No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

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

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the employer's share of the Federal Insurance Contributions 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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The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-33a) is reported at 242 F.3d 844. The opinion of the district court (App., *infra*, 34a-51a) is reported at 21 F. Supp. 2d 1097. The order of the district court denying reconsideration (App., *infra*, 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 (App., *infra*, 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 jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

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

STATEMENT

1. Respondent operates a restaurant in San Francisco, California. Employees of the restaurant receive tips directly from customers. Those tips are sometimes pooled or shared with other employees. App., *infra*, 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 Contributions 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]

Employees are required to make monthly reports to their employer of the tips they receive that constitute "wages" for FICA purposes. 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 the tips reported to them by their employees. See 26 U.S.C. 6053(c)(1), (4).

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

2. Respondent filed Forms 8027 that show that its employees reported tips of $247,181 for 1991 and $220,845 for 1992. These forms also showed, however, that the total amount of tips reported on customer credit card charge slips alone was $364,786 in 1991 and $338,161 in 1992. App., *infra*, 2a n.2. Respondent calculated its employer share of the FICA tax, however, only on the lesser tip amounts that its employees had reported receiving.

Because of the discrepancy in these reported tip amounts, the Internal Revenue Service conducted a compliance check of respondent's restaurant. The credit slip information reported by respondent revealed a 14.49% tip rate for 1991 and a 14.29% tip rate for 1992.[2] App., *infra*, 2a-3a. Multiplying these tip rates by respondent's gross receipts for those years—and then subtracting the total tips reported on respondent's Forms 8027—indicated that unreported tip income was approximately $156,545 for 1991 and $147,529 for 1992. *Id.* at 3a n.3. Applying the 7.65% FICA tax rate to these unreported tip amounts resulted in FICA tax deficiencies for the employer 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). In calculating the amount of respondent's FICA tax deficiencies, the Service did not conduct individual audits to determine the unreported tips received by each individual employee. App., *infra*, 3a.

3. Respondent paid a portion of the tax and filed this refund suit. Respondent did not dispute the reasonableness or accuracy of the Service's calculation of the

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[2] In 1991, 90% of respondent's sales were made on charge card slips. In 1992, 92% of sales were by charge. C.A. App. 55, 56.

amount of unreported tips. See App., *infra*, 32a-33a; C.A. App. 88. 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. App., *infra*, 34a-51a.

4. a. The court of appeals affirmed in a 2-1 decision. App., *infra*, 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." App., *infra*, 6a, 10a.

The majority also stated that the Service's method of estimation "has some serious flaws." App., *infra*, 8a. The court 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." App., *infra*, 13a. The court 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. App., *infra*, 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." App., *infra*, 22a. She concluded that these other circuits correctly rejected the assertion raised by respondent that individual audits of individual employees must be conducted before FICA taxes may be assessed against the employer. *Id.* at 23a-30a. In reaching that conclusion, she expressed "particular concern" with the majority's determination to "place[] the Ninth Circuit directly at odds with [its] sister circuits" and emphasized that "[u]niformity among Circuits is especially important . . . to ensure equal and certain administration of the tax system." *Id.* at 19a (quoting *Hill* v. *Commissioner*, 204 F.3d 1214, 1217-1218 (9th Cir. 2000)).

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

REASONS FOR GRANTING THE PETITION

This case presents a frequently recurring question of significant importance on which the courts of appeals are in sharp conflict. As the dissenting judge correctly noted, the decision of the court of appeals "creates a circuit split on a tax issue of national importance." App., *infra*, 18a. The correct resolution of the question presented in this case affects the taxes owed by each of the tens of thousands of businesses whose employees regularly receive tip income. Resolution of this conflict by this Court is needed to preserve uniform application of the FICA tax throughout the Nation and to avoid disparate treatment of similarly situated taxpayers based solely upon the happenstance of their geographical location.

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). 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 U.S.C. 3121(q). 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).[3] 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 indicates "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 * * * ." H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 802 (1987).

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

b. Employees are required to report their tips in monthly statements to the employer. 26 U.S.C. 6053(a). Under 26 U.S.C. 3102(c)(1), the employer's duty to collect the *employee* 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).[4] 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 has thus specified that the employer portion of the FICA tax may be assessed even when employees do not accurately report their tips.[5]

In this case, respondent paid the employer portion of the FICA tax only on the tips that were reported by the employees on their 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 IRS determined the aggregate amount of tips received by respondent's employees

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

[5] 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 note 4, *supra*, and accompanying text.

and assessed the resulting taxes under 26 U.S.C. 3111. See page 3, *supra*.

2. a. The court of appeals erred in holding that this "aggregate" method of assessing the employer's portion of the FICA tax is impermissible. The court majority did not dispute that the employer portion of the tax may be assessed without making equivalent assessments of individual employees. The court reasoned, however, that the employer portion of the tax could lawfully be determined only by adding up individual employee tips and not by estimating the aggregate amount of tips received by all employees. App., *infra*, 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 7-8, *supra*. 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.

Nor is the court below correct in concluding (App., *infra*, 11a) that the IRS lacks authority to base FICA tax assessments on reasonable aggregate estimates rather than on individual, factual audits. The court acknowledged that 26 U.S.C. 446(b) has long "been interpreted as giving the IRS authority to make an assessment based on an estimate." App., *infra*, 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 *Mendelson* v. *Commissioner*, 305 F.2d 519 (7th Cir.), cert. denied, 371 U.S. 877 (1962). Even without referring to Section 446(b), other courts have approved of the use of estimates in determining the amount of unreported income simply as a reasonable method of determining a disputed factual issue. See, *e.g.*, *Erickson* v. *Commissioner*, 937 F.2d 1548 (10th Cir. 1991); *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). See also *United States* v. *Janis*, 428 U.S. 433, 437, 441 (1976) (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) (wagering excise tax assessment properly based on a reasonable estimate of total wagers accepted by a bookmaker); *DiMauro* v. *United States*, 706 F.2d 882 (8th Cir. 1983) (same). The conclusion of the majority in this case that the IRS lacks authority to make aggregate estimates of items of income in assessing taxes thus conflicts with the long-established contrary holdings of all other courts that have addressed this issue.

The majority nonetheless concluded that Section 446 suggests an intention to limit aggregate estimates of items of income based on the proposition that "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." App., *infra*, 10a. That reasoning is erroneous, 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).

It thus cannot realistically be asserted that the statutory text reveals an intention of Congress to preclude the use of methods of estimation in tax calculations in circumstances other than those expressly described in the statute. See *Palmer* v. *IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997) ("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."). As the Eleventh Circuit correctly concluded in *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529, "[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."

In her dissent in this case, Judge McKeown properly 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." App., *infra*, 26a. As the Federal Circuit concluded in rejecting the same contentions endorsed by the court 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 553, 565 (Fed. Cir. 1998). While the panel in the present case acknowledged that its decision conflicts with the decision of the Federal Circuit in *Bubble Room* (App., *infra*, 12a, 13a n.9, 15a n.12), the panel failed to address the reasoning of that decision and gave no consideration to the relevance of Section 6201 to this case.

b. 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 the factual question of the amount of tips received in this context, other courts of appeals have 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.

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" (App., *infra*, 13a), suffers from an obvious internal contradiction. If the IRS were to audit each employee to determine the amount of tips each employee earned, those individual determinations would themselves necessarily be based on estimates. 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.

c. For the reasons already described, the majority erred in suggesting (App., *infra*, 10a) that the IRS must obtain some more express authorization from Congress before making aggregate assessments of the employer portion of the FICA tax on tips. In making that suggestion, moreover, the majority failed to consider the most recent legislation enacted by Congress to address the FICA tax on tip income. In 1998, in response to restaurant industry complaints about the IRS practice of determining 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 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. 685. 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., 1st Sess. Pt. 1, at 199 (1998).

As the dissent in this case correctly observed, this 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. App., *infra*, 28a. As the dissent 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." *Ibid*.

d. The majority also erred in concluding that the aggregate estimate of tips made by the IRS in this case has "some serious flaws." App., *infra*, 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. *United States*, 203 F.3d at 996. See also *United States* v. *Schroeder*, 900 F.2d 1144, 1149-1150 (7th Cir. 1990) (proof that amount of assessment is incorrect does not invalidate entire assessment), *Burns* v. *United States*, 974 F.2d 1064, 1066 (9th Cir. 1992).

Moreover, there is no evidence to support the majority's conclusion that "flaws" exist in the agency's aggregate estimate of tips.[6] The majority first suggested that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" because "experience shows that charged tips generally exceed cash tips." App., *infra*, 4a, 8a. There is simply no evidence in the record of this case to support the court's assertion that "experience" reveals that the charge tip rate at respondent's restaurant exceeded the cash tip rate at that restaurant.

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[6] The suggestion of the court of appeals that there are "flaws" in the aggregate estimate of tips is particularly inappropriate in this case since respondent has not itself challenged the reasonableness or accuracy of the agency's estimate. See C.A. App. 88. 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 App., *infra*, 33a.

Similarly, the majority erred in stating that, "[a]s 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." App., *infra*, 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. See also *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567-568. In fact, California statutes expressly prohibit the theoretical practice that the court of appeals assumed to have been applied in this case. See Cal. Labor Code § 351 (West 2001) ("An employer that permits patrons to pay gratuities by credit card shall pay the employees the full amount of the gratuity that the patron indicated on the credit card slip, without any deductions for any credit card payment processing fees or costs that may be charged to the employer by the credit card company."). The asserted "flaw" identified by the court of appeals was thus solely of its own conjecture, not of the agency's method of estimation.

Finally, the court stated that "the estimate [does not] make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." App., *infra*, 9a; see note 1, *supra*. But there again is 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. *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567 (failure to take the "wages band" into account does not "make the assessment unlawful" but, rather, "merely suggests 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"); *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 declined to mount such a challenge in this case.

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." App., *infra*, 8a. That concern, however, is belied by the proceedings in the *Bubble Room* case. The employer in that case 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. As correctly observed by the dissent here, "the aggregate method is predicated on a reasonable estimate and that may be challenged by the taxpayer." App., *infra*, 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 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.*

3. The majority acknowledged (App., *infra*, 10a, 13a n.9, 14a) that its holding that the IRS may not make aggregate estimates of tip income in determining the employer portion of the FICA tax conflicts directly with the decision of the Federal Circuit in *Bubble Room, Inc.* v. *United States*, 159 F.3d at 554, 560-561. As the dissenting judge noted in her opinion below (App., *infra*, 21a-22a), the decision in this case also conflicts with the decisions of the Seventh Circuit in *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996, and the Eleventh Circuit in *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529.

