PKF PERSPECTIVES

SUPREME COURT AFFIRMS IRS' RIGHT TO USE *AGGREGATE ESTIMATION METHOD* FOR TIPS

... Leo Parmegiani, CPA and M. Howard Pell, CPA

In a significant victory for the Internal Revenue Service, on June 17, 2002 the U.S. Supreme Court held that the IRS' use of the ***aggregate estimation method*** *(defined later in this article)* to calculate a restaurant's employment tax liability for unreported tip income is authorized by the Internal Revenue Code. The case, *United States v. Fior D'Italia Inc., U.S., No. 01-463, 6/17/02*, focused on whether the IRS can assess a restaurant for FICA taxes based upon tips that its employees **may** have received, but did not report.

The key point decided was whether the law authorizes the IRS to base its assessment upon the so-called **aggregate estimation method** to determine all tips the restaurant's customers paid to its employees, **or** whether, instead, to determine tip income by estimating each employee's income separately and then adding them together to create a total. **The Supreme Court ruled that the IRS can use the *aggregate estimation method*.**

Background

The taxpayer in this case was Fior D'Italia, a San Francisco based restaurant, which paid FICA tax based upon the tip amount reported by its employees. However, the reports provided to the IRS showed that tips listed on customer credit card slips exceeded the reported tip amount.

The IRS made a compliance check and assessed additional FICA taxes employing its ***aggregate estimation method***, under which it:

- examined the credit card slips;
- found the average percentage tip paid by those customers;
- assumed that cash paying customers paid at the same rate;
- calculated total tips by multiplying the tip rate by Fior D'Italia's total receipts;
- subtracted the tips already reported;
- applied the FICA tax rate to the remainder; and
- assessed additional taxes owed.

After paying a portion of the taxes, Fior D'Italia filed a refund suit, claiming that the tax statutes did not authorize the IRS to use the ***aggregate estimation method***. Rather, it required it to first determine the tips that each individual employee received and then use that information to calculate the employer's total FICA tax liability.

Supreme Court Holding

The Supreme Court reversed the Court of Appeals [which already had affirmed a District Court decision] which held the IRS was **not** authorized to use this estimation method. In citing statutory language, the High Court surmised that since the IRS is authorized and required to make inquiries, determinations and assessments of all taxes, the Internal Revenue Code also grants the Agency power to decide **how** to make assessments [at least within certain limits]. The Supreme Court reasoned that courts have consistently held those limits are not exceeded when the IRS estimates an individual's tax liability. (For example, by employing statistical samplings, bank deposit methods, and other extrapolation methods).

Fior D'Italia's argument was that the IRS' method was unreasonable because the method fails to account for the possibilities that:

1 Customers who pay cash tend to leave a lower tip percentage;

2 Some customers 'stiff' the waiters, leaving no tip at all;

3 Some customers write a high tip on the credit card slip and ask for cash back, leaving a lower net amount to the waiter; **and**

4 Some restaurants deduct the credit card company fee from the tip reducing the amount payable as a tip.

In the Supreme Court's view, however, these considerations do not show that the ***aggregate estimation method*** is unreasonable and is definitely not illegal. They merely show that the IRS approach is refutable by taxpayers who have evidence that an assessment is inaccurate in a particular case. In the Court's opinion, the restaurant does not need to prove its case with precision, only demonstrate that in its particular case the aggregate estimation method produces a harsh unreasonable approach.

PKF Comments

The decision is clearly a blow to restaurants both large and small across the nation who now believe they must become "tip police" to obtain credible evidence that the ***aggregate estimation method*** does not produce a reasonable assessment. Peter Kilgore, General Counsel and Senior Vice President of Operations of the National Restaurant Association is quoted as saying, *"We are deeply disappointed by the Supreme Court's decision, which basically condones the IRS unfair and unjust tactics to pit restauranteurs against their own employees, turning them into tip police."*

While the restaurant industry expressed disappointment, Commissioner of Internal Revenue Charles Rossotti praised the ruling. He said, *"The IRS plans to continue working cooperatively with the restaurant industry and other industries where tips are common."* He continued, *"Our goal is to create a fair, accurate system for reporting tip income while minimizing burden on taxpayers and businesses."*

Regarding future examinations and proposed assessments of unpaid FICA tax, restaurant owners should be mindful of their right to challenge results obtained through the use of the ***aggregate estimation method***. The Supreme Court stressed in the Fior D'Italia case that taxpayers are free to present evidence that the assessment was inaccurate.

Challenges should be raised with the IRS for any reason, or reasons, as to why the ***aggregate estimation method*** produces unfair results. The IRS may agree to some of the challenges and, at least, there will be a record of disagreement should the case be taken to court.

Possible reasons for inaccurate results include those mentioned above by Fior D'Italia. In addition, other reasons may include:

- Consideration of numerous busboys and others who work few hours and earn under $20 a month in tips (this category is exempt from FICA tax), and,

- For high-priced restaurants, the method does not take into account that some waiters are over the Social Security wage base.

