that additional federal tax revenues would be raised by requiring merchant acquiring entities and third-party settlement organizations to report the amounts paid to their participating merchants and sellers – because those merchants and sellers would be more likely to report and pay tax on their true income if they knew that the amounts were being



reported to the IRS, and because the IRS would collect information that could be used to enforce the collection of additional tax from merchants and sellers that underreported their income.

The final regulations for Section 6050W tax reporting were released on August 16, 2010. They are available as published in the Federal Register at <http://edocket.access.gpo.gov/2010/pdf/2010-20200.pdf>.

REDUCING THE FORM 1099-MISC BURDEN: IF REPORTED ON FORM 1099-K, NO DUPLICATE REPORTING ON FORM 1099-MISC

Internal Revenue Code Sections 6041 and 6041A require reporting to the IRS (and to the payee) of many types of payments made in the course of trade or business that aggregate \$600 or more to a payee for the calendar year. The method of payment has never been a factor in the reportability of such payments. Whether made by cash, check, electronic funds transfer, card account, or any other means, all such payments require 1099-MISC reporting unless there is a specific exception for the payee or an exception for whatever was paid.

New IRC Section 6050W, requiring Form 1099-K reporting of gross payment amounts settled for the payee by payee's merchant acquiring entity or third-party settlement organization, covers many of the same payments and payees for which Form 1099-MISC reporting is required.

With the intent of preventing the reporting of the same transaction more than once, the final tax regulations for Sec. 6050W provide that payment card and third-party network transactions that otherwise would be reportable under both Sections 6041 (or 6041A) and 6050W must be reported under Section 6050W (on Form 1099-K) and not Section 6041/6041A (Form 1099-MISC).

Many payers can now code many payments as "no 1099-MISC required"

Payers that can take advantage of this relief from duplicate reporting can now code as "not reportable" payments they make through cards and third-party payment networks. Records should be kept to document why there is reason to believe that the specific payments qualify for relief from 1099-MISC reporting because they are being included on a Form 1099-K filed by another entity. But, watch out for uses of the card or electronic settlement to pay non-U.S. service providers, because Form 1099-K filing by the merchant acquiring entity or third-party settlement organization does not cover payments that are

withholdable under Secs. 1441 or 1442 of the Internal Revenue Code and are reportable on Form 1042-S. For such payments, withholding and Form 1042-S reporting remains the responsibility of your company.

Also, the IRS has made a point of stating that direct sales (box 9 of Form 1099-MISC) continue to require reporting, without relief. Box 9 amounts will never be duplicated by Form 1099-K reporting, so they remain reportable if they aggregate \$5,000 or more for the calendar year for consumer goods sold to any buyer on a buy-sell, deposit-commission, or other basis for resale other than in a permanent retail establishment.

ARE YOU REQUIRED TO FILE FORMS 1099-K?

YES: If you are a "merchant acquiring entity," defined as the bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions. "Payment card" is defined broadly as including (but not limited to) all credit cards, debit cards, and stored-value cards, including gift cards. The acceptance of a card account number, or other indicia associated with a payment card, is treated as a payment card transaction the same as if a tangible card were used.

YES: If you are a "third-party settlement organization," defined as the central organization that has the contractual obligation to make payment – to participating unrelated payees – of third-party network transactions. A specific written contract for network processing is not necessary for this definition to apply; any "agreement or arrangement" that says the provider of the goods or services will be paid is enough to qualify as a "contractual obligation to make payment," so it appears to include routine arrangements to pay such items as purchase orders or invoices.

YES: At this point it is not entirely clear that a shared services organization providing Accounts Payable services will be covered under these requirements, but an outsourced AP or purchase-to-pay services company more than likely will be. A third-party settlement organization is required to report on 1099-K if (1) "a substantial number of unrelated providers of goods and services have established accounts with the shared-service organization," and (2) "this arrangement enables purchasers of goods and services to transfer funds to these providers, who are obligated by contract to accept guaranteed payments from the shared-service organization in settlement of their transactions with the purchasers." The final regulations do not include a definition of "substantial number," but for these purposes the Joint Committee on Taxation in its Technical Explanation of the Housing Assistance Tax Act of 2008 said that "substantial" means



more than 50 participating payees. The IRS could have picked up this limit in the final regulations, but chose to remain silent and use only the word “substantial” to limit the application leaving the term ambiguous. The final regulations make it clear that the “third-party network” rules apply to certain shared-service Accounts Payable processes (see Example 18 at Section 1.6050W-1(e)). Although this example addresses an outsourcing operation in which there are multiple purchasers unrelated to the service provider, other aspects of the example describe attributes that are also present in the shared-service model where the purchasers are related to the service provider. Section 1.6050W-1(c)(3) of the final regulations shows that a factor in Form 1099-K reporting liability is having contractual relationships with unrelated sellers, and is not influenced by whether the purchasers of the goods or services are related to the service provider. The IRS has indicated that they plan to release FAQs to assist in making this determination.