The dissent correctly observed that the majority's attempt to distinguish *Morrison Restaurants* and *330 West Hubbard* is "transparently unsuccessful." App., *infra*, 22a. The majority asserted that *Morrison Restaurants* and *330 West Hubbard* "considered only whether the IRS must assess the employees prior to assessing the employer and not whether the IRS may rely upon aggregate estimates—the issue which is the fulcrum of our ruling." App., *infra*, 13a n.9. The very passages of the two decisions that the majority quotes (*ibid*.), however, show that the authority of the IRS to use aggregate estimates in calculating the employer portion of the FICA tax was at the heart of those cases. For example, in *330 West Hubbard*, 203 F.3d at 994 (emphasis added), the court rejected the taxpayer's contention that the IRS is not authorized "to assess employer FICA taxes based on an *aggregate estimate* of the tip income received by its employees without first determining the amount of under reporting by individual employees." Similarly, in *Morrison Restaurants, Inc.* v. *United* States, 118 F.3d at 1529 (emphasis added), the court rejected the taxpayer's assertion that "the IRS lacks statutory authority to assess the employer's share of FICA taxes *without determining the individual employees' unreported tips*." As the dissenting judge correctly concluded, the panel decision thus "creates a circuit split on a tax issue of national importance" and "places the Ninth Circuit directly at odds with" the decisions of "[t]hree other circuits." App., *infra*, 18a-19a.

4. The question presented in this case is one "of national importance" because it affects the tens of thousands of businesses whose employees receive tip income. The National Restaurant Association stated in an amicus brief filed in the court of appeals that this issue has significant "impact on the industry nationwide," for it directly affects the 170,000 restaurant units operated by its members (Amicus Br. 1, 6). Moreover, as the panel majority recognized, "the problem of collecting taxes on employee tips" involves a "substantial amount of revenue." App., *infra*, 17a.

The correct reporting of tip income is a matter of recurring and substantial importance in the enforcement of the FICA tax. The Internal Revenue Service has been charged with the responsibility of ensuring full compliance with the FICA tax. The reasonable estimation of tip income—in combination with the related TRAC program described at page 14, *supra*—has been recognized by Congress as an indispensable component of that enforcement program. A study mandated by Congress in 1984 revealed that tipped employees generally reported only slightly more than one-half of their tips. Research Division, Internal Revenue Service, Pub. 1530, *Tip Income Study: A Study of Tipping Practices in the Food Service Industry for 1984* (1990). The enforcement programs pursued by the IRS in response to this 1984 study have substantially increased tip reporting in the restaurant industry. The

IRS advises us that the amount of reported tips from that industry increased from $8.52 billion in 1994, to $9.45 billion in 1995, to $10.19 billion in 1996, to $11.14 billion in 1997, to $12.17 billion in 1998, and to $14.31 billion in 1999. Similarly, in other industries in which the agency's tip enforcement programs have been implemented (such as the Nevada gaming industry), tip reporting has increased significantly even without any corresponding increase in associated industry revenues.

But, as the dissent noted, the majority's approach in this case "invites employers and employees alike to evade their statutory tax obligations." App., *infra*, 31a (citing *Bubble Room, Inc.* v. *United States*, 159 F.3d at 597; *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530). Especially in view of the "substantial amount of revenue" affected by this decision (App., *infra*, 17a), review by this Court is warranted to resolve the sharp conflict that now exists among the circuits on the important, recurring question presented in this case.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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SEPTEMBER 2001

APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 99-16021

FIOR D'ITALIA, INC., PLAINTIFF-COUNTER-DEFENDANT-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-COUNTER-CLAIMANT-APPELLANT

[Argued and Submitted Mar. 15, 2000]
[Filed Mar. 7, 2001]

OPINION

KOZINSKI, Circuit Judge.

In a dispute involving a restaurant's share of Social Security taxes on its employees' tip income, we explore the outer bounds of the IRS's power to make tax assessments.

I

Like most restaurants, Fior D'Italia employs waiters, table bussers, bartenders and others whose earnings come in part from tips left by customers. Although these tips are paid by customers directly to employees, federal law deems them to have been paid by the employer for purposes of FICA taxes. *See* I.R.C. §§ 3101, 3111, 3121(a) & (q). This puts employers in an awkward position: They are "deemed," for purposes of tax law, to have paid large sums of money that they have never touched and whose exact amounts they have no way of ascertaining. *See* I.R.C. § 3121(q).[1] Yet employers need to know how much tip income employees receive in order to calculate their own FICA taxes and withhold appropriate amounts from the wage portion of the employees' compensation, pursuant to I.R.C. § 3102.

To make this information known to employers, tipped employees must submit monthly statements (usually on Form 4070) reporting all tip earnings that qualify as wages under the statute. *See* I.R.C. § 6053(a); Treas. Reg. § 31.6053-1(a). Employers, in turn, must report to the government (on Form 8027) their gross sales, charged tips and the tip amounts reported by employees. *See* I.R.C. § 6053(c)(1).

The dispute before us arose because in 1991 and 1992, Fior D'Italia reported aggregate tips that were significantly less than the tips that appeared on its credit card charge slips.[2] The Internal Revenue Service assessed Fior for additional FICA taxes on what it deemed was unreported tip income for those years. To determine

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[1] Some restaurants (not Fior) require all employees to pool cash tips for subsequent redistribution, in which case they do know, at least insofar as employees do not pocket some of the tips before pooling the rest. *See 330 West Hubbard Restaurant Corp. v. United States,* 203 F.3d 990, 993 (7th Cir. 2000).

[2] For 1991, disclosed total charged tips were $364,786, while total tips reported by employees were $247,181. For 1992, the numbers were $338,161 charged and $220,845 reported.

what Fior owed, the IRS used a simple calculation: For each year, it divided total tips charged on credit cards by total credit card receipts, yielding an average tip rate of 14.49% and 14.29% for 1991 and 1992, respectively. It then applied this "tip rate" to the restaurant's gross receipts to get a presumed tip total for the year. The IRS assessed Fior additional FICA taxes based on the difference between its presumed total and the amount of tips Fior's employees had reported.[3] The IRS did not readjust the FICA or income tax liability of the various employees who may have understated tip income on their 4070 forms.

Fior challenged the assessment method in district court, arguing that it exceeded the IRS's authority. The district court agreed, *Fior D'Italia, Inc. v. United States*, 21 F. Supp. 2d 1097 (N.D. Cal. 1998), and the government appeals.

II

Because we must decide whether the IRS's assessment is valid, we begin by examining what exactly the IRS is assessing. Section 3111 imposes on every employer a tax equal to a percentage of "the wages . . . paid by him with respect to employment." I.R.C. § 3111(a). These wages are defined to include "tips received by an employee in the course of his employment." I.R.C. § 3121(q). But Congress did not treat all tips as taxable wages for this purpose. In section 3121(a)(1), it excluded all remuneration from the employer (salary plus tips) that exceeds the Social

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[3] The IRS concluded that unreported wages totaled $156,545 in 1991 and $147,529 in 1992.

Security wage base for that year.[4] In section 3121(a)(12)(B), it excluded all cash tips received by an employee if that amount was less than $20 in a given month. These latter two provisions are often described as defining the "wages band" outside of which tip income is not taxed. *See Bubble Room, Inc. v. United States*, 159 F.3d 553, 555-56 (Fed. Cir. 1998) (*Bubble Room II*). For the IRS's aggregate assessment method to precisely equal the tips on which the employer's FICA tax is calculated, the cash tipping rate must be exactly the same as the tipping rate on charge slips, and total tips received must be distributed among employees so that none falls outside the wages band.

Neither condition will hold true in most cases. First, experience shows that charged tips generally exceed cash tips. *See Yukimura v. Commissioner*, 43 T.C.M. (CCH) 467, 470, 1982 WL 10891 (1982). One can think of many reasons why this would be so. Spending credit is easier than spending cash, because actual payment is deferred. Also, people dining on expense accounts generally pay with credit cards, and spending someone else's credit is even easier than spending one's own. Then there is the convenience of being able to write a tip in precisely the amount one deems appropriate. People paying in cash, however generous they may feel, are limited by the amount actually in their wallets and the need to keep some cash until their next visit to Gringott's. Applying the charged tip rate to cash receipts will thus tend to overestimate the cash tips actually paid. And charged tips paid to employees may be less than appears on the credit card receipts, because some employers pass on the three percent fee

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[4] This base was $53,400 in 1991 and $55,500 in 1992.

assessed by the credit card companies. *See Bubble Room, Inc. v. United States,* 36 Fed. Cl. 659, 663 (1996) (*Bubble Room I*), *rev'd, Bubble Room II,* 159 F.3d 553.

The assumption that all tip income falls within the wages band is even more problematic because Fior's employees, like those of many other restaurants, engage in tip sharing. Waiters receive tips from the customers and then share them with table bussers, bartenders and other employees. Much like tips left by the customer, the exact amount shared with others depends on the waiter's generosity and his evaluation of how much other employees contributed to customer satisfaction. Looking only at the aggregate tips collected, we cannot tell how many table bussers made less than $20 in indirect tips per month for some or all of the periods in question.[5] Nor is there any way of knowing how many waiters and hosts received salaries plus tips exceeding the Social Security wage base-something we cannot rule out for an upscale restaurant like Fior D'Italia.

While an employer may be aware that reported tips are less than actual charged tips, it cannot be sure that employees are understating tips in their 4070 forms. Some or all of the discrepancy could be explained by the fact that employees are not required to report tips falling outside the wages band. Even if the employer suspects that some employees are understating their tip income, it has no way of knowing who is under-reporting or by how much. Restaurants cannot force waiters to divulge how much they have actually

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[5] While $20 in tips per month is not very much, employees who start employment, leave employment, or take vacation or sick leave within a particular month may well earn less than that.

received in tips, and how those amounts were shared with other employees. Nor are employees likely to volunteer such information, because they would be admitting that they committed tax fraud by understating their tip income on the IRS form they submitted to the employer.

The IRS is unimpressed. It believes itself empowered to use any rational method for assessing the tax; the difficulties the employer raises can be considered in determining the precise amount of tax actually owed. If the assessment is valid, the burden shifts to the taxpayer to prove the amount (if any) by which the assessment overstates the tax owed. The question remains whether the assessment is valid.

III

The IRS's authority to make assessments is a very powerful tool. By making a valid assessment, the IRS shifts to the taxpayer the burden of proving that it does *not* owe the amount of tax the IRS has assessed it. If the taxpayer cannot persuade a trier of fact that the amount assessed is incorrect, the IRS wins and the taxpayer is required to pay that amount. *See Palmer v. IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997). So long as the assessment is supported by a "minimal factual foundation," the IRS need not present any additional evidence; the risk of uncertainty falls on the taxpayer. *Id.*

In the income tax context, an assessment becomes even more powerful when coupled with the IRS's authority pursuant to I.R.C. § 446 to redefine the manner in which the taxpayer computes income. Section 446 has been interpreted as giving the IRS authority to make an assessment based on an estimate rather than a computation. *See McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122, 1125, 1973 WL 2419 (1973). This means that, in making the assessment, the IRS need not rely on the actual records kept by the taxpayer. Where such records are inadequate, the IRS may make an educated guess as to how much tax is owed, and then put the burden on the taxpayer to prove it wrong.

