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ARTICLES

THE TIP POLICE: AFTERMATH OF THE *FIOR D'ITALIA* RULE

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You can't escape the responsibility of tomorrow by evading it today.[1]
Abraham Lincoln

INTRODUCTION

As Mr. Lincoln aptly described, responsibility is inescapable; this is so particularly in the area of reporting employee tips.[2] It is practically axiomatic that employees tend to underreport their tips to their employers. The employers bear the ultimate responsibility for the payment of deficient Federal Insurance Contributions Act (FICA) taxes owed on underreported tips.[3] The magnitude of this underreporting can have a dramatic effect on the public fisc.[4]

Due to the substantial amount of tax liability, and thus potential revenue,[5] it is not surprising that the Internal Revenue Service (IRS or the Service) seeks to collect these taxes. It would be cumbersome for the IRS to audit individual employees who underreport their tips; therefore, the IRS pursues the reporting agent, the employer.[6] The difficulty for

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1. THE FORBES BOOK OF BUSINESS QUOTATIONS 721 (Ted Goodman ed., 1997).

2. Many consider "tip" to be an acronym that means "to insure promptness." *See* The Original Tipping Page, *at* http://www.tipping.org/tips/TipsPageDefinitions.html (last visited Sept. 3, 2002).

3. *See* I.R.C. §§ 3111, 3121(q) (2002) (stating that the legal incidence of the FICA tax is imposed on the employer).

4. *See Economic Progress Pushes Tips Higher*, ORLANDO SENTINEL, Nov. 12, 2000, at H8. Meals in restaurants account for over one billion dollars per day. *Id.* Assuming an average tip of fourteen percent, the respective tip income could be as high as $114,000,000 per day. *Id.*

5. Assuming that a mere ten percent of the average daily $114,000,000 in estimated tips is unreported, at the current 7.65% (2002) FICA rate (comprised of a 6.20% Social Security tax rate and a 1.45% Medicare tax rate), the loss to the fisc would be an average daily amount of $872,100. *See* I.R.C. § 3111 (2002).

6. *See* I.R.C. §§ 3111, 3121(q) (2002). These sections recognize the need to audit the recalcitrant employee who fails to report or underreports her tip by tying the employer's

employers is not the IRS' statutory authority to regulate taxes on tips but rather the methodology that it employs to achieve its end.[7] The efficacy of that methodology was put to rest by the Supreme Court in *United States v. Fior D'Italia, Inc.*,[8] where the Court approved the so-called aggregate estimate methodology that is routinely applied by the IRS.[9]

Fior D'Italia results in a rule of aggregate estimation that compels employers to act as surrogate police in the monitoring, administering, and reporting of tips – a so-called "tip police."[10] Employers are now mandated either to establish bookkeeping reserve accounts for a future FICA assessment[11] or to enter into a Tip Reporting Alternative Commitment (TRAC) with the Service.[12] Neither option is palatable for most small businesses because of the increased administrative burden.

FICA liability to the audit period for its employees. *Id.* An employer can only be assessed for the duration of a FICA audit of its employees. *See id.*

7. *See* United States v. Fior D'Italia, Inc., 122 S. Ct. 2117 (2002). Assessment methodology is at the heart of the present controversy; under this methodology, the IRS relies upon an aggregate estimate assessment methodology developed in the case of *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122, 1125 (1973).

8. 122 S. Ct. 2117 (2002).

9. *See id.* at 2121. The decision of the Court did not lack dissenters in the six-to-three result and the significant criticism of the restaurant trade group. *Id.*; *see also* National Restaurant Association, *U. S. Supreme Court Rules Against Restaurants in Tip Reporting Case: National Restaurant Association Vows To Take Fight to Congress*, *at* http://www.restaurant.org/legal/tips/legal.cfm (last visited Sept. 3, 2002).

10. *See* National Restaurant Association, *U.S. Supreme Court Decision Could Have Grave Ramifications for Nation's Restaurants*, *at* http://www.restaurant.org/pressroom/pressrelease.cfm?ID=453 (last visited Sept. 10, 2002). The increased administrative costs of policing tip reporting, attendant to the *Fior D'Italia* rule, should not be underestimated considering that such burdens have continued to increase over time. Indeed, before the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, the employer was not required to collect and pay over, as its portion of the FICA tax, the amount of tips received by the employee in excess of the difference between the wages paid and the federal minimum wage. *See* Omnibus Budget Reconciliation Act of 1987, § 9006, 26 U.S.C. § 3121(q) (2000).

11. Reserves for estimated expenses (future FICA tax expense assessments) are defined as "amounts established for financial reporting purposes by accrual method taxpayers as a deduction against current income, designed to reflect future expenses. The effect is a current reduction in net income but a later reversal of the account . . . and a rational matching of income and expenses." RICHARD A. WESTIN, WG&L TAX DICTIONARY 667 (2000).

12. *See Fior D'Italia*, 122 S. Ct. at 2126. The TRAC Program is a proactive tax strategy that limits employers' FICA tax liability to actual rather than estimated reported tips. *See id.* Developed in 1993, the Service created this agreement concept and agreed not to initiate any tip audit examinations covered in the agreement if the employer educates and trains its employees about tip reporting and maintains certain procedures to ensure accurate tip reporting. *See id.* at 2132 (Souter, J., dissenting); *see, e.g.*, I.R.S. Notice 2000-21, 2000-1 C.B. 967.

The purpose of this Article is to explore the *Fior D'Italia* rule and its impact on employers. A historical context of the rule will shed light on the nature of the aggregate estimation method. Next, this Article will examine an outcome assessment of the rule to identify its future viability. Finally, current tax strategies that are available to employers will be discussed.

I. ASYMMETRICAL LIABILITY

Prior to 1987, the issue of asymmetrical liability for FICA taxes on unreported tips had not arisen.[13] The employer was not required to collect and pay over, as its portion of the FICA tax, the amount of tips received by the employee in excess of the difference between the wages paid and the federal minimum wage.[14]

With asymmetrical liability now an issue, it is the employer's exclusive responsibility to develop a formal recording method to assess the amount of FICA taxes due for unreported tips.[15] There is no concomitant FICA tax assessment for a credit for Social Security benefits on the employee.[16] Conversely, the record-keeping provisions of section 6001 of the IRC require that employees keep tip records,[17] but no such obligation is imposed upon employers.[18] Employers are statutorily exempt from such a tip record-keeping requirement.[19]

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13. *See* Omnibus Budget Reconciliation Act, *supra* note 10; *see also* Social Security Amendments of 1975 § 313(c), 26 U.S.C. § 3102 (2000).

14. *See* Omnibus Budget Reconciliation Act, *supra* note 10; *see also* Social Security Amendments, *supra* note 13.

15. 26 U.S.C. § 3121(q) (2000).

16. *See id.*

17. *See* I.R.C. § 6053 (2002); Treas. Reg. § 31.6053-4(a). A daily record of tips by employees is required as an adjunct to §6001. I.R.C. § 6053 (2002).

18. *See* I.R.C. § 6001 (2002).

19. *See id.*

> Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title. *The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a).*

Id. (emphasis added).

Ordinarily, if employees are deficient in the record-keeping function, the employer is liable for its portion of the FICA taxes on the unreported tips only after notice and demand has been made by the Service.[20] Even this procedural aspect raises some questions. Consider the "typical" income tax assessment procedure. An individual taxpayer is liable for federal income tax, and the Service makes a timely assessment under section 6201.[21] The IRS follows with a notice and demand for unpaid taxes assessed pursuant to section 6303.[22] The notice and demand is the predicate step essential to impose a levy or a lien under section 6321 and section 6331, respectively.[23]

Now, consider the FICA tax assessment. Here the notice and demand, by necessity, must precede the assessment -- just the opposite of what is provided in the statutory scheme. How then does the Service make a notice and demand under section 6303 without satisfying the assessment provisions of section 6201? It "guesstimates."[24] In other words, the Service is compelled to reach a "pre-assessment" estimate[25] upon which the notice and demand is based -- all absent *any* statutory or regulatory authority. It is precisely this "guesstimate" that is the basis of the current dispute.

II. AGGREGATE ESTIMATION METHODOLOGY

The Service employs an aggregate estimation formula.[26] This methodology is based upon an aggregate estimate of all tips that the employer's customers paid to the employees.[27] Using this method, the Service merely examines the credit card slips for the years in question, determines the customer's average tip rate, assumes that cash customers tipped at the same rate, and then simply multiplies this derived tip rate

20. *See* Rev. Rul. 95-7, 1995-4 I.R.B.

21. *See* I.R.C. § 6201 (2001).

22. *See* I.R.C. § 6303 (2001).

23. *See* I.R.C. §§ 6321, 6331 (2001).

24. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1008 (1996) (defining guesstimate as "to form an estimate of (as future population, costs, employment) without adequate factual or statistical information"). Guesstimates are used in accounting and finance on a daily basis. For instance, the provision for the allowance for doubtful accounts, or bad debts, is a "guesstimate" — a cross between an educated guess and an estimate.

25. *See, e.g.*, United States v. Fior D'Italia, Inc., 122 S.Ct. 2117, 2131 (2002) (Souter, J., dissenting). Section 3121(q) does not require that a previous assessment against the employee be a condition of the employer assessment. *See id.*

26. *See id.* at 2121 (finding that the law authorizes the IRS to use the aggregate estimation method).

27. *Id.* at 2121-22.

by the employer's total receipts.[28] The Service then subtracts the amount already reported from the product to determine the FICA tax base.[29]

Because most of the tip cases arise in the bar and restaurant industries, the Service has developed a unique guideline for these industries.[30] Nevertheless, this methodology[31] applies to *any* employer who has employees that receive tips equal to or in excess of twenty dollars per month.[32] Any employee who receives twenty dollars or more in monthly tip income must report that income to the employer.[33] Consequently, any employee who receives tips at the floor or ceiling levels need not report to the employer.[34]

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28. *See id.*

29. *Id.* at 2122.

30. *See generally* IRS, *Market Segment Specialization Program Guideline: Bars and Restaurants*, *available at* http://www.irs.gov/pub/irs-mssp/bars.pdf (last visited Sept. 9, 2002).

