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INTEREST OF THE *AMICUS CURIAE* [1]

Patricia R. Guancial is a private citizen. She was previously employed as a waitress and directly experienced the effects of the IRS's aggregate method of estimating unreported tip income, since her employer used this method to allocate tips to her which she did not earn. Her concern for the welfare of similarly situated employees has led to the filing of this brief. Ms. Guancial has not previously appeared before this court as *amicus curiae*.

SUMMARY OF ARGUMENT

The Court's decision in this case will affect both employers and employees in tip-receiving businesses. The use of aggregate estimates to assess the employer's FICA tax on unreported tip income creates a burden that ultimately and inappropriately may fall on the employees who will bear the costs of the tax. The decision of the Ninth Circuit should be affirmed. The IRS does not have the authority to use aggregate estimates in FICA assessments.

It is inappropriate for the IRS to refuse to credit the FICA accounts of employees under 42 U.S.C. § 405(c) for FICA taxes paid by an employer as the result of an

[1] Pursuant to U.S. Supreme Court Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for a party, and no person or entity, other than *amicus* and her counsel, made a monetary contribution to the preparation or submission of this brief. The parties' written consents to the filing of this brief have been filed with the Clerk of the Court.

aggregate estimate of unreported tip income. The purpose of the Social Security system would be undermined by permitting the IRS to impose FICA taxes without crediting the accounts of tip-receiving employees. Aggregate estimates of unreported tip income may significantly overestimate the amount of tip income received and impose a burden not only upon the employer, but ultimately on the employees.

Judge McKeown, dissenting from the Ninth Circuit opinion, contended that the accuracy of aggregate estimates is an entirely separate issue from authority to make these estimates. *Fior D'Italia v. United States*, 242 F.3d 844, 858-59 (2001) (McKeown, J., dissenting), *cert. granted* 122 S. Ct. 865 (2002). The issue of accuracy is necessarily tied to the authority to make these estimates. If the estimates are inaccurate, no one will claim a portion of the FICA taxes paid by the employer, because the accurate earnings records of the employees will not reflect these amounts.

If FICA taxes are imposed without credit to any employee's account, the FICA tax will become a general revenue raising tool, rather than the system of employee benefits as it was designed.

The petitioner contends that allocation of the FICA taxes paid by the employer would be administratively impractical. This is in direct opposition to the fact that the IRS conducts employee level audits of unreported tip income and uses estimates in increasing tip income to employees. The IRS should either use this employee level estimate to apportion FICA credits, or abandon the method in the employee income assessment context if it is truly imprecise.

ARGUMENT

I. AGGREGATE ESTIMATES OF EMPLOYER FICA LIABILITY DENY FICA CREDITS TO EMPLOYEES AND IMPERMISSIBLY TRANSFORM SOCIAL SECURITY INTO A GENERAL REVENUE RAISING DEVICE

The Social Security system in the U.S. is based upon the premise of a form of "social insurance" for the benefit of employees receiving wages qualified under the system. *See Fior D'Italia v. United States*, 21 F. Supp. 2d 1097, 1102 (N.D. Cal. 1998), *aff'd* 242 F.3d 844, *cert. granted* 122 S. Ct. 865 (2002). *See also Flemming v. Nestor*, 363 U.S. 603, 609 (1960). The FICA taxes that support Social Security are not intended to be a "general revenue gathering tool for the government". *See Quietwater Entertainment, Inc. v. United States*, 80 F. Supp. 2d 1323, 1329 (N.D. Fla. 1999); *Bubble Room, Inc. v. United States*, 36 Fed. Cl. 659, 674 (1996), *vacated and remanded by* 159 F.3d 553 (Fed. Cir. 1998). *Accord Mathews v. de Castro*, 429 U.S. 181, 185-86 (1976); *Reynolds v. Northern Pacific Railway Co*., 168 F.2d 934, 939 (8th Cir. 1948), *modified sub nom. Reynolds v. Chicago, St. P., M. & O. Railway Co.*, 168 F.2d 944 (8th Cir. 1948), *cert. den. sub nom. Railway Employees' Department of the American Federation of Labor v. Northern Pacific Railway Co.*, 355 U.S. 828 (1948). Contributions to the Social Security system are intended to result in a future benefit to the employee, when the employee is unable to work. *Quietwater*, 80 F. Supp. 2d at 1329, citing *Weinberger v. Wisenfeld*, 420 U.S. 636, 647 (1975). *Cf. Social Security Board v. Neirotko*, 327 U.S. 358, 362 (1946), *United States v. Fogarty*, 164 F.2d 26, 29 (8th Cir. 1947).

