No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the employer's share of the Federal Insurance Contribution Act (FICA) tax on employee tip income must be determined by accumulating the result of individual audits of individual employees or may instead be based on a reasonable estimate of the aggregate amount of tips received by all employees.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-33a) is reported at 242 F.3d 844. The opinion of the district court (Pet. App. 34a-51a) is reported at 21 F.Supp.2d 1097. The order of the district court denying reconsideration (Pet. App. 52a-53a) is unreported.

JURISDICTION

The judgment of the court of appeals was filed on March 7, 2001. A petition for rehearing was denied on May 18, 2001. Pet. App. 54a. On August 3, 2001, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to September 15, 2001. The petition for a writ of certiorari was filed on September 14, 2001, and was granted on January 11, 2002. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of Sections 446, 3111, 3121, 6053, and 6201 of the Internal Revenue Code, 26 U.S.C. 446, 3111, 3121, 6053, and 6201, are set forth at Pet. App. 55a-62a.

STATEMENT

1. Respondent operates a restaurant in San Francisco, California. Some employees of the restaurant (such as waiters) receive tips directly from customers. Other employees (such as table bussers) receive tips indirectly when a waiter shares a portion of the tips received from the customer. Pet. App. 1a-2a, 4a-5a. Tips received by an employee who receives more than $20 in tips in any month are treated as "wages" for Federal Insurance Contribution Act (FICA) tax purposes. Both the employee and the employer are required to pay FICA taxes on the amount of such tips that are not in excess of the Social Security wage base. 26 U.S.C. 3111, 3121(a) and (q).[1]

Restaurant employers as well as their tipped employees are subject to certain reporting requirements with respect to tip income. Employees are required to make monthly reports to their employer of the tips they receive that constitute "wages" for FICA tax purposes, using IRS Form 4070 or a similar written substitute form. 26 U.S.C. 6053(a); 26 C.F.R. 31.6053-1(a)-(c). Restaurants with ten or more employees are required to make annual reports (Form 8027) to the Internal Revenue Service of tips reported to them by their employees. 26 U.S.C. 6053(c)(1), (4).

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[1] These limits on the amount of tips that constitute "wages" are referred to as the "wages band" for these tax calculations. Pet. App. 5a.

2. Respondent filed Forms 8027 that state that its employees reported tips of $247,181 for 1991 and $220,845 for 1992.[2] These Forms also showed, however, that the total amount of tips reported on customer credit charge slips alone was $364,786 in 1991 and $338,161 in 1992. Pet. App. 2a n.2; J.A. 38-39. Respondent nonetheless calculated its employer share of the FICA tax only on the lesser tip amounts that its employees had reported receiving. Pet. App. 35a.

Because of the discrepancy in these reported tip amounts, the Internal Revenue Service conducted a compliance check of respondent's restaurant. The credit charge slip information reported by respondent revealed an average tip rate of 14.49% for 1991 and 14.29% for 1992.[3] Pet. App. 2a-3a; J.A. 56. Multiplying these tip rates by respondent's gross receipts for those years—and then subtracting the total tips reported by respondent on Form 8027—indicated that unreported tips were approximately $156,545 for 1991 and $147,529 for 1992. Pet. App. 3a n.3; J.A. 52, 56. Applying the 7.65% FICA tax rate to these unreported tip amounts resulted in FICA tax deficiencies for respondent in the amount of $11,976 for 1991 and $11,286 for 1992. The Service sent a notice and demand for payment of these deficiencies to respondent pursuant to 26 U.S.C. 3121(q). J.A. 41-42. In calculating the amount of respondent's FICA tax deficiencies, the Service did not conduct individual audits to determine the unreported

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[2] The amounts reported for 1991 reflect $30,977 for indirectly tipped employees and $216,204 for directly tipped employees. The amounts reported for 1992 reflect $19,155 for indirectly tipped employees and $201,690 for directly tipped employees. J.A. 38-39.

[3] In 1991, 90% of taxpayer's sales were made on charge card slips. In 1992, 92% of sales were by charge. J.A. 38-39.

tips received by each individual employee. Pet. App. 6a.

3. Respondent paid a portion of the tax and filed this refund suit. J.A. 24. The government assessed the total FICA tax liability of $23,262 asserted in the notice and demand for payment and filed a counterclaim in this suit for the unpaid balance of the assessment. J.A. 31-33.

The parties filed cross-motions for summary judgment. Respondent did not dispute the reasonableness or accuracy of the Service's calculation of the amount of unreported tips. See Pet. App. 32a-33a, 36a; J.A. 35. Instead, respondent asserted that the Service lacks authority to assess taxes on employers by using an aggregate estimate of tip income. Respondent claimed that the Service must instead base any assessment of FICA taxes on employers on individual audits of individual employees.

The district court agreed with respondent. The court concluded that the Service is not permitted to make an assessment of employer FICA taxes on unreported tips until it first determines through individual audits the amount of unreported tips received by each individual employee. Pet. App. 34a-51a. Having concluded that the assessment was invalid, the court granted judgment to respondent on its refund claim and against the United States on its counterclaim for the balance of the taxes due. *Id.* at 51a. The parties then stipulated, without prejudice to their right to appeal, to the amount of the refund, and the court entered a judgment for that amount. J.A. 95-96.

4. a. The court of appeals affirmed in a 2-1 decision. Pet. App. 1a-33a. The majority concluded that the assessment was invalid because "[i]t rests on an estimate in circumstances where Congress has not authorized

the IRS to use estimation as an assessment method." *Id.* at 10a. While acknowledging that 26 U.S.C. 446 "has been interpreted as giving the IRS authority to make an assessment based on an estimate," the majority concluded that "the IRS cannot rely on section 446 as authority for the assessment here because the section does not apply to the collection of FICA taxes." Pet. App. 6a, 10a.

The majority also stated that the Service's method of estimation has "some serious flaws." Pet. App. 8a. The majority stated that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" (*ibid.*) because it is based on tips paid by customers using credit cards and "experience shows that charged tips generally exceed cash tips." *Id.* at 4a. The court also emphasized that "the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to employees by the restaurant" and does not "make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." *Id.* at 8a-9a. See note 1, *supra.*

The majority concluded that the Service may not employ an aggregate method for estimating the employer's FICA tax directly and must instead first "audit[] the employees' records or otherwise determin[e] the amount each employee earned in tips." Pet. App. 13a. The majority held that there is "no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned." *Ibid.*

b. Judge McKeown disagreed with the reasoning and conclusion of the majority. Pet. App. 18a-33a. She explained that, even if "the statutes do not directly address whether the IRS has the authority to make

aggregate assessments with respect to unreported tips, * * * they are certainly broad enough to permit the IRS to do so." *Id.* at 25a. She noted, moreover, that the decision in this case squarely conflicts with the decisions of several other circuits that have upheld the authority of the Internal Revenue Service to make assessments of employer FICA taxes based on aggregate calculations of unreported tip income. *Id.* at 19a-23a (citing *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d 990 (7th Cir. 2000); *Bubble Room, Inc.* v. *United States*, 159 F.3d 553 (Fed. Cir. 1998); *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d 1526 (11th Cir. 1997)). Judge McKeown emphasized that "[e]very circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority." Pet. App. 22a. She concluded that these other circuits correctly rejected respondent's assertion that individual audits of individual employees must be conducted before FICA taxes may be assessed against the employer. *Id.* at 23a-30a.

c. The petition for rehearing en banc filed by the United States was denied by the court of appeals. Pet. App. 54a.