31. *See id.* at 5-27. The methodology presented in the Guideline is set forth below:

FORMULA FOR TIP RATE CALCULATION
Step 1: Determine charge and cash tip rates.
Charge tip rate = Total charge tips/Total charge sales with charge tips*
Less: Difference between charge and cash tips (attributable to smaller and fewer tips)
Equals: Cash tip rate
Step 2: Compute tips earned per hour/sale[.]
Gross sales subject to tipping
Less: Stiff factor
Charged sales with charged tips
Other factors
Equals: Sales subject to cash tipping
Multiply: Cash tip rate
Equals: Cash tips received
Added: Charged tips
Tips received from other employees
Equals: Total tips received
Less: Tip outs
Equals: Adjusted tips
Divide: Total hours worked or total sales $
Equals: Tip rate per hour or sales $
Indirectly tipped employees[:] Compute tip rate per hour[.]
Tip rate per hour = Tips received from other workers/Total hours worked
* If this figure is unavailable, use "Total Charge Sales" for the denominator of the charge tip rate.

Id.

32. *See* IRS, *The Digital Dailey; 5 Taxable Tips*, *at* http://www.irs.gov/businesses/display/o,,i1=2&genericId=12729,00.html (last visited Sept. 9, 2002).

33. *See id.*

34. *See id.*

This guideline methodology springs from the Tax Court ruling in *McQuatters v. Commissioner*[35] and sets the stage for the present *Fior D'Italia* rule. A historical perspective of the *McQuatters* formula and concomitant authorities that interpret the aggregate estimation method will illuminate the significance of the *Fior D'Italia* rule.

III. A HISTORICAL PERSPECTIVE

A. *The* McQuatters *Formula*

The aggregate estimation methodology, which since has been promulgated in an IRS guideline,[36] had its birth in *McQuatters v. Commissioner.*[37] In *McQuatters*, the Tax Court found that failure by restaurant employees to maintain proper records for computing their tip income justified the Service in devising a four-part formula to determine the employees' income.[38] The Service used the following method:

> (1) [T]otal sales of food and beverages for the restaurant were reduced by ten percent to account for low or nontippers, sharing tips with captains, and banquets; (2) the resultant figure (sales subject to tips) was divided by the total number of hours worked by all waitresses during the year to determine a sales-per-waitress-hour average; (3) this average was multiplied by the number of hours in each year that each waitress worked to determine the yearly sales of each waitress; and (4) the yearly sales of each waitress was multiplied by 12 percent to determine the yearly tip income of each waitress. No distinction was made between tips on cash sales and charge sales.[39]

McQuatters turned on the plenary authority of the Service to reconstruct tip income by an indirect method pursuant to section 446(b) in those cases where taxpayers choose to ignore the record-keeping requirement.[40] *McQuatters*, therefore, stands for the proposition that an indirect method of aggregate estimation of tip income is allowable provided the methodology employed by the Service is both logical and factually sufficient.[41]

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35. 32 T.C.M. (CCH) 1122, 1126 (1973) (describing the Commission's methodology).

36. *See Guideline*, *supra* note 30, at 5-7.

37. 32 T.C.M. (CCH) 1122 (1973).

38. *Id.* at 1125-26.

39. *Id.* at 1125.

40. *See id.* (stating that the Service was justified in using the indirect method because the restaurant did not keep adequate records).

41. *See id.*; *accord* Mendelson v. Comm'r, 305 F.2d 519, 523 (7th Cir. 1962) (holding that the method the Service used was reasonable and that no method would be exact

*B. Post-*McQuatters *Formula*

Armed with the *McQuatters* decision, the Service aggressively pursued employers, principally in the food services industry, by handing up FICA tax assessments based on the aggregate estimation methodology.[42] Four significant post-*McQuatters* decisions bear study in view of their impact on *Fior D'Italia*. These decisions are *Morrison Restaurants, Inc. v. United States,*[43] *Bubble Room, Inc. v. United States,*[44] *330 West Hubbard Restaurant Corp. v. United States,*[45] and *Quietwater Entertainment Inc. v. United States.*[46] The legal strategy emerging from these cases is to either attack the lack of aggregate assessment authority of the Service or the deficient aggregate estimation methodology in *McQuatters* or, in some instances, both. Some of the cases, like *McQuatters*, dealt with employees who failed to maintain adequate records.

In conjunction with the *McQuatters* formula attack, employers posited that if the Service lacked the requisite authority to assess, which is a necessary precondition to application of the assessment methodology,[47] then *McQuatters* becomes irrelevant.[48] This back door approach to nullify *McQuatters* was presented in *Morrison Restaurants, Inc. v. United States.*[49]

In *Morrison Restaurants*, employees used a tip-sharing approach and reported tips to their employer.[50] The Service assessed employer FICA taxes for unreported tips based upon a modified *McQuatters* formula.[51] The Eleventh Circuit focused its analysis on whether the Service had the

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because the taxpayer did not keep records); Schroeder v. Comm'r, 40 T.C. 30, 33 (1963) (allowing wide latitude in the Service's aggregate estimation formula provided it was not arbitrary and capricious).

42. *See, e.g.*, Bubble Room, Inc. v. United States, 159 F.3d 553 (Fed. Cir. 1998); Morrison Rests., Inc. v. United States, 118 F.3d 1526 (11th Cir. 1997).

43. 118 F.3d 1526 (11th Cir. 1997).

44. 159 F.3d 553 (Fed. Cir. 1998).

45. 37 F. Supp. 2d 1050 (N.D. Ill. 1998), *aff'd*, 203 F.3d 990 (7th Cir. 2000).

46. 80 F. Supp. 2d 1323 (N.D. Fla. 1999), *rev'd in part, vacated in part without op.*, 220 F.3d 592 (11th Cir. 2000).

47. *See* I.R.C. § 3121(q) (2002).

48. *See, e.g., Morrison Rests.*, 118 F.3d at 1529.

49. *Id.*

50. *Id.* at 1527. There are numerous forms of tipping arrangements, but they tend to be classified as either direct arrangements, in which employees receive tips directly from customers, or indirect arrangements, in which employees receive tips through a pooling arrangement. Tip sharing occurs when a waiter or waitress "tips out" to other staff members, such as busers or barbacks. *See* National Restaurant Association, *Tips on Tip Reporting, at* http://www.restaurant.org/tabletalk/chat-refresh.cfm?ChatID=43 (last visited Sept. 3, 2002).

51. *Morrison Rests.*, 118 F. 3d at 1527-28.

statutory authority under section 3121(q) to assess the employer's share of FICA taxes on the employees' unreported tips "on an aggregate basis *without* determining the underreporting by the individual employees and crediting their wage history accounts."[52]

The district court granted the employer summary judgment, holding that the IRS assessment of the employer's FICA tax liability on the employees' unreported tips in the aggregate was invalid because the IRS did not determine the individual employees' underreporting.[53] The Eleventh Circuit panel disagreed and vacated the opinion.[54] The court analyzed the language and structure of both the Internal Revenue Code (IRC) and the Social Security Act to determine that Congress had intended to impose FICA taxes on employers and employees separately.[55] The court found that "[t]he separation of the provisions into different, parallel subchapters suggests that Congress contemplated that employees' and employer's shares could be imposed separately."[56]

While *Morrison Restaurants* maintained that assessment of an employer's share of FICA taxes on the unreported tips of its employees is valid even without a precedent assessment of the individual tip-reporting employees, *Bubble Room, Inc. v. United States*[57] recognized this contention but set siege to the primitive nature of the *McQuatters* formula. Thus, once again, the actual aggregate estimation methodology was called into question.

In *Bubble Room*, two Florida restaurants recognized their tip-reporting duties under sections 3121(q), 6053, and 3111 and made substantial efforts to have their 159 employees adhere to a tip-reporting standard.[58] Bubble Room informed all of its employees about the IRC and the regulations that required them to report their tip income to management and to make such disclosures on their income tax forms.[59] On several different occasions, Bubble Room handed out employee manuals and memoranda explaining how to report tip income.[60] At one time, Bubble Room even required employees to acknowledge in writing

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52. *Id.* at 1527 (emphasis added).

53. *Id.* at 1527-28.

54. *Id.* at 1527.

55. *Id.* at 1529.

56. *Id.*

57. 159 F.3d 553, 566-68 (Fed. Cir. 1998) (finding that the IRS may base its assessments on indirect formulas if it is clear that the taxpayer understated wages, making it impractical to determine the actual amount of wages received).

58. *Id.* at 558.

59. *Id.* at 572 (Plager, J., dissenting).

60. *Id.*

that they had an obligation to report their tip income to both management and to the IRS.[61] Employees were also required to report tip income daily as they checked out.[62] In the words of the dissenting judge, "[t]he only thing Bubble Room failed to do was to police individually the handling by its employees of any tips received, and to audit their personal records to ensure that cash tips were being fully reported."[63]

Notwithstanding such rigorous adherence to the reporting standards, the Service conducted an assessment using the *McQuatters* formula,[64] and the employer paid the assessment with a subsequent claim for refund.[65] The employer-taxpayer then sought redress, hoping for a favorable result, and filed the suit for refund in the United States Court of Federal Claims.[66] The Federal Claims Court found that the *McQuatters* formula was indeed punitive.[67] The court found that applying the *McQuatters* formula to this case would punish the employer even though it went out of its way to ensure tips were reported.[68] The court stated:

> Employers do not have an opportunity to verify the amount of cash tips earned by their individual employees. Their knowledge of employees' tip income is limited to copies of credit card charge slips and to reports of tips received from their employees, who have the direct interaction with the customers. Tipping was a voluntary activity between customers and Bubble Room employees[;] therefore, the plaintiff had no way of determining the exact amount of tips received by individual employees if the tip was not charged and if the employees were not forthcoming.[69]

The employer-taxpayer enjoyed a Pyrrhic victory. The Federal Circuit vacated the lower court's decision, including any shred of the punitive nature argument.[70] The court found that employers are required to pay