YES: If you have the contractual obligation to settle payments for “private label” and “quasi-private label” cards, such as the case involving an electronic payment facilitator, if payment is accepted by a network of unrelated merchants or unrelated service providers.

YES: If you have the contractual obligation to settle payments for “Mall cards,” if they are accepted as payment by a network of unrelated merchants. (Transactions in which the card is accepted by a payee related to the mall can be excepted from reporting.)

YES: If you have the contractual obligation to settle payments for “Campus cards,” if they are accepted as payment by a network of unrelated merchants. (Transactions in which the card is accepted by a payee related to the educational institution can be excepted from reporting.)

YES: If you are a provider of bill paying services and other electronic payment acceptance products – if the facts and circumstance put the provider entity in the position of a third-party settlement organization. But, see the exception further below for convenience checks which are thought to be loans rather than use of credit cards. An entity that has an arrangement with its merchant customers to settle payment transactions to an account the merchant customer has established at the entity may be operating a “third-party network” if the agreement or arrangement involves the establishment of accounts with a central organization by a substantial number of unrelated persons who provide goods or services and have agreed to settle transactions pursuant to the agreement or arrangement, and the central organization guarantees payment to those persons for the goods or services.

YES: If you are an ACH processor, but only if the facts and circumstances of certain of your service contracts create an independent third-party payment network separate from the Automated Clearing House network. Generally ACH processors are not covered under these rules unless they also service another role such as an electronic payment facilitator or where they contractually accept payment responsibilities from a third-party facilitator to make payments in settlement of reportable payment transactions.

YES: If you are the organization closest to the ultimate 1099-K reportable payee in a chain of transactions. If two or more entities qualify as payment settlement entities for a reportable payment transaction, then only the payment settlement entity that in fact makes payment in settlement of the reportable payment transaction is obligated to report the payment on Form 1099-K (A special rule permits the party with the obligation to report to designate a different entity to satisfy the Form 1099-K reporting obligation; however the originally obligated reporting entity remains liable for penalties if the designee fails to report).

NO: Processing a payment card solely to obtain a loan or cash advance.

PROBABLY NO: Health care networks, though without further guidance from the IRS, this area is still unclear. However, it is thought that health care networks that accept premiums or direct payments from employers as part of an insurance plan (whether self insured or not) are probably not considered third-party settlement organizations when they pay health care service providers.

NO: Processing “convenience checks” associated with a card account. *It is important to note that the use of convenience checks is thought to be a loan rather than a use of credit cards and thus will fall outside the scope of these rules. Accounts payable areas will need to continue to 1099-MISC report payments made by convenience checks.*

FOREIGN PAYEES ARE NOT REPORTABLE ON FORM 1099-K, BUT YOU MUST HAVE DOCUMENTATION OF FOREIGN STATUS TO EXCLUDE THE PAYEE

The section 6050W final regulations state that the appropriate requirement is for the payee to complete a Form W-8BEN (or other W-8 as appropriate) to certify its foreign status. However, a transition rule in the final regulations permits the payor to rely on a foreign address (without a Form W-8) for purposes of Form 1099-K reporting for payments made pursuant to a contractual obligation that was entered into before



January 1, 2011 – as long as the payor neither knows nor has reason to know that the payee is actually a U.S. person. This transition rule can also be used for payments under contractual obligations entered into prior to January 1, 2011, and subsequently renewed after January 1, 2011, as long as the renewal did not make a material modification of the contractual obligation.

There is also an allowable presumption of foreign status when a U.S. payer makes a payment outside the United States to an offshore account if the payee has a foreign address and no Form W-8, but the name of the payee indicates that it is a foreign per se corporation listed in regulations Section 301.7701-2(b)(8)(i), and the payor neither knows nor has reason to know that the participating payee is actually a U.S. person. For these purposes, U.S. payers include certain foreign payers that are:

- Controlled foreign corporations (CFC) within the meaning of IRC §957(a).
- Foreign partnerships, if at any time during their tax year, one or more of the partners are U.S. persons (as defined in §1.1441-1(c)(2)) who, in the aggregate, hold more than 50% of the income or capital interest in the partnership or if, at any time during its tax year, the partnership is engaged in the conduct of a trade or business in the U.S.
- Foreign persons for which gross income that is effectively connected to a U.S. trade or business represents 50% or more of income from all sources for the three-year period ending with the close of its taxable year preceding the collection or payment.
- U.S. branches of foreign banks or foreign insurance companies described in Reg. §1.1441-1(b)(2)(iv).

IF YOU MUST FILE FORMS 1099-K, WHAT DATA AND DOCUMENTATION MUST YOU TRACK?