McQuatters also involved tip income but, unlike our case, it involved the income taxes of the employees who had actually received the income. *See also Mendelson v. Commissioner*, 305 F.2d 519 (7th Cir. 1962). The tipped employees had failed to maintain adequate records of the tips they had received, and the courts held that the IRS was authorized to use an estimate in making its assessment. Because the employees should have maintained records of their income but failed to do so, it was deemed entirely appropriate to put the burden on them to prove that the IRS's estimate overstated their taxable income. *See id.* at 523 ("Obviously, where a taxpayer keeps no records disclosing his income, no method can be devised which will produce an exact result. The law does not require that much."); *McQuatters*, 32 T.C.M. (CCH) at 1125 ("In the absence of adequate record keeping by petitioners, [the IRS] was justified in reconstructing their tip income by an indirect method. . . .").

The taxpayer in our case is in a very different position from the taxpayers in *McQuatters* and *Mendelson*. While each employee knows how much he receives in tips, the restaurant does not. Employees, moreover, have an obligation to maintain records of their tip income and to accurately report such income to their employer on a monthly basis. The restaurant has no obligation to maintain records of tip income, except to the extent its employees report on Form 4070. Unlike the taxpayers in *McQuatters* and *Mendelson*, then, the taxpayer in our case did not fail to satisfy a legal duty imposed on it by the Internal Revenue Code, and thus did not give the IRS just cause for resorting to an estimate in constructing its assessment.

Also, unlike the taxpayers in *McQuatters* and *Mendelson,* Fior is not in an inherently better position than the IRS to determine what its employees actually earned in tips. Quite the contrary: Fior lacks the IRS's power to audit its employees and has no other means of forcing its employees to divulge how much tip income they earned during a given year.[6] Forcing the restaurant to prove that the estimate is wrong puts an impossible burden on it, making the already heavy presumption that attaches to an IRS assessment virtually conclusive.

We find this particularly troubling because the IRS's estimate has some serious flaws. As discussed above, the IRS's method for estimating cash tips likely overstates the amount of such tips received. *See* pp. 846-47 *supra.* 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

[6] The government suggests that the employer *could* know exactly how much each employee makes in tips by adopting a tip-pooling arrangement. *See* note 1 *supra.* But adopting such an arrangement would alter the way a restaurant does business by undermining the incentive structures created by discretionary tip-sharing. It would be akin to saying that a restaurant must charge a fixed service charge in lieu of tips. Obviously, a restaurant cannot be required to change its business practices in order to avoid paying taxes it doesn't owe.

employees by the restaurant. Nor does the estimate make allowance for the statutory wages bands which limit the restaurant's FICA tax liability.

We can't ignore these inaccuracies on the theory that they will cancel each other out in the long run; they all overstate the base on which the FICA tax is calculated and thus will combine to overstate the amount the taxpayer owes. As Judge Plager noted in his dissent in *Bubble Room II*, "[t]hough it may be that the excess taxes assessed in this manner against the employer amount to a relatively small amount, a Government demand for taxes that are not owed is unlawful on its face and remains unlawful regardless of the amount at issue." 159 F.3d at 569 (Plager, J., dissenting).

We have held that the IRS's power to rely on estimates in making its assessment is not without bounds; rather, the IRS must use a "rational method for approximating the correct amount." *Palmer*, 116 F.3d at 1312. Where more accurate information does not exist because the taxpayer failed to maintain adequate records, or where the taxpayer has much better access to the information in question, we will generally defer to the IRS's decision as to what is a rational method for approximating the amount of tax due. But a case where the taxpayer has done everything the law requires of it, where the IRS's access to the relevant information is no worse (and probably much better) than the taxpayer's, and where the estimation method adopted by the government ignores the statutory limits on what is taxable, sorely tests the limits of that deference.

Fortunately, we need not decide whether the IRS has stretched deference to the breaking point because its assessment suffers from a more fundamental flaw:

It rests on an estimate in circumstances where Congress has not authorized the IRS to use estimation as an assessment method. *McQuatters* and similar cases relied on I.R.C. § 446, which (as already discussed) gives the IRS broad authority to use estimates in making income tax assessments. But 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.

While acknowledging that section 446 is inapplicable, the Federal Circuit found it "informative" in concluding that the IRS is authorized to construct its assessment by means of estimation. *Bubble Room II*, 159 F.3d at 566. Like Judge Plager, we fail to understand "exactly how that section is informative with regard to the specific issue before us." *Id.* at 571 (Plager, J., dissenting). To the extent section 446 has any bearing at all, it suggests that the IRS here was *not* authorized to proceed by estimation. 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. Unlike our colleagues in the *Bubble Room II* majority, we do not believe such an important and sweeping power can be derived from the penumbras and emanations of the Internal Revenue Code.

The IRS points to another source of authority for its assessment, namely I.R.C. § 3121(q). This section provides that an employer is liable for its portion of FICA taxes even when "no statement including such tips is . . . furnished" or "the statement so furnished was inaccurate or incomplete." But this section doesn't help the government. All it says is that, where employees have not provided accurate tip information to the employer, and the IRS finds some other means of determining how much the employer owes, the employer must pay its share. Nothing in the text of section 3121(q) speaks to the *method* the IRS may use in making its assessment. In fact, section 3121(q) is worded so differently from section 446 that we cannot conclude they were meant to do the same work.

The IRS points to the fact that section 3121(q) allows it to assess the employer even after the time for assessing the employee has passed. *See* Rev. Rul. 95-7, 1995-4 I.R.B. 44 (Q & A 11).[7] According to the IRS, this implicitly authorizes the use of estimates. The chain of reasoning goes something like this: If the IRS is allowed to assess the employer when it may no longer audit the employees, it will have no way to conduct the assessment except by estimation. Congress therefore must have contemplated that the IRS would proceed by estimation in making the assessments.

We do not see this as a necessary implication. Rather, we read section 3121(q) as saying that the IRS need not also conduct an audit of the employer while it is auditing the records of individual employees. Congress doubtless understood that the only way the IRS can determine FICA taxes on tips is by examining the employees' records; there's no point in auditing the

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[7] The Code does this by providing that unreported tips "shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made." I.R.C. § 3121(q). Thus, the limitations period for the assessment of the employer's FICA taxes only begins to run after notice and demand is made, even if the limitations period for the assessment of the employee's tax has expired.

restaurant at the same time because it will have no record of tips, other than the information provided by the employees in their 4070 and 8027 forms. But, if the normal limitations period applied, the IRS might have to assess the employer before it finished auditing the employees. Section 3121(q) solves this problem by keeping the period open indefinitely-which means for however long it takes to complete the audit of the restaurant's tipped employees.[8]

This does not mean that the IRS may assess the employer only if it also assesses each of its employees. Three other circuits have rejected this argument and, for reasons well expressed in those opinions, we reject it as well. *See 330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 995 (7th Cir. 2000); *Bubble Room II*, 159 F.3d at 565; *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526, 1529 (11th Cir. 1997). As the government correctly points out, the employer's portion of FICA is separate from the employee's, and the IRS need not collect the one as a condition for collecting the other. Having audited an employee and determined the precise amount of FICA wages the employee has received, the IRS may then choose to assess only the employer, only the employee, or both. If the IRS cannot or will not assess the employee for

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[8] Tying the employer's liability to the audit period for its employees also avoids the anomaly that would arise from the fact that section 3121(q) provides no time limit for assessing the employer for additional FICA taxes, making it theoretically possible that the employer could be assessed 10, 20 or more years after the tax year in question. If employer assessments are tied to employee audits, the employer can only be assessed for however long it takes to conduct audits of its various tipped employees, plus a reasonable time thereafter.

additional FICA tax, this will not jeopardize its right to assess the employer.[9]

That having been said, it does not follow that the IRS can dispense with auditing the employees' records or otherwise determining the amount each employee earned in tips. For the reasons explained, 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. An aggregate assessment based on inaccurate estimates, as used by the IRS in this case, is simply not authorized.[10]

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[9] Accordingly, our holding is entirely consistent with those of the Seventh and Eleventh Circuits, both of which considered only whether the IRS must assess the employees prior to assessing the employer and not whether the IRS may rely upon aggregate estimates-the issue which is the fulcrum of our ruling. *See 330 West Hubbard Restaurant Corp.*, 203 F.3d at 994 ("On appeal, Coco Pazzo argues that the district court erred in holding that the IRS was authorized . . . to assess employer FICA taxes based on an aggregate estimate of the tip income received by its employees without first determining the amount of under reporting by individual employees."); *Morrison Restaurants*, 118 F.3d at 1529 ("Morrison Restaurants contends that, in view of Congress's silence, the IRS lacks statutory authority to assess the employer's share of FICA taxes without determining the individual employees' unreported tips and crediting the employees with the employer's share of the tax."). The Federal Circuit's decision in *Bubble Room II* is another story.

[10] The dissent worries that the IRS won't be able to collect the employer's share of FICA taxes, because it can't audit every waiter at every restaurant to determine the amount of under-reporting. *See* Dissent. Op. at 858. But if this turns out to be a problem, the IRS can solve it by promulgating a regulation allowing it to assess restaurants using estimates *See* pp. 851-52 *infra*. Even without such a regulation, we are not convinced that the IRS must audit every waiter in order to ensure effective

While recognizing that "I.R.C. § 3121(q) does not fully address the question at issue here," the Federal Circuit nevertheless found that the section "would . . . seem to imply that an indirect method may be used to calculate the amount of employer FICA tax in the absence of any better evidence." *Bubble Room II*, 159 F.3d at 565.[11] The Federal Circuit derived this implication as follows: Section 3121(q) comes into play only where "no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete)." I.R.C. § 3121(q). Because the section applies where the employer's records are inadequate, the Federal Circuit reasoned, Congress must have known that the IRS would have no choice but to use an aggregate estimation method. *See Bubble Room II*, 159 F.3d at 565.

Respectfully, we disagree with our colleagues. If the employer's records are inadequate, it is because its employees have failed to report all their tips. The direct and obvious way of determining the taxable tips actually received is for the IRS to audit the employees. Proceeding by aggregate estimate, and thereby forcing the employer to pay the price for its employees' dereliction, is simply not the only (nor even the best) way the IRS may proceed. We therefore cannot agree that Congress must have had this in mind when it passed section 3121(q).

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collection of the tax. As with other taxes, a vigorous enforcement program will encourage waiters to report tips more accurately, for fear of suffering penalties if caught. Moreover, when it *does* audit waiters, the IRS can also assess the restaurant for its portion of the tax.