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61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.* at 557, 559 (citing McQuatters v. Comm'r, 32 T.C.M. (CCH) 1122, 1125 (1973)).
65. Bubble Room, Inc. v. United States, 36 Fed. Cl. 659, 664 (1996), *vacated by* 159 F.3d 553 (Fed. Cir. 1998).
66. *Id.* at 661.
67. *Id.* at 676-78.
68. *Id.*
69. *Id.* at 676; *see also* Harold Peckron, *The McQuatter Formula: Punitive Result or Administrative Convenience?* 2000 L. REV. M.S.U.-D.C.L. 745, 750-51 (2000).
70. *Bubble Room*, 159 F.3d at 568.

the statutorily mandated FICA taxes regardless of whether or not they, or their employees, kept accurate records.[71] The court reasoned:

> [W]e reject the position that the *McQuatters* formula is punitive in nature and thus limited to situations where taxpayers fail to keep adequate records. We believe that the better view is that the IRS may base assessments on indirect formulas in circumstances where it is clear that the taxpayer has understated the amount of wages received and it is impossible or impractical to determine the exact amount of wages actually received.[72]

This system was used both in *McQuatters* and *Mendelson*.[73] Even with the Service's use of the indirect formula, all employers and employees as taxpayers are required to maintain accurate records of tax-related transactions.[74] *Bubble Room* effectively destroyed the notion that the *McQuatters* formula, used in assessing an employer-only FICA tax liability, is punitive in nature.[75]

The Seventh Circuit did not dispose of the aggregate estimation authority issue until *330 West Hubbard Restaurant Corp. v. United States*.[76] In affirming the district court and sustaining the Service's position, the Seventh Circuit noted that the Eleventh and Federal Circuits had held that the Service "is authorized to collect an employer's FICA taxes *without* first assessing individual employees and crediting their Social Security earnings records."[77] The Seventh Circuit responded to the chronic employer assertion that it is against public policy to assess employers on the underreported portion of the employees' tip income for FICA purposes while not crediting such amount to the employees' accounts.[78]

The court found that the employees were to blame for failing to report accurately their tip incomes and, in turn, for not receiving their Social Security earnings credit.[79] The employees were afforded the opportunity to amend their earnings records through IRS Form 4137, but failure to submit accurate reporting amounts to a waiver of the Social Security

71. *Id.* at 566.
72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.*
76. 203 F.3d 990 (7th Cir. 2000).
77. *Id.* at 994 (emphasis added).
78. *Id.* at 995.
79. *Id.* at 996.

credit.[80] The court then refused to hold the IRS aggregate method of assessment responsible for a reduction in an employee's earnings credit.[81]

The Service's victories in *McQuatters*, *Morrison Restaurants*, *Bubble Room*, and *330 West Hubbard Restaurant* appeared to establish the aggregate estimation methodology as the legal standard in employer-only FICA tax assessments. But two cases revealed an Achilles heel in the methodology: *Quietwater Entertainment, Inc. v. United States*[82] and *Fior D'Italia, Inc. v. United States*.[83]

Although *Quietwater* was reversed and vacated in part without a published opinion, its district court opinion is instructive. The court noted changes in the congressional view of tip income under FICA, from a reluctance to fund Social Security through general tax revenue to a gradual acceptance of the requirement that employers be held liable for tip amounts paid by and credited to employees.[84] The court highlighted the weaknesses in the *McQuatters* aggregate estimation formula:

> In making these changes, Congress has given no indication that it intended to alter the direct correspondence between employee and employer FICA contributions and the individualized employee Social Security benefits. Under the IRS's interpretation, the determination of underreported cash tips will be made without attempting to determine whether any of the employer's workers actually underreported or failed to report their cash tips, and employees' FICA benefits will not be credited from any increased tax paid by the employer. In light of the symmetrical scheme established by Congress as to FICA benefits, it does not appear that Congress ever intended that FICA taxes be assessed against an employer in excess of the

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80. *Id.* The court explained that employees are at fault when they fail to report, or when they underreport, their tip earnings. The court noted:

> The fifty employees whose Social Security earnings records will not be credited should have reported *all* their tips on IRS Form 4070 in the first place. Moreover, having failed to do what was required under 26 U.S.C. § 6053, these employees could have, as an alternative, filed IRS Form 4137 (Social Security and Medicare Tax on Unreported Tips) with their tax returns. The employees' failure to use either section 6053 or IRS Form 4137 to report their correct tip income[,] and thus effect a credit to their Social Security earnings records, constitutes a waiver of their right to the credit.

Id. (citations omitted).

81. *Id.*

82. 80 F. Supp. 2d 1323, 1330 (N.D. Fla. 1999), *rev'd in part, vacated in part*, 220 F.3d 592 (11th Cir. 2000).

83. 21 F. Supp. 2d 1097 (N.D. Cal. 1998), *aff'd*, 242 F.3d 844 (9th Cir. 2001), *rev'd*, 122 S. Ct. 2117 (2002).

84. *Quietwater Ent., Inc.*, 80 F. Supp. 2d at 1329-30.

> amount contributed by its individual employees when such taxes will never be credited to the individual employees' accounts.[85]

Therein is the difficulty with *McQuatters*; it fails to account for the floor or lower exempt wage band, making it violative of public policy.[86] Also, such an aggregate estimation method vests the Service with plenary authority that is profoundly lacking in either statutory or regulatory support. The *Quietwater* court noted that in the IRC, Congress addressed employers' and employees' shares of FICA taxes in separate provisions.[87] According to the Eleventh Circuit, "'[t]he separation of the provisions into different, parallel subchapters suggests that Congress contemplated that employees' and employers' shares could be imposed separately,'" and thus supports the conclusion that determination of individual employees' underreporting need not be linked to the assessment of the employer's FICA taxes."[88] The court noted, however, that the mere fact that Congress separated this information into two different subparts was insufficient to show congressional intent regarding unreported tips; the IRS had the burden of providing a statute or regulation that conferred on it the power to utilize its method of assessment.[89] The court noted:

> Since the *Morrison Restaurants* decision in 1997, Congress and the President have clearly expressed dissatisfaction with the IRS's unauthorized expansion of its tax gathering powers. Congress expressly directed, for example, that all IRS employees "may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering into a Tip Reporting Alternative Commitment Agreement." The IRS is a governmental agency whose powers are set by law, and it can only exercise those powers as expressly authorized or which are clearly necessary to carrying out an authorized duty.[90]

While the Eleventh Circuit in *Morrison Restaurants* supports the *McQuatters* formula, it is a salient point raised in the subsequent case of *Quietwater* that perhaps *Morrison Restaurants* should be revisited to

85. *Id.* at 1330.
86. IRS, *Withholding and Reporting, at* http://www.irs.gov/file/display0,,i1%3D52%26genericID%3D1628300.html (last visited Sept. 7, 2002).
87. *Quietwater Ent., Inc.*, 80 F. Supp. 2d at 1328-30.
88. *Id.* at 1328-29 (quoting Morrison Rests. v. United States, 118 F.3d 1526, 1529 (11th Cir. 1997)).
89. *Id.* at 1329.
90. *Id.* (citations omitted) (emphasis added).

reflect congressional intent.[91] Nevertheless, *Quietwater* did uncover the flaw in *McQuatters,* which was an essential element in the *Fior D'Italia* case.

IV. THE *FIOR D'ITALIA* RULE

As *Fior D'Italia*[92] approached the district court, chances of successfully challenging the aggregate estimation methodology were not good. The Federal, Seventh, and Eleventh Circuits had all uniformly held in favor of the Service, and the Tax Court was the genesis for the aggregate estimation method. Would the district court in California and, if need be, the Ninth Circuit be any different in their treatment of this onerous method of assessment? A pro-employer result,[93] which surprised the Service and the business community, could only be reconciled in the Supreme Court. Once again, the aggregate estimation method carried the day,[94] but not without a masterful dissent.[95]

A. Lower Courts

1. District Court

Fior D'Italia, like thousands of restaurants across the country, employs a waitstaff comprised of waiters, table busers, bartenders, and others whose earnings come in part from customer tips.[96] As required by law, the tipped employees[97] submitted monthly reports to their employer on Form 4070, identifying their tips.[98] Fior D'Italia, as the employer, submitted Form 8027 to the Service setting forth gross sales, charged tips, and the reported tip amounts of its employees.[99]

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91. *Id.* at 1328-29.

92. Fior D'Italia, Inc. v. United States, 21 F. Supp. 2d 1097 (N.D. Cal. 1998), *aff'd,* 242 F.3d 844 (9th Cir. 2001), *rev'd,* 122 S. Ct. 2117 (2002).

93. *See Fior D'Italia,* 21 F. Supp. 2d at 1104.

94. *See* United States v. Fior D'Italia, 122 S. Ct. 2117, 2121 (2002) (holding that the law authorizes the IRS to use the aggregate estimation method).

95. *See id.* at 2127-34 (Souter, J., dissenting). Justice Souter was joined in his dissent by Justices Scalia and Thomas. *Id.*

96. Fior D'Italia, Inc. v. United States, 242 F.3d 844, 845 (9th Cir. 2001), *rev'd,* 122 S. Ct. 2117 (2002).

97. *See id.* The Fior D'Italia waitstaff employees received their gratuities *directly* from customers and shared them with support waitstaff on a tip-sharing basis. *Id.* There were no cash-pooling arrangements or cash tip redistribution by the employer. *Id.* In this regard, Fior D'Italia's tip arrangement is typical in the industry. *See id.* at 845 n.1; *see also Top Tippers Share Strategies,* FLORIDA TODAY, July 9, 2002, at 1E.

98. *Fior D'Italia,* 242 F.3d at 845.

99. *Id.* at 845-46.

In 1991 and 1992, the reports filed with the Service indicated a discrepancy between the tips reported by employees and the listed tips on credit card slips.[100]

Year	Tips Reported by Employees[101]	Tips Reported on Charge Slips[102]	Variance
1991	$247,181	$364,786	$117,605
1992	$220,845	$338,161	$117.316
Totals	$468,026	$702,947	$234,921

This variance resulted in a "compliance check" by the Service, triggering a notice and demand to the employer, Fior D'Italia.[103]

The notice and demand set forth an aggregate estimation of the employer-only FICA tax liability based upon the underreported tips,[104] calculated in the following manner. First, the Service determined the "tip rate" evident in the charge slips:[105] 14.49% in 1991 and 14.29% in 1992.[106] Second, the Service multiplied the tip rates by the restaurant's total receipts to calculate total tips.[107] The *total* tips produced in 1991 and 1992 were $403,726 and $368,374, respectively.[108] Last, the Service determined that the unreported tips and FICA tax liability, at a rate of 7.65%, were as follows:

100. *Fior D'Italia*, 122 S. Ct. at 2121.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* at 2121-22.

