



New 2011 1099-K Merchant Services Tax Reporting Requirement Strives To Eliminate Unreported Income Through Credit Cards

As the New Year approaches, many small businesses are in store for a rude awakening. The 1099-K is here and is the latest reporting requirement of the IRS that is designed to eliminate unreported income for small businesses that use credit cards.

The new tax laws for issuing 1099's will create an unprecedented change in the way credit card income is reported to the IRS. "Payment Settlement Entities," such as credit card companies, PayPal, banks, and some third party processors will now be reporting deposits made to taxpayers. With 2010 estimates of unreported income exceeding \$2 trillion dollars, the IRS is determined to re-capture a significant portion of the unreported "non-cash" dollars through the 1099-K. Much of this additional tax will be collected from small businesses selling through e-commerce portals such as EBay or Amazon. Thus, for the e-commerce company that has been using one of these mediums for commerce yet not reporting all of their income, requiring the reporting of all gross credit card income for 2011 will be the year of reckoning.

An example of a company changing its policies to comply with the new IRS rules is PayPal. PayPal modified its User Agreement this year due to new IRS reporting requirements. The following verbiage has been added to Section 4.7 (Taxes): "You acknowledge that in starting in 2011, PayPal will report to the Internal Revenue Service the total amount of the payments you receive each calendar year into all the Accounts you own if you(i) receive more than \$20,000, and (ii) receive more than 200 payments, in that calendar year."

The elimination of a portion of the estimated \$425 to \$475 million dollars that companies evade each year in taxes is just the beginning of the IRS goals. Here are 10 things every taxpayers should know about complying with the 1099-K.

1. Month-to-month reporting is one factor that is important on the new 1099-K. Taking a look at the new 1099-K form, one will notice an interesting characteristic that is quite different than any other 1099. The reporting of income is "month-to-month" rather than yearly. The IRS made this unique design to aid federal agencies in assessing the period in which income will be earned. However, you can be certain that state agencies such as Sales and Use will also use this form in determination of the proper period for sales tax assessments. In the future, it will be quite easy for states to issue "minimum thresholds" of income subject to sales and use tax as well as "anticipated" income based upon credit to cash ratios.

Additionally, reporting of income in only the last quarter of the year will also be eliminated. Companies who reported the correct amount of total revenue and earnings for the year, yet loaded the revenue to the last quarter in attempt to delay tax payments will be subject to corrections when it comes to calculation of interest.

2. The new 1099-MISC also provides instructions for taxpayers that exclude payments that are now reported on the 1099-K. Specifically, here is an excerpt of the new instructions for the 2011 1099-MISC.

"Payments made with a credit card or payment card and certain other types of payment, including third party network transactions, must now be reported on Form 1099-K by the payment settlement entity under section 6050W and are not subject to reporting on Form 1099-



MISC. See the separate Instructions for Form 1099-K. ”

Starting in 2011, taxpayers will only report on the 1099-MISC those payments that are not subject to reporting on the 1099-K. This could lead to disaster for service companies like law firms or subcontract services where customers pay by credit card and have historically issued 1099-MISC to the firm at the end of the year.

Service companies must beware. Companies who historically received 1099-MISC should look closely this year to ensure the payees have correctly calculated the 1099-MISC income, with the exclusion of the 1099-K income when applicable. In the event of error, contact the company who issued the 1099-MISC immediately and request a corrected form reflecting the correct amount of cash income.

3. Off-shore bank account information will be captured for U.S. taxpayers. There is an exception to this rule in 2011 that will be short lived for companies where the payment settlement entity is uncertain as to whether the entity is a U.S. entity.

The capturing of off-shore income has been a hot topic for the IRS for many years. It now appears that the IRS has found a method of capturing a portion of income paid to offshore banks related to U.S. taxpayers. While the 1099-K will only capture the “non-cash” payments, this will eliminate the majority of payments made through e-commerce to off-shore accounts.

4. Only certain taxpayers will be affected. For the 1099-K, there is a two-fold requirement. First, the company must have a minimum of \$20,000 in payments. Secondly, the company must have at least 200 transactions. Each of these requirements must be met for the taxpayer to be affected.

Thus, if a business has 10 transactions totaling \$100,000, there will be no reporting requirement. Also, if a company has 500 transactions totally \$19,000 there is no need to report.

5. Gross sales, including charge backs, will be reported. As a result of using the gross methods, it will be crucial to track charge backs, merchant processing fees, etc. to ensure proper recording of credit sales. This is consistent with the IRS’s position that the proper approach for reporting sales is gross, with merchant expenses and charge backs as a cost of goods sold or bad debt expense.

The IRS did address the chargeback issue in its 1099-K guidance. IRS Sec. 6050W(a)(2) states that gross amounts must be reported and that it was improper to report net sales. However, the IRS also admits that the information reported on the 1099-K is not intended to be an exact match of the net, taxable, or even the gross income of a payee. Thus, in theory, if there is a slight variance in your credit sales numbers, it appears the IRS is not going to make an automatic correction, nor is the difference going to be an automatic audit flag.

6. The only reprieve in 2011 is the stay in collecting of back-up withholding for taxpayers in which payment settlement entities do not have a tax identification number. However, effective 2012, any taxpayer that does not submit a taxpayer identification number will be subject to back-up withholding. What does this mean? It means that the payment settlement entity will be withholding 28% of all gross payments that are processed and forwarding these monies to the IRS.



7. Certain types of credit cards do not have to report. For companies that have private cards where the card can only be used with the company, there are no reporting requirements. For instance, companies like Sears, Home Depot, etc. that have a credit card that can only be used at their stores, no reporting to the IRS is required. However, credits cards issued by malls, or where multiple taxpayers are able to receive credits cards, reporting to the IRS is required.

8. Convenience checks, cash advances, and ATM withdrawals have their own requirements and are not reported on the 1099-K. If you use a credit card to receive cash advances, make a payment using a credit card convenience check, or make an ATM withdrawal, these transactions do not trigger reporting to the IRS.

9. Government Payments are NOT exempt. If you use a government benefits card (i.e. with food stamps, welfare, or unemployment), those transactions are not exempt and will be tracked and reported (if you hit the reporting threshold).

10. The IRS will use the 1099K as an audit tool. Thus, the taxpayers that have significant jumps in revenue due to the new 1099K reporting requirement, will be at greater risk of prior year audits. This will be an unavoidable consequence of the 1099-K reporting.

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Longleaf's founder, [Michael Thompson](#), CPA/ABV, CFF, CFE, has more than 20 years of experience in the financial and accounting industry focusing primarily on accounting damages, fraud investigations and accounting expert witness services. Mr. Thompson has served as CEO, CFO and Risk Manager for firms facing complex financial crisis and has extensive experience valuing damages and has significant experience and expertise in managing staff, offices and companies. More information may be found at <http://www.longleaftech.com> or e-mail us at contact@longleaftech.com.

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