The petitioner claims that the payment of FICA taxes is dependent only upon the earnings records of the employee and not the payment by the employer. This is based upon a flawed interpretation of *Flemming v. Nestor*, 363 U.S. 603 (1960). *Flemming* addressed the issue of whether payments into the Social Security system represented an accrued property right. *Id.* at 608. The present case concerns taxes imposed without respect to an individual employee's earnings record, an issue not addressed by *Flemming*.

It is the administrative policy of the IRS to allow aggregate assessments of employee tip income for the purpose of determining the employer's FICA liability. *See 330 W. Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 992 (7th Cir. 2000); *Bubble Room, Inc. v. United States*, 159 F.3d 553 (Fed. Cir. 1998); *Morrison Restaurants Inc. v. United States*, 118 F.3d 1526, 1529 (11th Cir. 1997); *LIR Management Corp. v. United States*, 86 F. Supp. 2d 340, 341 (S.D. N.Y. 2000); *Quietwater*, 80 F. Supp. 2d at 1328; *Fior D'Italia*, 21 F. Supp. 2d at 1102. The purported authority for these assessments has been 26 U.S.C. §§ 446(b), 3121(q) or 6201. *See, e.g.*, *Bubble Room*, 159 F.3d at 565-66. The aggregate method of assessing employer liability does not appear explicitly within these statutes and arises only from administrative procedures. *See e.g.*, *LIR*

Management Corp., 86 F. Supp. 2d at 345; *Quietwater*, 80 F. Supp. 2d at 1328.

These administrative procedures have been inconsistently applied and have led to assessments that have been struck down as excessive in a number of contexts. For example, the differences between charge tips and cash tips, tip-outs, and the "wages band" have all resulted in aggregate estimates of unreported tip income which were reduced by the courts. *See Fior D'Italia*, 242 F.3d at 846-47; *Quietwater*, 80 F. Supp. 2d at 1330; *Bubble Room*, 36 Fed. Cl. at 663. *Accord Yukimura v. Commissioner*, 43 T.C.M. (CCH) 467, 470 (1982).

Judge McKeown contended that accuracy of the assessments and authority to make aggregate assessments should not be confused. *Fior D'Italia*, 242 F.3d at 858-59 (McKeown, J., dissenting). *See also Bubble Room*, 159 F.3d at 568. In fact, the two issues are inextricably linked. If the assessment is an accurate determination of the income of all employees, the aggregate reporting of the employees should match this amount. It is likely, and shown in practice to be the case, that an aggregate estimate at the employer level overestimates the amount of tip income received. *See Fior D'Italia*, 242 F.3d at 846-47; *Bubble Room*, 36 Fed. Cl. at 676.

If the aggregate estimate of the employees' tip income is inaccurate, the FICA taxes imposed will not correspond to the actual amounts of income received, or required to be reported by the employees. The employees will report and pay their share of FICA taxes only on the amounts actually received. The employees will be entitled to benefits only on the amounts that they report. Since the practice of the IRS in reported cases has been to assess solely against the employer without an allocation among the employees of FICA credits, there is no matching of the FICA taxes paid with the credits that should correspond to payment. *See Fior D'Italia*, 242 F.3d at 846; *330 W. Hubbard Restaurant Corp.*, 203 F.3d at 996; *Bubble Room*, 159 F.3d at 571; *Morrison Restaurants Inc.*, 118 F.3d at 1528; *Quietwater*, 80 F. Supp. 2d at 1326; *LIR Management Corp.*, 86 F. Supp. 2d at 343.