106. Fior D'Italia, Inc. v. United States, 242 F.3d 844, 846 (9th Cir. 2001), *rev'd*, 122 S. Ct. 2117 (2002). To compute these yield percentages, the Service "divided total tips charged on credit cards by total credit card receipts." *Id.*

107. *Fior D'Italia*, 122 S. Ct. at 2121-22.

108. *Id.* at 2122.

Year	Actual Tips Reported by Employees[109]	Estimated Total Tips by IRS[110]	Unreported Variance[111]	FICA Tax (FICA Rate 7.65%[112])
1991	$247,181	$403,726	$156,545	$11,976
1992	$220,845	$368,374	$147,529	$11,286
Totals	$468,026	$772,100	$304,074	$23,262

After the payment of $23,262, taxpayer Fior D'Italia filed a claim for refund that, upon denial, triggered the filing of suit in the United States District Court for the Northern District of California.[113] Plaintiff, Fior D'Italia, argued that the Service was statutorily unauthorized to employ an aggregate estimation methodology and that, pursuant to section 3121(q), the Service must first determine the *individual* employee tips received and then compile that information to compute the employer's total FICA tax liability.[114] Petitioner stipulated that it would not dispute the estimation that the Service had used in this case and thereby reduced the dispute to the sole legal issue of the Service's statutory authority to use aggregate estimation.[115]

The district court rejected the Service's aggregate estimation method as being violative of the congressional intent manifest in section 3121(q).[116] The court stated that there was no evidence of congressional intent to place more responsibility on employees for payment of FICA taxes on tips, nor was there evidence of congressional intent to tax employers without crediting employees' Social Security accounts – both of which occur when the aggregate assessment method is used.[117]

The court also noted that a tax on employers based upon the aggregate assessment methodology, absent consideration for the employee Social Security account credit, functions as a general revenue tax for the government beyond what the court found to be the congressional intent of the FICA tax.[118] Such an estimation methodology presents the

109. *Id.* at 2121.

110. *Id.* at 2121-22.

111. *Id.* at 2122.

112. Fior D'Italia v. United States, 21 F. Supp. 2d 1097, 1098 (N.D. Cal. 1998), *aff'd*, 242 F.3d 844 (9th Cir. 2001), *rev'd*, 122 S. Ct. 2117 (2002).

113. *Id.*

114. *See id.* at 1099.

115. *Id.* at 1098.

116. *Id.* at 1103.

117. *Id.* at 1102.

118. *Id.*

taxpayer-employer with a proverbial "Catch-22." It appears that the aggregate assessment nullifies the section 45B tax credit to employers for FICA taxes, such as Social Security and Medicare taxes, that employers pay on employees' tips in excess of the federal minimum wage.[119] The aggregate assessment method, according to the court in *Fior D'Italia* would prevent the employer from taking advantage of the section 45B credit because the unreported tips must be quantified for each employee in order to determine if each employee has paid his FICA taxes.[120] Thus, employees' taxable wages must be ascertained prior to the employer's payment of FICA taxes accounting for each employee.[121]

The Service also argued that allowing it to use the aggregate assessment method provides for administrative convenience.[122] In disputing this rule, the court noted that "administrative convenience does not guide a court's interpretation of a statute unless Congress has indicated that it shares that interest."[123]

Finally, the court took a less than favorable view of the Service's argument that disallowing the *McQuatters* formula would create a moral

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119. *See id.* at 1103. Section 45B allows employers to reduce their federal income taxes by the amount of the FICA taxes paid on certain employee tips. *Id.* In general, a section 45B credit is allowed for any FICA taxes paid on tips in *excess* of a statutory tip credit. *Id.* A statutory tip credit is defined as the necessary amount to meet the employers' federal minimum wage obligation. *Id.* For example:

> [Restaurant X operates in State A] where employers pay the federal minimum wage of $5.15 [per hour] and take the maximum "tip credit" ($3.02). . . . This means the employee is receiving a cash wage of $2.13 an hour ($5.15 minimum wage minus $3.02 allowable federal tip credit). [If] this employee averages $8.00 an hour in tips, [then the employer is entitled to a section 45B credit of $0.38, computed as follows]:
>
> | | |
> |---|---|
> | Employees' cash wage | $2.13 |
> | Add: Hourly Tips | $8.00 |
> | Subtotal | $10.13 |
> | Less: the federal minimum wage | -$5.15 |
> | (1) Tip Tax Credit Base | $4.98 |
> | (2) Current FICA Rate | 7.65% |
> | Section 45B Credit (line 1 x line 2) | $0.38 |
>
> For each hour this employee works, [Restaurant X is] eligible for a 38-cent 45B credit against federal income taxes.

National Restaurant Association, *How To Claim a Federal Income Tax Credit for FICA Taxes You Pay on Employees' Tips*, *at* http://www.restaurant.org/legal/law_fica.cfm (last modified June 1, 2001); *see also* 26 U.S.C. § 45B (2000).

120. *Fior D'Italia*, 21 F. Supp. 2d at 1103.

121. *Id.*

122. *Id.* at 1104.

123. *Id.*

hazard.[124] That is, because the employer's share of FICA taxes is based on the employees' reported tips, the employer might be inclined to ignore blatant underreporting in order to pay less FICA tax.[125] The Service argued that, if the court disallowed the *McQuatters* formula and any aggregate estimation methodology, employers would encourage underreporting of employee tips.[126] The court disagreed with the argument that the aggregation method would cause the moral hazard of encouraging the underreporting of employees' tips, stating that "Congress never suggested that its legislation was for the purpose of preventing employers from encouraging employees to underreport tips."[127] The court then cited to a letter from the Treasury Department to the Senate, which explained the Service's perception of Congress' intent: that regulation will "prevent an employer from claiming the credit for FICA taxes paid pursuant to a § 3121(q) notice and demand following a tips examination by the IRS."[128] However, the court disputed this supposed congressional intent by citing Congress' amendment to section 45B in 1996, and it concluded that discarding the aggregate assessment method would not cause such a discomfort in Congress.[129] Despite the Service's reliance on that legislative history, the court decided to abandon the aggregate assessment method.[130]

2. Appellate Court

After this favorable decision for Fior D'Italia,[131] the Service immediately appealed to the Ninth Circuit Court of Appeals on the sole

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124. *Id.* at 1103. A moral hazard may arise in numerous contexts and involves the tendency of one party to alter his or her behavior after an event, such as contract signing or liability determining, which could be costly to the other party. Thus, basing the employer's share of FICA taxes exclusively on the employees' reported tips would provide an incentive to the employer to discourage accurate tip reporting. *See, e.g.*, CAMPBELL R. MCCONNELL & STANLEY L. BRUE, ECONOMICS: PRINCIPLES, PROBLEMS, AND POLICIES 604 (2002) (explaining the moral hazard problem generally); *see also* Peckron, *supra* note 69, at 754.

125. *Fior D'Italia*, 21 F. Supp. 2d at 1103-04 (explaining that Congress' intent is clearly that the FICA tax "credit is applicable to the employer's FICA tax obligation 'attributable to reported tips'") (Letter from Leslie B. Samuels, Assistant Secretary, Department of Treasury, to Senator Trent Lott, United States Senate (March 30, 1994)).

126. *Id.* at 1103-04.

127. *Id.* at 1103.

128. *Id.* at 1104.

129. *Id.*

130. *Id.* at 1103-04.

131. *See id.* (granting plaintiff's motion for summary judgment).

issue of the statutory validity of the aggregate estimation methodology.[132] In a two-to-one decision, the Ninth Circuit affirmed the district court, concluding that the Service did indeed lack statutory *and* regulatory authority to apply the aggregate estimation methodology in computing employer-only FICA taxes on unreported employee tip income.[133]

The court initially examined the nature of the FICA tax assessment and found that for the "aggregate assessment method to precisely equal the tips on which the employer's FICA tax is calculated, the cash tipping rate must be *exactly the same as* the tipping rate on charge slips" and that "total tips received must be distributed among employees so that none falls outside the wages band."[134] The court found that neither of these conditions held true in most cases.[135] Charged tips generally exceed cash tips due to, for example, customers' spending habits or expense accounts.[136] Also, some charged tips are actually less than they appear on the charge slips because some employers charge their employees the three percent fee assessed by credit card companies.[137]

The court also found that the assumption that all of Fior D'Italia's employees' tips fell within the wages band was problematic because the employees participated in tip sharing.[138] The court noted that by looking only at the aggregate tips collected, it could not tell how much employees profited.[139]

The Service responded by arguing that it is authorized to employ *any* rational method for tax assessment and, if valid, the burden shifts to the taxpayer to show the amount by which the assessment overstated the tax.[140] In large measure, the Ninth Circuit agreed, pointing to the plenary statutory authority of section 446, which maintains that if a taxpayer's records are inadequate or nonexistent, an estimation method for taxable income is justified.[141]

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132. Fior D'Italia, Inc. v. United States, 242 F.3d 844, 845-46 (9th Cir. 2001), *rev'd*, 122 S. Ct. 2117 (2002).

133. *Id.* at 845, 852.

134. *Id.* at 846.

135. *Id.*

136. *Id.*

137. *Id.* at 846-47.

138. *Id.* at 847.

139. *Id.*

140. *Id.*

141. *Id.* at 847-48, *see also* Palmer v. IRS, 116 F.3d 1309, 1312 (9th Cir. 1997); Mendelson v. Comm'r, 305 F.2d 519 (7th Cir. 1962); McQuatter v. Comm'r, 32 T.C.M. (CCH) 1122, 1125 (1973).

