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## Payment Settlement Entities and IRS Reporting Requirements

The Internal Revenue Code (IRC) requires entities making certain types of payments, including wages paid to employees and business payments to contractors, to file information returns with the Internal Revenue Service (IRS). Information returns are intended to improve voluntary compliance with tax law by providing information about potentially taxable transactions to the IRS and taxpayers.

The information reporting requirement for certain transactions processed by payment settlement entities has been of legislative interest in the 117<sup>th</sup> Congress. This In Focus reviews that reporting requirement (codified at IRC §6050W), its legislative history, current legislative proposals, and related policy considerations.

### Payment Settlement Entities

Section 6050W applies to payment settlement entities. Payment settlement entities broadly include *merchant acquiring entities* and *third party settlement organizations*.

As the IRS has explained, a merchant acquiring entity is “the bank or other organization that has the contractual obligation to make payment to a merchant or other business ... in settlement of payment card transactions.” For example, if a customer pays for a good or service with a credit card, the credit card company that pays the merchant would generally be the merchant acquiring entity.

Third party settlement organizations include entities that make payments to payees of third party network transactions. They generally function as intermediaries between buyers and sellers of goods or services, and charge a fee for serving as an intermediary. Examples of these types of entities include some online auction or marketplace services (such as eBay and Amazon), some gig economy platforms (such as Uber and Airbnb), and some cryptocurrency processors (such as BitPay and Coinbase before 2020).

Whether a specific entity is a third party settlement organization partially depends on the entity’s legal structure. Two entities may perform a broadly similar service while one takes the position it is a third party settlement organization, whereas the other does not. For example, the payment service Venmo will issue an information return to applicable users under Section 6050W, while the bank transfer service Zelle maintains it is not a third party settlement organization and will not issue an information return under Section 6050W.

### Reporting Requirements for Payment Settlement Entities

Generally, merchant acquiring entities are required to file a Form 1099-K with the IRS (and send a copy to the taxpayer) reporting the gross amount of reportable transactions for all payees. There is no de minimis exception.

Starting in 2022, third party settlement organizations are required to report to the IRS the aggregate amount of payments to users that exceed \$600 in a calendar year. This reporting threshold is the same as the threshold for payments made by other businesses that are not made through a third party settlement organization (26 U.S.C. §6041). Reporting requirements do not change the tax obligations of taxpayers. Taxpayers are required to report all the income they receive, in any form they receive it, whether it is reported by a third party to the IRS or not, unless the income is statutorily or otherwise excepted from the computation of taxable income.

The reporting changes do not mean that taxpayers will need to pay taxes on the whole amount reported to the IRS. Taxpayers may claim any allowable deductions against their receipts for amounts reported to the IRS by payment settlement entities. For example, suppose a seller receives \$1,000 from a third party settlement organization for selling goods. Although the \$1,000 would be reported to the IRS, the seller could deduct the cost of making the goods. If the materials to make the goods cost \$700, then the taxable income (profit) would be \$300.

### Legislative History

Section 6050W, which was enacted in the Housing and Economic Recovery Act of 2008 (P.L. 110-289), required an information return to be filed by a third party settlement organization for payees whose gross amount of reportable transactions exceeded \$20,000 and who settled over 200 transactions. These payments were also reported to the IRS on Form 1099-K. With these thresholds, only relatively frequent users of third party payment networks would exceed both thresholds, and thus have payment information reported to the IRS.

The provision was intended as a revenue offset for the bill. The Joint Committee on Taxation (JCT) estimated that the new reporting requirements would increase revenue by \$9.5 billion from FY2008 to FY2018. This estimate largely reflects anticipated increased tax compliance. IRS studies suggest that a substantial portion of uncollected taxes are the result of underreported business and self-employment income that is not subject to third-party reporting to the IRS.

The Bipartisan Budget Act of 2018 (P.L. 115-123) amended how Section 6050W applied to people with a foreign address. The original version of Section 6050W provided that a person with a foreign address could *not* be a participating payee except as provided by the IRS. The Bipartisan Budget Act of 2018 added that a person with a foreign address could *not* be a participating payee only because that person receives payments in U.S. dollars. JCT estimated that this change would reduce revenue by \$10 million from FY2018 to FY2027.