[11] The Federal Circuit used the term "indirect method" where we use the term "estimate." Both mean the same thing.

We are aware that auditing individual employees is much more cumbersome than slapping the employer with assessments based on aggregate estimates. The fact remains that Congress authorized the IRS to use estimates in collecting income taxes but withheld such authority in collecting FICA taxes. By using an estimate-and particularly one that ignores the statutory wages bands-and putting on the employer an impossible burden in rebutting the estimated amount, the IRS has effectively increased the tax payable by the employer above that provided in the Internal Revenue Code.[12]

Nor is the IRS without recourse. If auditing individual employees proves too cumbersome, it can seek to have Congress extend its section 446 authority to the collection of FICA taxes. Or, it may proceed by regulation. I.R.C. § 6205(a)(1) speaks to this situation:

> If less than the correct amount of tax imposed by section 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of wages or compensation, proper adjustments, with respect to both the tax and the amount to be deducted, shall be made, without interest, *in such manner and at such times as the Secretary may by regulations prescribe.*

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[12] As the Court of Federal Claims rightly remarked:

> "Even a substantially low reporting of cash tips . . . does not justify allowing the IRS to shift its responsibility to the employer for policing the acknowledged problem of under-reporting of tips by employees. It is the responsibility of the IRS to track down and collect unreported income. If the IRS wishes to shift its duty to employers to ensure proper compliance, it should do so through a congressional enactment and continued cooperation between restaurants and the IRS."

Bubble Room I, 36 Fed. Cl. at 678 (Horn, J.).

Id. (emphasis added). This provision seems to authorize the Secretary to give the IRS authority to make assessments based on aggregate estimates by promulgating a regulation to that effect. But, before imposing such rough justice, the Secretary must follow the procedural requirements of notice-and-comment rulemaking.

These are not idle steps. The rulemaking process, by its very design, encourages public scrutiny of an agency's proposed course of action. By giving notice of a proposed rule, the agency provides interested parties with the opportunity to express their views and bring their political influence to bear on the process. *See* 1 Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise*, § 6.7 (3d ed. 1994) (noting that rulemaking enhances the "political accountability of agency policy decisions adopted through the rulemaking process"); Bernard Schwartz, *Administrative Law*, § 4.16 (2d ed. 1984) ("Rulemaking provides the agency with a forum for soliciting the informed views of those affected in industry and labor before adopting a new policy.").

The political process plays a particularly significant role in the arena of tax policy. Congress has delegated to the Secretary broad regulatory powers to adjust the legal obligations of taxpayers. *See, e.g.,* I.R.C. § 6205(a)(1). But before the Secretary can give a regulation legal force, he must endure the scrutiny of interested groups, legislative critics and the public at large. Congress maintains a particularly vigilant oversight through the Joint Committee on Taxation, whose large staff monitors and reports on the collection activities of the Department of the Treasury. *See* I.R.C. §§ 8001, 8004, 8022.

Indeed, Congress has blocked at least one of the IRS's recent efforts to enhance the collection of FICA taxes on cash tips. In 1993, the IRS promulgated a regulation that constrained restaurants' ability to take advantage of a FICA tax credit by limiting the credit to the amount of tip income received and reported by the employee (as opposed to the amount of FICA taxes paid by the restaurant). *See* Treas. Reg. § 1.45B-1T (1994). The purpose of the regulation was to give employers an incentive for encouraging employees to report their tips. *See, e.g., Fior D'Italia,* 21 F. Supp. 2d at 1103-04 (quoting Letter from Leslie B. Samuels, Assistant Secretary of the Treasury, to Senator Trent Lott (Mar. 30, 1994)). Responding to industry complaints, Congress rejected this incentive scheme in 1996 and provided that the tax credit would be available "without regard to whether such tips are reported under section 6053." I.R.C. § 45B(b)(1)(A).

This episode demonstrates the difficulty the executive and the legislative branches have had in reaching common ground on the problem of collecting taxes on employee tips. This should surprise no one, given both the substantial amount of revenue involved and the serious administrative difficulties in determining the amounts employees receive in tips. In the wake of political setbacks, the IRS has tried to solve the problem by assessing restaurants based only on the rough, and somewhat inflated, estimates that we have seen in this case. But before it can take such a significant step, it must obtain authorization directly from Congress or by exercising Treasury's own regulatory authority. Either path involves significant political checks on agency discretion, and we decline to assist the IRS in avoiding the public scrutiny such a process would entail.

AFFIRMED.

MCKEOWN, Circuit Judge, dissenting:

The issue in this case is the authority of the Internal Revenue Service to use the aggregate method of assessment for the employer's share of Social Security taxes on unreported tip income. The separate issue of the accuracy of the assessment is not before us and the two concepts-authority and accuracy-should neither be confused nor mixed and matched. In affirming the district court's rejection of the aggregate approach, the majority creates a circuit split on a tax issue of national importance. Unlike Quidditch or Fizzing Whizbees, there is nothing magical about the IRS's assessment-the employer owes taxes on the unreported tip income and the IRS has simply devised a practical means of calculating the tip income. In view of our respect for the decisions of sister circuits in tax cases, our deference to the IRS in interpreting the tax code, and the logic and practicality of the aggregate method, I respectfully dissent.

A. OTHER CIRCUITS.

The question of whether the IRS is authorized to assess the employer's share of Federal Insurance Contribution Act ("FICA") taxes, commonly known as Social Security taxes, based on the aggregate method without first determining the amount of under-reporting by individual employees is one of first impression in this circuit. Three other circuits, however, have already addressed this issue, and all three have held that the tax code ("Code") authorizes the IRS to do so. *See 330 West Hubbard Restaurant Corp. v. United States,* 203 F.3d 990, 997 (7th Cir. 2000); *Bubble Room, Inc. v. United States,* 159 F.3d 553, 568 (Fed. Cir. 1998) (*Bubble Room II*); *Morrison Restaurants, Inc. v. United States,* 118 F.3d 1526, 1530 (11th Cir. 1997); *see also LIR Mgmt. Corp. v. United States,* 86 F. Supp. 2d 340, 346 (S.D.N.Y. 2000); *Quietwater Entm't, Inc. v. United States,* 80 F. Supp. 2d 1323 (N.D. Fla. 1999), *rev'd in part, vacated in part without op.,* 220 F.3d 592 (11th Cir. 2000).

The majority's position places the Ninth Circuit directly at odds with our sister circuits, which is of particular concern in this case, as "[u]niformity among Circuits is especially important . . . to ensure equal and certain administration of the tax system." *Hill v. Comm'r,* 204 F.3d 1214, 1217-18 (9th Cir. 2000) (internal quotation marks and citations omitted). Until now, we have "hesitate[d] to reject the view of another circuit" in this area. *Id.* (internal quotation marks and citations omitted).

Three years ago the Eleventh Circuit was the first circuit to address the question before us. In *Morrison Restaurants,* the employer sought a refund and abatement of FICA taxes assessed on unreported employee tips. 118 F.3d at 1528. The employer argued that the IRS does not have the authority under 26 U.S.C. § 3121(q) to assess its share of FICA taxes on unreported tips on an aggregate basis without first determining the under-reporting by individual employees and crediting their wage history accounts. *Id.* at 1529. This is precisely the position advocated by Fior

D'Italia. The Eleventh Circuit rejected this argument, noting that § 3121(q)

> clearly states than an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips. *It also suggests that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined.*

Id. (emphasis added). The court concluded:

> [W]e 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 and crediting the individual employees' wage history accounts.

Id. at 1529-30. The Eleventh Circuit deferred to the IRS's use of the aggregate method because its interpretation of the Code was reasonable. *Id.* at 1530.

The next year, in *Bubble Room II*, 159 F.3d at 554, the Federal Circuit similarly addressed whether the IRS has the authority to assess the employer's share of FICA taxes on unreported tips on an aggregate basis "without first determining the under-reporting by the individual employees and then crediting their Social Security wage earnings records." The court concluded that the statutes authorize the IRS to do so:

> I.R.C. § 3121(q) expressly contemplates that the employer may be liable for its share of FICA taxes even if the records supplied by the employee are

> missing, inaccurate, or incomplete. Although not conclusive, § 3121(q) would thus seem to imply that an indirect method may be used to calculate the amount of employer FICA tax in the absence of any better evidence.
>
> However, I.R.C. § 3121(q) does not fully address the question at issue here-whether the particular indirect formula used by the IRS to estimate the [employer's] FICA tax liability was illegal. I.R.C. § 6201 speaks to this question. Under I.R.C. § 6201, the IRS is "authorized and required to make the inquiries, determinations, and assessments" necessary for all taxes imposed by the Code, "which have not been duly paid . . . in the manner provided by law. " I.R.C. § 6201 implicitly authorizes the IRS to use an indirect formula in order to carry out the general power granted in I.R.C. § 6201. For example, 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.

Id. at 565. The Federal Circuit concluded that the statutes authorize the IRS to use the aggregate method without first determining the individual employees' tip income. *See id.* at 566-68.

Most recently, in *330 West Hubbard Restaurant*, 203 F.3d 990, 997, the Seventh Circuit addressed the issue and similarly concluded that the statutes authorize the IRS to assess the employer's share of FICA taxes based on the aggregate method without first determining the amount of under-reporting by individual employees. The Seventh Circuit was unequivocal:

> We conclude that [the employer] has failed to demonstrate that the IRS's aggregate method of collecting employer FICA taxes is an impermissible reading of the tax code. Accordingly, we uphold the IRS's interpretation of its authority to use the aggregate method of collecting FICA taxes.

Id. at 997.

Every circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority. The majority's attempt to avoid the weight of circuit authority by suggesting that its position is somehow in line with that of *330 West Hubbard Restaurant* and *Morrison Restaurants* is transparently unsuccessful. *See* Maj. Op. at 850 n.9 ("our holding is entirely consistent with those of the Seventh and Eleventh Circuits"). As noted above, both the Seventh and Eleventh Circuits held that the IRS has the authority to use the aggregate method with respect to unreported tip income without determining the under-reporting by individual employees and crediting their wage history accounts. *See 330 West Hubbard Restaurant*, 203 F.3d at 994, 997; *Morrison Restaurants*, 118 F.3d at 1529-30. Although the majority agrees that the IRS need not assess the employees in order to assess the employer, the majority concludes that the IRS may not rely on the aggregate method and must *audit* the employees. *See* Maj. Op. at 850 & n.9. Requiring an audit is simply another way of saying that the IRS cannot estimate and that the only way the IRS can assess taxes on unreported or under-reported tips is to undertake an individual accounting of employees. This view can hardly be viewed as "entirely consistent" with that of the Seventh and Eleventh Circuits. The IRS's authority to use the aggregate method was at the heart of the cases in those circuits. The majority's recharacterization can only pretend consistency with these cases.