SUMMARY OF ARGUMENT

I. An "assessment" is the government's administrative determination of the amount of taxes due. 26 U.S.C. 6203. Unless the taxpayer establishes that the assessment is arbitrary and "without *any* foundation" (*United States* v. *Janis*, 428 U.S. 433, 441 (1976)), the assessment is entitled to a rebuttable "presumption of correctness" in tax litigation. This presumption of correctness places both the burden of going forward

and the burden of persuasion on the taxpayer in tax litigation.

Indeed, in a refund case, the taxpayer has a dual burden of proof: he must first prove that the assessment is erroneous and must then establish the correct amount of tax owed. It is not enough in a refund suit for the taxpayer to prove only that the government's assessment is procedurally or substantively defective. *United States* v. *Janis*, 428 U.S. at 440. If the assessment is invalid, the court may give it no weight but the taxpayer nonetheless retains the burden of establishing "the correct amount of his tax liability." *Ibid.*

By contrast, in a collection case brought to enforce an unpaid tax assessment, the government bears the initial burden of going forward, which it fulfills by establishing the fact and the amount of the unpaid assessment. Only if the assessment is shown to be "naked and without *any* foundation" will the government bear the burden of proof in a collection suit. *United States* v. *Janis*, 428 U.S. at 442.

Beyond this limited evidentiary function, the validity or invalidity of the assessment is not determinative of the ultimate liability of the taxpayer. Regardless of the allocation of the burden of proof, either party may offer competent evidence to establish the amount of taxes owed.

II. A. Respondent has not disputed the reasonableness or the factual basis of the government's assessment in this case. Instead, respondent claims only that the government may not lawfully make an assessment of the employer's share of FICA taxes owed on employee tip income by estimating the aggregate amount of tips received by all employees. Respondent claims, and the court of appeals agreed, that the government must instead make that assessment by

adding up individual determinations of employee tips for each employee, one at a time. In adopting that contention, the court of appeals did not point to any language in the Internal Revenue Code as support for its conclusion, and there is none.

The employer component of the FICA tax is a separate and distinct obligation from the employee component of that tax. These two separate exactions are imposed, determined and assessed under separate provisions of the Code. There is no requirement in these provisions that the employer tax be based upon, or be determined by, the amount of taxes owed or paid by employees. To the contrary, the governing statutory provisions make clear that the employer is required to pay taxes on the full amount of tips received by employees even when its employees fail to report, or pay taxes on, that amount.

B. Moreover, it is well established that the government may make tax assessments based upon aggregate estimates of relevant items of income. Section 6201 of the Code authorizes and directs the Internal Revenue Service to make "inquiries, determinations, and assessments of all taxes * * * imposed by this title." 26 U.S.C. 6201. The use of aggregate estimation methods in making such assessments has routinely been upheld as a reasonable method of determining a disputed factual issue. Since respondent has not disputed the reasonableness or factual basis for the assessment challenged in this case, it should have been upheld.

The majority's conclusion that an estimate of the employer's FICA tax liability is impermissible, and that what is required is an "employee-by-employee determination of the taxable tips each has earned" (Pet. App. 14a), departs from the established rule that estimation of controverted items of income is permissible. More-

over, the rule adopted by the court of appeals suffers from an obvious internal contradiction. If the IRS were to audit each employee to determine the unreported amount of tips each employee earned, those individual determinations would themselves necessarily be based on estimates. Cash tips that are not reported on the credit charge slips retained by the employer cannot be traced and determined by the government with precision. A method of estimation based on the average tip rate and the gross sales of the restaurant is far more likely to achieve factual accuracy than the individual audits suggested by the court of appeals.

C. The court of appeals erred in concluding that the aggregate estimate of tips made by the IRS in this case has "some serious flaws" (Pet. App. 8a). As other courts have emphasized, "whether there are flaws in the indirect formula used to estimate the FICA tax is a separate matter from whether the IRS has the authority to assess an employer-only FICA tax based on an aggregate estimate of unreported tip income." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 568. Even if there were proof that the *amount* of an assessment was incorrect, that would not make the assessment invalid. An "assessment is intended to be an estimate. It is expected to be rational, not flawless." *Dodge* v. *Commissioner*, 981 F.2d 350, 353 (8th Cir. 1992), cert. denied, 510 U.S. 812 (1993). When the reasonableness or amount of the assessment is challenged, "the proper course is not to void the assessment * * * but to determine what, if anything, the taxpayer owes the government." *United States* v. *Schroeder*, 900 F.2d 1144, 1148 (7th Cir. 1990).

In the present case, however, the taxpayer elected not to challenge the reasonableness or the factual basis of the assessment. There is thus no evidence in the

record of this case to support any claim that factual defects exist in the assessment. As Judge McKeown correctly stated in dissent, "the issue of accuracy is not before us, because [respondent] did not challenge the accuracy of the calculation * * * ." Pet. App. 33a.

ARGUMENT

I. A TAX ASSESSMENT HAS EVIDENTIARY IMPORTANCE, AND IS ENTITLED TO A "PRESUMPTION OF CORRECTNESS," UNLESS IT IS ARBITRARY OR LACKS A MINIMAL FACTUAL FOUNDATION

An "assessment" is the government's administrative determination of the amount of taxes due. 26 U.S.C. 6203. Unless the taxpayer establishes that the assessment is arbitrary and lacks even "a minimal factual foundation," the assessment is entitled to a rebuttable "presumption of correctness" in tax litigation. *Palmer* v. *IRS*, 116 F.3d 1309, 1312 (9th Cir. 1977). See *United States* v. *Janis*, 428 U.S. 433, 440 (1976); *United States* v. *Lease*, 346 F.2d 696, 700 (2d Cir. 1965). This presumption is based in part "on the probability of its correctness" and in part "upon considerations of public policy." *Psaty* v. *United States*, 442 F.2d 1154, 1160 (3d Cir. 1971) (footnotes and citations omitted):

> [A]s to the accuracy of the amount assessed, the presumption furthers the policy of requiring the taxpayer to meet certain bookkeeping obligations placed upon him by the Code. It also recognizes that the taxpayer has more readily available to him the correct facts and figures.

The "presumption of correctness" of the assessment places on the taxpayer "both the burden of going for-

ward and the burden of persuasion." *Ibid.*[4] Beyond this evidentiary function, however, the validity of the assessment is not determinative of the ultimate liability of the taxpayer.

For example, in any refund case, the taxpayer has a dual burden of proof: he must (i) first prove that the assessment of the tax is erroneous and (ii) then establish the *correct* amount of tax. *Compton* v. *United States*, 334 F.2d 212, 216 (4th Cir. 1964); *Taylor* v. *Commissioner*, 70 F.2d 619, 620 (2d Cir. 1934) (L. Hand, J.), aff'd *sub nom. Helvering* v. *Taylor*, 293 U.S. 507 (1935). It is not enough in a refund suit for the taxpayer to prove only that the government's assessment is procedurally or substantively defective. If the assessment is invalid, the court may ignore it but the taxpayer nonetheless retains the burden of establishing the amount of tax actually owed. An "action to recover on a claim for refund is in the nature of an action for money had and received, and it is incumbent on the claimant to show that the United States has money which belongs to him." *Lewis* v. *Reynolds*, 284 U.S. 281, 283 (1932). In a refund suit, "[it] is not enough for [the taxpayer] to demonstrate that the assessment of the tax for which refund is sought was erroneous in some respect." *United States* v. *Janis*, 428 U.S. at 440. See also *Ehlers* v. *Vinal*, 382 F.2d 58, 65-66 (8th Cir. 1967); *Roybark* v. *United States*, 218 F.2d 164 (9th Cir.

