

May 5, 2018

Governor Doug Ducey
State Capitol
1700 West Washington
Phoenix, AZ 85007

Re: Request to Veto Real Time Tax Collection Bill (SB 1091)

Dear Governor Ducey:

The payments industry strongly recommends that you veto SB 1091. The Electronic Transactions Association (“ETA”) submits these comments regarding SB 1091 which requires the Department of Revenue to develop, adopt, and use a payment system that enables immediate remittance and collection of tax in real time as the point of sale. This is an expensive solution in search of a problem and has been rejected in every state where it has been considered. ETA appreciates the opportunity to provide comment on behalf of the payments industry and hopes these comments will help you to see that this bill, if signed, will ultimately hurt Arizona small businesses, consumers, and the state.

ETA is the leading trade association for the payments industry, representing more than 500 companies that offer electronic transaction processing products and services. ETA’s members include all parts of the electronic payments ecosystem including financial institutions, acquiring banks, merchant service providers and processors, merchants, and payment card networks. ETA member companies are creating innovative offerings in financial services, revolutionizing the way commerce is conducted with safe, convenient, secure, and rewarding payment solutions.

Executive Summary

- **Real time sales tax collection is not a cost-effective proposal. A recent State Tax Research Institute study estimates a similar proposal in Massachusetts would cost \$1.22 billion in up-front costs and \$28 million annually to implement.**
- **This tax collection scheme has been rejected by every state where it has been considered and has been dismissed by the National Conference of State Legislatures as “not a solution.”**
- **The payments ecosystem has been developed over the last 50 years to quickly, safely and accurately process and settle transactions. This bill would require building a duplicative system to run parallel with a well-established complex system of interrelated companies, here in the U.S. as well as globally.**
- **The state would have to create, thoroughly test and implement a new remittance channel to receive payments on a daily basis that seamlessly integrates with multiple payment processors servicing Arizona merchants.**
- **This bill would make the business climate much worse for processors and national merchants and many would have to strongly consider whether it makes business sense to continue processing for merchants in Arizona.**

Accelerated Tax Collection By Payment Processors Has Been Previously Studied

This issue has been studied and rejected as not cost-effective by every state in which it has been considered, and it was dismissed by the National Conference of State Legislatures.

Massachusetts

In Massachusetts, the Department of Revenue Commissioner studied the cost effectiveness of implementing a similar proposal and deemed that it was not cost effective to implement that proposal. According to the Retailers Association of Massachusetts, “Retailers would jump at the chance to get out of the sales tax collection business, if we thought that was possible. However, this is a flawed and unproven proposal that has been rejected by multiple states, NCSL, and all of the parties involved in the payment processing industry. It would be bad for retailers, consumers and taxpayers.”

Connecticut

In Connecticut, The Department of Revenue Commissioner studied the cost effectiveness of implementing a similar proposal and determined that daily sales tax collection and remittance by payment processors is not cost effective. In fact, Commissioner Kevin Sullivan called it **“a solution in search of a problem or at least it’s the wrong solution.”** In his testimony on March 22, 2016 to the Connecticut Finance Committee, he stated that “Unfortunately, what this proposal will do is add significant cost to credit card processors, retailers, and -ultimately- taxpayers. It will also add significant costs at [the Connecticut Department of Revenue]. Those who will overwhelmingly bear this cost in added fees and expenses are retailers who already meet their state sales tax obligations in full and on time.”

The National Conference of State Legislatures

The bipartisan National Conference of State Legislatures Executive Committee Task Force on State and Local Taxation carefully examined “real-time” remittance of sales taxes by parties other than the taxpayer, such as a payment processor, and concluded that “...’real time’ sales tax process is not a solution.” “...while the goal of expedited sales tax remittance is admirable, the proprietary, patented process being promoted as ‘real time’ sales tax collection raises significant challenges, creates additional burdens for both retailers and state tax administrators, imposes new burdens on businesses not currently involved in the sales tax collection process, and thus is not a process that this Task Force could recommend to the states.”

Enormous Scale

To understand how the proposal would affect the payments ecosystem, it is important to understand what is currently in place and consider a list of possible compliance challenges that would need to be overcome to implement what the proposal would require. Given the vagueness of the proposal, there are more questions than answers for how to implement what is proposed and there is certainly no consensus from the thousands of market participants as to how to go about implementing something like this. What is clear is that this proposal is not cost effective.