The American Rescue Plan Act of 2021 (ARPA; P.L. 117-2) changed the de minimis reporting threshold for third party network transactions. As noted above, starting in 2022, third party settlement organizations will need to file a Form 1099-K reporting the gross amount of reportable transactions for all payees with aggregate transactions exceeding \$600. Unlike the previous threshold, there is no requirement for the number of transactions. JCT estimated this change would increase federal tax revenue by \$8.4 billion from FY2021 to FY2031.

### Policy Considerations

Increasing reporting of transactions with payment settlement entities potentially involves a trade-off: increased reporting may improve tax compliance and reduce the tax gap (i.e., the difference between taxes owed and taxes collected), while also increasing complexity for some taxpayers.

As mentioned above, the anticipated increased revenue from increasing information reporting under Section 6050W is largely related to increasing third-party reporting of business and self-employment income. These types of income are often not subject to third-party reporting, and the IRS believes they form a substantial portion of the tax gap.

In a 2021 study published in the *Journal of Public Economics*, authors Adhikari, Alm, and Harris found that the change to reporting requirements “modestly increased reported receipts without significantly increasing deductions.” This change was larger for smaller firms, firms in business-to-consumer industries, and partnerships. Overall, the authors concluded the change implied a “modest increase in tax compliance.”

Increasing information reporting for payment settlement entity transactions may increase tax complexity. Certain third party settlement organizations serve users acting in a personal (i.e., nonbusiness) function. For example, consider an online marketplace user who sells some used furniture bought for \$800 for \$700. This user did not earn income from this transaction, and it is not taxable. However, under current law, the user will receive a Form 1099-K reporting \$700 in reportable transactions, which is also reported to the IRS. Taxpayers who typically have relatively simple tax situations may not know how to report this transaction on their income tax return while also claiming the correct deduction for it.

Taxpayer confusion related to Section 6050W reporting may affect IRS enforcement resources. Currently, for individual taxpayers, the amounts reported on Form 1099-K are frequently reported on Schedule C (Profit or Loss from Business, Sole Proprietorship). The taxpayer from the example above, who sold used furniture for a loss, may report the transaction using Schedule C. This would result in a loss of \$100, which would reduce the taxpayer’s income. However, this would likely be disallowed by the IRS under IRC §183 and related regulations (sometimes called the hobby loss rule), which prevents deductions for activities not done for profit. The taxpayer’s primary reason for selling the used furniture was likely to get rid of it and receive some amount of money for doing so, not to engage in a business for profit. Identifying and adjusting tax returns with losses like this would require IRS resources and may delay processing of those taxpayers’ returns.

### Legislation in the 117<sup>th</sup> Congress

The Build Back Better Act (H.R. 5376), as passed by the House, includes a provision that would extend backup withholding to third party network transactions. Backup withholding is when the IRS requires a portion of the payment (currently 24%) to be sent to the IRS. This is only for payments with a potentially higher risk of not being later reported on a tax return. This happens either when the person receiving the payment does not provide a taxpayer identification number (either a SSN or ITIN) to the network making the payment, or when the taxpayer has failed to report certain interest or dividend payments on previous federal income tax returns. In the first case, the taxpayer can end backup withholding by providing a taxpayer identification number to the entity making the payment.

Backup withholding is *not* an additional tax or penalty. The additional amount withheld is credited as tax withholding on an income tax return and can be refunded if it is in excess of the taxpayer’s tax liability.

Other bills introduced in the 117<sup>th</sup> Congress would change the ARPA-enacted de minimis threshold. The Saving Gig Economy Taxpayers Act (H.R. 3425) and a similar bill in the Senate (S. 948) would change the threshold back to \$20,000 in aggregate transactions *and* 200 transactions annually. The SNOOP Act of 2022 (H.R. 6913 and S. 3546) would make similar changes.

The Cut Red Tape for Online Sales Act (H.R. 7079 and S. 3840) would increase the de minimis threshold to \$5,000, require a plain-language explanation of the taxability and potential deductions for payments reported on Form 1099-K, and apply backup withholding in certain situations to payments reported under Section 6050W.

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**Anthony A. Cilluffo**, Analyst in Public Finance

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