B. THE IRS'S INTERPRETATION IS REASONABLE.

The Supreme Court has instructed that we must defer to an agency's interpretation of its statutes and that our review is restricted to determining whether that interpretation is reasonable. *See Chevron U.S.A. Inc. v. Natural Resources Def. Council, Inc.*, 467 U.S. 837, 843, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984) ("[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."); *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 730, 105 S. Ct. 2919, 86 L. Ed. 2d 565 (1985) ("The IRS's understanding of the terms of the Code is entitled to considerable deference."); *Bob Jones Univ. v. United States*, 461 U.S. 574, 596, 103 S. Ct. 2017, 76 L. Ed. 2d 157 (1983) ("this Court has long recognized the primary authority of the IRS . . . in construing the Internal Revenue Code"). We have likewise limited our review of IRS interpretations of the Code. *See Walthall v. United States*, 131 F.3d 1289, 1297 (9th Cir. 1997) (concluding that where the IRS's interpretation is reasonable, "[w]e must . . . show the IRS interpretation substantial deference"); *Durando v. United States*, 70 F.3d 548, 550 (9th Cir. 1995) ("Courts give deference to IRS rulings and interpretations of the Code."); *Hawkins v. United States*, 30 F.3d 1077, 1082 (9th Cir. 1994) (recognizing "the well-settled rule that an agency's interpretation of a statute is entitled to deference unless it contradicts the statute's plain meaning").

In reviewing the IRS's interpretation of the Code, we "need not find that the agency construction [is] the only one it permissibly could have adopted to uphold the construction, or even the reading that [we] would have reached if the question initially had arisen in a judicial proceeding." *Chevron,* 467 U.S. at 843 n.11, 104 S. Ct. 2778; *accord Walthall,* 131 F.3d at 1297 (concluding that although "[t]he statute is not susceptible only to the [taxpayers'] interpretation . . . the IRS's interpretation . . . is reasonable" and "[w]e must therefore show the IRS interpretation substantial deference"). Moreover, we owe deference to the IRS's interpretation of the Code even absent a formal IRS rule. *See Alexander v. Glickman,* 139 F.3d 733, 736 (9th Cir. 1998) ("We owe deference to the agency's interpretation of the statute even absent a formal agency rule interpreting the statute.").

The IRS's interpretation of the statutes at issue here-that is, its conclusion that the statutes permit it to use the aggregate method-is reasonable in light of the statutory language. Nothing in the statutes or regulations requires the IRS to determine the amount of unreported tips before assessing the employer's FICA tax liability, and nothing in the statutes or regulations prohibits the IRS from using the aggregate method. Rather, the IRS's use of the aggregate method is *entirely consistent* with the statutes and regulations and therefore is entitled to substantial deference. A brief review of the relevant Code sections reveals that the Code does not require or bar any method, but leaves selection of the method to the agency.

Section 3111 imposes a FICA tax on employers that is computed as a percentage of wages paid by the employer to its employees. 26 U.S.C. § 3111; 26 C.F.R. §§ 31.3111-1, 31.3111-4. "Wages" includes all tips received by employees except those that amount to less than $20 in any calendar month. 26 U.S.C. § 3121(a)(12)(B), (q); 26 C.F.R. § 31.3121(a)(12)-1. Section 3121(q) requires employers to pay the § 3111 taxes on the *total* amount of tips and other remuneration, up to the Social Security wage base. *See* 26 U.S.C. § 3121(a)(1). As the Federal Circuit recognized,

> [i]n the case of the *employee* FICA tax, the employer need only consider those tips that "are included in a written statement furnished by the employee to the employer pursuant to section 6053(a)." Unlike the employee FICA tax, however, *there is no parallel provision which limits the employer's FICA tax liability to tips that are included in the written statement furnished by the employee.*

Bubble Room II, 159 F.3d at 556 (quoting 26 U.S.C. § 3102(c)) (emphasis added).

Although the statutes do not directly address whether the IRS has the authority to make aggregate assessments with respect to unreported tips, *see* Maj. Op. at 849-50, they are certainly broad enough to permit the IRS to do so. In fact, it is precisely the statutes' silence that requires *Chevron* deference. *See Chevron*, 467 U.S. at 843, 104 S. Ct. 2778. In particular, § 3121(q) provides that, even in cases where employees do not provide the employer with tip statements under 26 U.S.C. § 6053(a) or where the statements are inaccurate or incomplete, the IRS may issue a notice and demand for employer FICA taxes. *See* 26 U.S.C. § 3121(q). The statute does *not* suggest, let alone require, that the IRS must first audit the employees to determine the amount of unreported tips.

This statutory silence is buttressed by § 6201's express delegation authorizing the IRS to determine and assess the amount of FICA taxes imposed by § 3111. *See* 26 U.S.C. § 6201. Specifically, § 6201(a) permits the IRS to "make the inquiries, determinations, and assessments of all taxes . . . imposed by this title." 26 U.S.C. § 6201(a). It is up to the IRS to choose the method, so long as reasonable, and it is reasonable for the IRS to conclude that the authority to determine and assess taxes includes the authority to use the aggregate method to assess the employer's taxes on unreported tips. Indeed, the IRS uses estimation methods in other contexts-specifically, to determine the amount of tips received by employees and assess a FICA tax against them under 26 U.S.C. § 446(b). Like § 6201(a), § 446(b) does not specifically authorize estimates, but § 446(b) has been interpreted to permit the IRS to use estimates to determine tax assessments. *See Bubble Room II*, 159 F.3d at 557-58. The majority posits that use of estimates with respect to employees is permissible but not so with employers. *See* Maj. Op. at 847-48. This dichotomy overlooks the fact that employers and employees have independent tax obligations with respect to tips. And, although employers arguably have a more difficult burden than employees in documenting the actual amount of tips, the implementation of estimates is a judgment best left to the IRS, not the court. The majority's approach tramples the deference owed to the IRS.

The IRS's interpretation of the statutes is also consistent with § 3111's imposition of a single tax on the employer based on the *aggregate* tips and other wages received by its employees. *See* 26 U.S.C. § 3111(a)-(b); *Bubble Room II*, 159 F.3d at 566 ("[T]he employer FICA tax imposed by I.R.C. § 3111 is expressed in terms of the employees' aggregate tip income."). Similarly, the limitations period for the assessment of employer FICA taxes is consistent with the conclusion that the IRS need *not* audit employees before assessing the employer; the limitations period does not begin to run until after notice and demand by the IRS under § 3121(q), *even if the limitations period for assessing employees has run*. *See* Rev. Rul. 95-7, 1995-4 I.R.B. 44 (Q & A 11). In other words, because the IRS can assess the employer even after it may no longer audit the employees, the statute implicitly authorizes the use of estimates. Although, as the majority points out, other interpretations of the statute are possible, *see* Maj. Op. at 849-50, to be reasonable, the IRS's interpretation need not rule out alternatives.

Congressional action in recent years suggests that Congress believes that the IRS has the authority to use the aggregate method as well. In 1998, Congress passed a law that prohibited the IRS from "threaten[ing] to audit [a] 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. 685, 755 (July 22, 1998). Under the TRAC program, the employer 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 employer 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. 105-599 at 274 (1998), U.S. Code & Cong. Admin. News at 297; S. Rep. No. 105-174 at 75 (1998); H.R. Rep. No. 105- 364 (Pt. 1) at 73 (1997). The TRAC program is a special initiative that limits the employer's liability to actual rather than estimated tips. But, in making sure that TRAC is not used as a cudgel, *Congress acknowledged the IRS's power to make aggregate calculations* of employer tax obligations, before or without making determinations with respect to individual employees.

As the majority concedes, the IRS need not *assess* each employee before it can assess the employer. *See* Maj. Op. at 849. The majority stresses, rather, that the IRS need only *audit* each employee before assessing the employer. *See* Maj. Op. at 850 & n.9. But, as the majority recognizes, employer and employee tax obligations are *completely separate. See* Maj. Op. at 850. One has nothing to do with the other. Although the employer and employee may be bound together through an employment relationship, their tax obligations arise separately. *See Bubble Room II*, 159 F.3d at 565 ("We read §§ 3101 and 3111 as imposing a separate and distinct tax liability on employers.").[1] Where

[1] Many of Fior D'Italia's arguments against use of the aggregate method focus on employees; for example, incentives with respect to employee tip-reporting and crediting of employee Social Security accounts. But the employer and employee tax obligations are separate and not completely parallel. Whether employees report their tips and receive Social Security credit is not at issue here. If employees do not receive Social Security credit for all of their income, it is because they under-reported their income-not

the wages fall within the wages band, the employer must pay taxes on them, regardless of whether the employees reported them. *See* 26 U.S.C. § 3121(q).

The employer's independent tax obligation resonates in the structure and text of the Code. The respective employer and employee tax obligations are set forth in different subchapters. The employer's obligation is set forth in § 3111; the employees' obligation is set forth in § 3101. As previously noted, the employer's duty to collect and remit the *employees'* share of FICA taxes applies only with respect to *reported* tips—the employer's duty is not so limited. *See* 26 U.S.C. § 3102(c)(1), 3121(q). Finally, as discussed above, the limitations periods for the two tax obligations are different. *See* 26 U.S.C. § 3121(q).

The majority makes much of the IRS's lack of specific regulatory authority to use the aggregate method. But, as noted earlier, the IRS does not need to adopt a regulation in order to benefit from the deference owed to its interpretation of the Code. The majority also projects the image of a rogue IRS exercising its muscle to collect employer taxes on unreported tips, trampling on restaurants' rights and ignoring basic process. This characterization obscures the congressional dictate to tax all wages, specifically including unreported tips, and ignores the fact that the IRS's method is based on justifiable projections, not "thin air" estimates.

The majority also intimates that Congress tried to put the brakes on the IRS's effort to collect employer taxes on tips. An examination of recent legislation

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because of the aggregate method of assessing employer FICA taxes.

dispels this notion. Code § 45B generally allows an income tax credit to an employer for employer FICA taxes paid with respect to employee tips. *See* 26 U.S.C. § 45B. In 1996, Congress amended § 45B to clarify that the tax credit is available for employer FICA taxes paid on *all* tips, regardless of whether the employees reported the tips. *See* 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. 1755, 1759 (1996). The majority reads this amendment as "demonstrat[ing] the difficulty the executive and the legislative branches have had in reaching common ground on the problem of collecting taxes on employee tips." *See* Maj. Op. at 852. But, rather than a rebuke of "the IRS's recent efforts to enhance the collection of FICA taxes on cash tips," as the majority suggests, Maj. Op. at 852, the amendment merely confirms that the employer's tax obligation is completely separate from the employees' obligation. And the amendment does more-it confirms that the IRS may impose taxes on all tips and that the employer may benefit from a tax credit on those tips, whether reported or not.