The *Fior D'Italia* court then distinguished the instant case from *McQuatters*[142] and *Mendelson:*[143]

> Unlike the taxpayers in *McQuatters* and *Mendelson*, then, the taxpayer in our case did not fail to satisfy a legal duty imposed on it by the Internal Revenue Code, and thus did not give the IRS just cause for resorting to an estimate in constructing its assessment.
>
> Also, unlike the taxpayers in *McQuatters* and *Mendelson*, Fior is not in an inherently better position than the IRS to determine what its employees actually earned in tips. Quite the contrary: Fior lacks the IRS's power to audit its employees and has no other means of forcing its employees to divulge how much tip income they earned during a given year. Forcing the restaurant to prove that the estimate is wrong puts an impossible burden on it, making the already heavy presumption that attaches to an IRS assessment virtually conclusive.[144]

However, the most disturbing aspect of the aggregate estimation method for the court was the defect in the method itself. The court found that the method had serious flaws in that it overstated cash tips, failed to account for credit card adjustment by employers, and failed to consider the statutory wages band.[145] In denouncing the theory that the inaccuracies would cancel each other out, the court concluded that the aggregate estimation method "overstate[s] the base on which the FICA tax is calculated and thus will combine to overstate the amount the taxpayer owes."[146]

The Service contended that there was further authority for its method; section 3121(q) alone, the Service argued, granted it the statutory authority to make estimates of an employer's FICA tax liability.[147] Indeed, its own published ruling implicitly authorized the use of estimates even after the time for assessing the employee has passed.[148] The court reduced the Service's reasoning to the following syllogism: "If the IRS is allowed to assess the employer when it may no longer audit the employees, it will have no way to conduct the assessment except by

142. 32 T.C.M. (CCH) 1122 (1973).
143. 305 F.2d 519 (7th Cir. 1962).
144. *Fior D'Italia*, 242 F.3d at 848.
145. *Id.*
146. *Id.*
147. *See id.* at 849.
148. *Id.* (citing Rev. Rul. 95-7, 1995-4 I.R.B. 44 (Q & A 11)).

estimation. Congress therefore must have contemplated that the IRS would proceed by estimation in making the assessments."[149]

In rejecting such circuitous logic, the court noted:

> We do not see this as a necessary implication. Rather, we read section 3121(q) as saying that the IRS need not also conduct an audit of the employer while it is auditing the records of individual employees. Congress doubtless understood that the only way the IRS can determine FICA taxes on tips is by examining the employees' records; [there is] no point in auditing the restaurant at the same time because it will have no record of tips, other than the information provided by the employees in their 4070 and 8027 forms.[150]

The pregnant assertion that auditing the employees' records must precede the employer-only FICA tax assessment does present an administrative difficulty to the Service given the highly mobile workforce in the food services industry.[151] In response, the court noted that, if this is problematic for the Service, it can always promulgate a regulation allowing for an estimate assessment of employers.[152] In the alternative, a "vigorous enforcement program" should encourage waitstaff to be more forthcoming in their accurate tip-reporting obligation.[153]

The court noted that auditing individual employees would be more burdensome for the Service, but Congress specifically withheld the estimation power from the IRS in collecting FICA taxes.[154] By using an estimate, the IRS effectively increased the amount of the tax owed by the employer.[155]

Finally, it is manifest in congressional intent, as recently as less than a decade ago, that tax policy prohibits an expansion of the Service's authority to make aggregate estimates of an employer's FICA tax liability.[156] In 1996, Congress, in effect, blocked an IRS attempt to collect more FICA taxes on cash tips.[157] The court found that:

> In the wake of political setbacks, the IRS has tried to solve the problem by assessing restaurants based only on the rough, and

149. *Id.* at 849-50.

150. *Id.* at 850.

151. *See id.* at 850 n.10, 858; *see also Top Tippers Share Strategies*, *supra* note 97.

152. *Fior D'Italia*, 242 F.3d at 850 n.10.

153. *Id.* at 850-51 n.10.

154. *Id.* at 850 ("The fact remains that Congress authorized the IRS to use estimates in collecting income taxes but withheld such authority in collecting FICA taxes.").

155. *Id.* at 851.

156. *See id.* at 852.

157. *Id.*

> somewhat inflated, estimates that we have seen in this case. But before it can take such a significant step, it must obtain authorization directly from Congress or by exercising Treasury's own regulatory authority. Either path involves significant political checks on agency discretion, and we decline to assist the IRS in avoiding the public scrutiny such a process would entail.[158]

Despite a valiant attempt by the dissent to posit that the aggregate estimation methodology is both reasonable[159] and practical,[160] the Federal, Eleventh, and Seventh Circuits, as well as the Tax Court, have all approved the Service's authority under section 3121(q) to use the aggregate estimation methodology inherent in *McQuatters*.[161] With the Ninth Circuit in direct opposition, the U.S. Supreme Court took the opportunity to dispose of the issue.

B. Supreme Court

1. Majority Opinion

The question in front of the Supreme Court in *Fior D'Italia* was whether the Service is authorized to base an employer's FICA tax assessment upon its aggregate estimate of *all* the tips that the employer's customers paid its employees or whether the law requires the Service to determine tip income by estimating each individual's tip income *separately* - before adding the individual estimates together to create a total.[162] In a six-to-three decision, the majority set forth the underlying basis for the power of assessment delegated to the Service under the IRC.[163] Inherent in such authority, posited the Court, is the simultaneous grant of authority to decide how to make that assessment, including the use of estimates.[164]

The Court was not enamored by the literal interpretation of section 3121(q), argued by Fior D'Italia, that tips are "received by *an* employee in the course of *his* employment"[165] and that legal significance should attach to the singular case. According to the Court, section 3121(q) is

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158. *Id.*
159. *Id.* at 855-56 (McKeown, C.J., dissenting).
160. *See id.* at 858 (McKeown, C.J., dissenting).
161. *See supra* Part III.B.
162. *Fior D'Italia*, 122 S. Ct. 2117, 2121 (2002).
163. *Id.* at 2121-22 (citing 26 U.S.C. § 6201(a)).
164. *Id.* at 2122.
165. *Id.* at 2123.

merely definitional, *not* operational.[166] Thus, sections 3111(a) and (b) are the apposite sections, which are operational in nature and impose liability for the totality of wages paid, thereby speaking in the plural.[167]

In a similar vein, the Supreme Court rejected the Ninth Circuit's view that the Service was statutorily proscribed from making aggregate assessments under either section 446(b) or section 6205(a)(1).[168] But Fior D'Italia raised several points directly attacking the aggregate estimation methodology via the wage band and credit slip overstatement. The attacks focused on certain features of the aggregate estimate that Fior D'Italia considered "unreasonable."[169] First, the restaurant pointed out that "an aggregate estimate will sometimes include tips that should not count in calculating FICA tax the employer owes."[170] The overinclusion arises because the law excludes an employee's tips from FICA wages when they are less than twenty dollars a month or over a certain annual level.[171] Second, Fior D'Italia argued that using the aggregate estimation method will result in an overstatement of tips when they are based solely on customer charge slips.[172] The overstatement results because the method fails to account for the following:

> (1) customers who pay cash tend to leave a lower percentage of the bill as a tip; (2) some customers "stiff" the waiter, leaving no tip at all; (3) some customers write a high tip on the credit card slip, but ask for some cash back, leaving a net lower amount;

166. *Id.*

167. *Id.* Had taxpayer's counsel perused earlier decisions, he or she would have encountered the identical argument which, as in the Supreme Court, fell on deaf ears. *See, e.g.*, 330 West Hubbard Rest. Corp. v. United States, 203 F.3d 990, 995 (7th Cir. 2000) (holding that use of the singular is not meaningful in federal statutes and, therefore, nothing can be inferred from the statute's use of the singular "employee"). The court stated:

> [The] argument is misplaced. Use of the singular is not meaningful in federal statutes. . . . Thus, the fact that the statutes regarding assessment of employer FICA taxes make reference to "individuals" or to "an employee" is not an indication of the manner in which Congress intended the IRS to collect employer FICA taxes. This language makes clear that an employer's FICA tax liability is not necessarily limited to tax on the income reported by its employees. . . . Accordingly, nothing can be inferred from the statute's use of the singular "employee". . . .

Id. at 995-96 (citations and footnote omitted).

168. *See Fior D'Italia*, 122 S. Ct. at 2123-24. It is interesting to note that the taxpayer's counsel chose not to raise the negative implication argument of §§ 446(b) and 6205(a)(1). *See id.* at 2124.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

> and (4) some restaurants deduct the credit card company fee from the tip, leaving the employees with a lower net amount.[173]

While admittedly valid points, the Court did not concede that their validity strikes at the heart of the aggregate method; rather, it concluded that such considerations do not demonstrate that the Service's method is unreasonable.[174] The Court also rejected Fior D'Italia's claim that it lacked the information by which to dispute the Service's aggregate assessment, stating that it could not understand how a restaurant owner was unable to discover the earnings of its personnel in order to satisfy an argument that the aggregate method is unreasonable.[175] The Court continued by stating that a restaurant owner need only prove that the aggregate method produced an inaccurate result in order to convince a judge to use a more accurate formula.[176] The Court concluded that the employees' individual assessments are no more reasonable than the aggregate estimate because they are both based on estimates.[177]

Fior D'Italia introduced a fairness argument based on the application of an IRS regulation, which identifies wages for purposes of calculating FICA to include only tips actually reported to the employer.[178] It then asked the Court to consider how an employer is to calculate the FICA tax on the amount of tips actually reported *and* on the amount of tips received but not reported.[179] In response, the Court noted that section 3121(q) accounts for this situation because, before penalties can attach and interest can accrue, there must be an actual notice and demand made

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173. *Id.* at 2124-25.

174. *Id.* at 2125. The Court did note that had Fior D'Italia not stipulated as to the accuracy of the Service's assessment, it could have presented evidence challenging its accuracy. *Id.*

175. *Id.* The Court explained:

> Why does a restaurant owner not know, or why is that owner unable to find out: how many busboys or other personnel work for only a day or two – thereby likely earning less than $20 in tips; how many employees were likely to have earned more than $55,000 or so in 1992; how much less cash-paying customers tip; how often they "stiff" waiters or ask for a cash refund; and whether the restaurant owner deducts a credit card charge of, say 3%, from employee tips? After all, the restaurant need not prove these matters with precision. It need only demonstrate that use of the aggregate method in the particular case has likely produced an inaccurate result. And in doing so, it may well be able to convince a judge to insist upon a more accurate formula.