If the employees report a lower amount of earnings than is assessed against the employer, the excess FICA taxes paid by the employer will be paid into the undesignated coffers of the government. Since the Social Security Act was not designed to be a "general revenue raising" device, this action is contrary to the intent of the statute. *See Quietwater*, 80 F. Supp. 2d at 1329; *Bubble Room*, 36 Fed. Cl. at 674. *Accord Mathews v. de Castro*, 429 U.S. at 185-86; *Reynolds v. Northern Pacific Railway Co.*, 168 F.2d at 939.

The costs of excess FICA taxes without credit to employee FICA accounts are costs which will inevitably be passed on to others. Employees without credit to their FICA accounts must make other arrangements for retirement and disability income. Also, the immediate expense of the taxes must be passed on through the business.[2] These expenses may be passed on by purchasing lower-quality goods for resale, foregoing improvements to the premises, lowering employees' salaries, or reducing the number of employees.

The imposition of FICA taxes in such a way that may result in the loss of employees' jobs is clearly contrary to the purpose of the Social Security system. Permitting the IRS to use an aggregate method in this context will only allow the IRS to expand various audit methods in the future and force more taxpayers into the extraordinarily difficult position of disproving the adjustments proposed by the IRS. *See e.g., Fior D'Italia*, 242 F.3d at 848.

The IRS is not authorized to transform the purpose of the Social Security system into a general revenue gathering tool. In practice, this is what has occurred in the context of tip-receiving businesses. *See Fior D'Italia*, 21 F. Supp. 2d at 1102; *Quietwater,* 80 F. Supp. 2d at 1329-30; *Bubble Room*, 36 Fed. Cl. at 674. As the District Court stated: "a tax on employers based on aggregate assessment without individual employee credit, operates as a general revenue tax for the government beyond the purpose of the FICA taxes." *Fior D'Italia*, 21 F. Supp. 2d at 1102. The obligation of the IRS in administering FICA tax assessments is thus not for the generation of revenue, but rather must be consistent with the aims of a delayed benefits plan for the employees covered.

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[2] The total cost to employers of FICA taxes on estimated tip income may be greater than a normally imposed FICA tax, due to the disallowance of the 26 U.S.C. § 54B credit against income taxes. *See Fior D'Italia*, 21 F. Supp. 2d at 1102-03.

The IRS has contended and successfully argued that the failure of employees to report their tips amounts to a waiver of Social Security benefits. *See 330 W. Hubbard*, 203 F.3d at 996; *Bubble Room*, 159 F.3d at 565; *Morrison*, 118 F.3d at 1530; *LIR Management Corp.*, 86 F. Supp. 2d at 346-47. Not only does the Social Security Act not provide for the waiver of benefits, but the result is inappropriate. Since the aggregate estimate may overestimate employees tip income, the employees may not have records which would apportion the entire amount of FICA taxes imposed against the employer.[3]

Collection of FICA taxes without credit to an individual account is not supported by the legislative history of the Social Security Act. *See Morrison Restaurants Inc. v. United States*, 918 F. Supp. 1506, 1514 (N.D. Ala. 1996), *rev'd* 118 F.3d 1526 (11th Cir. 1997); *Quietwater*, 80 F. Supp. 2d at 1329-30; *Fior D'Italia*, 21 F. Supp. 2d at 1102; *Bubble Room*, 36 Fed. Cl. at 674.

In the present case, the petitioner relies upon 26 U.S.C. § 3121(q). The Report of the Senate Committee on Finance on the 1987 amendments to 26 U.S.C. § 3121(q) stated: ". . . employers should be subject to tax on all tips which are *credited for benefits purposes*." S. Print. No. 63, 100th Cong., at 203, 133 Cong. Rec.