C. PRACTICALITY OF AGGREGATE METHOD.

The majority's policy arguments against the aggregate method are just that-the court making policy. Equally availing practical and policy considerations support the IRS's approach and weigh against the majority's position. For example, the majority's approach effectively prohibits the IRS from assessing the employer's share of FICA taxes with respect to unreported tips because the IRS cannot possibly audit all tipped employees to determine the degree of under-reporting. *See Bubble Room II*, 159 F.3d at 567 ("[A]s a practical matter, the IRS lacked the resources necessary to audit each of the [employer's] tipped employees to determine the unreported tip income of each tipped employee."). The majority's approach thereby invites employers and employees alike to evade their statutory tax obligations. *See id.* ("[R]equiring the IRS to make an assessment against each employee for employee FICA taxes on unreported tips before the IRS could make an assessment against the employer for employer FICA taxes on such tips might also provide an incentive to an employer to discourage accurate reporting or to ignore clearly inaccurate reporting by its employees."); *Morrison Restaurants*, 118 F.3d at 1530 ("[B]asing 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 inaccurate reporting by the employees so that the employer could pay less FICA tax.").

The IRS's interpretation—the one to which we owe deference—requires only that employers comply with the law; it is neither unfair nor a punishment. *See Bubble Room II*, 159 F.3d at 566 ("[W]e reject the position that the *McQuatters* formula [i.e., the aggregate method] is punitive in nature and thus limited to situations where taxpayers fail to keep adequate records."). *Cf.* Maj. Op. at 848. Employers are required, by statute, to pay their share of FICA taxes on reported *and* unreported tips. Use of the aggregate method is not an effort to tell restaurants how to run their businesses. It is simply an alternate means of assessing the tax when individual employees' records are unavailable. Restaurants can continue to pool tips or not, to require certain reporting from their employees or not, and to create a specialized tip system or not. The choice lies with the restaurant, not the IRS. The consequence is that the tax is still owed and the IRS will impose a reasonable method to assess it. Because the IRS's conclusion that it can assess the employer's share of FICA taxes with respect to unreported tips based on the aggregate method is reasonable, we should defer to that interpretation, particularly here, in light of the need for uniformity in administering the national tax system and the views of our sister circuits.

D. USE OF THE AGGREGATE METHOD DOES NOT PRECLUDE A CHALLENGE AS TO ACCURACY AND AMOUNT.

The majority confuses the IRS's authority to use the aggregate method with the accuracy of that method. *See* Maj. Op. at 846-47, 848-49. "[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 II*, 159 F.3d at 568.

Adoption of the aggregate method does not preclude an employer from challenging the amount of the assessment by showing, for example, that some of the tips were received by employees who fell outside the wages band. *See 330 West Hubbard Restaurant,* 203 F.3d at 996 ("[The employer's] argument [regarding the wages band] is misplaced because it fails to distinguish between the IRS's authority to collect taxes and the correctness of the IRS's calculation of the amount of those taxes."); *Bubble Room II,* 159 F.3d at 567 (concluding that failure to take the wages band into account does not "make the assessment unlawful" but, rather, "merely suggests 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"). Here, however, the issue of accuracy is not before us, because Fior D'Italia did not challenge the accuracy of the calculation-it challenged only the IRS's authority to assess taxes under the aggregate method.

The IRS is not just plucking a number out of the air and shifting the burden to the taxpayer as the majority would have us believe. Use of the aggregate method does not shift the normal burdens in some topsy-turvy manner. Instead, the aggregate method is predicated on a reasonable estimate and that may be challenged by the taxpayer. There is nothing new or unusual in this scheme of tax assessment.

* * * * * *

Our review of the IRS's interpretation of the Code is limited. Because the IRS's conclusion that it has the authority to use the aggregate method is reasonable, we must defer to it, as have three circuits before us. This approach preserves the right to challenge the accuracy of the assessment resulting from the aggregate method. Therefore, I respectfully dissent.

APPENDIX B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Filed Sept. 18, 1998]

OPINION AND ORDER ON CROSS MOTIONS FOR SUMMARY JUDGMENT

LEGGE, District Judge.

The plaintiff taxpayer challenges the Internal Revenue Service's use of a so-called "aggregate" method to determine, assess and collect an employer's share of FICA taxes on the tips received by its restaurant employees. Plaintiff has moved for summary judgment on this issue, and the government has filed a cross-motion for summary judgment on its counterclaim for the payment of the IRS's assessment. The motions were argued and submitted for decision. The court has reviewed the moving and opposing papers, the record and the applicable authorities.

I.

Plaintiff Fior D'Italia operates a restaurant in which its employees receive tips. It computes and pays its share of Federal Insurance Contribution Act ("FICA") taxes for each employee, based on each employee's salary and tip reports. Each year it files a Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips.

In 1994 the Internal Revenue Service ("IRS") sent plaintiff a Notice and Demand to pay its share of FICA taxes allegedly due on tips *not* reported by its employees for the years 1991 and 1992. The IRS computed the alleged amount of plaintiff's share by using the information on plaintiff's Forms 8027. Specifically, the IRS determined the percentage of tips on the food and services that were charged on credit cards, by dividing the total amount of tips charged by the total charges. It then estimated the total tips received by all employees, by multiplying that percentage by plaintiff's total receipts. The tips that had been actually reported to the IRS were then subtracted from that amount, to determine the estimate of *un* reported tips. That figure was then subjected to the employers' FICA tax rate of 7.65% to determine plaintiff's alleged FICA tax liability.

The IRS did not attempt to identify the amount of unreported tips of each employee. It instead used the above formula as to all of plaintiff's employees in the aggregate.

The IRS thus calculated that plaintiff owed additional FICA taxes on the aggregate unreported tips of all employees, in the amounts of $11,976 in 1991 and $11,286 in 1992. Plaintiff paid a small portion of those taxes under protest, and then brought this suit for a refund. For purposes of this litigation, plaintiff does not dispute the facts or determinations used by the IRS to assess the aggregate unreported tip income. However, plaintiff challenges the use of the above *aggregate* method to determine its share of FICA taxes. It argues that the statutes governing FICA taxes, particularly 26 U.S.C. § 3121(q), require the IRS to determine FICA taxes for each employee *individually* in order to assess the employer's share. The government argues that the statute allows the IRS to use its aggregate method to determine the employer's share.

II.

These cross-motions for summary judgment do not dispute any facts. The parties agree that the motions turn solely on questions of statutory interpretation. The motions are therefore appropriate for resolution under Fed. R. Civ. P. 56.

A plaintiff in a tax refund action bears the ultimate burden of proving an overpayment of its taxes and the amount that it is entitled to recover. *United States v. Janis*, 428 U.S. 433, 440, 96 S. Ct. 3021, 49 L.Ed.2d 1046 (1976). The IRS's determination of a tax deficiency is presumed to be correct, and the taxpayer bears the burden of overcoming that presumption. *United States v. Barretto*, 708 F. Supp. 577, 579 (S.D.N.Y. 1989).

Here, the plaintiff taxpayer objects to the government's interpretation of Section 3121(q). As will be discussed below, the language of the statute does not directly answer the issue. And the IRS has not promulgated a regulation on the issue. It has enforced its interpretation only by making assessments against certain restaurant employers.

This court's analysis of the issue is governed by the following requirements:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress had directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43, 104 S. Ct. 2778, 81 L.Ed.2d 694 (1984). The deference given to an administrative agency's interpretation of a statute applies even if no formal regulation exists. *Alexander v. Glickman*, 139 F.3d 733, 736 (9th Cir. 1998).

Principles of statutory construction require courts to interpret a statute as a whole. *Beecham v. United States*, 511 U.S. 368, 372, 114 S. Ct. 1669, 128 L.Ed.2d 383 (1994). "In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." *Mastro Plastics Corp. v. NLRB*, 350 U.S. 270, 285, 76 S. Ct. 349, 100 L.Ed. 309 (1956) (quoting *United States v. Boisdore's Heirs*, 8 How. 113, 122, 12 L.Ed. 1009). And a court may also examine the legislative history if the meaning of the statute is not plain on its face.

III.

FICA tax payments come from two sources: (1) the employee's share, which is usually paid by deductions from an employee's wages, and (2) the employer's contribution, usually equal to the employee's share. Subchapter A of the Federal Insurance Contributions Act governs the tax on employees. 26 U.S.C. § 3101 ("there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b)) . . ."). The tax on employers is governed by Subchapter B. 26 U.S.C. § 3111 ("there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b)) . . .").

The dispute here concerns the interpretation of Section 3121(q), which states:

> (q) Tips included for both employee and employer taxes.—For purposes of this chapter, tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of subsections (a) and (b) of section 3111). Such remuneration shall be deemed to be paid at the time a written statement including such tips is furnished to the employer pursuant to

> section 6053(a) or (if no statement including such tips is so furnished) at the time received; except that, in determining the employer's liability in connection with the taxes imposed by section 3111 with respect to such tips in any case where no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary.

Plaintiff contends that this section, when read in conjunction with the rest of the code dealing with FICA taxes, does not permit an *aggregate* assessment of unreported tips to determine the employer's share, but requires an *individual* determination of the unreported tips for each employee. The government contends that nothing in the statute prohibits the use of an aggregate method, and that the IRS's method is a reasonable interpretation of the section.

Only two cases have ever addressed this question. In *Morrison Restaurants, Inc. v. United States*, 918 F. Supp. 1506 (S.D. Ala. 1996), the district court adopted the interpretation advanced by plaintiff. That decision was vacated and remanded by the Eleventh Circuit in *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526 (11th Cir. 1997), which court decided that an aggregate assessment is permitted by the statute. However, in *The Bubble Room, Inc. v. United States*, 36 Fed. Cl. 659 (1996), the Court of Federal Claims held that the IRS may not assess an employer's share of the FICA tax by using the aggregate method.

There is no case authority in this circuit.

IV.

This court starts, as it must, with the language of the section. If the meaning of the statute is clear and unambiguous on its face, the court need go no further. Here, plaintiff argues that the meaning of Section 3121(q), as well as related Section 3111, is plain.

Plaintiff points out that § 3111, which imposes the FICA tax on employers, provides that it is imposed on an employer with respect to having *individuals* in his employ, equal to the percentages of wages defined in Section 3121(a) paid "with respect to employment (as defined in section 3121(b)) . . ." (emphasis added by plaintiff). Plaintiff contends that the use of the term "individuals" is significant.

Plaintiff also highlights the definition of "employment" in Section 3121(b): "any service, of whatever nature, performed . . . by *an* employee for the person employing him." (emphasis added by plaintiff).

And plaintiff points to the language in Section 3121(q) which states that "tips received by *an* employee in the course of *his* employment shall be considered remuneration for such employment." (emphasis added by plaintiff).