CLAIMING REFUNDS

... M. Howard Pell, CPA

The Job Creation and Workers Assistance Act of 2002, signed into law on March 9, 2002, changed the carryback period for applying net operating losses (NOLs) for losses arising in tax years ending in 2001 and 2002.

The law was modified in two respects:

– First, a 5-year carryback period, instead of the normal 2-year period, was added.

– Second, any taxpayer entitled to the 5-year carryback period may relinquish that period, and use the 2-year carryback period instead.

Because of the timing of the new law, some taxpayers that incurred a net operating loss (NOL) in a year ending in 2001, filed returns before the Act became law, and either elected the 2-year carryback, or elected to relinquish the NOL carryback period. These persons were not afforded the opportunity to avail themselves of the new law. In view of this, various members of Congress have advised the Treasury Department of their intent to pursue legislation to rectify the inequity.

In anticipation of the expected correcting legislation, the Internal Revenue Service recently announced rules, that can now be followed:

- **Taxpayers who elected to forgo the carryback period:** Any taxpayer who previously elected to forgo the carryback period for an NOL for any taxable year ending in 2001 or 2002 may revoke such election in order to apply the 5-year carryback period. This revocation period ends after October 31, 2002.

- **Taxpayers who applied the 2-year carryback period:** If a taxpayer, who previously filed an application for a tentative carryback adjustment (whether or not the IRS has acted upon the application) or an amended return using a 2-year carryback period for an NOL incurred in a taxable year ending in 2001 or 2002 and did not elect to forgo the 5-year carryback period, and who wants to use the 5-year carryback, may do so if done on or before October 31, 2002.

  A taxpayer who filed an application for a tentative carryback adjustment or an amended return using a 2-year carryback period for an NOL incurred in a year ending in 2001 or 2002 and prefers to apply the 2-year period, may do so. A taxpayer need not file any forms or statement to elect the 2-year period.

- **Taxpayers who neither elected to forgo the carryback period nor applied the 2-year carryback period:** Any taxpayer who filed a return ending in 2001 or 2002, did not elect to forgo the carryback period for an NOL incurred in such year, and did not previously file for a tentative carryback adjustment or an amended return using a 2-year carryback period, may apply the 2-year carryback period, if this election is filed by October 31, 2002. Absent this election, the 5-year carryback period would apply by operation of law.

In order to effect these changes, the IRS has recently revised Form 1045, **APPLICATION FOR TENTATIVE REFUND**, which is used by individuals, estates and trusts in order to request a quick refund. The new form encompasses the changes discussed above. The extended carryback period may provide new opportunities for taxpayers with an NOL in years ending in 2001 or 2002. Taxes paid more than two years ago may now possibly be recouped. Many taxpayers have already filed returns with net operating losses for years ending in 2001 and 2002. These taxpayers should pay particular attention to expanded opportunities and an October 31, 2002 deadline, when various options will expire.

AT YOUR SERVICE

Members of PKF's executive tax ranks are:

Director **M. Howard Pell, CPA,** holds a B.S. degree from the New York Institute of Technology, has over 30 years experience with particular expertise in tax matters affecting the hospitality, real estate and manufacturing industries and is especially knowledgeable on pension and employee benefits issues as well as estates and trusts.

Director **Leo Parmegiani, CPA**, with a masters degree in taxation from Pace University, has almost 20 years of experience, eight of which are with one of the Big 4, with specialized knowledge in corporate restructuring, transfer pricing, and international taxation issues.

Senior Manager **Joseph V. Bencivenga, CPA**, a graduate of Iona College, has over 30 years experience having attained a great degree of expertise in tax matters affecting small businesses.

Senior Manager **Antonio D. Pimenta, CPA**, a graduate of Charter Oak State College, has over 20 years industry experience with particular emphasis in the retail, manufacturing and service sectors, as well as the international tax area.

Senior Manager **John W. Halloran, CPA**, holds a master's degree in taxation from St. John's University, has over 15 years of public accounting experience servicing partnerships, S-corporations, and not-for-profit entities, as well as individuals.

IN THE WORDS OF ...

Investor's Business Daily (April 19, 2001 issue):

Average time taxpayers spent preparing their 2001 tax returns: **27 hours**

Number of pages of instructions for the 1040 form for the year 2001: **117**

Number of pages of instructions for the 1040 form for the year 1985 (the year before "simplification" was passed): **55**

Items in this publication should not be considered official statements of position, nor advice for individuals or organizations without consulting a tax advisor. For more information, please contact Howard Pell or Leo Parmegiani at:

PKF

Certified Public Accountants
A Professional Corporation
29 Broadway
New York, NY 10006
Telephone: (212) 867-8000
Telefax: (212) 687-4346
www.pkfnewyork.com
E-mail: info@pkfny.com

Issue No. 9 - August 2002