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U.S. Supreme Court Reviews Employers' Responsibilities Regarding Tip Reporting and FICA Taxes

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U.S. SUPREME COURT REVIEWS EMPLOYERS' RESPONSIBILITIES REGARDING TIP REPORTING AND FICA TAXES

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ABSTRACT

The recent Supreme Court Case, *U.S. v. Fior D'Italia, Inc.* (2002), has given the Internal Revenue Service broad new authority to conduct audits of restaurant owners in order to estimate and assess the amount of FICA taxes owed for employee tips and wages. The court approved the use by the IRS of the "aggregate method" to estimate the amount of tips received by employees in employer tax audits without requiring the prior audits of individual employees. The decision will force restaurant employers to become much more actively involved in obtaining accurate information from their employees as to the precise amount of their tip income in order to avoid the "employer first" audits. As such, the various alternatives for restaurant owners in deciding how to handle employee tips and FICA taxes are better understood.

Introduction

Tip reporting has long complicated tax compliance for both employers and employees in the hospitality industry. Tipped employees are employees who are paid an hourly wage. Just like non-tipped employees, they receive a W-2 at the end of each year telling them what they earned and what was withheld so they can file their personal income tax returns. In this respect, they are like any other non-tipped employee. However, in another respect, they are more like self-employed individuals. Self-employed individuals are responsible for maintaining records of the revenue they collect and expenses they incur in their business. In turn, these records are used to prepare their personal income tax returns and compute their tax obligation. Tipped employees are responsible for maintaining records of the tips they collect and properly reporting this to their employer and on their personal income tax returns. The employer is responsible for paying withholding taxes and FICA taxes based upon the amount of the employee wages and tips received. Tipped employees hold a hybrid status under tax law-part employee, part self-employed. It is this hybrid status and the accuracy of the amounts of self-reported employee tips that led to the U.S. Supreme Court taking on the previously unresolved question of whether the IRS may use estimation methods in calculating FICA taxes due in *U.S. v. Fior D'Italia, Inc.* (2002).

This paper will discuss the reporting of tip income and the payment of FICA taxes in restaurants, including the obligations of employees and employers; the facts, issues, and decision of the Fior D'Italia case; proposed legislation; the position of the National Restaurant Association; and implications for the industry.

To understand the basis of the question and issues put before the U.S. Supreme Court, it is necessary to review the legal obligations of tipped employees and their employers.

Employee Obligations

Tipped employees are required to report and pay taxes on all income earned, just like all other taxpayers. The portion of their earnings derived from an hourly wage poses no problem. The hourly wage is paid directly to the employee from the employer. The employer maintains payroll records and uses these to generate the required W-2 at the end of the calendar year.

It is the portion of income derived from tips that is less straightforward. IRS Publication 531—Reporting Tip Income (2004) details the obligations of employees who receive tips from customers. Generally speaking, the requirements are simple:

1. Keep a daily tip record.
2. Report tips to your employer.
3. Report all your tips on your income tax return.

The IRS recommends that employees keep a daily tip diary documenting all tips received as well as amounts paid to other employees through tip splitting or pooling agreements. While not required, the IRS offers tipped employees Form 4070A entitled Employee's Daily Record of Tips with appropriately labeled columns for the purpose of facilitating this recordkeeping. In most cases, employees are required to report tips to their employers on a monthly basis.

Employer Obligations

Employers have multiple obligations with regard to employee tip income. In the simplest terms, employers are required to collect employee tip reports, withhold employee income taxes and the employee share of FICA taxes based upon wages and tip income received, and then report this information to the IRS. In addition, employers are required to pay the employer share of FICA taxes based on the total wages paid to tipped employees as well as the tip income declared in the tip reports.