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[4] In 1998, Congress revised the burden of proof rules that apply to some (but not all) income tax and estate and gift tax cases that arise from examinations that are commenced after July 22, 1998. See 26 U.S.C. 7491(a) (Supp. V 1999); Pub. L. No. 105-206, § 3001(a), 112 Stat. 726. Those new burden of proof rules are inapplicable here both because this case does not involve an income tax or estate and gift tax and also because this case arose from an examination commenced before July 22, 1998.

1954). "[T]he ultimate question in a suit for refund is not whether the Government was wrong, but whether the plaintiff can establish that taxes were in fact overpaid * * * . The plaintiff, to prevail, must establish the exact amount for which she is entitled to recover." *Compton* v. *United States*, 334 F.2d at 216. Accord, *United States* v. *Janis*, 428 U.S. at 440; *Crosby* v. *United States*, 496 F.2d 1384, 1390 (5th Cir. 1974).[5]

By contrast, in a collection case brought by the government to enforce an unpaid tax assessment, the government bears the initial burden of going forward, which it fulfills by establishing the fact and the amount of the unpaid assessment. *Palmer* v. *IRS*, 116 F.3d at 1312; *Psaty* v. *United States*, 442 F.2d at 1160.[6] Once the government has satisfied its burden of going forward by introducing a copy of the record of assessment,[7] the ultimate burden of persuasion as to the

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[5] "The presumption of correctness must be distinguished from the taxpayer's burden of proof. A taxpayer has the burden of proving by a preponderance of the evidence that the assessment or determination is incorrect and, in a refund suit, the correct amount, if any, of tax. The presumption of correctness, on the other hand, assigns to the taxpayer the separate burden of coming forward with sufficient evidence from which a trier of fact could find in his favor or of suffering an adverse decision if evidence is not produced." M. Saltzman, *IRS Practice and Procedure* ¶ 1.05[2][c], at 1-37 (2d ed. 1991) (footnotes omitted).

[6] When, as in the present case, a refund suit is brought for the recovery of a divisible or periodic tax (such as the FICA tax), and the taxpayer has not paid the full amount of the tax prior to filing suit, the government commonly files a counterclaim for the unpaid balance. See J.A. 32-34; *Flora* v. *United States*, 362 U.S. 145, 166 (1960); *Caleshu* v. *United States*, 570 F.2d 711 (8th Cir. 1978).

[7] In support of its counterclaim in this case (see note 6, *supra*), the government introduced a certified copy of a Certificate of Assessments and Payments. J.A. 77-78. This document is suffi-

correctness of the tax liability shifts to the taxpayer. *United States* v. *Rexach*, 482 F.2d 10, 16-17 (1st Cir.), cert. denied, 414 U.S. 1039 (1973); *Psaty* v. *United States*, 442 F.2d at 1159-1160. See also *United States* v. *Janis*, 428 U.S. at 440; *Flora* v. *United States*, 362 U.S. at 166. If, however, the taxpayer establishes that the determinations made in the assessment are arbitrary, excessive, and without even a minimal factual foundation, the burden of proof shifts back to the government.[8] *Palmer* v. *IRS*, 116 F.3d at 1312. When an assessment is shown to be "naked and without *any* foundation," the government is required to bear the burden of proof in a collection suit. *United States* v. *Janis*, 428 U.S. at 442.

Thus, while an invalid assessment does not alter the burden of proof that the taxpayer always bears to establish the "correct" amount due in a refund case, a "naked" assessment that wholly lacks any foundation does shift the burden of proof to the government in a

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cient to establish the fact and the amount of the assessments. See *Hefti* v. *IRS*, 8 F.3d 1169, 1172 (7th Cir. 1993); *Hughes* v. *United States*, 953 F.2d 531, 540 (9th Cir. 1992); *United States* v. *Chila*, 871 F.2d 1015, 1018 (11th Cir.), cert. denied, 493 U.S. 975 (1989).

[8] "A court disregards the presumption [of correctness] where the Commissioner's method of determining the amount of the deficiency in income is arbitrary and invalid." M. Saltzman, *supra*, ¶ 1.05[2][c], at 1-38. Respondent did not argue below that the amount of the assessment was arbitrary, excessive, or otherwise unreasonable. Respondent's brief in the district court stated that, "[f]or purposes of this litigation alone, [t]axpayer does not dispute the facts, estimates and/or determinations used by IRS as a basis for its calculation of an amount of aggregate unreported tip income by all directly and indirectly tipped employees of the taxpayer collectively." J.A. 35. Respondent's sole challenge to the assessment was the contention that aggregate estimation of employee tips is an improper method of assessment that exceeds the agency's authority. Pet. App. 3a.

tax collection case. In neither situation, however, is the validity or invalidity of the assessment alone determinative of the ultimate question of the taxpayer's liability. Regardless of the allocation of the burden of proof, either party may offer competent evidence to establish the amount of taxes owed.[9]

The parties in this case, however, have treated the validity of the government's assessment as if it were determinative of the ultimate question of the tax liability of respondent.[10] While we do not seek to revive issues that were not preserved below (and have no need to do so), it is important, for clarity of analysis, to emphasize that the question whether a tax assessment is valid or invalid typically has a far narrower—and different—role in tax litigation than the parties have assigned to it in this case.

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[9] If a taxpayer's challenge to the government's method of making an assessment is rejected, the taxpayer is still entitled to raise factual contentions it may have concerning the amount of taxes owed. See note 5, *supra*. For example, in *Bubble Room, Inc.* v. *United States*, the court of appeals upheld the aggregate estimation method used by the government in making assessments of the employer share of FICA taxes on tip income but then remanded that case for the trial court to determine whether, notwithstanding the "presumption of correctness" of the assessment, the taxpayer could establish that a lesser amount of taxes is actually due and thereby show "that it is entitled to a partial refund of the FICA tax assessed against it." 159 F.3d at 568.

[10] In the present case, after the district court held that the Service is prohibited from "assessing employer FICA taxes by aggregating unidentified employees' unreported tips" (Pet. App. 50a), the parties stipulated to the entry of a final order in the district court that, subject to the retained right of the parties to appeal, provides (i) a refund of the taxes paid by respondent and (ii) a judgment in respondent's favor on the government's counterclaim for unpaid taxes from other periods. J.A. 95-96. The issue addressed in the court of appeals, and the question presented in the petition, is therefore limited to whether the method of assessment applied by the Service in this case is valid.

II. THE EMPLOYER'S SHARE OF THE FEDERAL INSURANCE CONTRIBUTION ACT (FICA) TAX ON EMPLOYEE TIP INCOME MAY BE DETERMINED AND ASSESSED BASED ON A REASONABLE ESTIMATE OF THE AGGREGATE AMOUNT OF TIPS RECEIVED BY ALL EMPLOYEES

1. a. The FICA tax has an employee portion and an employer portion. Each employee is required to pay a specified percentage of the "wages" he receives. 26 U.S.C. 3101. This employee portion of the tax is to be withheld from the employee's "wages" and remitted by the employer to the Treasury. 26 U.S.C. 3102(a). Congress has also imposed a separate FICA tax on every employer. 26 U.S.C. 3111. The employer portion of the FICA tax is a specified percentage of the "wages * * * paid by him with respect to employment." 26 U.S.C. 3111(a).[11] The term "wages" is defined for this purpose to mean "all remuneration for employment." 26 U.S.C. 3121(a). Tips received by an employee are included within this definition of "wages" unless the amount is less than $20 in any calendar month. 26 U.S.C. 3121(a)(12)(B); 26 C.F.R. 31.3121(a)(12)-1.