Id.

176. *Id.*

177. *Id.* Apparently the Court chose to ignore the provisions of § 6001 wherein employers are excepted from the statutory record-keeping requirement in relation to charged tips. *See, e.g., supra* note 17.

178. *Fior D'Italia*, 122 S. Ct. at 2125 (citing Treas. Reg. § 31.6011(a)-1(a)(2002)).

179. *Id.*

for the deficient FICA taxes and the employer must refuse to pay the amount.[180]

It is interesting to note the "pragmatic" bookkeeping remedy offered by the Court to employers who receive such an assessment:

> Indeed, the statute (and its accompanying Revenue Ruling) contemplates both a restaurant that does not police employee tip reporting and a later assessment based on unreported tips. It makes clear that, at most, such a restaurant would have to create a reserve for potential later tax liability. Although the reporting scheme may place restaurants in an awkward position, the Tax Code seems to contemplate that position; and its bookkeeping awkwardness consequently fails to support the argument that aggregate estimation is unlawful.[181]

Fior D'Italia also argued that the Service, in achieving a victory at bar, can bring FICA tax assessment audits for back years, thereby manifesting an abuse of power.[182] Fior D'Italia argued that the new "aggregate estimate" approach would "effectively force[] the employer into . . . verifying, investigations, monitoring, and policing compliance with its employees - responsibilities which Congress and the Courts have considered, evaluated, and steadfastly refused to transfer from the IRS to the employer."[183] It also suggested that the IRS could threaten to gain access to restaurant owners' previous tax years' records, which would compel employees to report all tips accurately.[184] Fior D'Italia believed that these would be the only reasons for the IRS to bring a case because there may not be any revenue production for the government given the FICA income tax set-off.[185]

But the "aggregate estimate" approach was not found unlawful under Fior D'Italia's "abuse of power" argument.[186] The Court found that the IRS did not act illegally, even if one could assume through Fior D'Italia's reasoning that an improper motive unlawfully produced a statutorily permissible enforcement method.[187] Instead, the "abuse of power" argument suggests that the aggregate estimation method leads to abusive

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180. *Id.* at 2125-26. Once again, the Court opted to ignore the statutory provision that prevents the running of interest on unpaid FICA taxes at § 6205(a)(1). *See id.*

181. *Id.* at 2126.

182. *Id.*

183. *Id.* at 2126-27.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

action.[188] However, the possibility of abuse by agencies could not support the inference that all agency action is unreasonable.[189]

In summary, the Supreme Court held that the aggregate estimation methodology was valid because the Service had the requisite statutory authority to devise an estimation method. It was reasonable despite possible violations of the wage band, and the potential abuses of power by the Service were not inherent in the use of the aggregate estimation methodology.[190]

2. *Criticism of the Majority Opinion*

The majority view was not without its critics. The dissent skillfully parried with the majority view and raised several thought-provoking questions.[191]

Initially, the dissent pointed out, in concurrence with the majority view, that the aggregate estimation method *inflates* liability.[192] The dissent reiterated the fallacious assumptions for calculating aggregate estimation that give rise to a skewed liability.[193] The dissent stated:

> As the majority acknowledges, the next problem is that the aggregate estimation necessarily requires the use of generalized assumptions for calculating such estimates, and the assumptions actually used tend to inflate liability. In the first place, while the IRS's assumption that many employees are underreporting is indisputably sound, the assumption that every patron is not only tipping, but tipping 14.49% in 1991 and 14.29% in 1992, is probably not. Those percentages are based on two further assumptions: that patrons who pay with credit cards tip at the same rate as patrons who pay in cash, and that all patrons use the tip line of the credit card slip for tips, rather than to obtain cash. But what is most significant is that the IRS's method of aggregate estimation ignores the wage band entirely, assuming that all tips are subject to FICA tax, although this is not true in law, and certainly not always the case in fact.[194]

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188. *Id.* at 2127.

189. *Id.* (citing Heckler v. Chaney, 470 U.S. 821, 831 (1985)).

190. *Id.* at 2121.

191. *See id.* at 2127-34 (Souter, J., dissenting).

192. *Id.* at 2128-29 (Souter, J., dissenting).

193. *Id.*

194. *Id.* The dissent regarded the "aggregate estimation" approach as problematic because of the generalized assumptions used to calculate the estimated tip value. *Id.* These assumptions tend to inflate liability. *Id.* Although employees may be underreporting their tips, it cannot be assumed that all patrons were tipping at the rate of 14.49% in 1991 and 14.29% in 1992. *Id.* at 2129 (Souter, J., dissenting). The percentages

Even more disturbing to that one-third of the Supreme Court was the enormous lack of equity in the calculation.[195] According to the dissent's view, employers are *not* required to maintain tip records; consequently, their ability to contest an aggregate assessment is substantially compromised.[196] To placate this dilemma, the majority posited that employers should keep track of *each* and *every* employee's tips.[197] But the absolution from record keeping and the exigencies of the business preclude any such monitoring.

The IRS has not offered a viable solution.[198] Primarily, the IRS initiated an unenforceable requirement that employers depend upon their employees to accurately record the amount earned in tips.[199] If an employer could not rely on the honesty of her employee, the IRS propounded that the employee should not have been hired. The proposal was met with laughter.[200] In the Ninth Circuit, the IRS proposed that employees pool their tips so that employers could generate records.[201] The circuit court's holding rejected the proposal as "'alter[ing] the way a restaurant does business . . . . It would be akin to saying that a restaurant must charge a fixed service charge in lieu of tips.'"[202]

A careful study of the majority view discloses one recurring theme: it tends to ignore the practical aspects of the restaurant business.[203] The dissent recognized this lack of a pragmatic result:

> The majority doubts that there is any practical difference between determining the liability of one employee, very possibly with an estimation similar to the one used here, and estimating the aggregate amount for an employer. But determinations limited to an individual employee will necessarily be more tailored, if only by taking the wage band

present two further assumptions: that patrons paying with cash tip comparable amounts to those paying with credit card and that the tip line on credit cards receipts is used only for tips and not to obtain cash. *Id.* Most significantly, however, the "aggregate estimation" method disregards the wage band. *Id.*

195. *Id.* at 2127, 2129 (Souter, J., dissenting). The dissenters included Justices Souter, Scalia, and Thomas with Justice Souter writing the dissenting opinion.

196. *Id.* at 2129 (Souter, J., dissenting).

197. *Id.* at 2125.

198. *See id.* at 2129 n.3 (Souter, J., dissenting).

199. *See id.*

200. *Id.*

201. *Id.*

202. *Id.* (citing Fior D'Italia v. United States, 242 F.3d 844, 848, n.6 (9th Cir. 2001).

203. *See id.* at 2117-25. Numerous instances can be found in the majority opinion to support this conclusion: the admitted failure of the formula assumptions, the deficient record keeping, and the reserve account dicta, to name a few. *Id.*

> into account. In fact, any such determination would occur in consequence of some audit of the employee, who would have an incentive to divulge information to contest the IRS's figures where possible, and generate the very paper trail an employer would need to contest liability while availing himself of the exception in § 6001.
>
> The overall implication is that employers are meant to pay taxes based on specific information provided by others. As a practical matter, the tips themselves are not the true basis for liability; instead, it is an employee report that creates the obligation.[204]

The dissent also raised a powerful statutory argument: as a practical matter, before a notice and demand can be issued, there must be an assessment based upon actual liability.[205] The majority opinion, on the other hand, weakened this concept.[206] The dissent asserted that there must be a taxable event in connection with unreported tips to allow the IRS to make an assessment.[207] However, before the government can make an assessment, notice and demand must first be established according to section 6201.[208] The IRS acknowledged that rather than relying upon section 6201, it uses a "pre-assessment" estimate.[209] Following this initial estimate, the IRS "issues notice and (liability having now attached) uses the same estimate for the official assessment under § 6201."[210]

Although this method of making an assessment is not commonplace, the employer-taxpayer does not benefit by neglecting payment of FICA taxes on reported tips using the aggregate assessment practice.[211] However, the dissent noted two very important differences. First, while the employer who fails to report tips faces liability, the employee's report serves as an important safeguard.[212] As a result, the employer must accurately report the tips received.[213] While the employee may be

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204. *Id.* at 2130-31 (Souter, J., dissenting) (citations omitted).

205. *Id.* at 2131 (Souter, J., dissenting).

206. *Id.* at 2131 n.7 (Souter, J., dissenting).

207. *Id.* at 2131 (Souter, J., dissenting) (stating that a taxable event satisfies the notice and demand required by § 3121(q)).

208. *Id.*

209. *Id.* (noting that statutory authorization does not exist for the "pre-assessment" estimate).

210. *Id.*

211. *See id.*

212. *Id.*

213. *Id.* (stating that the employee faces more taxation if he reports more tips than actually received).

disinclined to procure a false report for the fear of paying more taxes, the dissent noted:

> [T]his safeguard is entirely lost to the employer, through no fault of his own, if the Government can make aggregate assessments. The innocent employer has few records and no protection derived from the employee's interest. Yet without any such protection he is, on the Government's theory, immediately liable for the consequences of notice and demand at the very instant liability arises.[214]

The second notable difference dealt with the authorization in estimating liability.[215] Typically, configuring the assessment, which follows the event creating the liability, gives rise to the assessment.[216] The dissent continued:

> But in the case of the tips unreported by the employee, there would be no liability until notice and demand is made under § 3121(q), and it is consequently at this point that the estimate is required. The upshot is that the estimate has to occur before the statute claimed to authorize it, § 6201, is even applicable. That is, the IRS says it can estimate because it can assess, and it can assess because it can previously estimate. Reasoning this circular may warrant suspicion.[217]

In addition, one of the technical points developed by the dissent was the interaction of the section 45B employer FICA tax credit and the employer-only FICA tax assessment.[218] The section 45B credit is an income tax credit for certain employers in the amount of FICA taxes paid on tips in excess of the minimum wage.[219] The dissent questioned the logic in the Service's insistence on conducting employer FICA tax audits, absent employee FICA tax audits, when the ultimate amount paid will be refunded.[220] The dissent responded:

> In fact, the only real advantage to the IRS seems to be that the threat of audit, litigation, and immediate liability may well force employers to assume the job of monitoring their employees' tips to ensure accurate reporting. But if that explanation for the Government's practice makes sense of it, it also flips the Government from the frying pan into the fire. Congress has

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214. *Id.*
215. *Id.*
216. *Id.*
217. *See id.*
218. *See id.* at 2132 (Souter, J., dissenting).
219. *Id.*; *see also supra* note 119.
220. *Fior D'Italia*, 122 S. Ct. at 2132 (Souter, J., dissenting).