FICA taxes are required pursuant to the Federal Insurance Contributions Act (FICA), calculated as a percentage of the wages and tips received by their employees. They pay for Social Security benefits. Tip income has not always been subject to the employer share of the FICA tax (*U.S. v. Fior D'Italia, Inc.*, 2002, dissent). Prior to 1987, employees paid FICA taxes on tips, but employers did not. In 1987, the Internal Revenue Code was amended to require employers to pay the employer share on tip income as well as on hourly wages (*U.S. v. Fior D'Italia, Inc.*, 2002, dissent; Federal Insurance Contributions Act).

The FICA tax obligation of both employees and employers is limited to earnings that fall within what is often referred to as the *wage band.* Neither the employee nor the employer owes FICA tax on an employee's tips that total less than $20 for any given month. Furthermore, no employee or employer is required to pay FICA taxes "on remuneration in excess of the Social Security wage base" (*U.S. v. Fior D'Italia, Inc.,* 2002, dissent). That is, after total earnings reach a certain threshold in a given calendar year, no more FICA taxes are due for that year. In the case of *U.S. v. Fior D'Italia, Inc.,* the wage bases for the years in question were $53,400 and $55,500 (2002, dissent).

At the end of each calendar year, employers provide employees with W-2's. For tipped employees, the total wages listed will include the tips reported to the employer. Individual employees are required to declare unreported tips on their individual income tax returns and pay the applicable taxes (Publication 531). In addition, employers must file Form 8027 if they have more than ten tipped employees working on an average business day (Instructions for Form 8027, 2002). Form 8027 does not directly involve the payment of any tax. It does, however, serve two purposes. First, it provides the IRS with information that may be used in subsequent audits of the employer or employees. Among other things, Form 8027 requires an employer to identify gross sales, total credit card receipts, total credit card tips, and the total of all reported tips (Instructions for Form 8027, 2002). In the case of *U.S. v. Fior D'Italia, Inc.,* the facial inconsistencies in the information provided on Form 8027 precipitated the audit in dispute (*U.S. v. Fior D'Italia, Inc.,* 2002, Solicitor General's Brief, p. 3). While not relevant to the case before the U.S. Supreme Court, another purpose of Form 8027 is to calculate the allocation of tips in those instances where reported tips do not meet the expected threshold of eight percent of gross sales (Instructions for Form 8027, 2002).

The laws regulating tip income pose difficulties for employers. As a practical matter, employers don't control the payment, collection, or recording of tips. The transaction occurs between the tipped employee and the customer, and the recordkeeping obligation rests with the employee. Furthermore, applicable law prohibits employer involvement beyond collecting tip income reports from employees, and then filing and paying required taxes (*U.S. v. Fior D'Italia, Inc.,* 2002, dissent). The compliance problems with this system are obvious. While many customers tip on credit cards, thereby creating a documented record, many customers tip using cash for which there is no record beyond that created by the tipped employee. Consequently, it is easy and not uncommon for tips to be underreported. According to a tip income study conducted by the IRS in 1984, tipped employees report about one-half of the tips they actually receive (Tip Income Study, 1984). Nevertheless, more current IRS data indicates that reported tip income has increased from $8.52 billion in 1994 to $14.31 billion in 1999 (*U.S. v. Fior D'Italia, Inc.,* 2002, Solicitor General's Brief, p. 20). This increase in the reporting of tip income is the result of multiple factors. One factor was the 1993 enactment of Section 45B of the Internal Revenue Code. In an effort to create an incentive for employers to encourage employee reporting while preventing the IRS from using tax assessments as a threat, Congress enacted Section 45B that "allows employers to take a dollar-for-dollar income tax credit for FICA taxes paid with respect to employee tips in excess of those treated as wages for the minimum wage requirements" (*U.S. v. Fior D'Italia, Inc.,* 2002,

Respondent's Brief, pp. 9–10). In other words, employers are given a tax credit on the business's income tax return for FICA taxes paid on the portion of tipped employees' wages that exceed the minimum wage.

United States v. Fior D'Italia, Inc.