Section 3121(q) of the Code specifies that the tips received by an employee are "deemed to have been paid by the employer" for purposes of the FICA tax. 26

[11] The employer portion of FICA taxes consists of two separate taxes, the Social Security tax in the amount of 6.2 percent of wages (26 U.S.C. 3111(a)) and the Medicare tax in the amount of 1.45 percent of wages (26 U.S.C. 3111(b)). The employee portion of FICA taxes similarly consists of the Social Security tax (26 U.S.C. 3101(a)) and the Medicare tax (26 U.S.C. 3101(b)).

U.S.C. 3121(q).[12] The statute thereby requires employers to pay the employer share of FICA taxes on all tips received by employees, up to the Social Security wage base. 26 U.S.C. 3121(q); see 26 U.S.C. 3121(a)(1) (limiting "wages" to amount of Social Security wage base).[13] As the Eleventh Circuit explained in *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529, Section 3121(q) provides "that an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips" and thereby "suggests that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined." The history of Section 3121(q) comports with this understanding, for the Conference Report on the bill that enacted this provision specifies that the employer portion of the FICA tax must be paid "on the total amount of wages and cash tips up to the Social Security wage base." H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 802 (1987). Accord, H.R. Rep. No. 391, 100th Cong., 1st Sess. Pt. 2, at 855 (1987).

Employees are required to report their tips in monthly statements to the employer, using IRS Form 4070 or a similar written substitute form. 26 U.S.C. 6053(a); 26 C.F.R. 31.6053-1(a)-(c). Under 26 U.S.C. 3102(c)(1), the employer's duty to collect the *employee*

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[12] Section 3121(q) was amended to include this text by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9006(a), 101 Stat. 1330-288-1330-289. Prior to that amendment, an employer was liable for the employer share of FICA taxes for tips only to the extent of the excess of the federal minimum wage over the actual wage paid by the employer. 26 U.S.C. 3121(t) (1982).

[13] In 1991 and 1992 (the years at issue in this case), the Social Security wage base was $53,400 and $55,500, respectively.

share of FICA taxes applies only for the tips included in the employee's written statements under Section 6053(a). See 26 C.F.R. 31.3102-3(a)(2).[14] In 26 U.S.C. 3121(q), however, Congress provided a different rule for the *employer* portion of the FICA tax, specifying that, "where no statement including such tips was * * * furnished [by the employee]," the employer's obligation to pay its portion of the tax is deemed to have been incurred "on the date on which notice and demand for such taxes is made to the employer by the Secretary." Congress thereby again specified that the employer portion of the FICA tax may be assessed even when employees do not accurately report their tips.[15] *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529.

b. In this case, respondent paid the employer portion of the FICA tax only on the tips that were reported by the employees on their written statements under Section 6053(a). Sections 3111 and 3121(q) impose the employer portion of the FICA tax on *all* tips received by the employees, however, whether those tips have been reported or not. Pursuant to the authority conferred on the Treasury to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title" (26 U.S.C. 6201), the Service determined the aggregate amount of tips received by respondent's employees, and then assessed the resulting FICA taxes

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[14] The IRS therefore has not claimed that respondent has underwithheld the employee share of FICA taxes.

[15] The restriction under 26 U.S.C. 3102(c) concerning withholding of the Section 3101 employee tax does not apply to payment of the employer tax. See notes 12 & 14, *supra*, and accompanying text.

imposed on respondent with respect to those tips under 26 U.S.C. 3111.

The aggregate amount of tips received by respondent's employees was calculated by multiplying the average tip rate revealed on the charge sales records from respondent's restaurant (approximately 14%) times the aggregate sales made by that restaurant. Pet. App. 3a.[16] That estimate, based on the actual sales records of respondent's restaurant, is neither arbitrary nor "without *any* foundation" (*United States* v. *Janis*, 428 U.S. at 441). It is therefore entitled to a "presumption of correctness," which places the burden on respondent either to make a contrary factual showing or "suffer[] an adverse decision if evidence is not produced." M. Saltzman, *supra*, ¶ 1.05[2][c], at 1-37; see note 5, *supra*.

In this case, respondent expressly chose not to dispute the factual basis or the reasonableness of the government's assessment. J.A. 35. Respondent also offered no competing evidence to challenge the assessment. *Ibid.* On this record, judgment should therefore have been entered in the government's favor on both the refund and collection claims in this case. See pages 11-14, *supra*.

2. The court of appeals, however, adopted respondent's contention that this "aggregate" method of

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[16] This estimate was made necessary by the fact that the information returns provided by respondent revealed that actual tip income had been received by respondent's employees from charge sales alone that exceeded the total amount of tip income that respondent reported and on which respondent had paid FICA taxes. As the court of appeals noted, credit card receipts *alone* for 1991 and 1992 disclosed tips of $363,786 and $338,161 respectively, while respondent reported and paid FICA taxes on tips for those years of only $247,181, and $220,845. Pet. App. 2a n.2.

assessing the employer's portion of the FICA tax is legally impermissible. The court did not dispute that the employer portion of the tax may be assessed without making equivalent assessments against individual employees. The court reasoned, however, that the employer portion of the tax could lawfully be assessed only by adding up individual determinations of employee tips and not by estimating the aggregate amount of tips received by all employees. Pet. App. 13a.

The court did not point to any language in the Internal Revenue Code as support for its conclusion, and there is none. The employer portion of the FICA tax imposed by Section 3111 is a separate and distinct obligation from the employee tax in Section 3101. Nothing conditions the determination of one on any determination of the other. Section 3111(a) imposes the tax on an employer in an amount equal to a specified percentage of "the wages * * * paid by him with respect to employment." 26 U.S.C. 3111(a). Section 3121(q) defines wages to include tips but, for the reasons described above, refutes the suggestion that only the tips reported by the employee are to be treated as "wages" in determining the employer portion of the tax. See pages 15-17, *supra*. As the Eleventh Circuit correctly recognized, "the separation of these [employer FICA tax and employee FICA tax] provisions into different, parallel subchapters suggests that Congress contemplated that employees' and employer's shares could be imposed separately." *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529.

The employer FICA taxes are computed as a percentage of "the wages * * * paid by [the employer] with respect to employment * * * ." 26 U.S.C. 3111(a), (b). Sections 3111(a) and (b) thus impose an accumulative tax liability for the employer based on the

employment of multiple employees. As shown on the Employer's Quarterly Federal Tax Return (Form 941) (J.A. 80-88), employer FICA taxes are imposed on the aggregate amount of tips and other wages received by *all* of the employer's employees. See *Bubble Room, Inc.* v. *United States*, 159 F.3d at 556 ("the employer FICA tax imposed by I.R.C. § 3111 is expressed in terms of the employees' aggregate tip income"). Because an employer is not assessed the employer FICA tax separately for each employee, there is no requirement that the tax be calculated based upon individual employee determinations. As the Federal Circuit emphasized in *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565, "the IRS is not obligated to assess FICA tax against each employee before it can assess FICA tax against the employer."