Plaintiff argues from the frequent use of the singular term and from the word "individuals" that Congress intended that the IRS assess an employer's share of FICA taxes as to *each* of its employees. While certainly relevant, this argument is not conclusive, particularly in light of the rules of construction stated at the beginning of the United States Code. "In determining the meaning of any Act of Congress, unless the context indicates otherwise—words importing the singular include and apply to several persons, parties, or things;

words importing the plural include the singular. . . .” 1 U.S.C. § 1 (1994). Thus, the meaning of Section 3121(q) is not made unambiguous simply because the section uses singular nouns and articles.

The government argues that the language of the section not only allows for an aggregate assessment method, but clearly contemplates it. It notes that Section 3121(q) provides that tips are “deemed to have been paid” by the employer, and that the IRS may issue a notice and demand for the employer’s share of FICA taxes even if employees fail to report their tips accurately. Specifically, the section states:

> [I]n determining the employer’s liability in connection with the taxes imposed by section 3111 with respect to such tips in any case where no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the secretary.

The Circuit Court in *Morrison* found that argument significant:

> This provision clearly states that an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips. It also suggests that the employer can be assessed its share of FICA taxes even when the individual employee’s share is not determined.

118 F.3d at 1529. In further support, the *Morrison* court emphasized that Congress placed the provisions imposing the employer’s and employee’s share of FICA taxes in separate subsections. *Id.* The court reasoned

that this placement indicated "that Congress contemplated that employees' and employer's shares could be imposed separately." *Id.*

However, that does not directly answer the question here. Even though Section 3121(q) allows the IRS to serve a demand on employers for the FICA taxes on unreported tip amounts, without also serving a demand on the employees, it does not say that the IRS may determine the employer's share through *aggregation*. That is, it does not impose the employer's obligation based on the estimated tips of *all* of the employees as a group.

The government also argues that the section provides a different statute of limitations for employers and employees. It provides that the "remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary." Subtitle F contains procedural and administrative provisions, including: the statute of limitations on assessments, I.R.C. § 6501; the timing of assessments, I.R.C. § 6201; and at what point interest begins to accrue, I.R.C. § 6601. The government contends that for employees, the tips are deemed paid when they submit a tip report to their employer or, if no report is furnished, when the tips are received, and the statute of limitations begins to run at one of those times. For employers, the tips are deemed paid when the employee submits a tip report or, if no report is furnished or if the report is inadequate, when a notice and demand is served on the employer. The government says that this extends the statute of limitations for the employer, potentially beyond the point at which the IRS could still assess unpaid taxes against the employee. The government argues that the clause therefore anticipates that the IRS might assess unpaid FICA taxes against an employer without making a corresponding assessment against the employee.

That may well be true. But it again does not answer the question here; that is, whether the IRS can assess the FICA tax on an employer in the aggregate—for the estimated tips of *all* employees as a group.

It seems unlikely that Congress intended that the above clause of the section was for the purpose of authorizing such aggregate computation of a tax. It does not directly say so. A more likely interpretation is that the clause does only what it says it does—define the timing of assessments and when interest begins to accrue. Congress probably wanted to start the accrual of interest earlier for employees, because the employees know about their tips from the time of receipt, whereas employers should not be subject to interest accrual until they have knowledge of the unreported tips, such as when a notice and demand is made.

The court concludes that the statute, Section 3121(q) and its related I.R.C. sections, simply does not address the subject of an aggregate method of assessment that is at issue here.

V.

The court therefore turns to the legislative history of FICA taxes, the purposes of FICA, and the interaction of Section 3121(q) with other sections involving FICA taxes—particularly what they say about the FICA taxation of tips.

The United States has always subjected tips to *income* tax liability, but it did not always consider tips in determining an employee's wage earning history for the purposes of Social Security. *Bubble Room*, 36 Fed. Cl. at 672. Congress amended the statutes in 1965 to provide that an employee's Social Security wage earning history would include tip income. *Id.* (citing Social Security Amendments of 1965, Pub. L. No. 89-97, Title III, § 313, 79 Stat. 286, 380-85 (1965) (now codified as amended in various sections of Title 26 of the U.S.C.)). The tip income would be credited to the employee's Social Security account. As a result of those amendments, tips were considered remuneration for employment and were deemed paid when a written statement of the tips was furnished to the employer; or when the tips were received by the employee, if the employee failed to provide the statement. *Bubble Room*, 36 Fed. Cl. at 672-73 (citing Social Security Amendments of 1965, Pub. L. No. 89-97, Title III, § 313(c)(4), 79 Stat. 286, 383 (1965)) (codified at I.R.C. § 3121(q)(1982)). Employers could then deduct and withhold from an employee's wages the employee's share of FICA taxes attributable to the tips. But the same tips were not then considered for purposes of the *employer's* share of FICA taxes. *Bubble Room,* 36 Fed. Cl. at 673.

In the Social Security Amendments of 1977 employers were then required to pay FICA taxes on a portion of tips received. Pub. L. No. 95-216, § 315(a), 91 Stat. 1509, 1536 (1977), *repealed by* Pub. L. No. 100-203, Title IX, § 9006(b)(2), 101 Stat. 1330-289 (1987). At that time, Sections 3111 and 3121 were amended to provide that employers must pay FICA taxes on tips up to the federal minimum wage amount. H.R. Rep. No. 95-702, 95th Cong., 1st Sess. 11 (1977), reprinted in 1977 U.S.C.C.A.N. 4155, 4168. As a result, employees were required to pay FICA taxes on all tips, but employers were required to pay FICA taxes on the employees' tip income only up to the federal minimum wage. *Bubble Room,* 36 Fed. Cl. at 673.

Section 3121 was later amended by the Omnibus Budget Reconciliation Act of 1987, this time requiring employers to pay the same amount of FICA taxes as paid by the employees. *Id.* at 673 (citing Pub. L. No. 100-203, Title IX, § 9006, 101 Stat. 1330-288-289 (1987)). The relevant portion of the Senate Committee on Finance Print regarding that amendment to Section 3121(q) indicates that the main purpose of the amendment was to equalize the payments made by employers and employees. S. Print No. 63, 100th Cong., 1st Sess. 202-03 (1987); 133 Cong. Rec. S34,826 (1987). Congress also intended to equalize the FICA contributions of employers whose employees' receive tips with the FICA contributions of employers whose employees do not. Nothing in the legislative history indicates a Congressional intention to make employers *more* responsible than the employees for FICA taxes on tips. And nothing indicates an intention to place a tax on employers that is not credited to the employees' Social Security accounts, as the government's aggregate assessment method here would do.

Plaintiff argues that the general purpose of FICA taxes, and the manner in which the Social Security system operates, indicate that FICA taxes must be assessed on an individual basis. The system is a form of "social insurance" in which contributions are collected from current employees and employers in order to provide insurance for those who no longer support themselves through employment. *Flemming v. Nestor,* 363 U.S. 603, 609, 80 S. Ct. 1367, 4 L.Ed.2d 1435 (1960).

As the government points out, however, the eligibility for Social Security benefits does not depend entirely on the amount of an employee's own contributions to the system.

> Plainly the expectation is that many members of the present productive work force will in turn become beneficiaries rather than supporters of the program. But each worker's benefits, though flowing from the contributions he made to the national economy while actively employed, are not dependent on the degree to which he was called upon to support the system by taxation.

Id. at 609-10.

Nevertheless, employees' entitlements to Social Security benefits and the amount to which they are entitled are determined by their wage earning history. *Id.* at 608. The method of assessing the employers' share of the FICA tax here, based on an aggregate of unreported tips, without attributing those amounts to the earnings records of individual employees, would not enhance the employees' later entitlement to Social Security benefits. It amounts to a tax on the employers without a commensurate benefit to the employees. The government responds that such a result is caused by the employees' own failure to make full disclosures of their tip income. While this is true, 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.

Some evidence of the intent of Congress in Section 3121(q) can also be found in another subsection, Section 3121(a), and in another section of the Internal Revenue Code, Section 45B.

Section 3121(a) states that the term "wages" includes all remuneration for employment, but lists exceptions. Among those exceptions are "cash tips received by an employee in any calendar month . . . unless the amount of such cash tips is $20 or more." I.R.C. § 3121(a)(12)(B). Thus, tips are not "wages" for FICA tax purposes unless they are more than $20 *per employee* per month. When the IRS uses its aggregation method for determining unreported tips, it does not ascertain whether *each* employee's tips exceeded $20 and are therefore subject to the FICA tax. It cannot determine whether that exception applies unless it determines *each* employee's tip amounts.

Further, Section 45B provides a tax credit to employers equal to:

> any tax paid by an employer under section 3111 with respect to tips received by an employee during any month to the extent such tips—. . . are deemed to have been paid by the employer to the employee pursuant to section 3121(q) (without regard to whether such tips are reported under section 6053) . . .

to the extent that it exceeds the employer's tax due on the federal minimum wage rate applicable to the employee. 26 U.S.C. § 45B(b).

Essentially, employers may take a tax credit for FICA taxes paid on tips in excess of the tax due on federal minimum wage. An employer cannot take advantage of this tax credit if the IRS assesses his FICA taxes on unreported employee tips in the aggregate. The unreported tips for *each* employee must be determined in order to ascertain whether the employer has paid FICA taxes on that employee's wages in excess of the minimum wage. That provision expressly applies to situations in which the employee has failed to report or has underreported tips ("without regard to whether such tips are reported under section 6053"), and therefore anticipates that each employee's taxable wages will have been determined before the employer is required to pay FICA taxes as to that employee.

Sections 3121(a) and 45B therefore indicate that Congress intended that individual wage assessments would be made before the employer's share of FICA taxes could be assessed. Those provisions could not be applied otherwise. If the IRS were permitted to make assessments of taxes due on an aggregation of unreported tips, those credits and exemptions would become a nullity for many employers. It is a basic rule of statutory construction "that one provision should not be interpreted in a way . . . that renders other provisions of the same statute inconsistent or meaningless." *Shields v. United States*, 698 F.2d 987, 989 (9th Cir. 1983).

VI.

The government argues that disallowing the IRS's aggregate assessment method would provide an incentive to employers to encourage their employees to underreport tips. The *Morrison* court agreed. "We are concerned . . . that 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 inaccurate reporting by the employees so that the employer could pay less FICA tax." 118 F.3d at 1530.

While that result could follow, nothing in the legislative history indicates that Congress had this objective in mind when it amended Section 3121(q). *See* S. Print No. 63, 100th Cong., 1st Sess. 202-03 (1987); 133 Cong. Rec. S34,826 (1987). Rather, Congress was concerned with equalizing the taxes paid on tips by employers with those paid by employees. And as stated, nothing in Section 3121(q) expressly authorizes or compels the use of an aggregation method. Congress never suggested that its legislation was for the purpose of preventing employers from encouraging employees to underreport tips.