Although tipped employees are obligated to accurately report to employers the amount of their tip income received, the IRS has continued to believe that employees were underreporting that information. At the same time, the IRS is (and continues to be) reluctant to audit all of the tipped employees in a restaurant in order to ensure that the correct amounts of tips are being reported. The IRS had been employing a method of estimating tips called the "aggregate method." By using this method, the IRS does not attempt to identify the amount of unreported tips of each employee, but it instead uses a formula to estimate the amount of the tips. The IRS and the restaurant Fior D'Italia were involved in a dispute over the amount of 1991 and 1992 tip income reported by employees and then reported to the IRS by the restaurant. The dispute ultimately landed in the Supreme Court of the United States in the case *United States v. Fior D'Italia, Inc.*, 122 S. Ct. 2117 (2002). On June 17, 2002, the Supreme Court of the United States decided the Fior case involving the estimation method used by the Internal Revenue Service to calculate the amount of tip income received by restaurant employees when conducting a compliance check and assessment against a restaurant. The amount of tip income estimated by the IRS was then used to determine the amount of FICA tax owed by the restaurant.

Facts of the Case

Fior D'Italia owns and operates a restaurant in San Francisco, California. The restaurant's customers pay for their meals in cash or with the use of credit cards. Employees receive compensation in the form of hourly wages paid by the owner and tips received from the customers. The tips are given in cash when the customer pays in cash or included with their credit card payment. The employees are required to report to their employer the amount of tips (either in cash or from credit card transactions) that they receive. Based upon the salaries and the tip reports of each employee, Fior computed and paid its share of the Federal Insurance Contribution Act ("FICA") taxes for each employee. As part of its reporting obligations to the IRS, Fior filed Form 8027, the Employer's Annual Information Return of Tip Income and Allocated Tips. As discussed previously, this form requires the employer to report to the IRS its total annual sales, total charge card sales, total charge card tips, and total tips reported by the restaurant employees.

The restaurant reported total restaurant revenue, total tips received from credit card sales (as calculated from credit card slips), and the amount of tips received as reported by the employees. The restaurant then paid FICA taxes to the Internal Revenue Service based upon the amount of wages paid by the employer and tips received, as reported by the employees. What caused the IRS to question Fior on the accuracy of the tip income reported was that the amount of *just* the credit card tips received (as shown from the credit card slips) was greater than the *total* amount of tips that the employees reported.

The amount of tips shown on credit card transactions was $364,786 for 1991 and $338,161 for 1992. The employees of Fior reported tip income from all sources to their employer in the amounts of $247,181 in 1991 and $220,845 in 1992. As a result of the wide discrepancy between the total tips reported by the employees and just the credit card tips, the IRS conducted a compliance check. As a result of the compliance check, the IRS issued an assessment against Fior for the additional FICA tax due. When the Fior case was being litigated in the U.S. District Court (*United States District Court for the Northern District of California*, 21 F. Supp 2d 1097 (1998), the court stated at p. 2:

> In 1994 the Internal Revenue Service ("IRS") sent plaintiff a Notice and Demand to pay its share of FICA taxes allegedly due on tips not reported by its employees for the years 1991 and 1992. The IRS computed the alleged amount of plaintiff's share by using the information on plaintiff's Forms 8027. Specifically, the IRS determined the percentage of tips on the food and services that were charged on credit cards, by dividing the total amount of tips charged by the total charges. It then estimated the total tips received by all employees, by multiplying that percentage by plaintiff's total receipts. The tips that had been actually reported to the IRS were then subtracted from that amount, to determine the estimate of unreported tips. That figure was then subjected to the employers' FICA tax rate of 7.65% to determine plaintiff's alleged FICA tax liability.