In short, nothing in the relevant statutes that impose the employer portion of the FICA tax requires the IRS to make the individual determinations required by the court of appeals. Section 3111 imposes a tax, and respondent has not disputed the reasonableness of the government's determination of the amount of the tax. See note 8, *supra*. That should be the end of the matter.

3. a. In rejecting the government's authority to make a reasonable aggregate estimate of the amount of tip income received by respondent's employees, the court of appeals acknowledged that 26 U.S.C. 446 "has been interpreted as giving the IRS authority to make an assessment based on an estimate." Pet. App. 6a (citing *McQuatters* v. *Commissioner*, 32 T.C.M. (CCH) 1122 (1973)). That statute provides that, "[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be

made under such method as, in the opinion of the Secretary, does clearly reflect income." 26 U.S.C. 446(b). In *McQuatters*, the Tax Court concluded that this statute authorizes the agency to use aggregate estimates to determine the amount of an employee's unreported tip income for income tax purposes. See also *Cracchiola* v. *Commissioner*, 643 F.2d 1383 (9th Cir. 1981); *Mendelson* v. *Commissioner*, 305 F.2d 519 (7th Cir.), cert. denied, 371 U.S. 877 (1962); *Krause* v. *Commissioner*, 60 T.C.M. (CCH) 1430 (1990), aff'd without op., 944 F.2d 897 (3d Cir. 1991). As the court stated in *Palmer* v. *IRS*, 116 F.3d at 1312, "Congress specified no particular methods or evidentiary burdens on the Commissioner when choosing a method for reconstructing a taxpayer's income under Section 446. The Commissioner, therefore, has wide discretion in choosing an income-reconstruction method."

The principle adopted by the Tax Court in *McQuatters*, however, has a far broader foundation. Even apart from the situations involving improper tax accounting methods to which Section 446(b) applies, courts have routinely approved the use of reasonable estimates in determining items of unreported income for income tax purposes simply as a reasonable method of determining a disputed factual issue. See, *e.g.*, *Anaya* v. *Commissioner*, 983 F.2d 186 (10th Cir. 1993); *Dodge* v. *Commissioner*, 981 F.2d 350 (8th Cir. 1992); *Erickson* v. *Commissioner*, 937 F.2d 1548 (10th Cir. 1991); *Polland* v. *Commissioner*, 786 F.2d 1063 (11th Cir. 1986) *Delaney* v. *Commissioner*, 743 F.2d 670 (9th Cir. 1984); *Gerardo* v. *Commissioner*, 552 F.2d 549 (3d Cir. 1977); *Mitchell* v. *Commissioner*, 416 F.2d 101 (7th Cir. 1969), cert. denied, 396 U.S. 1060 (1970); *Ehlers* v. *Vinal*, 382 F.2d at 63. See also *United States* v. *Janis*, 428 U.S. at 437, 441 (describing the calculation of a

wagering excise tax assessment based on a reasonable estimate of wagers made); *Carson* v. *United States*, 560 F.2d 693, 698-700 (5th Cir. 1977) (upholding a wagering excise tax assessment based on a reasonable estimate of total wagers accepted by a bookmaker during the relevant period); *DiMauro* v. *United States*, 706 F.2d 882, 885 (8th Cir. 1983) (same); *Collins* v. *Daly*, 437 F.2d 736, 737-738 (7th Cir. 1971) (describing wagering excise and special occupational tax assessments based on estimates). The government's reasonable aggregate estimate of tip income constitutes relevant evidence in tax litigation, for it tends "to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed. R. Evid. 401. As the court emphasized in *Dodge* v. *Commissioner*, 981 F.2d at 353, an "assessment is intended to be an estimate. It is expected to be rational not flawless." The conclusion of the majority in this case that the Service lacks authority to make aggregate estimates of items of income in assessing taxes thus departs from the long-established rule to the contrary.

b. Section 446(b) of the Internal Revenue Code, which was cited by the Tax Court in *McQuatters*, applies only to the correction of improper methods of accounting employed in determining the "income" of the taxpayer and therefore arguably has no direct application to this employment tax case. Pet. App. 10a. While other courts have nonetheless found that provision "'informative' in concluding that the IRS is authorized to construct its assessment by means of estimation" (*ibid.* (quoting *Bubble Room, Inc.* v. *United States*, 159 F.3d at 566)), the court of appeals in the present case sought to draw a different conclusion. The court stated that the fact that Section 446(b) does not

apply directly to employment tax cases suggests that Congress intended to *limit* the Service's use of estimates in employment tax cases, for "Congress obviously knew how to give the IRS the authority to use estimation in lieu of actual calculations, and just as clearly thought it necessary to say so explicitly when it wished to confer that power." Pet. App. 10a.

That reasoning is erroneous on its own premise, however, for Section 446(b) plainly does *not* "explicitly" say anything about using estimates. It merely authorizes the Treasury to require methods of accounting that "clearly reflect income." 26 U.S.C. 446(b). Nothing in this statutory text reveals any intention of Congress to preclude the use of methods of estimation in tax calculations in *any* circumstance. As the Eleventh Circuit correctly concluded in *Morrison Restaurants*, 118 F.3d at 1529-1530, "[g]iven the structure of the Internal Revenue Code, we are unconvinced that Congress's silence can be construed to mean that an employer cannot be assessed its share of FICA taxes based on employees' unreported tips in the aggregate without determining the underreporting by the individual employees."

c. In her dissent in this case, Judge McKeown correctly identified the source of the agency's general authority to use estimates in making FICA tax assessments. Section 6201 broadly authorizes the Secretary to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title." 26 U.S.C. 6201. In making tax assessments under the Internal Revenue Code (including FICA tax assessments), Congress has thus left it "up to the IRS to choose the method [to determine the amount of taxes], so long as reasonable." Pet. App. 26a. See, *e.g.*, *Anaya* v. *Commissioner*, 983 F.2d at 188; *Dodge* v. *Commis-*

sioner, 981 F.2d at 353; cases cited pages 21-22, *supra*. As the Federal Circuit concluded in rejecting the contentions that were endorsed by the majority below in this case, "[26 U.S.C.] 6201 implicitly authorizes the IRS to use an indirect formula" because "the IRS would have to use an indirect formula to estimate the amount of FICA tax owed by an employer when there is no other way to 'determine and assess' the wages deemed to have been paid by the employer." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565. While the panel in the present case acknowledged that its decision conflicts with the decision of the Federal Circuit in *Bubble Room* (Pet. App. 12a, 13a n.9, 14a), the panel gave no consideration to the relevance of Section 6201 to this case.

d. The fact that reasonable, aggregate estimates may properly be employed in determining the employer's FICA tax liability is especially apparent in view of the fact that Section 3121(q) authorizes the IRS to issue a demand for payment of such taxes even when the statements given by employees to the employer are "inaccurate or incomplete." 26 U.S.C. 3121(q). In such circumstances—where accurate and complete records showing the amount of tips do not exist—the IRS has no plausible alternative but to rely on an indirect method to estimate the tips. In resolving factual questions concerning the amount of unreported tips, other courts of appeals have thus unanimously concluded 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." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 566. See *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d 990,

996-997 (7th Cir. 2000); *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530.