[3] Additionally, it has been suggested that even if the aggregate estimate was correct, current IRS reporting methods for amended tip income statements will not be credited to employees FICA accounts. Brief of Amici Curiae Fior D'Italia, *et al*. on petition for rehearing *en banc* at 1, *Bubble Room, Inc. v. United States*, 159 F.3d 553 (1998).

S34,826 (1987). To allow the collection of FICA taxes without credits to employees' accounts is precisely what the IRS terms a "whipsaw". The IRS is attempting to levy taxes which should be earmarked for redistribution to the employees, without obtaining the necessary information to redistribute these amounts.

II. AGGREGATE ESTIMATES OF UNREPORTED TIP INCOME AT THE EMPLOYEE LEVEL ARE REGULARLY CONDUCTED BY THE IRS AND THE IRS HAS AN ADMINISTRATIVELY VIABLE METHOD FOR ALLOCATING FICA CREDITS

The IRS contends that employee level allocations of FICA credits are not possible due to imprecision. Petitioner's Brief at 9. *See also*, *Morrison*, 918 F. Supp. at 1514. This contention is particularly surprising, given that the IRS has used estimates to determine the amount of tips received by individual employees since the 1940's. *See Roberts v. Commissioner*, 10 T.C. 581 (1948), *aff'd* 176 F.2d 221 (9th Cir. 1949).

Should the IRS choose to investigate the unreported tip income of an individual employee, the IRS is not without methods. Two procedures exist. The first possibility is that an aggregate assessment will be made of the income from the business and the tip percentage of the employee will be determined. *See e.g.*, *Brown v. Commissioner*, 72 T.C.M. (CCH) 59, (1996); *Bruno v. Commissioner*, 49 T.C.M. (CCH) 1147 (1985); *Meneguzzo v. Commissioner*, 43 T.C. 824, 832 (1965). Alternatively, an hourly tip rate will be determined and multiplied by the number of hours the employee worked.

If the hourly tip rate method is used, the tip rate will be determined by examining the tips received per hour of other employees. *See e.g., Martin v.Commissioner,* 65 T.C.M. (CCH) 2470 (1993); *Louis v. Commissioner*, 63 T.C.M. (CCH) 3098 (1992); *Cohen v. Commissioner*, 60 T.C.M. (CCH) 1509; *Way v. Commissioner*, 60 T.C.M. (CCH) 1264 (1990); *Settle v. Commissioner*, 57 T.C.M. (CCH) 227 (1989); *McGaha v. Commissioner*, 52 T.C.M. (CCH) 517 (1986); *Ward v. Commissioner*, 50 T.C.M. (CCH) 1062 (1985). The IRS has employed both of these methods to determine the individual tax liability for tipped employees. These methods may not accurately estimate the employee's income. If the income is overstated, the employee may not have the funds to pay the taxes due.

The *McQuatters* case is most often cited as the case granting the IRS the authority to make estimates of an individual employee's tip income based upon the combined income of all employees. *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122 (1973). In this case, and in a line of cases since, the IRS's assessments have been successfully challenged as unreasonably high. Although the authority of the IRS to make aggregate assessments under 26 U.S.C. § 446 was upheld in *McQuatters*, the court found that the assessment overestimated the taxpayer's income. *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122 (1973).

The most significant instances of individual tip income audits have been the result of IRS surveillance projects in Nevada and Atlantic City from 1981 through at least 1988. *See Martin*, 65 T.C.M. (CCH) 2470

(Nevada, 1988); *Louis*, 63 T.C.M. (CCH) 3098 (Nevada, 1986-87); *Krause v. Commissioner*, 63 T.C.M. (CCH) 2968 (1992) (Atlantic City, 1980, 1981, 1984, 1985, 1987, 1988, 1990); *Cohen*, 60 T.C.M. (CCH) 1509 (Atlantic City, 1984-1985); *Settle*, 57 T.C.M. (CCH) 227 (Nevada, 1982); *Ward*, 50 T.C.M. (CCH) 1062 (Nevada, 1981-1982). These programs demonstrate that the IRS has at its disposal investigative methods which have been used to allocate tip income among individual employees.

