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EMPLOYER TAX LIABILITY FOR EMPLOYEES' TIPS: *Fior D'Italia*

By Steve R. Johnson

Given Nevada's heavy concentration of businesses in which employees are tipped, lawyers here may be more than usually interested in a recent decision by the United States Supreme Court. On June 17, 2002, the Court decided *United States v. Fior D'Italia, Inc.*¹ By 6 to 3, the Court held that the IRS may use an "aggregate estimation" method to determine employers' liability for Social Security (FICA) taxes imposed on their employees' tip income. The decision is an important development in a controversy of long duration, but it is not the end of that controversy. This article provides background, describes the Court's decision, and discusses the administrative and legislative aftermath.

Background

Federal Insurance Contribution Act taxes, calculated as a percentage of wages, are imposed on employers, as well as employees.² For this purpose, tips received by employees in the course of their employment are deemed to have been paid as wages by the employer.³ An employee who receives wages in the form of tips is required monthly to report tip amounts to the employer, which must send copies of those reports to the IRS.⁴

There are three problems with this scheme. First, employees consistently underreport their tips, often substantially. Estimates of unreported tip income by restaurant employees range from \$9 billion to \$30 billion per year.⁵ Second, employers often do not have good information from which to determine how much their employees actually receive in tips. Third, given the large number of employees⁶ and the amounts of extra tax that likely could be recovered from each, it is uneconomic for the IRS - faced with declining audit resources - to audit each employee individually.

One of the Government's responses to these problems is the IRS's use of the aggregate estimation method. Under this method, the IRS bases its assessment of the employer's FICA liability on an estimate of all of the tips customers paid to the business' employees, instead of estimating each individual employee's tip income separately, then adding individual

estimates together to create a total. The legality of the aggregate estimation method has been litigated many times, with the preponderance of the cases favoring the IRS.⁷

1. *Fior D'Italia*

Fior D'Italia has been a restaurant in San Francisco for 116 years. Its Forms 8027 filed with the IRS for 1991 and 1992 reflected that its employees had reported total tip income of about \$247,000 and \$221,000 for these years respectively. The restaurant calculated its FICA tax liabilities based on those amounts. However, the Forms also showed that the total amount of tips on customer credit card charge slips alone totaled over \$364,000 and \$338,000 for these years. Not surprisingly, these discrepancies led the IRS to audit. The IRS found that the credit card slips reflected average tips of 14.49% for 1991 and 14.29% for 1992. Assuming that cash customers tipped the same, the IRS multiplied these tip rates by the restaurant's total receipts, then subtracted tips already reported, and multiplied by the FICA tax rates.⁸ As a result, the IRS assessed additional FICA taxes against *Fior D'Italia* of over \$23,000 for the two years combined.

The restaurant challenged the use of the aggregate estimation approach. The District Court and the Ninth Circuit, by 2 to 1, held for the restaurant,⁹ thus standing against the preponderance of decisions on this issue.

The Supreme Court reversed, holding for the IRS. First, the Court noted: "It is well established in the tax law that an assessment is entitled to a legal presumption of correctness - a presumption that can help the Government prove its case against a taxpayer in court."¹⁰ In the Court's view, I.R.C. § 6201(a), by granting the IRS assessment authority, must simultaneously grant the IRS power to decide how to make that assessment - at least within certain limits. And the courts have consistently held that those limits are not exceeded when the IRS estimates an individual's tax liability - as long as the method used to make the estimate is a "reasonable" one.¹¹

Among other arguments, the restaurant offered a number of reasons why aggregate estimation may lead to unreasonable results.¹² The majority rejected these

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reasons in part because (1) some of the problems would plague individual audits too, (2) the restaurant had stipulated that it would not challenge the accuracy of these particular IRS calculations, and (3) "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."¹³

2. Aftermath

The significance of *Fior D'Italia* is both general and particular. Generally, the Court reaffirmed both that IRS assessments are presumed correct and that considerable "play" will be accorded before IRS estimates are deemed unreasonable. These principles will be applied broadly, not simply to tips.¹⁴

Fior D'Italia is particularly significant for businesses with tipped employees;¹⁵ however, several factors cloud its significance. First, the majority opinion for the Court concludes with the recognition that the business sector "remains free to

make its policy-related arguments to Congress."¹⁶ It is doing so. On Sept. 24, the Tip Tax Fairness Act was introduced in the U.S. House of Representatives to overturn *Fior D'Italia*. It is sponsored by Representatives Herger and Tanner, a California Republican and a Tennessee Democrat, both members of the Ways and Means Committee.

Second, should the proposed legislation fail, *Fior D'Italia* would not necessarily preclude further litigation. *Fior D'Italia* stipulated it would not challenge the specifics of the IRS's calculations in the case. The Court's decision would not foreclose a challenge by a business which is prepared to make such a challenge in its case.

Third, many Nevada restaurants are covered by Tax Tip Determination Agreements, under which the business agrees to enhanced tip reporting procedures and the IRS agrees not to initiate audits. *Fior D'Italia* does not supersede those Agreements. However, current Agreements will expire at the end

of 2002, and the Supreme Court's decision may give the IRS greater leverage in the negotiations for new Agreements. ■

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ENDNOTES

1. 536 U.S. _____, 122 S. Ct. 2117 (2002).
2. See I.R.C. §§ 3101, 2111 & 3121(q).
3. I.R.C. § 3121(q).
4. Treas. Reg. § 31.6011(a)-1(a). Businesses providing food or beverages that have over ten employees are subject to reporting requirements under I.R.C. § 6053(c)(3).
5. See Richard L. Papiernik, *Employees Face Added Audits After Court Ruling*, NATION'S RESTAURANT NEWS, Nov. 11, 1996, p. 4.
6. There are about 200,000 restaurants with tipped employees, and many other businesses also have workers who receive tips. Gina Holland, *High Court Endorses IRS Method on Tips*, LAS VEGAS REVIEW-JOURNAL, June 18, 2002, p. 1A.
7. E.g., 330 *West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990 (7th Cir. 2000); *Bubble Room, Inc. v. United States*, 159 F.3d 553 (Fed. Cir. 1998); *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526 (11th Cir. 1997).
8. The percentages used by the IRS may be within the range of reason. The average restaurant tip today is around 17% although it was lower in earlier years. A SHOW OF GRATITUDE, LAS VEGAS REVIEW-JOURNAL, Aug. 20, 2002, p. 2E (quoting Michael Lynn, Cornell University associate professor and editor of the CORNELL HOTEL RESTAURANT ADMINISTRATION QUARTERLY).
9. 21 F. Supp. 2d 1097 (N.D. Cal. 1998), *aff'd*, 242 F.3d 844 (9th Cir. 2001).
10. *Fior D'Italia*, 122 S. Ct. at 2122.
11. *Id.* (emphasis in original).
12. See *id.* at 2124-27.
13. *Id.* at 2127 (emphasis in original).
14. See, e.g., *Medchem (P.R.), Inc. v. Commissioner*, 295 F.3d 118, 123 (1st Cir. 2002) (quoting *Fior D'Italia's* language as to the presumption of IRS correctness in a possessions tax credit case).
15. The "bottom line" effect of the case is reduced by I.R.C. § 45B, which provides an income tax credit for certain employers in the amount of FICA taxes paid on tips in excess of the minimum wage. Thus, sometimes, extra FICA taxes will be offset by lower income taxes. The offset will not occur in all cases, however, and will not be total in all cases in which it does occur.
16. 122 S. Ct. at 2127.