> previously stymied every attempt the IRS has made to impose such a burden on employers.[221]

Congress, through legislation, prevented the IRS from mandating that W-2 forms include tip income.[222] The IRS faced a similar objection by congressional enactment of the Small Business Job Protection Act of 1996.[223] Through the Act, Congress explained "that the credit [available under section 45B] would apply to all FICA taxes paid on tips above those used to satisfy the employer's minimum wage obligations."[224] Once again, "Congress forbade the IRS from 'threaten[ing] to audit any taxpayer in an attempt to coerce the taxpayer into participating" in the newly created Tip Reporting Alternative Commitment (TRAC) program.[225] Lastly, the dissent pointed out:

> And although the use of a threatened aggregate estimate (after an audit) to induce monitoring of employee tips may not technically run afoul of that statute, it is difficult to imagine that Congress would allow the aggregation practice as a lever on employers, when it forbade the use of an audit for the same purpose.[226]

While the dissent argued, as an alternative to the majority treatment, that section 3121(q) be viewed as requiring individual employee audits and not aggregate estimation employer audits, such an alternative would pose a cumbersome audit option to the Service.[227] Nevertheless, the dissent understood that the burden should rest on the Service and not on employers.[228]

The dissent ultimately contended that the assumptions underlying the aggregate estimation methodology are misleading.[229] In addition, the dissent found that the aggregate estimation method lacks fairness in the context of employer record-keeping, compels a strained reading of the assessment statute by allowing for notice and demand to precede assessment, and permits the Service to conduct more employer FICA tax audits with little economic gain to the fisc.[230]

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221. *Id.*
222. *Id.*
223. *Id.*
224. *Id.* (citing the Small Business Job Protection Act of 1996, Pub. L. No. 104-188 § 1112(a), 110 Stat. 1759).
225. *Id.*
226. *Id.* at 2132-33 (Souter, J., dissenting).
227. *See id.* at 2133-34 (Souter, J., dissenting).
228. *Id.* at 2134 (Souter, J., dissenting).
229. *See id.* at 2128 (Souter, J., dissenting).
230. *Id.* at 2128-34 (Souter, J., dissenting).

V. OUTCOME ASSESSMENT

The Supreme Court of the United States annunciated the *Fior D' Italia* rule, which states that the Service is authorized to base its employer-only FICA tax assessment upon an aggregate estimate of all the tips that the employer's customers paid its employees.[231] What, then, is the impact of this national rule on the thousands of businesses in the food services industry and other industries?[232] More importantly, what strategic[233] outcomes will be implemented to "soften" the rule's application?

Implications of the *Fior D' Italia* rule are dramatic. Employers with tipped employees will become surrogate enforcement officers — a so-called "tip police" – through a mandated program to monitor, educate, train, and audit their employees' tip-reporting. At first blush, it appears that the rule will impose only a substantial administrative burden. However, in addition to the administrative burdens, there are immediate financial and strategic concerns that a business with tipped employees must consider.

A. Administrative Burden

Paperwork and other administrative burdens will surely increase under the *Fior D'Italia* rule.[234] Whether employers seek to "go it alone" and devise their own compliance programs or enter into the Service's voluntary TRAC Program,[235] the economic cost of operation will rise. Moreover, even in a TRAC program, there are no guarantees of non-audit.[236]

For those employers who choose to opt out of the Service's TRAC program, there is always a bookkeeping form of self-insurance against future FICA assessments, that is, a reserve account established to

231. *See id.* at 2121.

232. There are over 200,000 restaurants and countless other businesses, such as golf courses and airports, with tipped employees. *See, e.g.*, National Restaurant Association, *Legal Update: National Restaurant Association Files Amicus Brief in the U. S. Supreme Court Tip Reporting Case, at* http://www.restaurant.org/legal/tips/fior020328.cfm (last visited Sept. 9, 2002); *see also Top Tippers Share Strategies*, *supra* note 97.

233. Strategic planning is the process of forging a cohesive set of strategies designed to deal with the environment and achieve the company's mission with a major environmental concern being the payment of employer-only FICA taxes. *See* AFSANEH NAHAVANDI & ALI R. MALEKZADEH, ORGANIZATIONAL BEHAVIOR 48 (1999) (discussing the formulation of management strategy).

234. *See* National Restaurant Association, *U.S. Supreme Court Rules Against Restaurants in Tip Reporting Case*, *supra* note 9.

235. *See* I.R.S. Notice 2000-21, 2000-I.B.C. 967.

236. *See id.* The Notice does not mention that entering into a TRAC program will keep the employer free from an audit. *See id.*

accommodate future tax assessments.[237] Unfortunately, such an account will adversely affect an employer's earnings and will have concomitant cash effects.[238]

In addition, these administrative costs are exacerbated by the nature of the food services industry and its waitstaff. Generally, there is a relatively high turnover of waitstaff employees, and the structure of the industry is comprised of relatively small restaurants unlike the major chains.[239] In a press release, the National Restaurant Association noted the following impact on the nation's 200,000 restaurants:

> "We are deeply disappointed by the Supreme Court's decision, which basically condones the IRS's unfair and unjust tactics to pit restaurateurs against their own employees, turning them into 'tip police,'" said Peter Kilgore, [the] general counsel and senior vice president of operations of the National Restaurant Association. "Seven out of [ten] restaurants are small businesses, many of which operate with slim margins. Quite frankly, this decision could mean the difference between a restaurant staying in business or closing its doors."[240]

B. Threat of Increased FICA Audits

One thing is abundantly clear from the *Fior D'Italia* rule: the Service may increase the employer-only FICA audits.[241] The possibility of additional audits cannot be disregarded because there exists no three-year limitations period, and existing TRAC programs do not shield non-TRAC years from being audited.[242] Thus, existing employers with tipped

237. *See* United States v. Fior D'Italia, Inc., 122 S. Ct. 2117, 2126 (2002) (recommending the use of a reserve account in case of future tax liability); *see also supra* note 11.

238. *See supra* note 11.

239. *See* WESTIN, *supra* note 11 (discussing the historical trends in turnover and composition in the restaurant industry). *See generally* Shirley Leung, *Local Restaurants Find Big Chains Eating Their Lunch*, WALL ST. J., July 9, 2002, at A1; National Restaurant Association, *Industry Research*, *at* http://www.restaurant.org/research (last visited Sept. 9, 2002).

240. National Restaurant Association, *U.S. Supreme Court Decision Could Have Grave Ramifications for Nation's Restaurants*, *supra* note 10.

241. It appears to be the dissent's belief that this may be the predominant motivation of the Service in arguing this case. *See Fior D'Italia*, 122 S. Ct. at 2132-33 (Souter, J., dissenting).

242. There is no statute of limitations on an employer's FICA tax liability for unreported tips because § 3121(q) does not run until after liability attaches, and no time limits are imposed upon the issuance of the notice that triggers liability. *See* Rev. Rul. 95-7, 1995-4 I.R.B. 44 (Q&A 11). There is a limitation, however, for assessments against employees under § 6501. Furthermore, non-TRAC years are subject to audit on the same

employees could be audited as far back as 1988 when their FICA liability arose.[243] This added threat, if materialized, will most certainly raise the economic cost of doing business. Thus, either a TRAC program for future years or a bookkeeping reserve account is needed. These measures are especially important because there is every indication that the Service *prefers* collecting more taxes through employers that are owed by their employees, especially with the strain on the Services audit resources.[244]

C. Employers' Tax Strategy

In light of the *Fior D'Italia* rule, employers must consider a proactive versus a reactive tax strategy. Such a strategy involves several key elements: restructuring existing employee tipping; TRAC and EmTRAC agreements; accrual-based reserve accounts; and creative solutions.

1. Restructuring Employee Tipping

Many restaurants set an automatic gratuity charge per table or per group of customers.[245] In such a case, it is the employer, and not the customer, who sets the gratuity; therefore, the set gratuity is considered income to the employer and not tip income to the employee.[246] The employer then distributes the fixed gratuity to the waitstaff; such amounts are treated as wages, not tip income, thereby negating the need

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basis for employers. *See* National Restaurant Association, *IRS Tip Agreements*, *at* http://www.restaurant.org/legal/tips/agreements.cfm (last modified Feb. 2002).

243. In 1987, Congress established an employer duty to pay FICA taxes on all tips that fall within the definition of wages. *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9006, 101 Stat. 1330-288, 289 (1987). Thus, the IRS can assess FICA taxes on employee unreported tips as far back as 1988. *See* National Restaurant Association, *U.S. Supreme Court Rules Against Restaurants in Tip Reporting Case*, *sūpra* note 9.

244. Former IRS Commissioner, Don Alexander, stated that "the IRS is going wholesale more than retail these days." John D. McKinnon, *Justices Hand IRS a Victory on Unreported Tips*, WALL ST. J., June 18, 2002, at D8.

245. The National Restaurant Association's panel of experts responded to various restauranteur inquiries and concerns that automatic gratuity charges for customers is establishment, not employee, income, thereby negating the tip income issue. *See* National Restaurant Association, *Tips on Tip Reporting*, *supra* note 50.

246. Tips must be gratuities or gifts from the customer to the employee. Absent this, the payments are not gifts and, thus, not tips. *See, e.g.*, Comm'r v. Duberstein, 363 U.S. 278 (1960) (holding that if a customer pays an employee out of a moral or legal duty, the payment is not a gift and, therefore, not a tip); Olk v. United States, 536 F.2d 876, 877-78 (9th Cir. 1976)(same); Schroeder v. Comm'r, 40 T.C. 30, 33 (1963) (stating that tips constitute services rendered).

for employee tip reporting.[247] Those employers that have this flexibility will be inclined to restructure the tipping process to avoid the *Fior D'Italia* rule.