The IRS did not attempt to identify the amount of unreported tips of each employee. It instead used a formula called an "aggregate estimation" method. The Supreme Court (p. 9) explains the method as follows:

> The IRS examined the restaurant's credit card slips for the years in question, finding that customers had tipped, on average, 14.49% of their bills in 1991 and 14.29% in 1992. Assuming that cash-paying customers on average tipped at those rates also, the IRS calculated total tips by multiplying the tip rates by the restaurant's total receipts. It then subtracted tips already reported and applied the FICA tax rate to the remainder. The results for 1991 showed total tips amounting to $403,726 and unreported tips amounting to $156,545. The same figures for 1992 showed $368,374 and $147,529.

Issues and Decision

The restaurant Fior argued that it complied with the statutory requirements when it paid its FICA taxes based upon the amounts of tips reported to it by the employees. They argued that the IRS has no authority to use an "aggregate method" to estimate total tip income, and that any disagreement with the amount of the reported tips should require the IRS to audit each employee separately before assessing the restaurant. If the separate audit of each employee revealed a difference in the amount of total employee tips reported, then, and only then, could the IRS make an additional assessment against the restaurant. The position of the IRS was that the statutes and prior cases allowed for use of the aggregate method to estimate total tip income to assess FICA taxes and did not require the prior audits of each employee before making an assessment.

While the U.S. Court of Appeals for the Ninth Circuit found that the IRS did have the right to estimate (and use an aggregate method) in cases determining income tax assessments, the court found no authority to estimate FICA taxes due, and ruled in favor of the restaurant. On appeal, the Supreme Court found that the IRS does, in fact, have the right to make assessments and estimates, using any reasonable method, to determine the amount of FICA taxes due from the employer.

Fior argued (p. 25) that the use of the aggregate method to estimate taxes could lead to abuse, coercion or error by the IRS.

> Fior D'Italia's "abuse of power" argument, however, does not constitute a ground for holding unlawful the IRS's use of aggregate estimates. Even if we assume, for argument's sake, that an improper motive could render unlawful the use of a statutorily permissible enforcement method in certain circumstances, cf. *United States v. Powell,* 379 U.S. 48, 58 (1964), we note that Fior D'Italia has not demonstrated that the IRS has acted illegally in this case. Instead, it has presented a general claim to the effect that the aggregate estimation method lends itself to abusive agency action. But we cannot find agency action unreasonable in all cases simply because of a general possibility of abuse—a possibility that exists in respect to many discretionary enforcement powers.

Fior also made arguments that the amount of tips determined by the aggregate method might be inaccurate because:

1. Some employees might be earning less than $20 per month and would be excluded from taxation;
2. The tip income of some employees might exceed the limit that was subject to FICA taxation (at that time, $53,400 in 1991 and $55,000 in 1992);
3. Some customers show a high tip on the credit card slip, but ask for cash back;
4. Some cash paying customers leave no tip;
5. Customers who pay cash often leave a lower percentage for a tip.

While the Supreme Court agreed that it might be possible that the method used by the IRS to calculate the total tips could be inaccurate in some cases, it rejected this argument as it related to the Fior case, stating "the taxpayer remains free to challenge the accuracy of the calculation" (p. 27). Fior had chosen not to challenge the results that the IRS calculated using the aggregate method and, in fact, had waived its right to challenge the accuracy of the assessment.

To summarize, the Supreme Court, in a 6-3 decision, found the following:

1. Section 6201(a) of the Internal Revenue Code provides that the IRS "is authorized and required to make the inquiries, determinations, and assessments of all taxes... which have not been duly paid."

2. The IRS may determine reasonable methods to assess FICA and other taxes;
3. The IRS use of the "aggregate method" to estimate total tip income was reasonable in this case;
4. The IRS may ignore the amounts of tip income reported by the employees and use the "aggregate method" to determine a more precise and accurate amount of tips received when conducting a compliance check and assessment;
5. An employer may challenge the IRS if it feels that the IRS is using a method that is being applied in an unfair or unreasonable manner.

Proposed Legislation

While the Supreme Court decision dealt a defeat to the food service industry, the battle is not over. Proposed legislation will, if passed, provide the industry with many of the same results sought in the D'Italia case.