In fact, Congress appears to have rejected that concern in its amendments to Section 45B, the section which provides a tax credit to employers for FICA taxes paid on tips in excess of the federal minimum wage. Prior to 1996, that section did not include any mention of unreported or underreported tips, and the IRS interpreted the statute to allow an employer to take the credit only for FICA taxes paid by the employer on *reported* tips. 58 F.R. 68033, *68033. The IRS's perception of Congress's intent was explained in a letter from the Department of Treasury to the Senate:

> The temporary regulation clarifies that the credit applies only to FICA taxes paid on tips *reported to the employer by its employees.* This provision is clearly supported by the Conference Committee Report to the Omnibus Budget Reconciliation Act of 1993, which states that the credit is applicable to the employer's FICA tax obligation "attributable to *reported* tips" (emphasis added).
>
> Consistent with this Congressional intent, the temporary regulation will prevent an employer from claiming the credit for FICA taxes paid pursuant to a section 3121(q) notice and demand following a tips

> examination by the IRS. We believe that this provides the only fair and logical result and provides employers with a strong incentive for encouraging employees to report their tips.

Letter from Leslie B. Samuels, Assistant Secretary, Department of the Treasury, to Senator Trent Lott, United States Senate (March 30, 1994).

Congress expressly disclaimed this intent when it amended Section 45B in 1996, providing that the tax credit was available "without regard to whether such tips are reported under section 6053." I.R.C. § 45B(b); *see also* 61 F.R. 67212, *67213. Thus, the *Morrison* court's fear that disallowing aggregate assessment would provide an incentive to employers to encourage their employees to underreport tips was apparently not shared by Congress in 1996.

Another reason argued by the IRS for allowing its aggregation method is administrative convenience. That reason has some merit. However, administrative convenience does not guide a court's interpretation of a statute unless Congress has indicated that it shares that interest.

Both concerns of the IRS may be good reasons to persuade Congress to amend the statute. But they do not provide support for the government's interpretation of the current statute.

VII.

In summary, Section 3121(q) on its face does not clearly allow or prohibit the IRS method of assessing employer FICA taxes by aggregating unidentified employees' unreported tips. However, when Section 3121(q) is read in conjunction with other sections of the FICA statutes, as well as other sections of the Internal

Revenue Code, this court believes that Congress intended that an employer's share of FICA taxes be based on individual assessments of each employee's wages. The basic structure of the FICA tax system is to provide ultimate benefits for individual employees. The legislative history further supports this interpretation. The legislation appears generally directed at equalizing the tax burdens of employees and employers. Section 3121(q) is not just for revenue enhancement. Although this court owes deference to the IRS's interpretation of the statute, its interpretation conflicts with other statutory provisions regarding employer FICA taxes on tips. It is therefore not a permissible construction of Section 3121(q).

This court therefore grants plaintiff's motion for summary judgment and denies the United States' motion for summary judgment on its counterclaim. However, further procedures are necessary to establish the amount of the tax refund that is due to plaintiff. There will be a status conference on October 30, 1998 at 11:00 a.m. to schedule those procedures.

IT IS SO ORDERED.

/s/ CHARLES A. LEGGE
CHARLES A. LEGGE
UNITED STATES DISTRICT JUDGE

APPENDIX C

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Received: Feb. 25, 1999]

ORDER ON MOTION FOR RECONSIDERATION

The United States has moved for this court to reconsider its Opinion and Order filed on September 18, 1998. The motion is based upon a subsequent decision by the Federal Circuit in *The Bubble Room, Inc. v. United States*, 1998 WL723830 (Fed. Cir. 1998). That case, in a split decision, ruled in favor of the United States on the same issue that is involved in this case. The United States has also called to this court's attention a later decision by a district court in *330 West Hubbard Restaurant, Inc. v. United States*, No. 98-C-178 (D. Ill. November 23, 1998).

Those decisions, and other decisions cited by this court on page 6 of the Order of September 18, 1998, illustrate the difference of opinion among the four district courts and two appellate courts that have addressed the question at issue here. There is no other decision in this circuit. While the appellate courts of the other circuits are entitled to respectful deference, this court is not bound by their holdings and respectfully disagrees for the reasons set forth in the September 18, 1998 order. The issue is both difficult and close. Assuming that the United States will continue to disagree with this court and agree with the other circuits, the issue will have to be resolved here by the Court of Appeals for the Ninth Circuit on appeal of this case, and perhaps ultimately by the United States Supreme Court.

IT IS THEREFORE ORDERED that the motion for reconsideration is denied. Since the issue of damages has not been resolved, a final judgment cannot yet be entered. A status conference is set for March 12, 1999 at 11:00 o'clock to consider what further procedures are necessary for the entry of a final judgment.

IT IS SO ORDERED.

Dated: February 23, 1999.

/s/ CHARLES A. LEGGE
CHARLES A. LEGGE
UNITED STATES DISTRICT JUDGE

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 99-16021
D.C. No. CV-97-04613-CAL

FIOR D'ITALLA, INC, PLAINTIFF-COUNTER-DEFENDANT-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-COUNTER-CLAIMANT-APPELLANT

[Filed: May 18, 2001]

ORDER

Before: KOZINSKI, KLEINFELD and MCKEOWN, Circuit Judges.

The petition for rehearing is denied: Judge McKeown would grant the petition. The full court was advised of the petition for rehearing en banc and, no judge having requested a vote thereon, the petition is denied. Fed. R. App. P. 35.

APPENDIX E

1. 26 U.S.C. 446 provides, in relevant part:

(a) General rule

Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions

If 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.

* * * * *

2. 26 U.S.C. 3111 provides, in relevant part:

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))—

In cases of wages paid during:	The rate shall be:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))—

(1) with respect to wages received during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2) with respect to wages received during the calendar year 1978, the rate shall be 1.00 percent;

(3) with respect to wages received during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4) with respect to wages received during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5) with respect to wages received during the calendar year 1985, the rate shall be 1.35 percent; and

(6) with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

* * * * *

3. 26 U.S.C. 3121 provides, in relevant part:

(a) Wages

For purposes of this chapter, the term "wages" means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include—

(1) in the case of the taxes imposed by sections 3101(a) and 3111(a) that part of the remuneration

which, after remuneration (other than remuneration referred to in the succeeding paragraphs of this subsection) equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) with respect to employment has been paid to an individual by an employer during the calendar year with respect to which such contribution and benefit base is effective, is paid to such individual by such employer during such calendar year. If an employer (hereinafter referred to as successor employer) during any calendar year acquires substantially all the property used in a trade or business of another employer (hereinafter referred to as a predecessor), or used in a separate unit of a trade or business of a predecessor, and immediately after the acquisition employs in his trade or business an individual who immediately prior to the acquisition was employed in the trade or business of such predecessor, then, for the purpose of determining whether the successor employer has paid remuneration (other than remuneration referred to in the succeeding paragraphs of this subsection) with respect to employment equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) to such individual during such calendar year, any remuneration (other than remuneration referred to in the succeeding paragraphs of this subsection) with respect to employment paid (or considered under this paragraph as having been paid) to such individual by such predecessor during such calendar year and prior to such acquisition shall be considered as having been paid by such successor employer;

*   *   *   *   *

(q) Tips included for both employee and employer taxes

For purposes of this chapter, tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of subsections (a) and (b) of section 3111). Such remuneration shall be deemed to be paid at the time a written statement including such tips is furnished to the employer pursuant to section 6053(a) or (if no statement including such tips is so furnished) at the time received; except that, in determining the employer's liability in connection with the taxes imposed by section 3111 with respect to such tips in any case where no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary.

* * * * *

4. 26 U.S.C. 6053 provides, in relevant part:

(a) Reports by employees

Every employee who, in the course of his employment by an employer, receives in any calendar month tips which are wages (as defined in section 3121(a) or section 3401(a)) or which are compensation (as defined in section 3231(e)) shall report all such tips in one or more written statements furnished to his employer on or before the 10th day following such month. Such statements shall be furnished by the employee under such regulations, at such other times before such 10th day, and in such form and manner, as may be prescribed by the Secretary.

(b) Statements furnished by employers

If the tax imposed by Section 3101 ir 3201 (as the case may be) with respect to tips reported by an employee pursuant to subsection (a) exceeds the tax which can be collected by the employer pursuant to section 3102 or section 3202 (as the case may be), the employer shall furnish to the employee a written statement showing the amount of such excess. The statement required to be furnished pursuant to this subsection shall be furnished at such time, shall contain such other information, and shall be in such form as the Secretary may by regulations prescribe. When required by such regulations, a duplicate of any such statement shall be filed with the Secretary.

(c) Reporting requirements relating to certain large food or beverage establishments

(1) Report to the Secretary

In the case of a large food or beverage establishment, each employer shall report to the Secretary, at such time and manner as the Secretary may prescribe by regulation, the following information with respect to each calender year:

(A) The gross receipts of such establishment from the provision of food and beverages (other than nonallocable receipts).

(B) The aggregate amount of charge receipts (other than nonallocable receipts).

(C) The aggregate amount of charged tips shown on such charge receipts.

(D) The sum of—

(i) the aggregate amount reported by employees to the employer under subsection (a), plus

(ii) the amount the employer is required to report under section 6051 with respect to service charges of less than 10 percent.

(E) With respect to each employee, the amount allocated to such employee under paragraph (3).

(2) Furnishing of statement to employees

Each employer described in paragraph (1) shall furnish, in such manner as the Secretary may prescribe by regulations, to each employee of the large food or beverage establishment a written statement for each calender year showing the following information:

(A) The name and address of such employer.

(B) The name of the employee.

(C) The amount allocated to the employee under paragraph (3) for all payroll periods ending within the calender year.

Any statement under this subparagraph shall be furnished to the employee during January of the calender year following the calender year for which such statement is made.

* * * * *

(4) Large food or beverage establishment

For purposes of this subsection, the term “large food or beverage establishment” means any trade or business (or portion thereof)—

(A) which provides food or beverages,

(B) with respect to which the tipping of employees serving food or beverages by customers is customary, and

(C) which normally employed more than 10 employees on a typical business day during the preceding calender year.

For purposes of paragraph (C), rules similar to the rules of subsection (a) and (b) of section 52 shall apply under regulations prescribed by the Secretary, and an individual who owns 50 percent or more in value of the stock of the corporation operating the establishment shall not be treated as an employee.

* * * * *

(6) Nonallocable receipts defined

For purposes of this subsection, the term “nonallocable receipts” means receipts which are allocable to–

(A) carryout sales, or

(B) services with respect to which a service charge of 10 percent or more is added.

* * * * *

5. 26 U.S.C. 6201 provides, in relevant part:

(a) Authority of Secretary

The Secretary is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title, or accruing under any former internal revenue law, which have not been duly paid by stamp at the time and in the manner provided by law. Such authority shall extend to and include the following:

(1) Taxes shown on return

The Secretary shall assess all taxes determined by the taxpayer or by the Secretary as to which returns or lists are made under this title.

* * * * *