2. TRAC and EmTRAC Agreements

While only a scant 12.5%[248] of all restaurants have entered into either TRAC or EmTRAC agreements,[249] the number is expected to increase as the *Fior D'Italia* rule becomes more clearly known in the industry.[250] The TRAC Program is an agreement between the food service provider, the employee, and the Service regarding education and tip-reporting procedures.[251] In 2000, the Service promulgated an adjunct to the TRAC Program, known as EmTRAC, whereby specific procedures were established for food service providers to qualify their TRAC program and obtain Service approval.[252]

EmTRAC agreements are "available only to employers in the food and beverage industry that have employees who receive both cash and charged tips."[253] Employers who have more than one location, like large multi-state establishments, may select which sites to include in the program.[254] Violation of the specific compliance mechanisms in the EmTRAC program invalidates the agreement.[255]

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247. *See* National Restaurant Association, *Tips on Tip Reporting*, *at* http://www.restaurant.org/tabletalk/chat-refresh.cfm?chatID=43 (last visited Sept. 3, 2002).

248. *See* McKinnon, *supra* note 244 (stating that approximately 25,000 of 200,000 restaurants have entered into TRAC or EmTRAC agreements).

249. *See* I.R.S. Notice 2000-21, 2000-1 C.B. 967.

250. The National Restaurant Association Board of Directors passed a resolution urging members and *all* restaurateurs to execute a TRAC program with the Service for over two years *prior* to the *Fior D'Italia* decision. *See* National Restaurant Association, *U.S. Supreme Court Rules Against Restaurants in Tip Reporting Case*, *supra* note 9.

251. *See* I.R.S. Notice 2000-21, 2000-1 C.B. 967.

252. *Id.*

253. *See id.*

254. *Id.*

255. *See id.* As part of the EmTRAC Program, the employer must agree:

1. to comply with the requirements for filing all required federal tax returns and paying and depositing all federal taxes;
2. to maintain the following records for at least [four] years after the April 15 following the calendar year to which the records relate:
   a. gross receipts subject to tipping, and
   b. charge receipts showing charged tips; and
3. upon the request of the Service, to make the following quarterly totals available, by establishment, for statistical samplings of its establishments:
   a. gross receipts subject to tipping,
   b. charge receipts showing charged tips,

The beauty of this compliance program is that the Service assures the employer that: 1) it will not initiate any tip audit examinations; 2) it will not base any section 3121(q) notice and demand issued to the employer included in EmTRAC relating to any period during which the EmTRAC program is in effect; and 3) it will not evaluate the employer for compliance in the program for the first two quarters for which the program is effective.[256]

Thus, a definite outcome assessment of the *Fior D'Italia* rule is for the Service to collect more FICA tax from tipped employees, via their employers, who will be compelled to enter into EmTRAC programs in return for immunity from FICA tax assessments by the Service.

3. *Accrual Based Reserve Accounts*

As discussed earlier in this Article, employers that can afford the reduced income will establish reserve accounts to insure against future FICA tax assessments from earlier years.[257] Employers who operate on a cash basis or who cannot afford the book income reduction will be precluded from this alternative. Despite the Court's suggestion, few restaurants can afford such a reserve or have an interest in establishing one.[258]

Moreover, a reserve may not be needed. Consider the fact that Congress grants employers a section 45B FICA tax credit against their income tax and that the increased FICA tax assessment may be a proverbial "wash" when the section 45B tax credit is considered.[259]

4. *Creative Solutions*

In the future, the only real solution to the *Fior D'Italia* rule for employers is for Congress to act. It is clear from a review of legislative history that Congress understands the plight of the employer with tipped employees.[260] Existing trade organizations are lobbying Congress[261] to

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c. total charged tips, and
d. total tips reported.

Id.

256. *Id.*

257. *See, e.g., supra* note 11.

258. United States v. Fior D'Italia, 122 S. Ct. 2117, 2126 (2002).

259. *Id.* at 2132 (Souter, J., dissenting).

260. *See, e.g., id.* at 2132-34 (Souter, J., dissenting).

261. *See* National Restaurant Association, *U.S. Supreme Court Rules Against Restaurants in Tip Reporting Case, supra* note 9.

repeal the *Fior D'Italia* rule, much as the famous *Commissioner v. Soliman*[262] rule was repealed by subsequent legislation.[263]

Until the appropriate legislation is passed, other creative solutions will abound. Current examples of creative solutions include the reclassification of employees as independent contractors,[264] leasing of employees from an employee leasing unit,[265] and a myriad of other solutions, including incorporating the employer off-shore.[266]

The outcome assessment of the *Fior D'Italia* rule is to convert existing employers into a kind of "tip police," raising their administrative costs of doing business while pressuring them into EmTRAC agreements as a defensive measure. Of course, there is also an intangible cost: the further loss of esprit d'corps between employers and tipped employees because of more intrusive and antagonistic tip monitoring.

VI. CONCLUSION

The approval of the aggregate estimation method by the Supreme Court in *Fior D'Italia* created a rule that will substantially alter the manner in which certain employers conduct their business. No longer the passive tax information collectors, employers have become the new "tip police" of the future.

But does it make sense? The Supreme Court says to overlook the technical difficulties with the aggregate estimation methodology;[267] to

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262. 506 U.S. 168, 174-75 (1993) (formulating "two primary considerations in deciding whether a home office is a taxpayer's principal place of business: the relative importance of the activities performed at each business location and the time spent at each place").

263. *See* I.R.C. § 280A(c)(1)(2000) (redefining principal place of business as the "place of business which is used by the taxpayer for the administrative or management activities . . . if there is no other fixed location of such trade or business").

264. This area has long been fecund ground for Service attack, which has been largely successful. *See, e.g.*, *New IRS Document Explains Section 530 Relief Requirements*, I.R.S. News Release 96-44 (Oct. 30, 1996), *available at* 1996 WL 628643 (I.R.S.).

265. This arrangement allows an employer to pay a fixed "rental" to an independent company that is in charge of the human resource function, similar to a temporary employment agency. The difficulty with this arrangement, however, is the high turnover in the food services industry. *See, e.g.*, National Restaurant Association, *Industry Research*, *supra* note 239 (citing recent data and trends in the restaurant industry).

266. Many corporations (*e.g.*, pharmaceuticals, intangible property companies, hotels) have used off-shore entities to gain a tax-leveraged advantage, but not for avoiding a tax reporting responsibility. To understand how these special purpose entities work, see Glenn R. Simpson, *Island Tax Haven May Aid Pritzkers*, WALL ST. J., May 13, 2002, at A3 and REUVEN S. AVI-YONAH, U. S. INTERNATIONAL TAXATION 394-96 (Foundation Press 2002).

267. *See* United States v. Fior D'Italia, 122 S. Ct. 2117, 2128-29 (2002) (Souter, J., dissenting).

accept the fact that wage bands are ignored in the aggregate estimation;[268] to vacate the statutory order of liability, assessment, and notice and demand;[269] to concede that employers have no records in which an assessment may be challenged;[270] and to assume that, despite no real revenue to the fisc from such assessments given the section 45B credit, the Service will not pursue employer audits from 1988 to the present.[271]

On the other hand, just how does the Service obtain compliance with the tip-reporting standard when employees choose to underreport? On balance, is not the employer the linchpin in the process? And, if so, then how far afield is the Court's interpretation?

Tip police or responsible business owners? Consider the Court's support for the latter:

> And we do not accept Fior D'Italia's claim that restaurants are unable to do so -- that they "simply do not have the information to dispute" the IRS assessment. Why does a restaurant owner not know, or why is that owner unable to find out: how many busboys or other personnel work for only a day or two-thereby likely earning less than $20 in tips; how many employees were likely to have earned more than $55,000 or so in 1992; how much less cash-paying customers tip; how often they "stiff" waiters or ask for a cash refund; and whether the restaurant owner deducts a credit card charge of, say 3%, from employee tips? After all, the restaurant need not prove these matters with precision. It need only demonstrate that use of the aggregate method in the particular case has likely produced an inaccurate result. And in doing so, it may well be able to convince a judge to insist upon a more accurate formula.[272]

Perhaps it is time for employers to accept responsibility and not point to the chronic underreporting of tips by their employees. Business responsibility in all its forms – corporate governance, financial reporting, and tax strategies – needs to be made a priority.[273] Maybe it *is* time for the tip police.

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268. *See id.* at 2129 (Souter, J., dissenting).

269. *See id.* at 2131 (Souter, J., dissenting).

270. *See id.*

271. *See id.* at 2132 (Souter, J., dissenting).

272. *Id.* at 2125 (citation omitted).

273. To comprehend this failure of business responsibility, one need only consider a few of the following selected examples of corporate accountability observed by David Wessel:

Company	Issue
Adelphia	Whether it failed to properly disclose $3.1 billion in loans and guarantees to its founder's family.
Computer Associates	Whether it artificially inflated revenue and improperly rewarded top executives.
Enron	Admitted it improperly inflated earnings and hid debt through business partnerships.
Global Crossing	Whether it sold its telecom capacity in a way that artificially boosted its 2001 cash revenue.
ImClone Systems	Former CEO Samuel Waksal charged with insider trading.
Lucent Technologies	Adjusted fiscal 2000 revenues by $679 million, spurring SEC investigation. Agency also investigating whether vendor-financing played an improper role in its sales.
MicroStrategy	Settled without admitting wrongdoing an SEC suit accusing it of backdating sales contracts to meet quarterly financial estimates, among other improper revenue recognition practices.
Network Associates	Whether it hid expenses and overstated revenue from 1998 to 2000.
Qwest Communications	Whether it inflated revenue for 2000 and 2001 through capacity swaps and equipment sales.
Tyco International	Whether it improperly created 'cookie jar' reserves that were supposed to cover merger costs but instead were drawn on to boost profits.
WorldCom	Whether it used questionable methods to book sales, classify assets and account for debts it couldn't collect.

David Wessel, *What's Wrong?,* WALL ST. J., June 20, 2002, at A1.