Moreover, the majority's conclusion that an estimate of the employer's FICA tax liability is impermissible, and that what is required is an "employee-by-employee determination of the taxable tips each has earned" (Pet. App. 13a), suffers from an obvious internal contradiction. If the IRS were to audit each employee to determine the factual question of the amount of tips each employee earned, those individual determinations would themselves necessarily be based on estimates. See *McQuatters* v. *Commissioner*, 32 T.C.M. (CCH) at 1125 (describing method used by IRS to estimate the amount of tips received by individual employees).[17] It is obvious that any cash tips that are not reported on the credit charge slips retained by the employer cannot be traced and determined with precision. A method of estimation based on the average tip rate and the gross sales of the restaurant is far more likely to achieve factual accuracy than the individual audits suggested by the court of appeals. In any event, the court's suggestion that adding up the results of individual audits would make the estimation of tip income unnecessary is clearly incorrect—the sum of individual audits would simply be the sum of individual estimates of tip income.

4. a. The district court erroneously concluded (Pet. App. 47a-48a) that 26 U.S.C. 45B supports the view that assessments of the employer's FICA tax on unreported tips must be based upon a determination of individual employee earnings. Pet. App. 47a-48a.

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[17] See also *Cracchiola* v. *Commissioner*, 643 F.2d at 1385 (same); *Mendelson* v. *Commissioner*, 305 F.2d at 521-522 (same); *Krause* v. *Commissioner*, 60 T.C.M. (CCH) at 1431 (same).

Section 45B was added to the Internal Revenue Code by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13443(a), 107 Stat. 568. This statute generally allows an income tax credit to an employer for employer FICA taxes paid with respect to employee tips. The amount of the credit equals an employer's FICA tax payments attributable to tips in excess of those treated as wages for the minimum wage requirements of the Fair Labor Standards Act. 26 U.S.C. 45B(a), (b). The Fair Labor Standards Act allows an employer to pay less than the minimum wage directly to a tipped employee, by treating tips received by the employee as satisfying a portion of the statutory minimum wage. 29 U.S.C. 203(m); see *Kilgore* v. *Outback Steakhouse*, 160 F.3d 294, 298 (6th Cir. 1998); 29 C.F.R. 531.59.[18] Nothing in the text of this statute has any relevance to the issues addressed in this case, and the history of the statute also provides no indication that it is intended either to alter or inform the meaning of Section 3121(q). See H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 736-737 (1993).

The district court reasoned, however, that Section 45B indicates that individual employee determinations of tip income must be made so that the amount of the credit to which the employer is entitled under that statute may be determined. Pet. App. 47a-48a. The court's conclusion that "[a]n employer cannot take advantage of this tax credit [under Section 45B] if the IRS assesses his FICA taxes on unreported employee tips in the aggregate" (*id.* at 47a) is, however, simply wrong. The Section 45B credit is available for employer FICA taxes on *all* employee tips *except* those that

[18] The statutory minimum wage is set forth in 29 U.S.C. 206(a)(1).

are applied (under 29 U.S.C. 203(m)) to satisfy the employer's minimum wage obligation. 26 U.S.C. 45B(b)(1)(B). If the employer is paying its employees the minimum wage (or more), all tips included in the aggregate assessment of the employer's FICA taxes are eligible for the Section 45B credit. On the other hand, if the employer is paying less than the minimum wage, and using tips to bring an employee's wage up to the minimum wage, then the employer will know the amount of tips that are being used to satisfy the minimum wage requirement—for that is simply the difference between the minimum wage and the amount the employer is actually paying. In both situations, the employer therefore knows the amount of tips that are eligible for the Section 45B credit. The district court therefore erred in suggesting that the Section 45B credit "would become a nullity for many employers" if "the IRS were permitted to make assessments of taxes due on an aggregation of unreported tips" (Pet. App. 48a).[19]

b. The district court similarly erred in concluding (Pet. App. 49a-50a) that a 1996 amendment to Section 45B is relevant to this case. A Treasury Regulation promulgated in 1993 had provided that the tax credit provided by that statute is available only for taxes paid with respect to the tips reported by the employee to the employer under Section 6053(a). 26 C.F.R. 1.45B-1T. The Treasury believed that this interpretation of

[19] The court's reliance on Section 45B to interpret Section 3121(q) involves a temporal as well as a logical flaw. Section 45B was enacted in 1993, six years after the amendment of Section 3121(q) in 1987, and two years after the first of the two tax years involved in this case (1991 and 1992). Section 45B was thus not a part of the law, and does not inform the meaning of the law, for the years in issue in this case.

Section 45B "provides employers with a strong incentive for encouraging employees to report their tips." Pet. App. 50a (quoting Letter from Leslie B. Samuels, Assistant Secretary of Treasury, to Senator Trent Lott (Mar. 30, 1994)). In 1996, however, Congress amended Section 45B to clarify that the credit is available with respect to employer FICA taxes paid on *all* tips, "without regard to whether such tips are reported under section 6053." 26 U.S.C. 45B(b)(1)(A)), as amended by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1759.

The district court suggested that this 1996 amendment of Section 45B shows that Congress has no interest in providing employers an incentive to encourage employee tip reporting. Pet. App. 50a. In fact, however, what this amendment demonstrates is that Congress wished to provide the credit of Section 45B for the taxes *actually* paid by the employer even if the employees did not separately report and pay their share of FICA taxes on tips. That legislative determination is consistent with, not opposed to, the government's position in this case—for the government's position is that employers are required to pay the correct amount of employer FICA taxes they owe on tip income even if their employees fail properly to report and pay taxes on that income.

Nothing in Section 45B or its 1996 amendment suggests that Congress desired to "provide an incentive to an employer to discourage accurate reporting or to ignore clearly inaccurate reporting by its employees." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567. By contrast, "basing the employer's share of FICA taxes exclusively on employees' reported tips *would* provide incentive to the employer to discourage accurate reporting or ignore blatantly incorrect reporting

by the employees so that the employer could pay less FICA tax." *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530 (emphasis added).

c. Unlike the district court, the court of appeals did not attempt to rely directly on the 1996 amendment to 26 U.S.C. 45B. The court nonetheless reasoned that this legislation "demonstrates the difficulty the executive and the legislative branches have had in reaching common ground on the problem of collecting taxes on employee tips" and thereby supports a conclusion that the Treasury "must obtain authorization directly from Congress" to use estimates in determining employer FICA taxes. Pet. App. 17a.

Neither the text of the amendment nor the Committee Reports that preceded its enactment, however, say anything about Section 3121(q) or about assessments of employer FICA taxes on unreported tips. See H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 186-187 (1996); S. Rep. No. 281, 104th Cong., 2d Sess. 7-8 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 5-6 (1996). And, in reaching its unsupported conclusion, the court of appeals did not consider or address other contemporary legislation that in fact *has* addressed the assessment of the employer FICA tax on tip income.

In particular, in 1998, in response to restaurant industry complaints about the IRS practice of assessing an employer's liability for FICA taxes based on aggregate tip income (and the decision of the Eleventh Circuit in *Morrison Restaurants* approving of that practice), Congress elected *not* to prohibit the IRS from following that practice. Instead, Congress enacted a statute that provides that IRS employees "may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering a Tip Reporting Alternative Commitment [TRAC] Agreement." Internal Revenue

Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 755. A restaurant that signs a TRAC agreement with the IRS agrees to educate its employees about tax reporting, establish procedures to ensure accurate tip reporting, and fulfill various federal tax requirements. In return, the IRS agrees to base the restaurant's FICA tax liability solely on reported tips and any unreported tips discovered during an IRS audit of an employee. See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 274-275 (1998); S. Rep. No. 174, 105th Cong., 2d Sess. 75 (1998); H.R. Rep. No. 364, 105th Cong., 2d Sess. Pt. 1, at 8-9 (1998).