Current System

The payments ecosystem has been developed over the last 50 years for quickly, safely and

accurately processing and settling transactions. The electronic payments industry includes thousands of companies ranging in size from public Fortune 500 companies to small, local sales organization and tech firms. The current payments ecosystem does not contemplate calculating and remitting taxes owed by merchants to the state or any other parties.

The Proposal

The proposal is not cost effective and would require thousands of interconnected parties to build a new system to compute and remit tax on top of the current system. Those interconnected parties have spent decades building and delivering a secure global payment services network for merchants and consumers.

- The proposal will require redesigning a complex, long-established system of interrelated companies, here in the U.S., as well as globally.
- Every Arizona merchant, including the state itself, will have to update and test its point of sale system – costing millions of dollars, just for IT. These costs will be ultimately borne by Arizona merchants and their customers.
- Generally, the system is designed to process gross amounts for authorization – inclusive of sale and tax amounts. The settlement functions do not contemplate functionality to calculate, collect, retain, remit and reconcile state or local tax amounts: in the current payment environment, merchants bear the responsibility to calculate, collect, and remit applicable taxes as required by local jurisdictions.
- The state would have to create, thoroughly test and implement a new, duplicative, remittance channel to receive the payments that seamlessly integrates with all payment processors servicing Arizona merchants.
- The process would significantly decrease the attractiveness of Arizona as a place to do business.

Effect on the Arizona Merchant Payments Ecosystem

The proposal is not cost effective for merchants. The merchants and merchant Point of Sale (“POS”) ecosystem is not a ‘one-size-fits-all’ proposition – there are multiple variations (e.g. “Brick and Mortar,” Internet, cellphone, peer-to-peer, mobile-food trucks). In larger merchant operations, the POS may also include multiples of legacy systems from previous acquisitions and proprietary software systems like payroll, inventory, and others.

Every hardware or software system that touches payment transaction data will need to be updated and tested to accommodate the transmission of new data sets.

- Any new system will have to be tested before being integrated with each merchant and its POS system, and it will be subject to additional tests to ensure compliance with existing network rules and security measures. This will require years of testing and cost millions of dollars.

- Thousands of ‘swipe’ terminals (which are typically utilized by “Mom and Pop” merchants) in Arizona will require software updates (if the hardware is advanced enough to make a software update possible) or may need to be entirely replaced - at the merchant expense - to accommodate new transaction messages (data sets).
- Typical POS refresh cycles are 5 years. Roughly 40% of merchants nationwide have just completed a refresh to upgrade to EMV chip cards.
- With more complex POS ecosystems (such as those found with large, national retailers), the payment acceptance function may connect to multiple middleware (software) systems and/or may be transmitted to other third-party intermediaries (e.g. “Gateways”) before sales data is transmitted to one (or more) processors for routing (authorization) – all of these ‘intermediary’ systems will need to be updated to accommodate new transaction messages (data sets) and tested to seamlessly integrate with each other.
- Once the POS is updated, the payment terminal and payment gateway must also be updated. This is a software change, requiring certification to each processor. Currently, new software certifications, such as those required for the new chip cards and chip-reading terminals, take up to nine months, but many versions of software offered by the largest market participants are only updated once per year.
- Any business running “Integrated/Enterprise Software” – e.g. software that helps manage the entire business - inventory management, scheduling, accounting, AP, invoices, payroll, rewards, AR and an ‘integrated’ payments portal – will need to be updated to accommodate new transaction data sets.
- For all payments made to the state (or any political subdivision thereof) that are subject to transaction privilege tax, those front-end systems will need to be modified to handle new transaction data sets. *[e.g. there may be payments made on (at) higher education institution campuses where transaction privilege tax may be applicable, such as bookstores, commissaries, events/arenas (etc.).]*
- The issue is further complicated by customers with cards issued in foreign countries.
 - For example, with our globally-connected society, international travelers routinely visit brick and mortar retailers and eCommerce retailers domiciled in Arizona. In China, the dominant payment network is China Union Pay (CUP), owned and operated by the People’s Republic of China. Thus, it is likely that Chinese visitors to Arizona will use their CUP card to make a purchase. The same can be said for Japanese visitors using their JCB credit cards.