- **Gross amount** of reportable payment transactions. The “gross amount” is defined as the total dollar amount of aggregate reportable payment transactions for each participating payee without regard to any adjustments for credits, cash equivalents, discount amounts, fees, refunded amounts, or any other amounts. Tracking the reportable “gross amount” is one of the biggest challenges of Form 1099-K compliance.
- **De minimis thresholds per payee.** The de minimis rules only apply to third party settlement organizations. There are no de minimis exceptions for merchant acquiring entities where even a dollar transaction is reportable. For third-party settlement organizations, the threshold for Form 1099-K reporting is (i) over 200 transactions for the payee **AND** (ii) an aggregate gross payment amount over

\$20,000, for the calendar year. If these thresholds are not met, the payee is not reportable on Form 1099-K.

- **Date of transaction**, as the date of determining the reportable gross amount. The dollar amount of each reportable payment transaction is determined on the date of the transaction, not on the settlement date, posting date, date payment is made, or any other date. Merchant acquiring entities must report the gross amount of reportable transactions of any payee for whom they settle payment card transactions. Third-party settlement organizations must report the gross amounts of reportable transactions of any payee for whom they settle payments using their network if the de minimis thresholds are crossed.
- **Monthly amount** for each participating payee. The new Form 1099-K is to be filed annually, but it requires the reporting of 12 separate amounts, one for each month of the calendar year.
- **Payee name and Taxpayer Identification Number (TIN).**
- **Backup withholding liability, deposit and reporting.** Payments reportable on Form 1099-K are subject to the federal backup withholding requirements, effective for amounts paid after December 31, 2011. Thus, one year after payments become subject to Form 1099-K reporting, payments will also become subject to the 28% backup withholding rules. The final regulations give payors that one-year grace period to gear up for backup withholding of federal tax on payments for which the payee’s TIN is missing or incorrect.

The application of backup withholding to Form 1099-K reportable amounts is complex and awkward and requires new systems and procedures. First, complex recordkeeping is required to associate each payment to the “merchant” with specific transactions that have rolled into the payment. Then, where a payee is identified as subject to backup withholding, the withholding percentage must be applied to the transaction amount, not a net payment amount.

The following rules apply: (i) The obligation to backup withhold arises on the date of the transaction, but a payor is not required to withhold until the payment is made to the payee. (ii) The backup withholding percentage is applied to the gross amount of the transaction, because that is the reportable amount. (iii) If the payee’s account has less than the backup withholding amount on the date backup withholding is to be applied, the payor may withhold from an alternate source maintained by the payor for the payee, or backup withholding may be deferred until the payee’s account has enough money in it – or until the close of the fourth



calendar year after the obligation arose. (iv) If at the close of that fourth calendar year, the payee's account has insufficient funds and no alternate source of funds has been located, the backup withholding obligation will cease to exist.

- **U.S. dollar** conversion of payments made in foreign currencies. When a payment is made or received in a foreign currency, the U.S. dollar amount is determined by converting such foreign currency into U.S. dollars on the date of the transaction, at the spot rate or pursuant to a reasonable spot rate convention such as a month-end spot rate or a monthly average spot rate. Since backup withholding could apply to some payees, the better convention is to use the spot rate on transaction date for all gross amounts to assure that withholding when required in U.S. dollars will reflect the appropriate rate of the reportable gross amount when it comes time for 1099-K reporting.
- **Electronic consent** if you wish to offer, and payee wishes to receive, an electronic Form 1099-K. *Most 1099-K filers would probably prefer to furnish electronic 1099-Ks to their merchants, rather than sending paper through the mail, but the notice-and-consent regulations that apply to other types of 1099s also apply to 1099-K, so every merchant must opt in by responding to a notification; no previously existing merchant agreements will have anticipated an electronic tax statement.* The section 6050W regulations provide that the recipient must give affirmative consent to receive the Form 1099-K statement in an electronic format. Consent can be made electronically in any manner that reasonably demonstrates that the recipient can access the statement in the electronic format in which it will be furnished; or, consent can be on a paper document but, if so, it must subsequently be confirmed electronically. Prior electronic consent to receive from the furnisher other federal tax statements in an electronic format will also serve for the 1099-K.

- **Information reporting penalties.** Form 1099-K reporting is subject to the same monetary penalties as other Form 1099 reporting. And, remember that the penalties for information reporting failures have increased to twice, or more, their previous amounts, with the penalty ceiling raised to \$1.5 million per year – or no upper limit at all, if the IRS finds intentional disregard of the information reporting requirements. “Reasonable cause” regulatory provisions will be available to Form 1099-K filers who want to seek abatement of penalties. *The preamble to the section 6050W final regulations specifically rejects penalty relief for “good faith efforts” to implement the new IRC section 6050W reporting requirements. If you are required to file Form 1099-K, you need a new or upgraded system in place today.*