As the dissent in this case correctly observed, this 1998 statute reflects the understanding of Congress that, in the absence of such a TRAC agreement, the IRS has full authority to make aggregate assessments against employers without making determinations with respect to individual employees. Pet. App. 28a. As Judge McKeown correctly concluded, when Congress enacted the 1998 law, it necessarily "*acknowledged the IRS's power to make aggregate calculations* of employer tax obligations, before or without making determinations with respect to individual employees." Pet. App. 28a. Accord, *330 West Hubbard Restaurant Corp.* v. *United States*, 37 F. Supp.2d 1050, 1055 (N.D. Ill. 1998), aff'd, 203 F.3d 990 (7th Cir. 2000).[20]

4. The court of appeals also erred in suggesting (Pet. App. 15a-16a) that 26 U.S.C. 6205(a)(1) provides a fur-

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[20] If, as the court of appeals held in this case, the Service lacks authority to determine employer FICA taxes on unreported tips without first determining the amount of the individual employees' tips, "it would make no sense for a restaurant to enter into a TRAC agreement in return for the Service's agreement not to do that which it lacks authority to do." *330 West Hubbard Restaurant Corp.* v. *United States*, 37 F. Supp.2d at 1055-1056.

ther basis for its conclusion in this case. That statute provides that, when an incorrect amount of FICA taxes is paid by an employer, the employer may be allowed to correct its return and pay the proper amount "without interest, in such manner and at such times as the Secretary may by regulations prescribe." 26 U.S.C. 6205(a)(1). The court stated, without analysis or explanation, that this statute "seems to authorize the Secretary to give the IRS authority to make assessments based on aggregate estimates," but only "by promulgating a regulation to that effect." Pet. App. 15a-16a.

The court's unexplained conclusion is incorrect. Section 6205(a)(1) and its regulations encourage accurate reporting of FICA tax obligations by establishing procedures that permit employers, in limited circumstances, to report underpayments of FICA taxes without incurring interest obligations. See 26 C.F.R. 31.6205-1. An underpayment cannot qualify for interest-free treatment under those provisions, however, *after* an assessment of the tax has been made. See 26 C.F.R. 31.6205-1(a)(6). Respondent has not claimed that it came forward with any timely report of an underpayment of tax or is otherwise entitled to the benefits of this provision. Section 6205 and its regulations thus simply have no application to this case.[21]

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[21] Moreover, the question in this case is not whether the Treasury *could* issue a regulation that specifies that aggregate estimates may be used in determining employer FICA tax liability. Instead, the question presented is whether the general authority conferred on the Service to make determinations and assessments of taxes (26 U.S.C. 6201) permits the use of aggregate estimates of unreported tips that respondent concedes are both reasonable and factually based. See note 8, *supra*. The broad authority provided to the Secretary to prescribe rules and regulations for the enforcement of the Internal Revenue Code "does *not* require the promul-

III. THE IRS IS NOT REQUIRED TO CREDIT THE SOCIAL SECURITY EARNINGS RECORDS OF INDIVIDUAL EMPLOYEES AS A PREREQUISITE TO AN ASSESSMENT OF EMPLOYER FICA TAXES

The district court indicated that an aggregate FICA tax assessment against the employer would be improper because such a tax could not be "credited to the employees' Social Security accounts" and thus would not result in an increase in the employee's benefits. Pet. App. 45a. No provision in the Internal Revenue Code or the Social Security Act, however, links the imposition of the employer FICA tax to the crediting of employees' individual Social Security accounts. To the contrary, it is well established that the amount of Social Security benefits earned by an employee does "not in any true sense depend on contribution to the program through the payment of taxes, but rather on the earnings record of the primary beneficiary." *Flemming* v. *Nestor*, 363 U.S. 603, 609 (1960). See also *Calderon* v. *Witvoet*, 999 F.2d 1101, 1106 (7th Cir. 1993) (employee is entitled to Social Security credit for all sums earned, whether or not employer actually pays its FICA tax obligations). Accordingly, "nothing in the [Social Security] Act justifies the argument that a tax is due only when a corresponding benefit will flow to the taxpayer or his survivors. * * * [T]he liability for the tax is not under the Act made to depend in any way upon the assurance that the taxpayer's benefit will be thereby increased." *Whitaker* v. *United States*, 194 F. Supp.

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gation of regulations as a prerequisite to the enforcement of each and every provision of the Code." *United States* v. *Langert*, 902 F.Supp. 999, 1003 (D. Minn 1995); see *Granse* v. *United States*, 892 F.Supp. 219, 224-225 (D. Minn. 1995).

505, 507 (D. Mass.), aff'd per curiam, 295 F.2d 817 (1st Cir. 1961).

Moreover, the Social Security earnings record of an individual worker is based upon wages earned and reported, not on taxes paid. 42 U.S.C. 405(c)(2)(A). An employee is required to report his tips to the employer. 26 U.S.C. 6053(a). The employer, in turn, reports the amount of wages paid to the employee (including tips received) on Form W-2, and those amounts are then used by the Social Security Administration to compile earnings records. Tips that are not reported to the employer by the employee nonetheless must be reported to the IRS by the employee on IRS Form 4137 (Social Security and Medicare Tax on Unreported Tips), and the employee is required to pay the employee share of FICA taxes with respect to those tips. See Rev. Rul. 95-7, 1995-1 C.B. 185 (Q&A 6). As this reporting Form states, "The amounts you report below are for your social security record. This record is used to figure any benefits, based on your earnings, payable to you and your dependents or your survivors. Fill in each item accurately and completely."[22] Employees thus receive Social Security earnings credit for tips that are reported either (i) in statements they submit to their employer pursuant to 26 U.S.C. 6053(a) or (ii) in statements they submit to the IRS on Form 4137. See *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530. An employee fails to receive Social Security credit for tips earned only if he fails to report his earnings, as required by law. See *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996; *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565;

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[22] Form 4137 can be found in IRS Pub. 1132, *Reproducible Copies of Federal Tax Forms and Instructions* 321-322 (2000).

Morrison Restaurants, Inc. v. *United States*, 118 F.3d at 1530. Whether the employee is liable for, or pays, taxes due on the total amount of tips he receives is not determinative of the amount of benefits to which he is entitled under the FICA provisions.[23]

IV. THE COURT OF APPEALS ERRED IN RELYING ON ASSERTED FLAWS IN THE CALCULATION OF THE ASSESSMENT IN THIS CASE

1. The court of appeals also erred in concluding that the aggregate estimate of tips made by the IRS in this case has "some serious flaws." Pet. App. 8a. The dissent aptly observed that the majority "confuses the IRS's authority to use the aggregate method with the accuracy of that method." *Id.* at 32a. "[W]hether there are flaws in the indirect formula used to estimate the FICA tax is a separate matter from whether the IRS has the authority to assess an employer-only FICA tax based on an aggregate estimate of unreported tip income." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 568. Accord, *330 West Hubbard Restaurant Corp.* v.