The causes have been varied, but the result is consistent: aggregate assessments ultimately fail to accurately estimate the amount of tip income received by individual employees since employee capabilities and responsibilities vary. For example, under an IRS tip reporting program, it was found that Nevada bartenders' tip rates ranged from 7.9% to 79.4% as a percentage of total sales. Letter from Mark Giarratano, IRS Group Manager to Office of Specialty Taxes (December 11, 1996) *reprinted in* 97 Tax Notes Today 6-27 (1996).

This variability may be the result of efficiency of service, social interaction, time of day, location in the business, and a number of other factors which aggregate assessments do not consider. Successful challenges have been raised for a seemingly endless list of reasons, including: hours worked, type of position, tip-outs to other employees, disabilities, or skill at the position. *See, e.g., Brown*, 72 T.C.M. (CCH) 59 (tip-outs); *Martin*, 65 T.C.M. (CCH) 2470 (tip-outs, pregnancy); *Way*, 60 T.C.M. (CCH) 1264 (coupon sales, credit card stiffing; cash versus credit payments, tip-outs); *Settle*, 57 T.C.M. (CCH) 227 (employee disability); *McGaha*, 52 T.C.M.

(CCH) 517 (different shift times, different positions compared, decreased business due to remodeling and employee desertions); *Ward*, 50 T.C.M. (CCH) 1062 (different positions, changes in popularity of the business); *Bruno*, 49 T.C.M. (CCH) 1147 (tip-outs, amount of alcohol in cocktails, lunchbreaks); *Meneguzzo*, 43 T.C. 824, 834-35 (non-tipped hours, differences in business locations).

In recent employee tip allocation cases, the IRS had made assessments based upon "95% confidence limits". *See e.g.*, *Martin*, 65 T.C.M. (CCH) 2470; *Bruno*, 49 T.C.M. (CCH) 1147. This means that the tip income of 19 out of 20 individuals assessed should be equal to or less than the actual amount of tip income received. *Id*.

Imprecision of the assessments is problematic, but since the IRS believes that these assessments are accurate enough to impose income taxes, these same assessments should be precise enough to allocate FICA credits.

The IRS may be attempting to hide behind the technical distinction between "accuracy" and "precision". While it is possible that the increased accuracy of the estimates (that most individuals are assessed at or below their tip income level) comes at the cost of precision (individuals receiving particularly high tip rates will be significantly underassessed), this method provides an estimate, which by the IRS's own methodology should establish the minimum amount received by the employees in 95% of the cases.

The decision not to credit the FICA accounts of employees whose employers are subject to aggregate assessments is therefore not the result of lack of IRS-endorsed methods. Rather, this is a conscious choice by the IRS to refuse to credit the FICA accounts of employees as a penalty, and not merely an instance of administrative impracticality.

If the IRS's previous representations as to the accuracy of the individual assessments are incorrect, the IRS should discontinue the practice of individual tip income assessments. Indeed, the number of challenges sustained by the courts to the methodology indicates that there may be serious doubt as to the validity of these methods. As long as the IRS employs a method of determining individual employee tip income amounts, it should be equally appropriate to apply that method for allocating FICA credits to the individual employees' accounts.

CONCLUSION

The IRS is imposing FICA taxes without obtaining the necessary information to allow effective administration of the Social Security system. The IRS has justified this failure, in part, by reliance upon a claim that it lacks an appropriate method for allocating employee FICA credits. This is contrary to the IRS position that it is able to accurately assess individual employee tip income for the purpose of collecting income taxes. Taxpayers deserve uniform and fair treatment by the IRS.

If the allocations of individual employee income are indeed inappropriate, the practice should be discontinued. If these allocations are appropriate, then they should be implemented in the context of distributing FICA credits to prevent the collection of FICA taxes from becoming a general revenue raising device.

The imposition of FICA taxes without respect to the earnings record of any employee is contrary to the purpose of the Social Security system and is clearly outside the legislative expectations for the Social Security system.

Accordingly, the judgment of the Ninth Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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