Therefore, the application of this proposal will not be limited solely within the confines of the geographic boundaries of the state of Arizona or solely to Arizona residents or retailers – it will affect Arizona retailers, Arizona residents, any international traveler making purchases within the

state, all 11 U.S. debit networks, all four U.S. credit card networks, all non-U.S. debit and credit networks, all payment processors, all third party software vendors, and all financial institutions that authorize credit and debit card transactions for their cardholder customers. This proposal is not cost effective.

POS Terminals

The following compliance challenges with POS terminals would need to be dealt with in order to implement the proposal at significant cost to merchants.

- Typically, small merchants have one or two POS terminals:
 - Few of these POS terminals are capable of having updates pushed to them so each terminal would need to be manually updated. This requires a call center representative to walk the merchants through manually reprogramming these terminals or technology staff visiting each merchant in the state.
 - There are over 100 different terminal types that will all need new applications written specific to each processor. Each one of these terminals would need custom-made software written for them and tested on each machine.
 - Some terminals are past their expected life and new software is no longer being developed for them. These terminals would need to be replaced with new ones at the expense of the merchant. This would likely impact at least 10% of the terminals in the market today.
 - This system would rely on the merchants to properly enter the tax amount manually. Since the processor doesn't have access to the POS and what items are taxable, merchants would have to key the total amount and tax amount separately into the terminal.
 - It is unclear from the proposal who would bear the liability from unintentional human errors associated with mis-keying tax amounts. This liability would likely either fall on the merchants or be factored into increased reserves for merchants.
- Medium-sized and larger merchants typically have integrated POS systems.
 - There are approximately 1,000 different Independent Sales Vendors that produce generic and proprietary software for merchants. These are segment-specific solutions and produce software specific to every type of business from car washes to retailers and restaurants.
 - All payments software that touches a POS in Arizona would need to be updated to accommodate passing the tax amount through the processor. Once updated, merchants would have to install the new version of software on their system. This can be highly disruptive to the business and can change everything from work

flows to payroll integrations.

- Many merchants of all sizes have an E-commerce or online functionality which would be negatively affected by the proposal.
 - There are hundreds of digital shopping carts and ecommerce platforms and all of these platforms rely on a payment gateway to pass transaction information.
 - Each shopping cart relies on a processor or gateway software for payments, and each shopping cart can touch hundreds of these software systems.
 - Payment vendors would need to update and recertify each plug-in. Collectively this is thousands of plug-ins and would be a very time consuming and expensive procedure.
- Merchant call volume will increase dramatically as processors are forced to reduce their daily deposits. Many merchants today are on gross settlement and pay their interchange at months end. In other words, if they process \$100, they receive \$100 and are debited all of the transaction fees at month end. Processors would either need to float the tax amount until month end (transferring a potentially unworkable burden onto small processors) or deal with a major spike in calls to help merchants reconcile batches.

Effect on Processors

The proposal is not cost effective for processors. Processors play an instrumental role in the payments system. They facilitate the ability of merchants to accept card payments from consumers at brick and mortar locations, online or through a mobile device. They facilitate the authorization of the purchase as well as the settlement of funds from the card holder's bank to the merchant to complete the transaction. The proposed changes would trigger monumental and costly changes to authorization and settlement, as well as fundamentally altering processors' role in the payments system.

Processor Ecosystem (Authorization)

Significant changes would need to be made to processors' systems in order to calculate, receive, transmit, store, and report new message datasets for the sales and tax amounts from merchants.

Processor Ecosystem (Settlement)

Processors employ various and proprietary hierarchy schemes to manage processing reporting and settlement activities – a 'merchant' or MID (Merchant ID) doesn't necessarily tie out to a specific Arizona-based tax reporting entity – meaning settlement of funds to a particular "MID" may include funds for multiples legal entities and locations within or without the state. Examples include:

- Settlement to a parent corporation operating multiple locations, each of which may be incorporated separately and reporting tax individually.

- Payment Facilitators and/or Internet Marketplaces may have hundreds or thousands of sub-merchants (e.g. small business entities and/or sole-proprietors) for whom they aggregate transactions for authorization and settlement purposes.

Processors would need to recreate hierarchal systems to identify Arizona tax reporting entities/locations.