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[23] The district court's concern with Social Security benefits ignores the fact that one component of FICA taxes is the 1.45 percent Medicare tax of 26 U.S.C. 3111(b). See note 11, *supra*. Although the amount of an employee's Social Security benefits will be affected by the employee's reported earnings, all individuals entitled to Medicare are entitled to the full range of Medicare benefits. Entitlement to those benefits is based simply on a minimum number of quarters of coverage. See H.R. Rep. No. 241, 99th Cong., 2d Sess. Pt. 1, at 25-26 (1986); 42 U.S.C. 413, 414, 426. The wages and reported tips received by respondent's employees gave them quarters of coverage. The unreported tips (and the employer share of the Medicare tax on those unreported tips) would have no effect on their Medicare benefits even if the IRS made the individual determinations required by the court of appeals.

United States, 203 F.3d at 996. Indeed, it is well-settled that proof that the amount of an assessment is incorrect does not invalidate the entire assessment. *United States* v. *Schroeder*, 900 F.2d 1144, 1148 (7th Cir. 1990). Instead, "[w]hen a court is faced with an incorrect but otherwise valid assessment, the proper course is not to void the assessment * * * but to determine what, if anything, the taxpayer owes the government." *Ibid.* See also *Lewis* v. *Reynolds*, 284 U.S. at 283; *Burns* v. *United States*, 974 F.2d 1064, 1066 (9th Cir. 1992).[24]

2. Moreover, there is no evidence to support the majority's conclusion that "flaws" exist in the agency's aggregate estimate of tips.[25] The majority first suggested that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" (Pet App. 8a) because "experience shows that charged tips generally exceed cash tips" (*id.* at 4a). There is simply no evidence in the record of this case to support the court's factual assertion that "experience" reveals that the charge tip rate at respondent's restaurant

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[24] "Even if the formula overestimated tip income, the court should have modified it, not rejected it. An assessment that is too high should be reduced, but is not wholly invalid." Note, *Assessing Employer FICA Tax on the Estimated Aggregate Unreported Tips of Employees*, 53 Tax Law. 781, 788 (2000). "The court should have tried the case and determined the correct assessment instead of rejecting it completely." *Ibid.*

[25] The suggestion of the court of appeals that there are "flaws" in the aggregate estimate of tips in this case is particularly inappropriate since respondent has not itself challenged the reasonableness or accuracy of the agency's estimate. See Pet. App. 33a. Respondent relied solely on its assertion that the IRS lacked authority to make an aggregate estimate in determining the employer portion of the FICA tax on tips. See *id.* at 33a, 36a.

exceeded the cash tip rate at that restaurant. See note 25, *supra*.

Similarly, the majority erred in stating that, "as to credit card tips, the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to employees by the restaurant." Pet. App. 8a-9a. There is again no evidence in the record—or even any assertion by the taxpayer—that this procedure was in effect at respondent's restaurant. The asserted "flaw" identified by the court of appeals is thus solely one of its own conjecture and is not grounded in the record of this case.

Finally, the court stated that "the estimate [does not] make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." Pet. App. 9a; see note 1, *supra*. But there is again no evidence in this case that any of respondent's employees earned less than $20 in tips in any month; nor is there any evidence that any of its employees received tips plus salary in excess of the Social Security wage base. In the absence of evidence that some of the unreported tips fell outside the wages band, the court's suggestion that the failure to account for the such amounts is a "flaw" in the tip estimate is mere speculation. In any event, the theoretical possibility that some minor portion of the tips received might fall outside the wages band would not invalidate the entire assessment.[26] A failure to take the

[26] The effect of this theoretical possibility would be marginal. For example, if an employee happened to work only one day during a month, earned less than $20 that day, and repeated this practice on five occasions during the year, then the IRS's determination of the total amount of tips, would be $100 too high. The assessment of FICA taxes on that amount, at a rate of 7.65%, would in turn be $7.65 too high. If respondent were concerned that its taxes were too high on this factual rationale, it could have challenged the

"wages band" into account does not "make the assessment unlawful;" it would "merely suggest[] that the amount of FICA tax assessed against [the employer] may have been incorrect by some margin and that it may be entitled to a refund of some portion of the FICA tax assessed against it." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567; accord, *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996. It is the employer's obligation to establish the amount by which the assessment is incorrect, and the employer expressly declined to mount such a challenge in this case. See notes 24-26, *supra*.

3. The majority expressed concern that an aggregate estimate of unreported tip income "puts an impossible burden on [the taxpayer], making the already heavy presumption that attaches to an IRS assessment virtually conclusive." Pet. App. 8a.[27] That concern,

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amount of taxes that it owed on such a basis. Instead, however, respondent did not dispute the reasonableness of the estimate (Pet. App. 33a), did not raise any factual challenge to the estimate, and instead stipulated that it "does not dispute the facts, estimates and/or determinations used by IRS as a basis for its calculation of an amount of aggregate unreported tip income by all directly and indirectly tipped employees of the taxpayer collectively." J.A. 35.

[27] The court of appeals incorrectly stated that determining the employer's FICA liability by using an estimate amounts to "forcing the employer to pay the price for its employees' dereliction." Pet. App. 14a. All that the employer is required to pay is the employer FICA tax imposed on it by 26 U.S.C. 3111. That statute requires employers to pay FICA taxes on the total amount of tips and other remuneration, up to the Social Security wage base. The possibility that employees may fail to pay the proper taxes due on part of their tips does not excuse respondent from paying the proper taxes on those tips. "You can't resist the payment of taxes on the ground that someone else isn't being made to

however, is belied by the proceedings in the *Bubble Room* and *Morrison Restaurants* cases. The employer in *Bubble Room* pointed to several purported defects in the methodology employed by the IRS in calculating the assessment. The court concluded that there were genuine issues of material fact that made summary judgment on the *amount* of the employer's liability inappropriate. 159 F.3d at 567. The case was remanded to the district court for those factual issues to be addressed. *Ibid.* And, in *Morrison Restaurants*, based on information provided to the IRS by the restaurant and its employees, the IRS made its determination of unreported tips using a cash tip rate that was lower than the rate originally proposed by the IRS. *Morrison Restaurants, Inc.* v. *United States*, 918 F. Supp. 1506, 1513 (S.D. Ala. 1996), rev'd on other grounds, 118 F.3d 1526 (11th Cir. 1997).[28]

As correctly observed by Judge McKeown in her dissenting opinion in this case, "the aggregate method is predicated on a reasonable estimate and that may be

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pay his fair share." *Buchanan* v. *United States*, 87 F.3d 197, 202 (7th Cir.), cert. denied, 519 U.S. 950 (1996).

[28] The suggestion of the court of appeals that the restaurant "is not in an inherently better position than the IRS to determine what its employees actually earned in tips" (Pet. App. 8a) is wide of the mark. The restaurant has daily contact with, and information about, its employees that the IRS does not have. The restaurant has charge slips showing the amount of charged tips received by each of its employees. The restaurant also has records showing how many days, and how many hours each day, each employee worked during the year. The restaurant, for example, is clearly in a better position than the IRS to determine if any of the tip income fell outside of the "wages band." See note 1, *supra.* In any event, the IRS is authorized to make an assessment of tax in every case (26 U.S.C. 6201), and the existence of this power is not dependent on whether the taxpayer keeps, or fails to keep, adequate records.

challenged by the taxpayer." Pet. App. 33a. In this case, however, respondent chose not to raise any argument about the correct amount of its liability in the proceedings below. As the dissent emphasized, "the issue of accuracy is [thus] not before us, because [respondent] did not challenge the accuracy of the calculation—it challenged only the IRS's authority to assess the taxes under the aggregate method." *Ibid.*

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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