A bill was filed by U.S. Representative Wally Herger of California, co-sponsored by 35 other representatives, H. R. 5445, The Tip Fairness Act, during the 2002 legislative session. Although no action has been taken on the bill since 2002, it is still active. The current bill, co-sponsored by 30 other representatives, is called H.R. 2034. It was refiled on 5/8/2003 and is now referred to the House Committee on Ways and Means. The bill states:

> A bill to amend the Internal Revenue Code of 1986 to provide that an employer shall be liable for Social Security Taxes on unreported tips paid to an employee only after the Internal Revenue Service establishes the amount of tips received by that employee.

The bill is aimed directly at the IRS and its use of the aggregate method to determine total tip income. The intent of the legislation is to shift the burden in determining employee tip income from the restaurant owner to the IRS. Only after each employee has been audited would the IRS be able to assess the restaurant owner for additional taxes as a result of underreporting of tip income. The purpose of the bill is to require the IRS to obtain tip information first from the employees directly by audit or other means. For the IRS, it is much easier to audit the restaurant rather than auditing each of the employees of the restaurant.

National Restaurant Association Position

The proposed Tip Fairness Act has received strong support from the National Restaurant Association and its membership. Former NRA Chairman Xavier Teixido, owner of Harry's Savoy Grill, Wilmington, DE, has stated, "This legislation is crucial to the nation's 200,000 restaurants with tipped employees. The 'Tip Tax Fairness Act' simply clarifies the original intent of Congress and shifts the burden of tax collection back where

it belongs—to the IRS." The current treasurer of the NRA, Edward Tinsley, testified in support of the bill on July 15, 2004, and stated, "It is clearly the IRS's responsibility—not a restaurant operator's—to determine which employees failed to report tips before the IRS goes after the employer. This legislation is important to our industry ... By holding employers liable when employees allegedly fail to report all of their tips, the IRS puts restaurant operators in an untenable position, making them the 'tip police.' ... The NRA continues to believe that the IRS has gone beyond its authority in conducting employer-only audits and assessments."

Implications for the Industry

As discussed earlier, a restaurant owner currently has several alternatives available in trying to decide what to do about employee tips and the payment of FICA taxes.

1. Pay FICA taxes on the amount of employee reported tips. This is what Fior D'Italia did and they were subjected to an IRS audit and assessment. Most employers would choose (and most are being advised) to avoid putting themselves in a position where they might be subject to the type of employer-first audit that was forced upon Fior D'Italia.

2. Sign tip agreement contracts with the IRS. This Tip Reporting Alternative Commitment (TRAC) requires the owner to educate employees regarding their obligations to report tips and to set up an IRS-approved procedure to ensure that employees accurately report their tip income.

3. Sign a customized tip reporting contract with the IRS called an EmTrac. This method is similar to the TRAC agreement but allows the employer to customize the procedure to their business (subject to IRS approval).

Using either the TRAC or EmTrac alternatives, the employer receives protection from the IRS against employer-first audits. If the employer is complying with the agreed upon terms, the IRS agrees not to assess an employer for underpaying FICA taxes without first examining the employees. And whether the employer chooses any of the alternatives, they also continue to have the right to claim the 45(B) tax credit discussed earlier.

What seems to be clear when reviewing the alternatives above, and in light of the Supreme Court decision in D'Italia, the restaurant owner will probably choose either the TRAC or the EmTRAC. While both methods provide the protection against the employer-first audit "...there is still no guarantee that they won't get audited, ... but if they are audited, the only way to get assessed is by a full-blown employee tip examination." (Stratton, 2002.) With the National Restaurant Association and restaurant lawyers frequently recommending signing the Tip Agreements, the IRS will continue to get more employers to participate. And more off-the-shelf EmTrac plans developed by the NRA or others, with pre-approval from the IRS, will probably be the path that most restaurateurs (absent any legislative change) will take.

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