Processors create settlement files every day (365 days per year) and transmit those files to an Originating Depository Financial Institution (“ODFI”). [Note: These files are only sent by the ODFI on “banking business” days – e.g. On a Monday, the ODFI would transmit three settlement files for a MID representing Friday, Saturday and Sunday settlement amounts.]

- Merchant statements would need to be updated.
- Back office teams would need to be created to handle reconciliation and merchant disputes.

Secondary Revisions

Once a payment is processed, there are events such as disputed transactions, returns, and processing errors which modify original data and payment submissions. These are called secondary revisions. The proposal does not provide guidance on what would happen to secondary revisions to original submissions. This would be a fundamental issue for determining the total cost of compliance, and without guidance the industry is only able to identify potential issues with compliance. While a specific cost number cannot be ascertained without answering any of these questions, it is clear to all parties that even if the answers to these questions were all easy (they are not) it would still not be cost effective to implement this proposal.

When merchants issue refunds or a chargeback occurs, how will refunded tax amounts to consumers be handled and reconciled? This is an important question, particularly because there would be no “new” merchant sales or corresponding tax settlement amounts to apply these refunds amount(s) against. The *Processor would be carrying a “tax receivable refund” for the merchant.* Processors – and likely the networks on behalf of processors – would need to establish entirely new policies, processes and systems to handle cases in which one party has made errors in tax reporting, withholding, payment or adjustment. As a single example, in a case where a cardholder wins a dispute, there would need to be a process and system to re-collect remitted tax from Arizona and return it to the merchant to be refunded to the consumer. The cost of developing and supporting such systems would be prohibitive and the proposal is not cost effective. In each of the merchant scenarios, there is a material risk of being non-compliant, since there is reliance by the merchant on its POS provider to make timely updates in order to comply. As such, there would likely also need to be monitoring/editing processes developed to ensure that merchants located in Arizona are sending processors the appropriate data to remit. Again, the proposal is not clear as to what would happen at that point if the merchants fail to send the data.

To price for the processors’ increased liability brought on by the proposal, processors would likely need to consider holding funds and/or closing accounts to protect their own business. Placing

processors and networks in an active tax enforcement role could have a severely adverse effect on merchant sales and cash flow, interparty relationships and the consumer shopping experience. The results would be fewer options for merchants who seek payment processor options, and higher prices and reserves necessary to access those services.

Effect on Networks

This proposal is not cost effective for payment card networks. The effect on payments networks cannot be overstated. Payment networks that contract directly with Arizona merchants as processors will be subject to the same challenges outlined above. There will also be additional network-specific impacts for transactions acquired by third-party processors.

- Network operating rules and processor agreements are extremely complex and would need to be revised for a relatively small subset of merchants, along with the program documents governing the operational obligations, liabilities and detailed technical requirements applicable to all participants.
- Networks would need to build out and implement new compliance, audit, fraud monitoring, detection and mitigation programs specific to Arizona merchants.

Ultimately the proposal could force networks to modify existing pricing structures, increasing costs to Arizona merchants and consumers.

Overall Effect on Doing Business in Arizona

The fact that this will be a unique process only for Arizona could significantly complicate the overall development efforts. Any resources devoted to Arizona would decrease resources devoted to the entire country.

For all of the reasons discussed, this proposal would make the business climate much worse for processors and national merchants and many of them would have to strongly consider whether it makes business sense to continue processing for merchants in Arizona.

Additionally, the proposal will disrupt the allocation of resources and the drive towards innovation and competition. For example, a software startup would have to decide between investing in making improvements that will work in the other 49 states, or spend those same resources making its software compliant in Arizona. At the very least, there will be a lag between what is available nationwide and what is available in Arizona. A more realistic scenario would see the consumers in Arizona have less access to electronic payments, higher costs of products, and less retailers available to purchase those products.

Summary

This proposal for real time tax collection and remittance by payment processors is not cost effective. Even if the entire payments ecosystem, merchants, consumers, and the state were able to implement this system at a cost of billions of dollars over many, many years, it would remain unnecessary and ultimately do more harm than good for the businesses and consumers of Arizona. **For all the**

reasons discussed above, we request that you veto SB 1091.

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We appreciate you taking the time to consider these important issues. If you have any questions or wish to discuss any issues, please contact me or ETA Senior Vice President, Scott Talbott at Stalbott@electran.org.

Respectfully submitted,



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